CAMBRIDGE C|A ASSOCIATES

Market Matters

October 31, 2014

Life's but a walking shadow, a poor player, that struts and frets his hour upon the stage and then is heard no more; it is a tale told by an idiot, full of sound and fury, signifying nothing.
—Shakespeare's Macbeth

Whether volatility, like "Life" in the quote from Shakespeare, means something or nothing may depend on how you are positioned for it. The first part of October saw volatility return with a vengeance, as stocks sold off given weak economic data and stretched positioning. However, markets then quickly regained their poise and ended in the black, as a slew of earnings and data releases suggested all was not so bad and central banks in Europe and Japan made clear they stood ready to do more.

October was a dramatic month in the financial markets, as volatility briefly exploded but then evaporated, bulls overran bears, and many analysts were left scrambling to come up with credible explanations. Copious amounts of earnings releases, key economic announcements, and geopolitical events offered abundant source material for weaving a narrative. Sometimes the simplest explanation is the best. When valuations are stretched for many assets and investor nervousness is high, a "shoot first and ask later" mentality can take over—especially when computers and not human beings may be the ones doing the transacting.

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

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October can be neatly divided into two halves. During the first, September's gloomy mood carried over, and cuts to global growth forecasts, the (possibly) related theme of sinking commodity prices, and escalating geopolitical tensions in regions like Greece and Russia were all cited as reasons for cutting risk. Then on the 15th a "flash crash" occurred in the US Treasury market, where yields suddenly plunged only to quickly retrace lost ground, causing trading volumes to soar. Global equity markets then also sold off, as traders perhaps wondered if they had missed some policy or geopolitical event, before quickly recovering what had been substantial intraday losses. Equity volatility rose significantly in turn—at one point the US VIX Index was up over 70% to its highest level in two years before collapsing to just about where it started.

Bulls took charge during the second half of the month as economic data and policy initiatives surprised to the upside. US economic data continue to strengthen; in October it was reported that US GDP grew by 3.5% in third quarter; the past six months of growth have been the best in more than a decade. Other positive US data included unemployment claims dropping to the lowest level in 14 years and industrial production rising to the highest levels since 2012. The Federal Reserve cited some of this positive data when, as expected, it decided to curtail its bond purchases. Meanwhile, the European Central Bank announced it might start buying corporate bonds and announced the results of the Asset Quality Review, which revealed banks will need less capital than anticipated. Finally, the Bank of Japan (BOJ) showed it still had some ammunition left. On October 31, local stocks surged nearly 5% as the BOJ announced an increase in Japanese government bond purchases to a massive ¥80 trillion per year, and the main government pension fund announced a doubling of domestic equity purchases.

Positive earnings releases also boosted appetite for stocks. Of the 73% of S&P 500 companies that had reported through October 31, 81% reported positive earnings growth year-over-year of around 10%. In Europe, where just over 50% of companies have reported, 62% are reporting year-over-year growth of around 13%. Japanese and other releases were also greeted favorably. With less than two months to go before the end of 2014, consensus earnings growth forecasts all seem to be converging around 5% to 6% for these key markets.

The net result of all this was a swoon during the first half of the month followed by markets recovering their losses (and then some) during the final two weeks. Notwithstanding their 6% drop through the middle of the month, US equities returned 2.4% and the S&P 500 reached a record high. Japanese stocks were slightly behind, but ended in the black (0.9%) given the BOJ's end-of-month announcement. European equities could not fully recover from earlier losses but managed to finish down just 1.6%. Finally, emerging markets stocks posted a small gain (1.4%), taking their year-to-date total to 7.0%, though performance diverged across countries. For example, Greek stocks (-14.1%) sank as doubts resurfaced over debt sustainability, while Asian export economies like China (4.2%) and Taiwan (2.5%) performed much better.

Declining commodity prices frayed investors' nerves at the start of October,[1] though slower growth may be only part of the explanation behind the 23% drop in crude oil since the start of 2014. In recent months the International Energy Agency has steadily reduced its estimates of global oil demand. However, developments on the supply side have also confounded expectations. US production is expected to have risen more than 50% over the past three years and already reached 8.9 million barrels a day in October. As well, violence in the Middle East has not disrupted supply as anticipated and in fact Libya's production has tripled since June. Finally, and perhaps most importantly, a price war may have broken out. In early October Saudi Arabia announced price cuts for key customers, and a variety of OPEC members filed suit.

Fixed income markets were far from dull, but could not keep up with the drama in the stock markets. Despite the Fed ending tapering and releasing somewhat hawkish minutes, the yield on the ten-year US Treasury bond actually ended the month lower at 2.35%, contributing to a 1.0% return for the Barclays Aggregate Index (5.1% year-to-date). With the index yield having fallen to 2.24%, there will be little meat left on the bone for next year's returns, but clearly US yields in general look attractive relative to those in Europe and Japan. US high-yield bonds enjoyed a similar return (1.2%), as early in the month investors deemed the 6.47% yield attractive and subsequently pushed it back down to 5.83%. European credit fared less well, impacted by some of the same economic malaise as local equities. Pan-European high yield was basically flat, though year-to-date it has returned 5.9%. In recent months sentiment seems to have turned against the asset class, perhaps because sub-5% yields seem too low (they stand at 4.68%) given risks presented by the weak economy but also due to some high-profile defaults including UK phone retailer Phones4U. Even local currency emerging markets debt managed to eke out a small gain (2.0%), despite the Russian ruble and Brazilian *real* continuing to fall to what now seem oversold levels. For example, after another 8% drop in October, the ruble now trades at its lowest level against the US dollar on record. ■

[1] For a more comprehensive take on recent events and the intermediate-term outlook for energy prices, please see Sean McLaughlin et al., "Oil Prices Can't Find Their Footing, Even Amid Geopolitical Turmoil," Cambridge Associates Research Brief, October 30, 2014.

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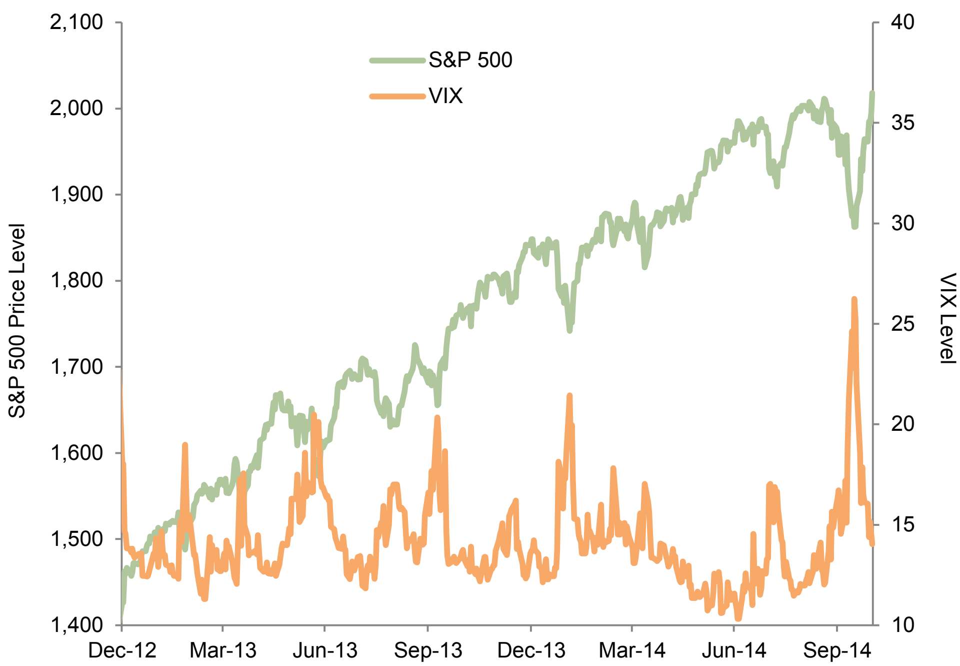
The views of our Chief Investment Strategist can be found each quarter in **VantagePoint**

S&P 500 and VIX Price Levels

December 31, 2012 – October 31, 2014

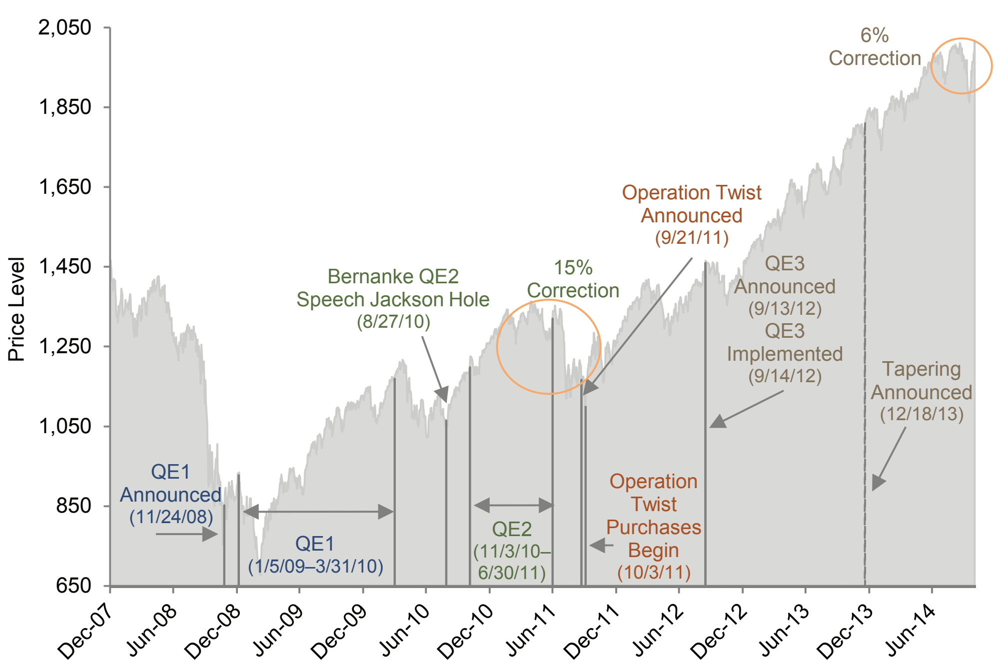


Sources: CBOE, Standard & Poor's, and Thomson Reuters Datastream.

Equity market volatility surged during the first half of October as markets responded to weaker global growth forecasts and stretched positioning/valuations; the VIX subsequently collapsed toward month end as positive earnings releases and better economic data improved sentiment

The S&P 500 and Quantitative Easing

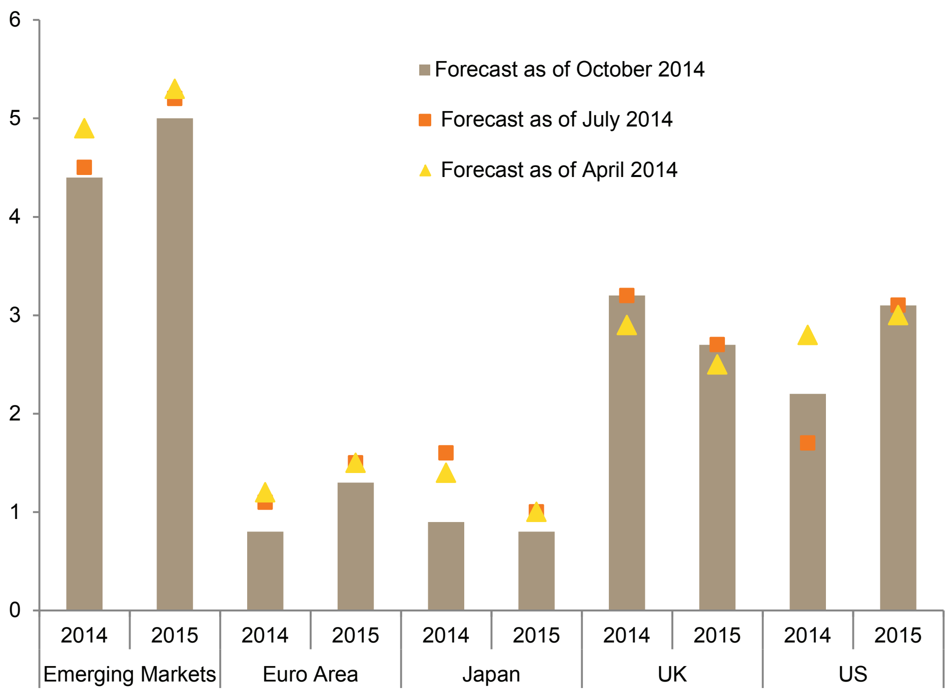
December 31, 2007 – October 31, 2014



Sources: Standard & Poor's and Thomson Reuters Datastream.

As expected, the Fed will cease its asset purchases this month. Market volatility coincided with previous rounds of QE ending; this October was no exception

IMF Forecast of GDP Growth for Selected Regions



Source: International Monetary Fund – World Economic Outlook.

Markets sold off in early October as the IMF and others cut certain growth forecasts and European data disappointed. Less discussed was that the IMF actually *boosted* its US forecast and the emerging markets outlook barely changed

Nikkei 225 Index

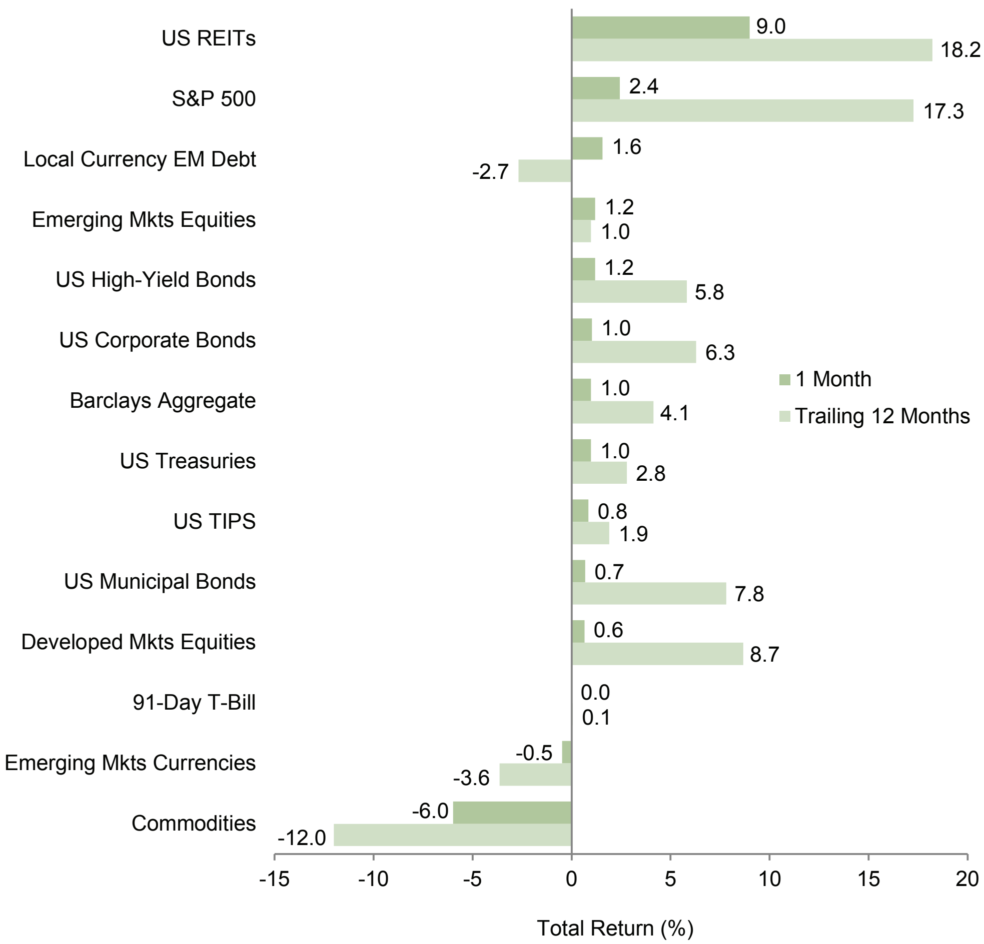
October 1, 2014 – October 31, 2014

Sources: Thomson Reuters Datastream and Tokyo Stock Exchange.

Japanese stocks soared at month end as the Bank of Japan and main government pension fund coordinated to make two supportive announcements: the BOJ will dramatically expand its balance sheet and GPIF will effectively reduce its bond holdings and increase purchases of Japanese (and other) stocks

Index Performance (US$)

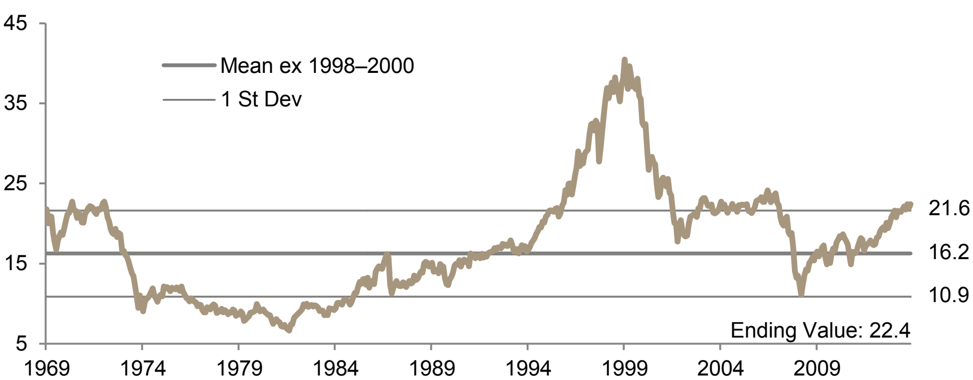
As of October 31, 2014



US REITs more than recovered from September's losses and posted their best monthly return in three years. Fixed income markets benefitted across the board from Treasury yields, which fell despite Fed tapering—in part because US yields remain attractive on a global basis

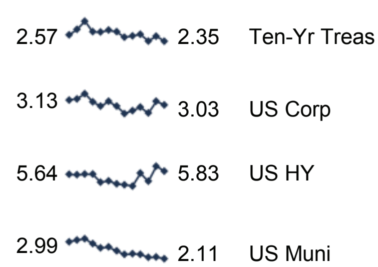
MSCI US Composite Normalized P/E

December 31, 1969 – October 31, 2014



Fixed Income Yields

October 2013 – October 2014

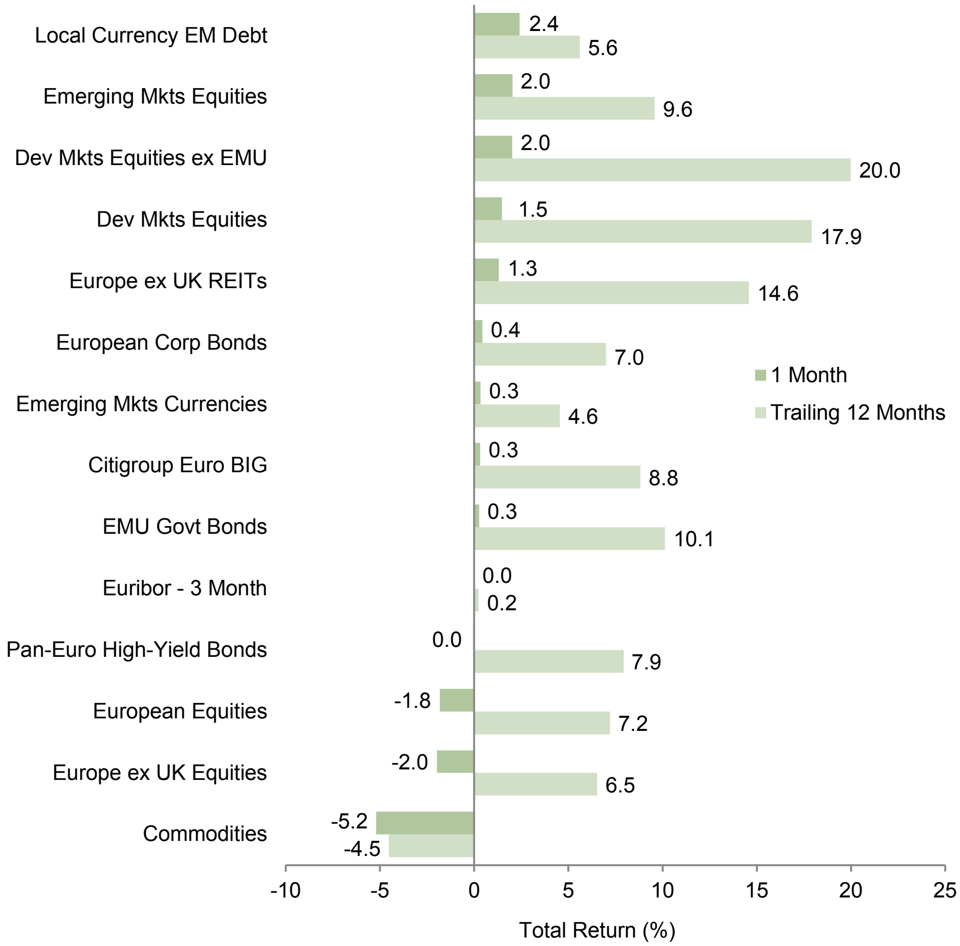


Sources: Barclays, BofA Merill Lynch, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

Index Performance (€)

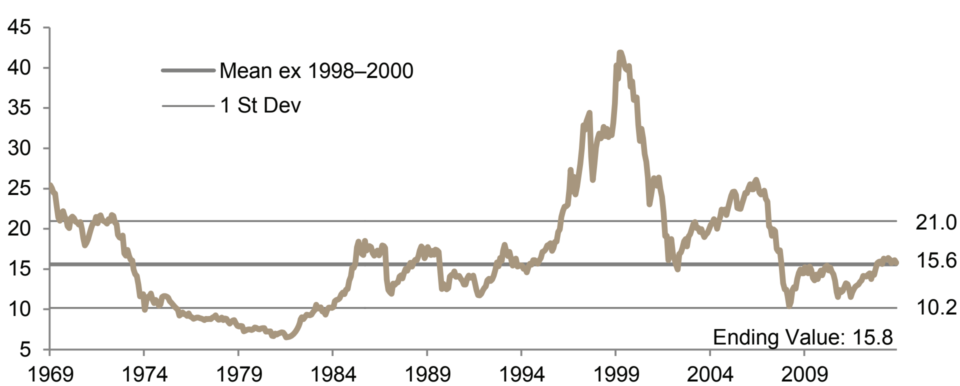
As of October 31, 2014



A declining euro continues to boost returns for unhedged holdings of foreign equities and EM bonds. Meanwhile, local equities are suffering from weaker data and political tensions over the right amount of fiscal stimulus

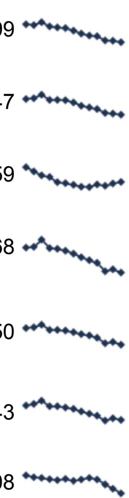
MSCI Europe ex UK Composite Normalized P/E

December 31, 1969 – October 31, 2014



Fixed Income Yields

October 2013 – October 2014

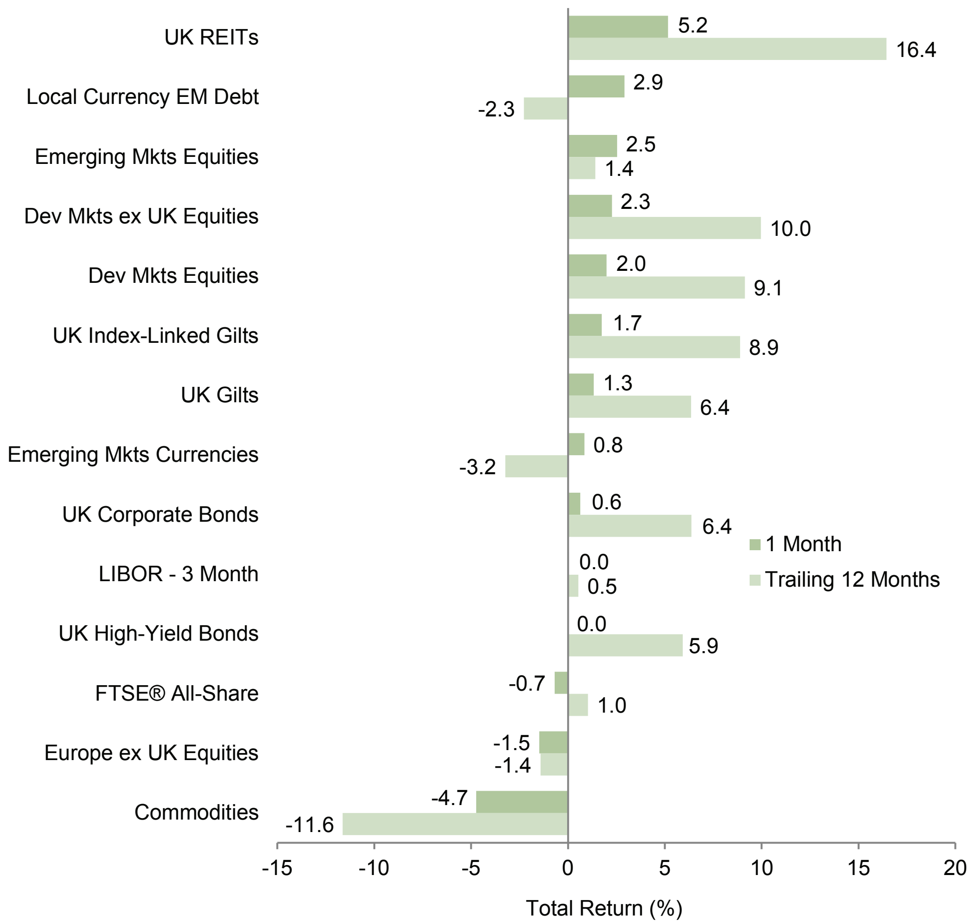


1.99	1.22	Euro Corp
1.47	0.78	Euro Corp AA
5.59	4.69	Pan-Euro HY
1.68	0.85	Ten-Yr Bund
2.50	1.52	20-Yr Nominal Yield
0.43	-0.30	20-Yr Real Yield
2.08	1.82	Euro 20-Yr Infl Expectations

Sources: Barclays, Bloomberg L.P., 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.

Index Performance (£)

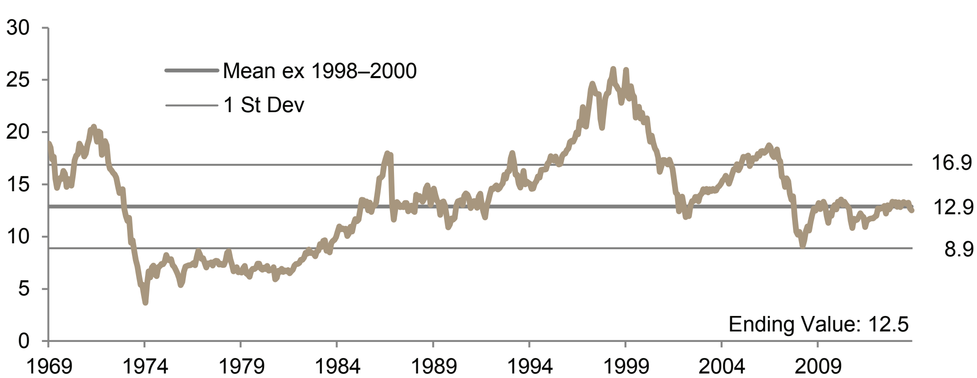
As of October 31, 2014



UK stock returns are being weighed down by industrials and oil & gas, as well as exposure to slowing EM economies. Despite strong domestic growth, weaker commodity prices mean inflation has slowed to just 1.2%, boosting returns for gilts and other bonds

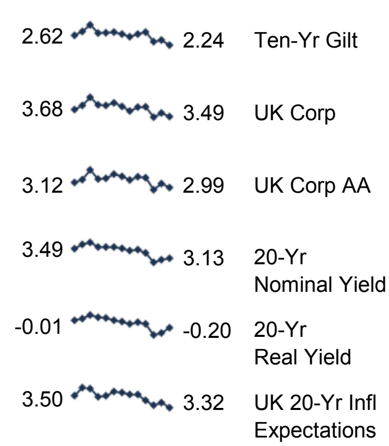
MSCI UK Composite Normalized P/E

December 31, 1969 – October 31, 2014



Fixed Income Yields

October 2013 – October 2014

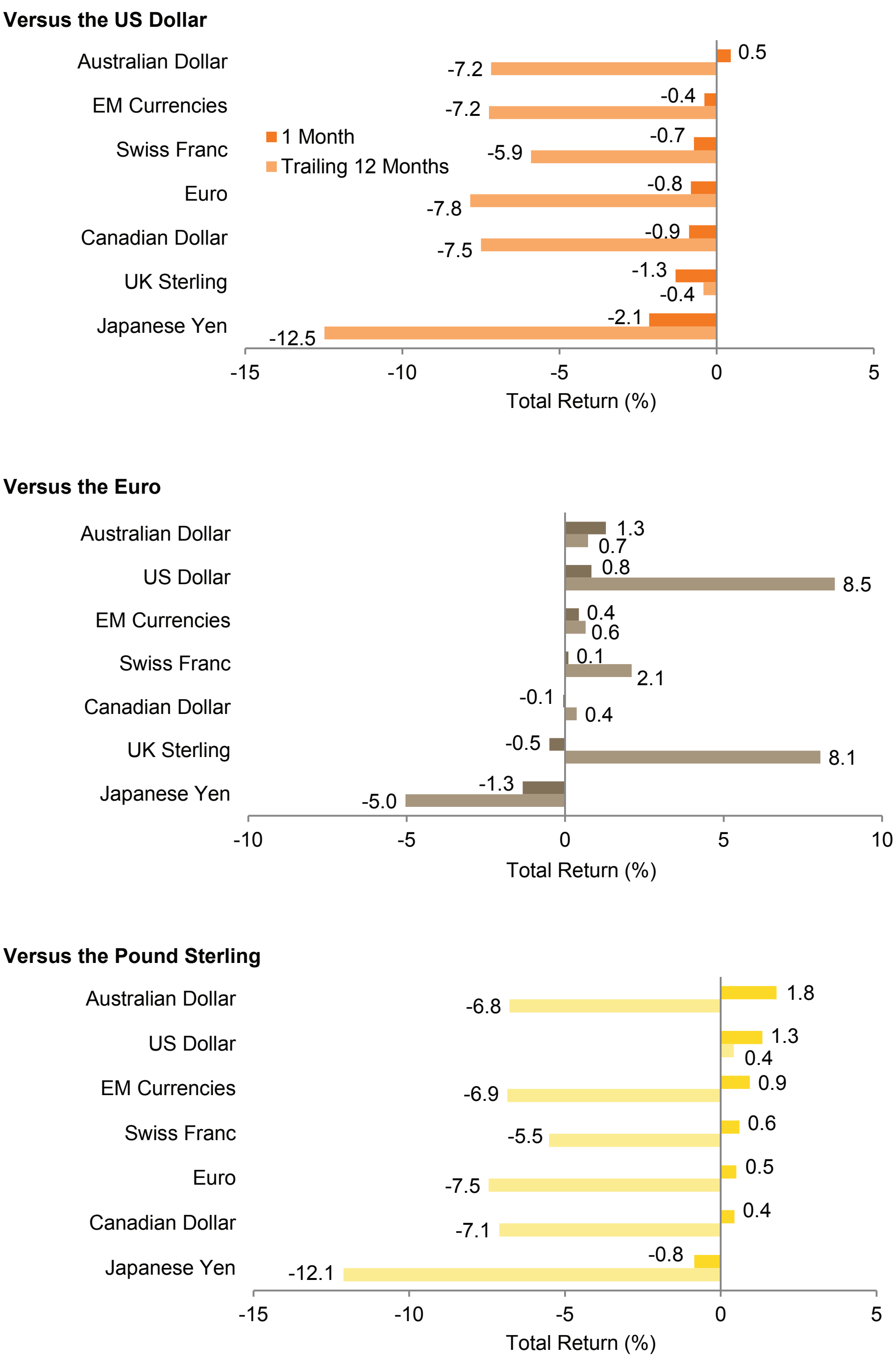


Sources: Bank of England, Barclays, BofA Merrill Lynch, EPRA, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

Currency Performance

As of October 31, 2014



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.

The yen appears to be winning the global currency wars, at least for now. Given the BOJ's surprise announcement of further quantitative easing, the yen declined over 2% against the US dollar and nearly every international peer. The one exception was the Russian ruble, which dropped 6% against the yen and 8% against the dollar (a new historical low), as concerns about Russia's balance of payments are growing and its foreign currency reserves are depleted

The euro fell again against the US dollar during the month as local economic data deteriorated; the ECB is focusing on buying assets like covered bonds to keep rates low but may need to do more in 2015, especially if the weaker yen starts to eat into Eurozone competitiveness

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 Aggregate: Corporate Bond, 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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