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Market Matters

May 31, 2014

Emerging markets and Japanese equities rebounded in May as global equities overall enjoyed another strong month; bonds also continue to rally across regions as data have been softer and further easing is expected from the ECB (and possibly others).

Interest rates continue to drop across the globe, with most developed markets central banks offering dovish guidance and many emerging markets seemingly approaching the end of their tightening cycles. As a result, fixed income asset classes continue to generate surprisingly high returns, though to a certain extent today's performance is simply borrowing from tomorrow's. Global equity returns are below those of the comparable period in 2013 but also surprisingly resilient, despite stretched valuations in some markets and disappointing earnings in others. Macro-driven themes notwithstanding, market action so far this year has reinforced the importance of being diversified across various assets, as last year's losers like real estate and emerging markets debt have rallied and generated impressive gains in 2014.

The main story in the United States is the ongoing rally in Treasury yields, which in many maturities have returned to levels previously seen prior to the tapering scare last May. A combination of forces is likely at work, including softer economic data, short covering by formerly bearish investors, and offshore flows from European and Asian investors to whom 2%+ yields might still seem relatively attractive. US first quarter GDP growth was revised

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All returns are total returns in local currency unless otherwise noted.

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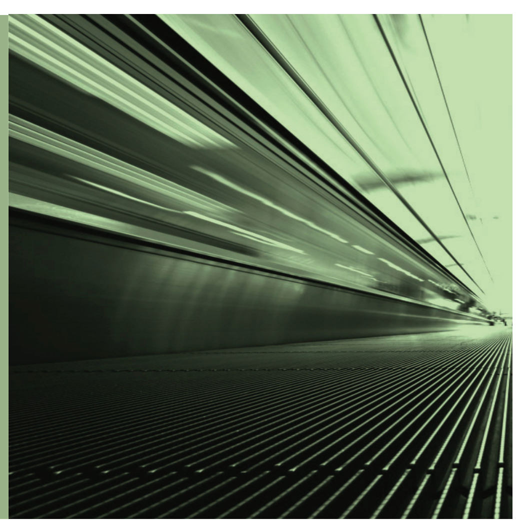
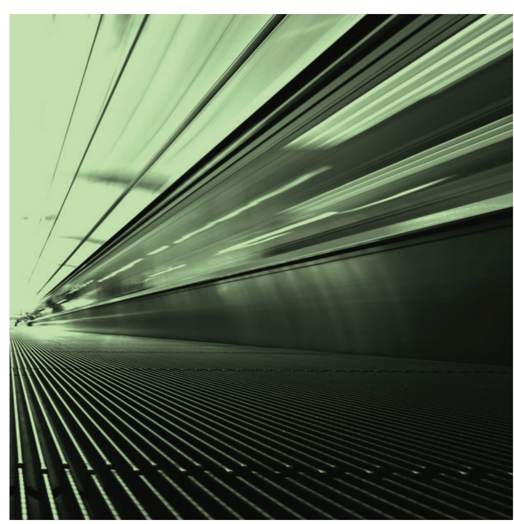




downward in May to show a slight contraction, though many continue to believe growth will accelerate as the economy shakes off the winter doldrums. The rally in rates is creating extremely bubbly conditions in the credit markets. Yields on high-yield bonds fell in May to a new historical low of 4.99%, boosting their year-to-date return to 4.6%. Investors (and regulators) appear increasingly uneasy about future return potential, especially in light of more aggressive issuance patterns. US stocks had another strong month, returning 2.3%, and have outperformed peers year-to-date despite a valuations headwind and weak recent earnings (first quarter earnings growth came in at just 2.1%). As with GDP growth, hope for earnings springs eternal, with analysts remaining optimistic for the remainder of 2014.

European stocks also performed strongly, returning 2.2%, bringing their year-to-date return to 5.9%. European equities are supported by reasonable valuations, though 2014 earnings forecasts continue to tick down and macro issues are overshadowing fundamentals. All eyes are on European Central Bank President Mario Draghi, who is expected later this week to take more decisive steps to stave off the threat of deflation or at least disinflation in the Eurozone. A cut in the already low base rate is likely and negative deposit rates may be used to spur more lending, though more aggressive measures like another repurchase facility for banks could be announced. Eurozone banks could use some help; many underperformed in May given ongoing concerns about capital levels (Deutsche Bank), profitability (Commerzbank), and legal settlements with US authorities (BNP). Eurozone bond markets seem priced for perfection and Draghi to delight; ten-year German bund yields sit at just 1.36%, and after some initial wobbles peripheral borrowing spreads also fell back close to historical lows.

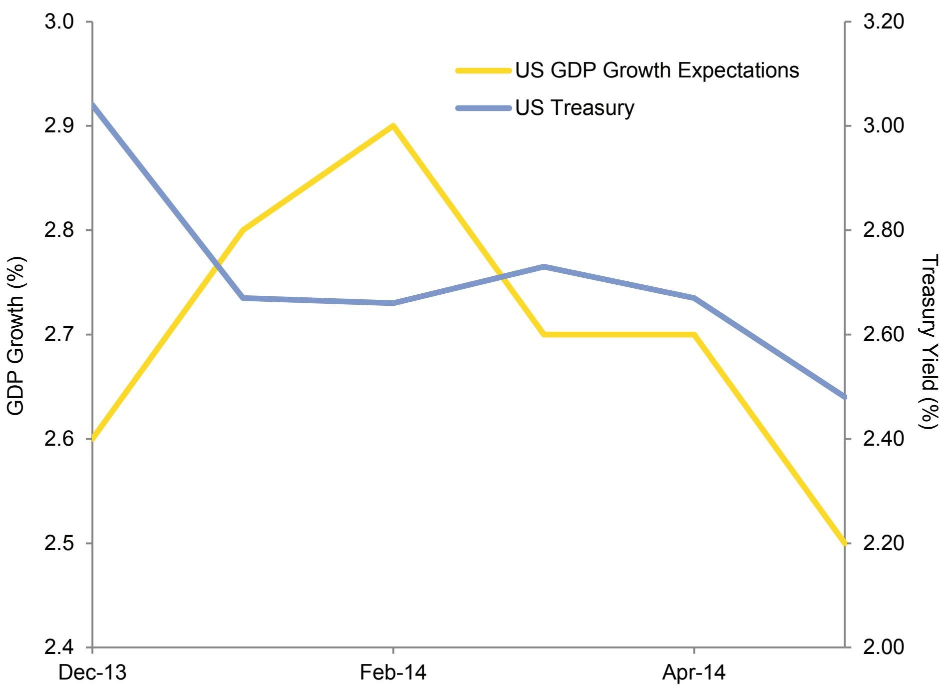
Elsewhere in developed markets, Japanese stocks (3.6%) had their first positive month since last December, trimming their year-to-date loss (-7.4%). Bullish strategists note improving relative valuations and that the correlation between the yen and the stock market seems to be breaking down as domestic demand should increasingly drive profits. Japanese stocks now trade around 1.2 times book value, around half the value of US equivalents. However, April's weakness in retail sales, industrial output, and employment all suggest the economic recovery remains lethargic, and earnings forecasts are coming down—albeit after a very strong 2013.

Emerging markets equities (2.9%) were one of the best-performing global equity markets in May, but still lag developed markets counterparts year-to-date (2.3%). Investor inflows during the month boosted performance, though year-to-date, emerging markets mutual funds and exchange-traded funds have still seen nearly $38 billion of withdrawals. Concerns linger about macro risk such as a Chinese slowdown and the vulnerability of some countries to capital outflows, though May saw some improvement in some of these areas. The official PMI in China has now increased for three straight months; Indian election results as well as its improved balance of payments have helped its equity market return 12% in 2014. Emerging markets fixed income also performed quite strongly. Local currency sovereign bonds returned 1.6% (4.4% year-to-date) but could not keep pace with US$-denominated sovereign bonds (3.1%; 8.3% year-to-date) given the strong rally in Treasuries. Guidance from central banks that rate hikes are coming to an end have also been supportive, as has the easing of tensions between Russia and Ukraine—the ruble was up 2.2% against the US dollar last month.

Real assets had a mixed month, though some sectors continued their recent strong run of performance. For example, US inflation-linked bonds returned 2.1% (5.5% year-to-date) as the rally in US Treasuries boosted duration-sensitive assets, and developed markets REITs returned 4.5% (10.1% year-to-date) as cap rates continued to compress. However, commodities (-2.9%) surrendered some of their recent gains; easing tensions in Ukraine lowered demand for safe-haven assets like precious metals (-3.5%) and improving crop forecasts pushed agricultural prices (-7.2%) lower. ■

US Treasury Yield and 2014 GDP Growth Expectations

December 31, 2013 – May 31, 2014

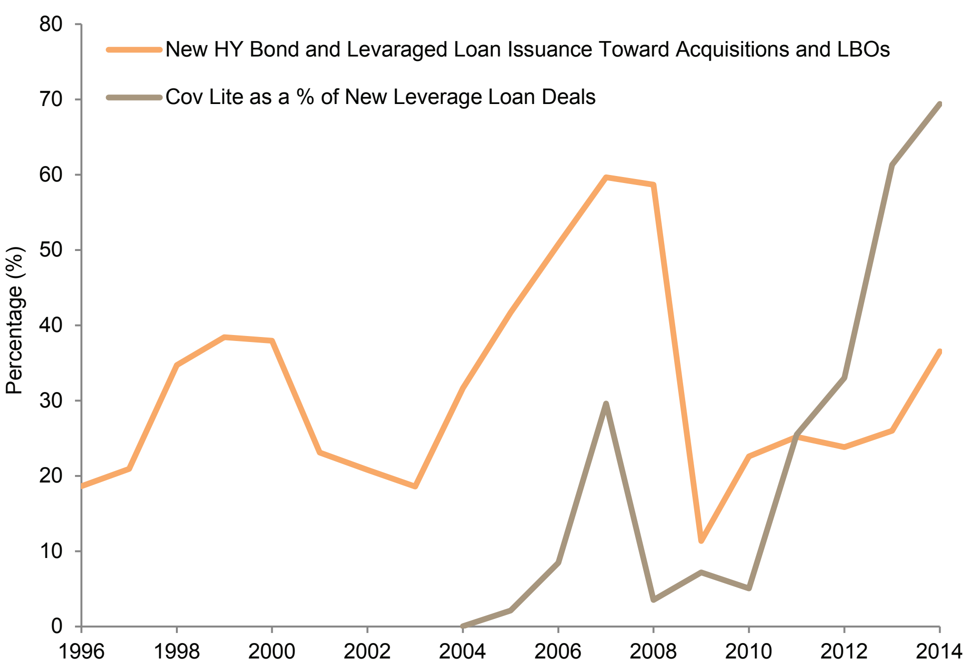


Sources: Bloomberg L.P., Federal Reserve, and Thomson Reuters Datastream.

Treasury yields have fallen back to pre–"taper scare" levels for several reasons, including weaker economic data, short covering by investors, and increased offshore demand given relative interest rate differentials

Speculative Use of High-Yield and Leveraged Loan Issuance Proceeds Over Time

1996–2014



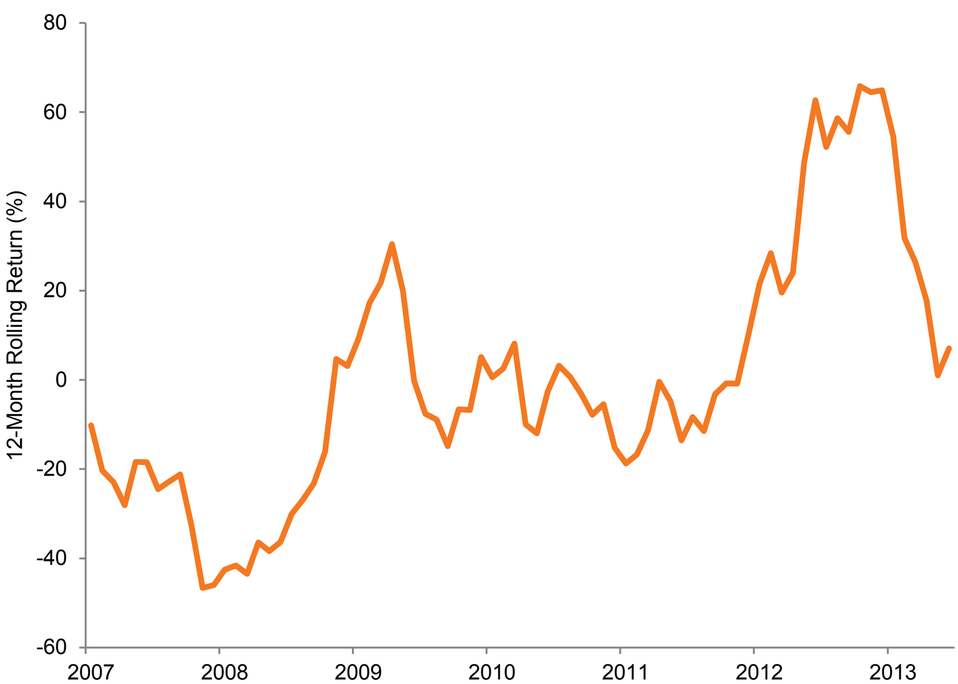
Sources: BofA Merrill Lynch and Standard & Poor's.

Note: Issuance data for 2014 are as of March 31, and covenant lite data are as of April 30, 2014.

Despite more aggressive new issuance trends, yields on high-yield bonds fell to historical lows in May; meanwhile, covenant-lite leveraged loan issuance is soaring even as investors are receiving little additional compensation

MSCI Japan 12-Month Rolling Returns

December 31, 2007 – May 31, 2014 • Local Currency

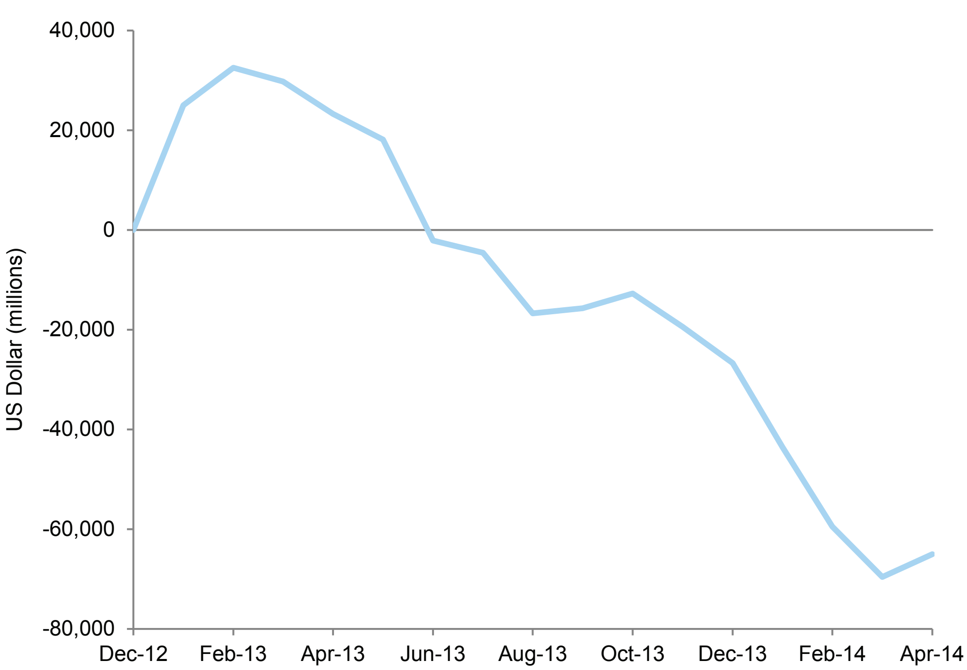


Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Japanese equities posted their first positive performance since December; however, trailing returns have crashed given overall year-to-date losses as Abenomics is reassessed and investors wait to see the impact of the consolidating yen

Cumulative Equity Fund Flows into Emerging Markets

December 31, 2012 – April 30, 2014



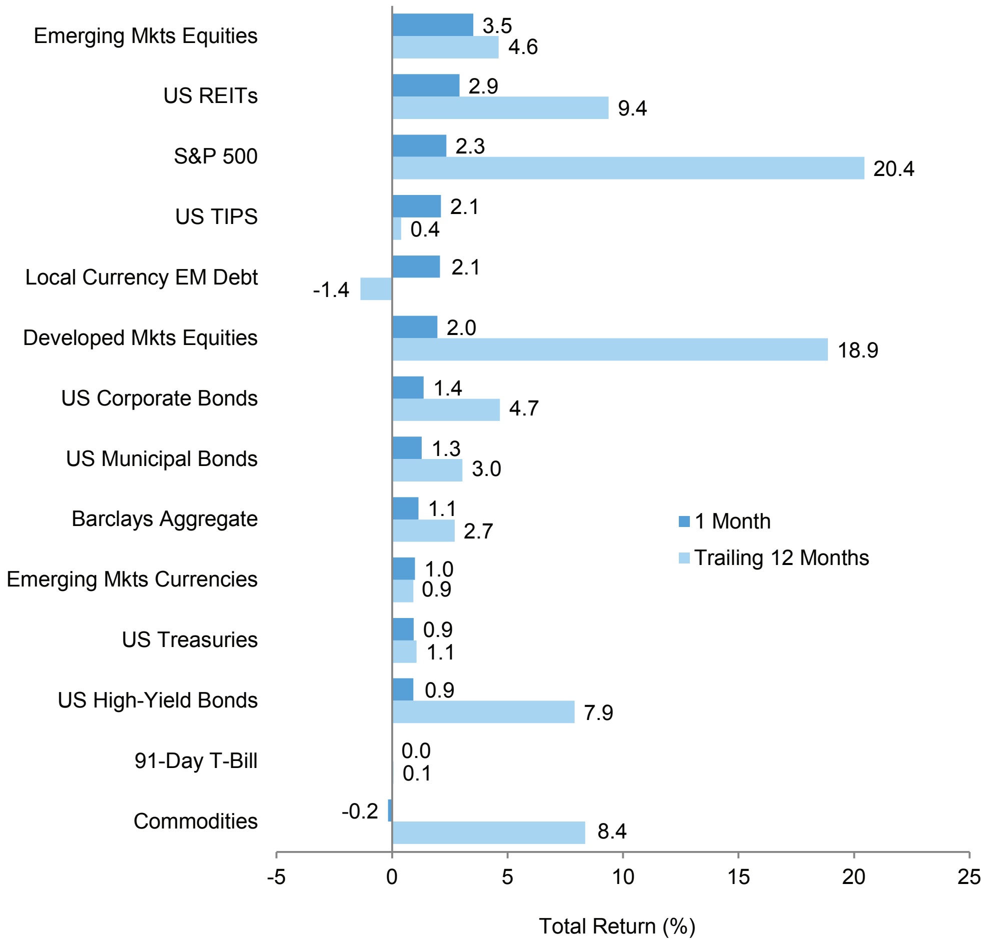
Source: EPFR Global.

Notes: Fund flows data are as of June 2. Data are monthly and may revise.

Investors have tiptoed back into EM equities recently, though cumulative outflows from ETFs and mutual funds since February 2013 have been nearly $100 billion, severely impacting performance

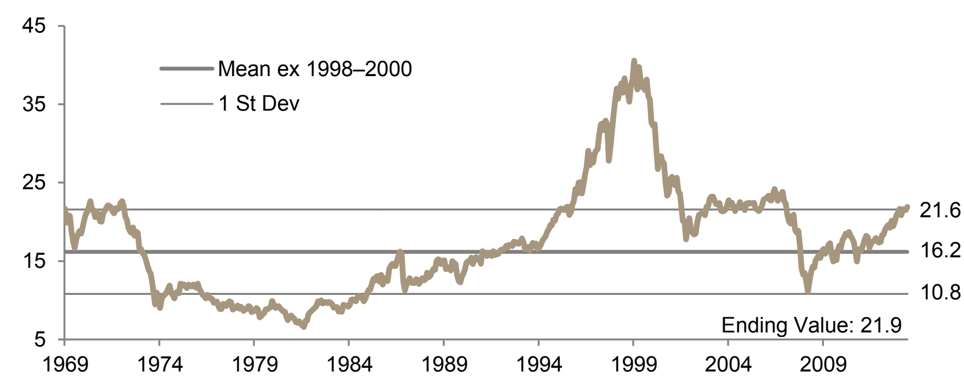
Index Performance (US$)

As of May 31, 2014



MSCI US Composite Normalized P/E

December 31, 1969 – May 31, 2014



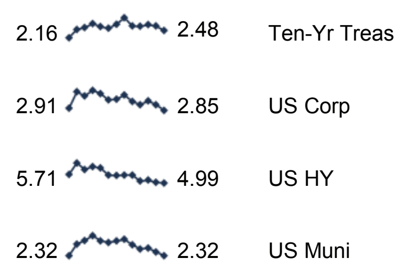
Sources: Barclays, BofA Merill Lynch, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

EM stocks performed strongly in US$ terms, boosted by currency appreciation as tapering fears continue to abate. Real assets like REITs and TIPS also continue to bounce back after a disappointing 2013

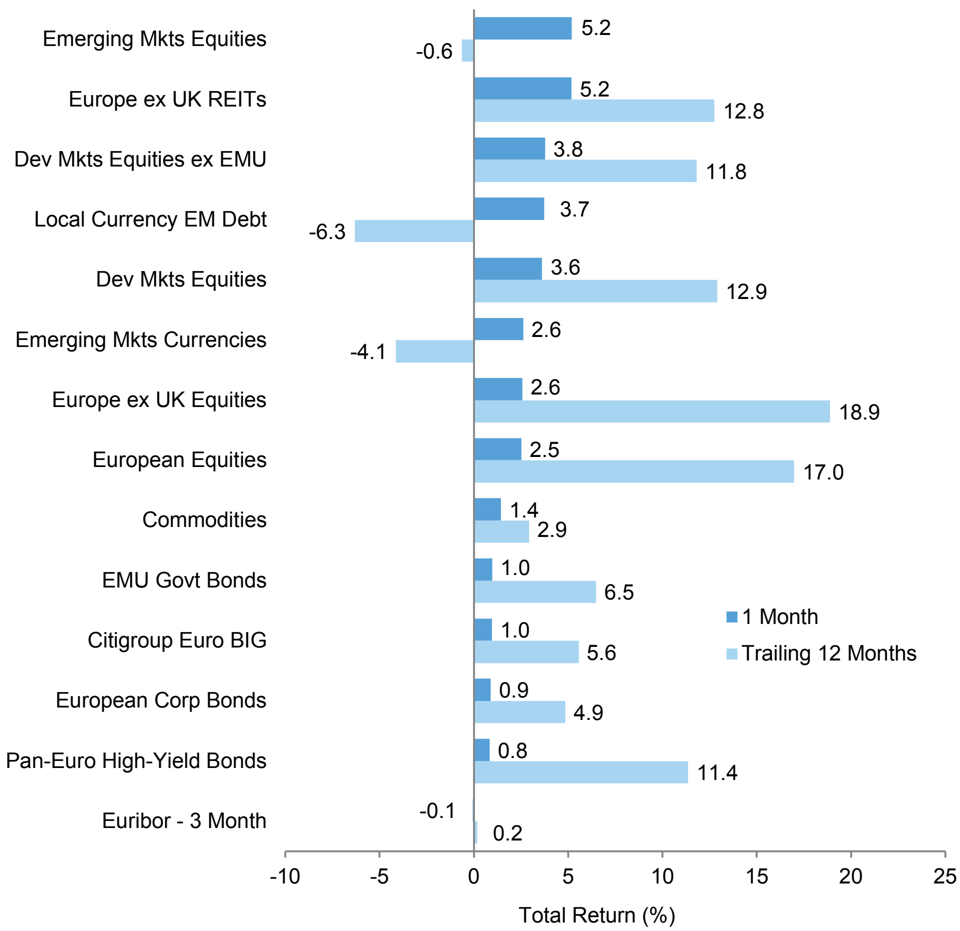
Fixed Income Yields

May 2013 – May 2014



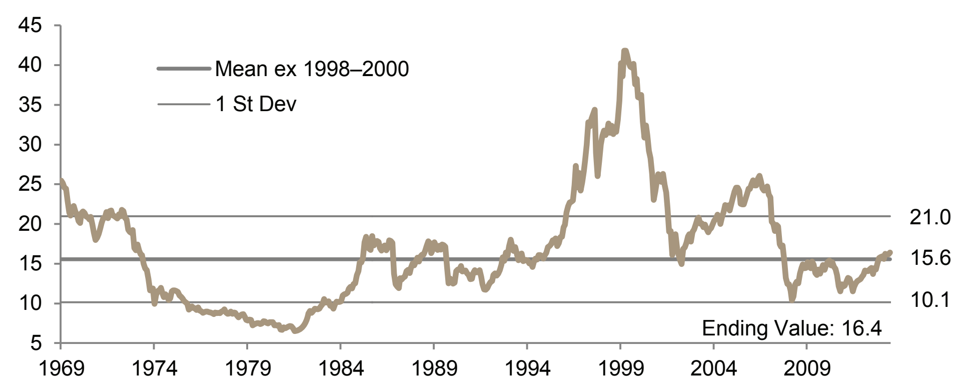
Index Performance (€)

As of May 31, 2014



MSCI Europe ex UK Composite Normalized P/E

December 31, 1969 – May 31, 2014



Sources: Barclays, BofA Merill Lynch, Citigroup Global Markets, EPRA, FTSE International Limited, MSCI Inc., J.P. Morgan Securities, Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

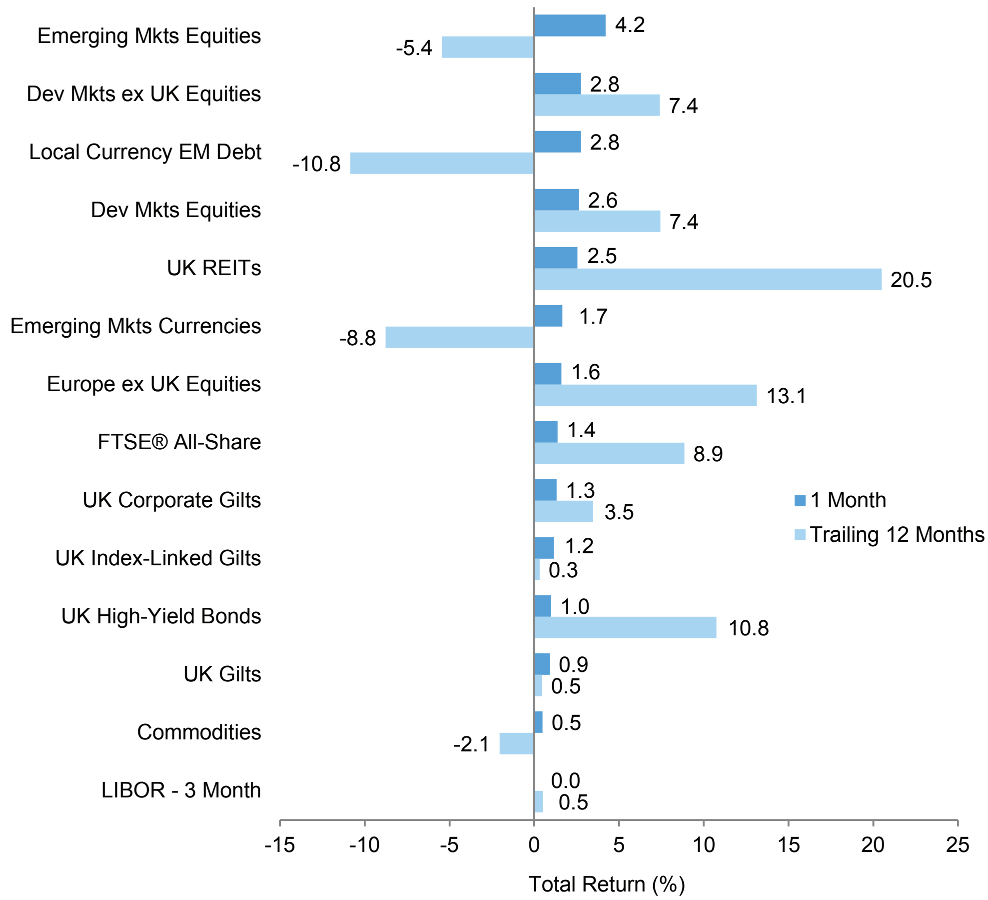
The euro weakened against a variety of currencies given expectations of additional ECB easing in June, boosting returns for assets like EM stocks (5.2%) and local currency EM bonds (3.7%); interest rates fell for similar reasons and led to strong returns for Europe ex UK property securities (5.2%) and sovereign bonds (1.0%) despite record-low yields in some maturities

Fixed Income Yields

May 2013 – May 2014

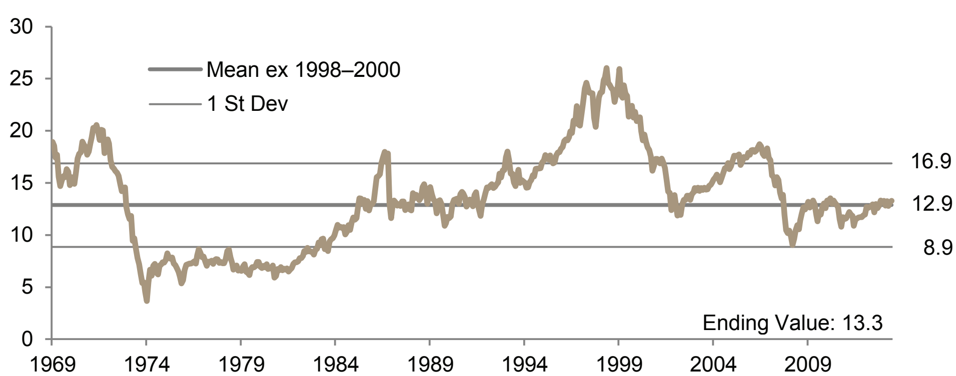
Index Performance (£)

As of May 31, 2014



MSCI UK Composite Normalized P/E

December 31, 1969 – May 31, 2014



UK equities under-performed developed markets peers in May as materials and telecom stocks continue to pull down index performance; health care stocks also suffered as the bid for AstraZeneca was abandoned. Gains for UK bonds have been muted on a relative basis given comparably stronger growth and inflation data

Fixed Income Yields

May 2013 – May 2014

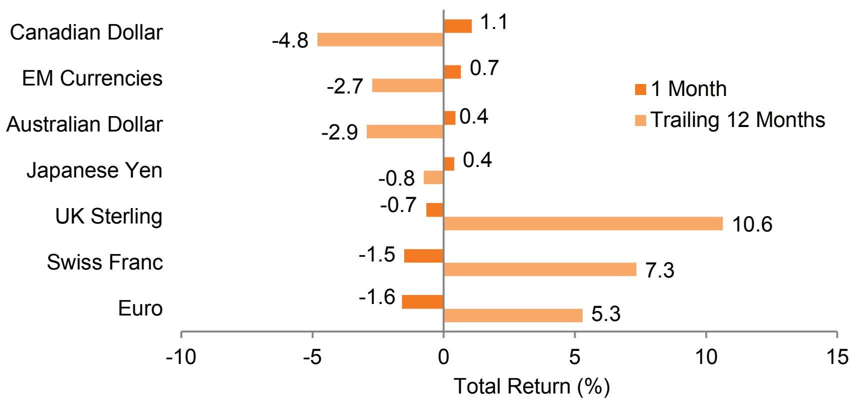
Sources: Barclays, BofA Merrill Lynch, EPRA, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

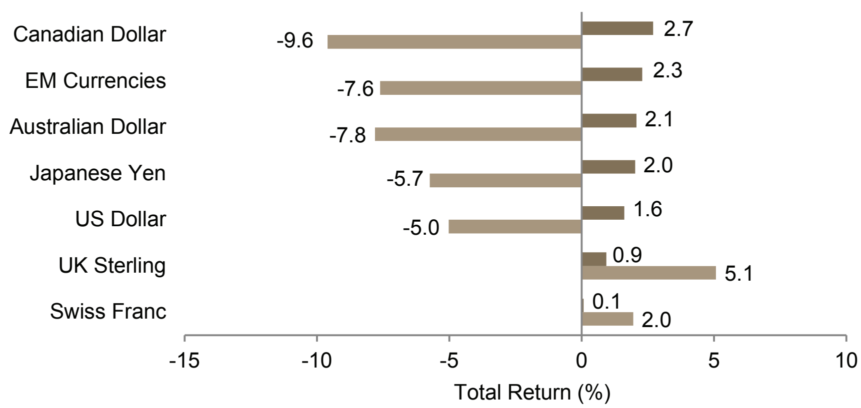
Currency Performance

As of May 31, 2014

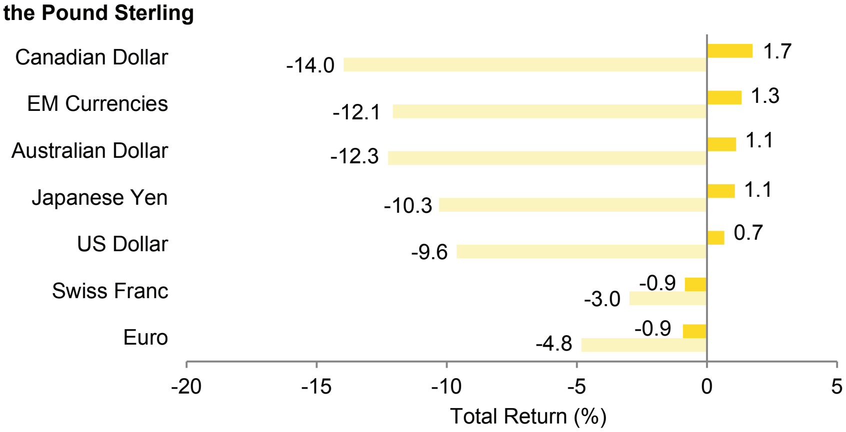
Versus the US Dollar



Versus the Euro



Versus the Pound Sterling



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: EM currencies is an equal-weighted basket of 20 currencies.

EM currencies stabilized against the dollar as balance of payment pressures are easing and as some EM central banks have come to an end of their easing cycle; in contrast, the euro moved sharply lower as the ECB is expected to cut rates in June and could take more decisive action such as outright QE or another LTRO

The yen moved slightly higher against the US dollar and posted solid gains against the euro and pound as the Bank of Japan refrained from further easing and an improving trade deficit decreased local demand for offshore FX

Exhibit Notes

Performance Exhibits
Total returns for MSCI developed markets indexes are net of dividend taxes. Total returns for MSCI emerging markets indexes are gross of dividend taxes.

US dollar index performance chart includes performance for the Barclays Corporate Investment Grade, Barclays High Yield Bond, Barclays Municipal Bond, Barclays US TIPS, Barclays US Treasuries, BofA Merrill Lynch 91-Day Treasury Bills, FTSE® NAREIT All Equity REITs, J.P. Morgan ELMI+, J.P. Morgan GBI-EM Global Diversified, MSCI Emerging Markets, MSCI World, and S&P GSCI™ indexes.

Euro index performance chart includes performance for the Barclays Euro-Aggregate: Corporate, Barclays Pan-Euro High Yield, Citigroup EMU Govt Bonds, FTSE® EPRA/NAREIT Europe ex UK RE, J.P. Morgan ELMI+, J.P. Morgan GBI-EM Global Diversified, MSCI Emerging Markets, MSCI Europe, MSCI Europe ex UK, MSCI World ex EMU, MSCI World, and S&P GSCI™ indexes.

UK sterling index performance chart includes performance for the Barclays Sterling Agg Corps, BofA Merrill Lynch Sterling High Yield, FTSE® British Government All Stocks, FTSE® British Government Index-Linked All Stocks, FTSE® EPRA/NAREIT UK RE, J.P. Morgan ELMI+, J.P. Morgan GBI-EM Global Diversified, MSCI Emerging Markets, MSCI Europe ex UK, MSCI World, MSCI World ex UK, and S&P GSCI™ indexes.

Valuation Exhibits
The composite normalized P/E ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity–adjusted earnings. We have removed the bubble years 1998–2000 from our mean and standard deviation calculations. All data are monthly.

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