Market Matters

September 30, 2014

Global developed and emerging markets stocks posted minor gains during the third quarter, but this disguises an uptick in volatility as economic growth and thus monetary policy appear to be diverging across regions; fixed income assets such as European sovereigns and credit continue to post strong gains, but lower real yields are causing associated currencies to plunge.

A September swoon limited gains for many risk assets during the third quarter, though some previous laggards like Japanese stocks outperformed and previous highfliers like commodities crashed back down to earth. Diverging economic data across regions were typically reflected in relative performance across asset classes (and increased volatility); other factors such as valuations and simmering geopolitical tensions also played a role.

These dynamics were clearly on display in global fixed income markets, where differing approaches to monetary policy caused bond yields across regions to move in opposite directions and currencies to move sharply. After Eurozone growth ground to a halt in the second quarter and inflation data came in well below targets, the European Central Bank unexpectedly cut rates twice and its president, Mario Draghi, expressed his desire to see its balance sheet expand by another €1 trillion—a roughly 50% increase from today's level. In contrast, given improving economic growth and employment data, the US Federal Reserve Bank confirmed it will cease purchasing assets in October and

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

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raised its projections for future interest rates. Yields on Eurozone sovereign bonds sank to record lows while those on US Treasuries edged higher; the euro depreciated nearly 8% against the US dollar to its lowest levels since the depths of the sovereign debt crisis in 2012. Not to be outdone, the Bank of Japan also sharply increased its quantitative easing efforts during the quarter; the yen depreciated by a similar percentage and touched the lowest levels against the greenback since 2007.

Developed markets equities (0.8%) posted minor gains for the quarter, masking an increase in volatility as investors digested economic and earnings releases. Focusing on major regions, US equities (1.1%) slightly outperformed peers, posting their weakest quarter since the end of 2012. While US economic data releases have been generally positive, estimates for 2014 US earnings growth have been cut to 6% and concerns are mounting that earnings can't outpace revenue growth forever. European equities posted a small loss given macro developments, though not all news was negative. The threat of the United Kingdom splitting up has at least temporarily eased and weaker currencies (both pound and euro) are part of the reason that European earnings growth expectations now match those of the United States. Japanese equities bucked the trend and returned nearly 6%, though their year-to-date return still trails that of developed markets peers. Japanese economic data have recently disappointed, but earnings growth has been strong and analysts hope that renewed yen weakness will generate further tailwinds given high levels of foreign sales for many companies.

Despite a 4.2% drop in September, emerging markets stocks still posted a slight gain (0.7%) for the quarter. As EM currencies generally weakened against the dollar, returns were very different for US$ (-3.4%) and euro-based investors (4.7%). Markets where hope (e.g., due to political developments) had been triumphing over experience (e.g., earnings growth) suffered. For example, Brazilian stocks had returned 19% year-to-date through August, but then plunged nearly 12% in September as polls started to suggest current President Dilma Rousseff could triumph in upcoming elections. Speculation over the potential for future Chinese stimulus also caused certain EM assets to oscillate. The Minister of Finance seemed to pour cold water on such hopes in early September, but developments on other fronts (such as eased mortgage-lending standards) suggest authorities are taking a more nuanced approach. Chinese equities had risen over the summer, but a 6.2% drop in September meant gains were much more muted for the quarter (1.7%). Political protests in Hong Kong weighed on sentiment and impacted a variety of other related investments such as shares in British banks that have a sizable local presence.

Geopolitical concerns and worries over rising rates also roiled some credit markets during the third quarter. Emerging markets debt bore the brunt of this, where local currency sovereigns eked out a small return for local investors (0.5%), but plunged (-5.7%) in US$ equivalent. The Turkish lira (-7%), Brazilian *real* (-10%), and Russian ruble (-14%) suffered from a variety of maladies. US high-yield bonds (-1.9%) also wobbled as retail outflows from exchange-traded funds accelerated. Sub-5% yields for US high-yield bonds earlier this summer meant that valuations were very stretched; even after the recent sell-off, the yield still only sits at 6.1%. However, US high-yield bonds are supported by generally improving credit fundamentals and a maturity schedule that has been pushed far into the future, contributing to low default rates. The story was better in Europe given declining benchmark yields; high-yield bonds broke even (-0.1%) and euro-denominated investment-grade bonds returned 1.8%. The resignation of a well-known manager from one of the world's largest bond funds in late September generated concern that client outflows could combine with tapering fears to trigger a sell-off for certain less-liquid holdings across global bond markets. While likely that many investors are still reviewing options, thus far redemptions from these funds (and associated short positioning) have generated little unusual market activity.

Finally, as concerns grew about global supply/demand imbalances, commodities dropped nearly 12% in the third quarter and dragged their year-to-date return into the red. In the energy market (-12% for the third quarter), US production continues to rise and civil wars in the Middle East have not had a material impact on supply, while forecasts for demand growth are being cut back given slower global economic growth. Meanwhile, industrial metals (-4%) are being dragged down by worries that slower growth in China will impact demand from the world's largest consumer of iron ore; iron ore fell to its lowest price since 2009. Nor is the picture much brighter in agriculture (-18%), where record supply forecasts caused futures for corn (-24%), soybeans (-35%), and other softs such as wheat (-16%) to plunge. Weaker commodity prices and declining inflation expectations combined with the technical pressures discussed earlier weighed on US inflation-linked bonds (-2.0% for the third quarter), though global inflation-linked bonds eked out a small gain (0.9%) as yields declined. ■

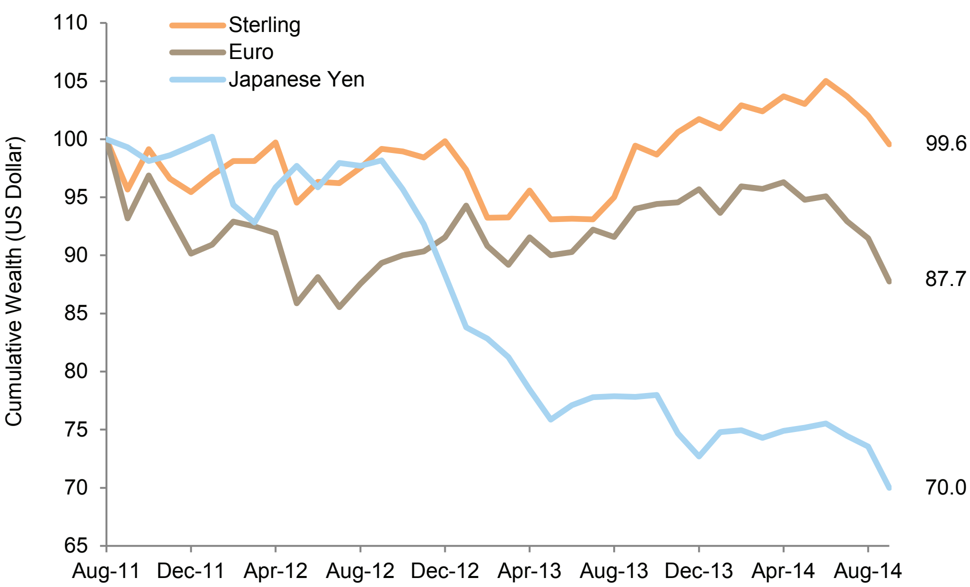
Access additional exhibits on market performance via the Market Update category on our **Exhibit Finder** application

For our views on specific asset classes, read **Asset Class Views**

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

Depreciation of Major Currencies vs US Dollar

August 31, 2011 – September 30, 2014 • August 31, 2011 = $100



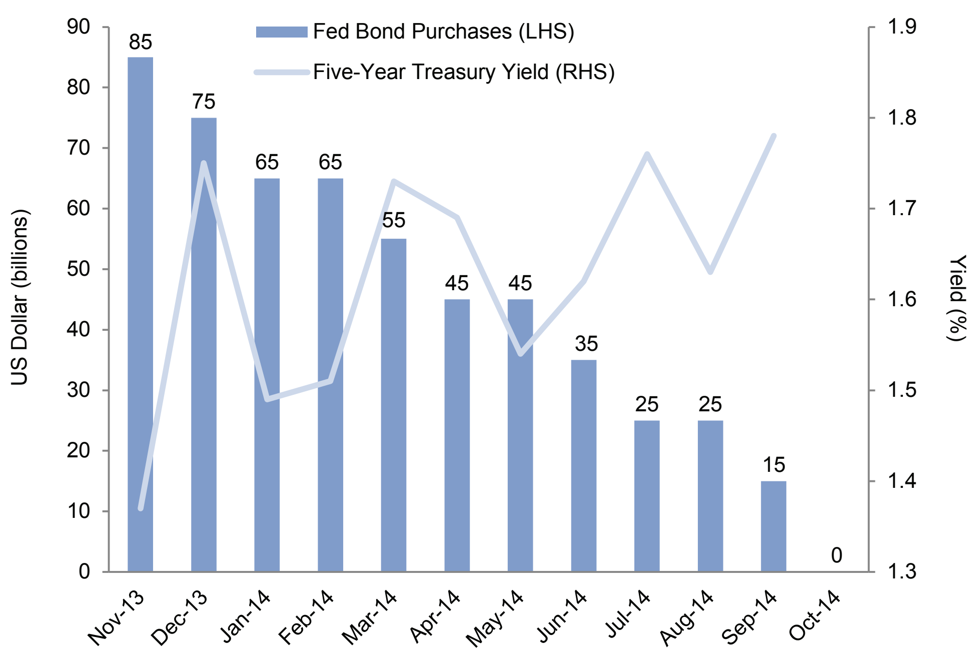
Source: Thomson Reuters Datastream.

Note: Cumulative wealth for the Japanese yen is based on exchange rates as reported on the Noon NY system by the Federal Reserve Bank of New York.

The Bank of Japan has been winning the global currency wars over the past several years, but in the third quarter the European Central Bank (ECB) cut rates and committed to further asset purchases, sending the euro over 8% lower versus the US dollar

Fed Tapering and Treasury Yields

November 30, 2013 – September 30, 2014



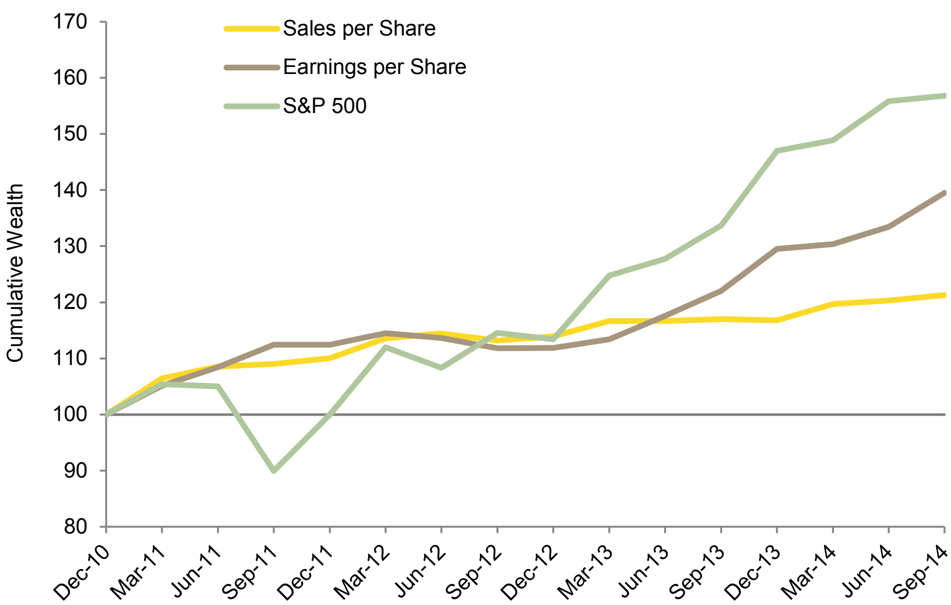
Sources: Bloomberg L.P. and Thomson Reuters Datastream.

Notes: Data are monthly. Fed purchases are expected to go to zero in October.

Stronger GDP growth and rising employment mean that the Federal Reserve will cease its asset purchases in October and could hike rates sooner than expected; however, US yields look attractive on a relative basis globally and this has limited the sell-off in rates

S&P 500 Sales and Earnings Growth vs Total Return

Fourth Quarter 2010 – Third Quarter 2014

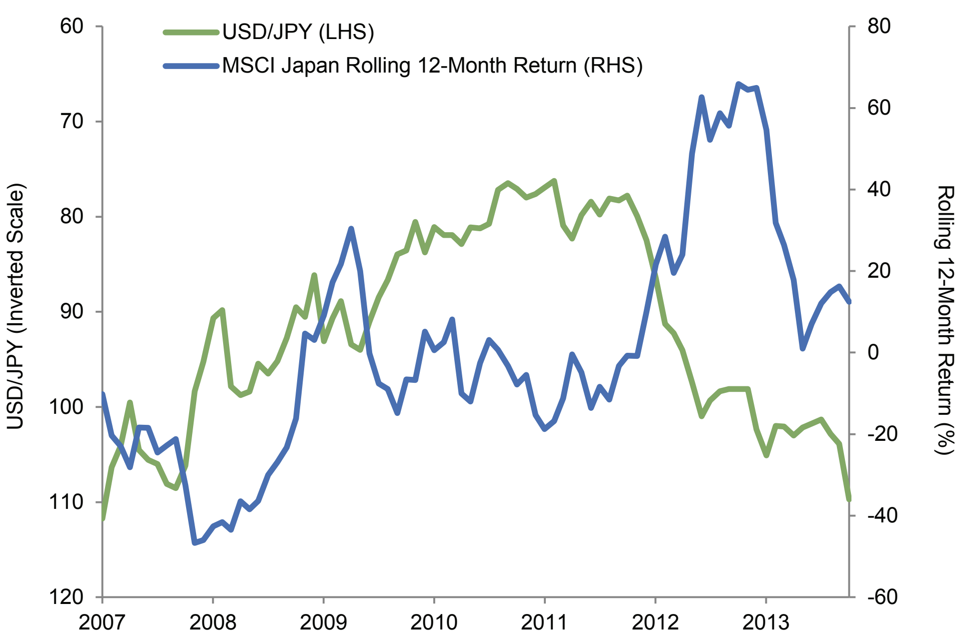


Sources: Bloomberg L.P., Standard & Poor's, and Thomson Reuters Datastream
Note: Data are quarterly and rebased to 100 on December 31, 2010.

Analysts are concerned that share prices have rapidly outpaced earnings growth, especially as stretched margins suggest earnings growth may slow

MSCI Japan vs USD/JPY

December 31, 2007 – September 30, 2014

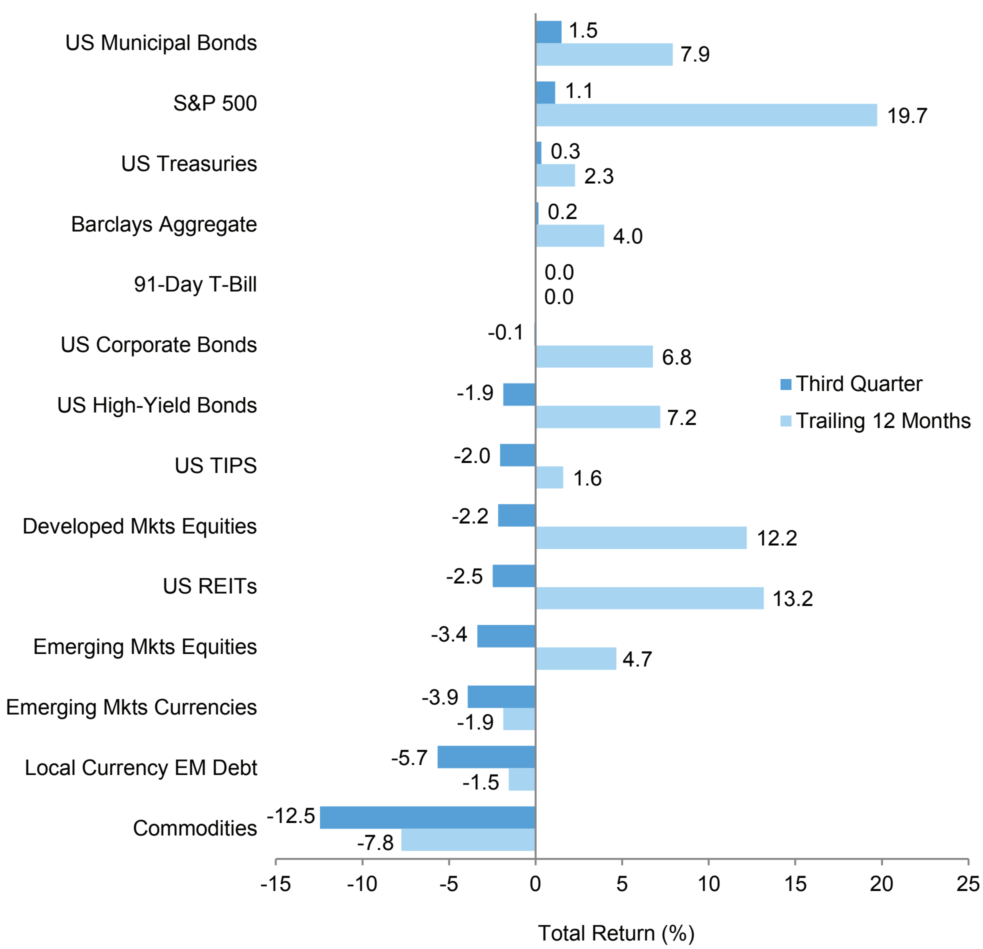


Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: The 12-month rolling return for the MSCI Japan Index is expressed in local currency.

Japanese stocks rebounded strongly in the third quarter, but lag developed markets peers in 2014; the larger than expected sell-off in the yen has helped generate impressive earnings growth, but the weak domestic macro picture may present a headwind

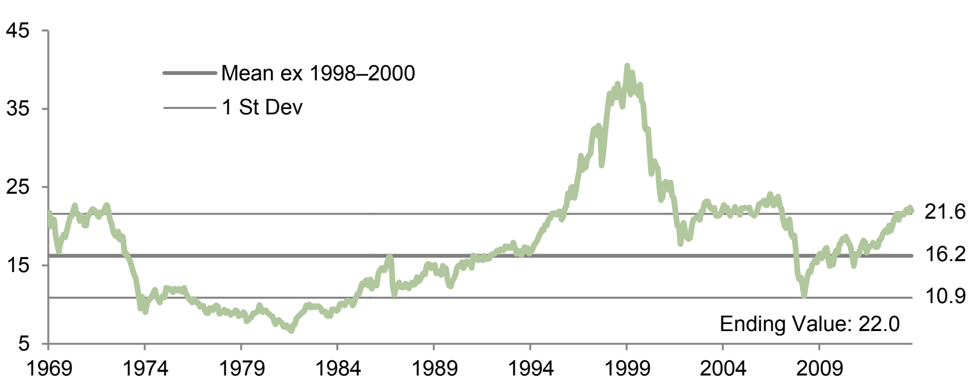
Index Performance (US$)

As of September 30, 2014



MSCI US Composite Normalized P/E

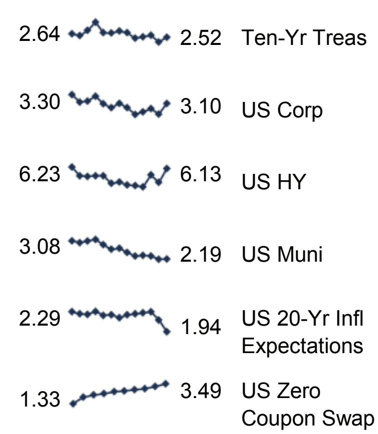
December 31, 1969 – September 30, 2014



US stocks posted muted returns given concerns over valuations and the pace of earnings growth while a rising US dollar generated losses for unhedged assets such as EM debt and equities. Commodity markets continue to adjust to greater-than-expected supply and weaker-than-anticipated demand, in part due to slower global growth

Fixed Income Yields

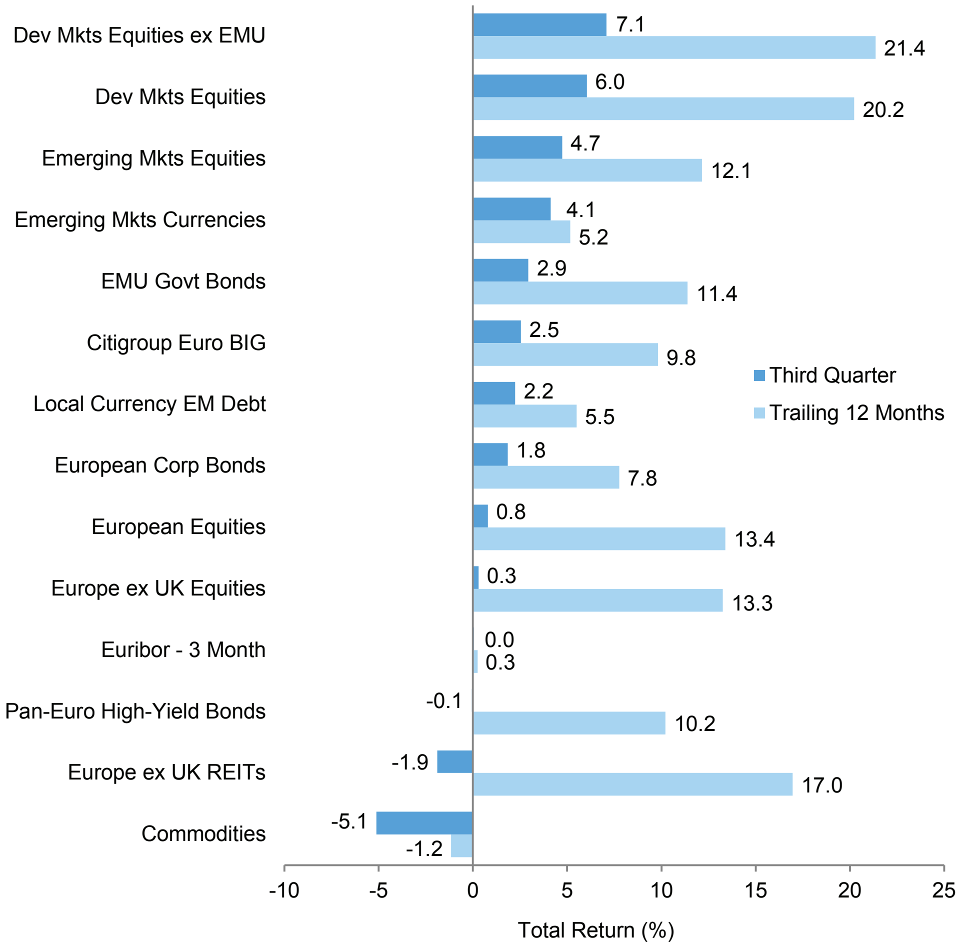
September 2013 – September 2014



Sources: Barclays, Bloomberg L.P., BofA Merrill 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 (€)

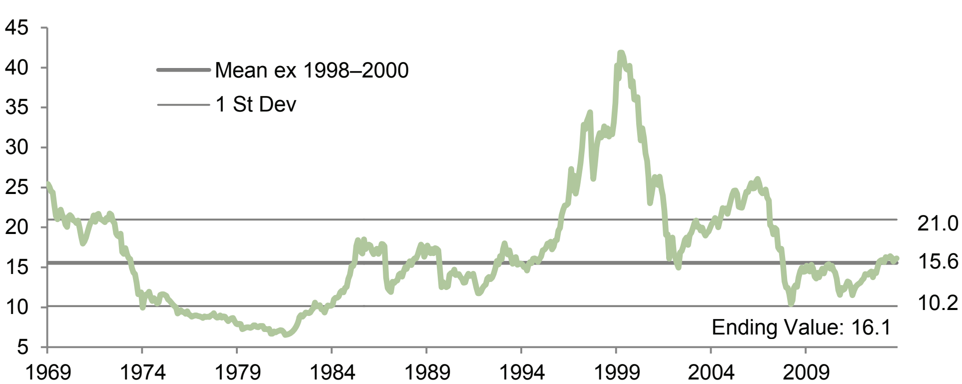
As of September 30, 2014



Euro depreciation meant local investors saw outsized gains on unhedged holdings of foreign equities, while local equity gains were more muted given growth concerns; an ECB firmly in easing mode helped drive large gains for many fixed income assets

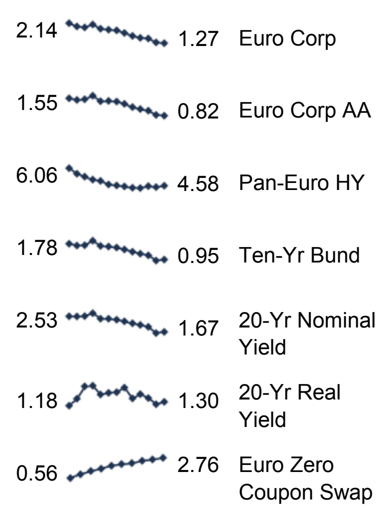
MSCI Europe ex UK Composite Normalized P/E

December 31, 1969 – September 30, 2014



Fixed Income Yields

September 2013 – September 2014

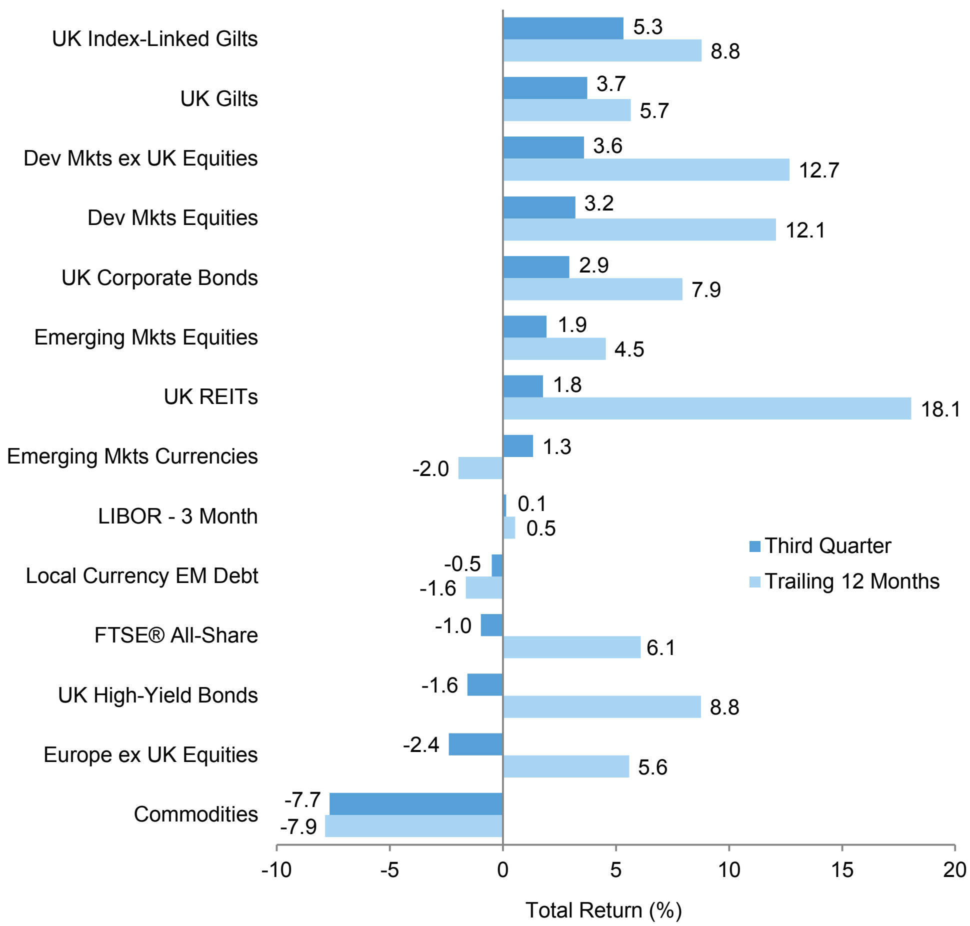


Sources: Barclays, Bloomberg L.P., BofA Merrill Lynch, Citigroup Global Markets, EPRA, FTSE International Limited, MSCI Inc., J.P. Morgan Securities, Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any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

UK equities failed to benefit from reduced uncertainty after the Scottish independence referendum, but gilt yields moved sharply lower in part due to easing inflation and fixed income assets generated strong gains

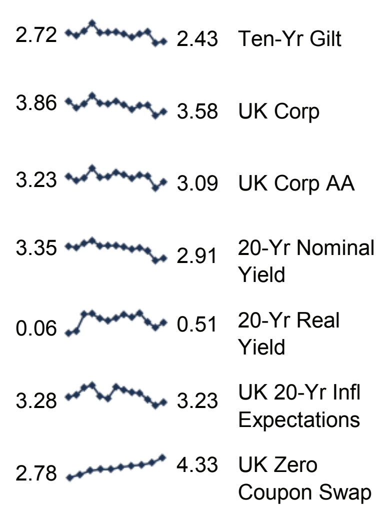
Index Performance (£)

As of September 30, 2014



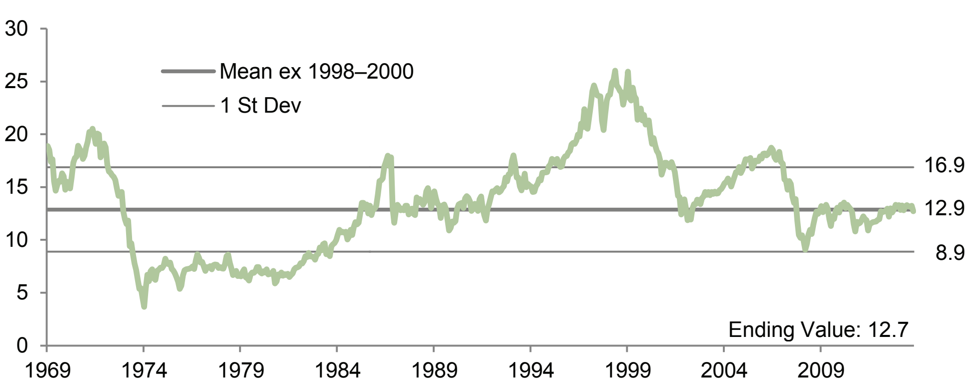
Fixed Income Yields

September 2013 – September 2014



MSCI UK Composite Normalized P/E

December 31, 1969 – September 30, 2014



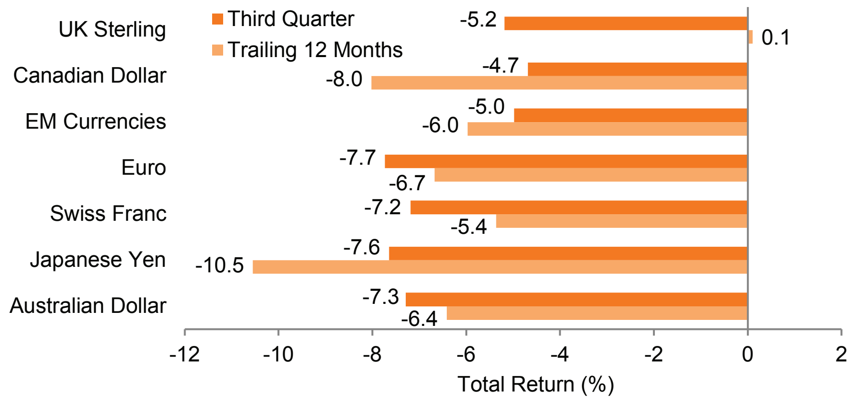
Sources: Barclays, Bloomberg L.P., BofA Merrill Lynch, EPRA, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

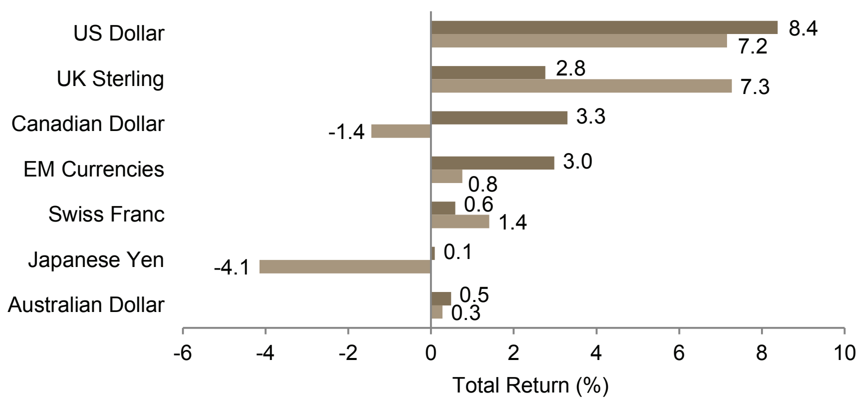
Currency Performance

As of September 30, 2014

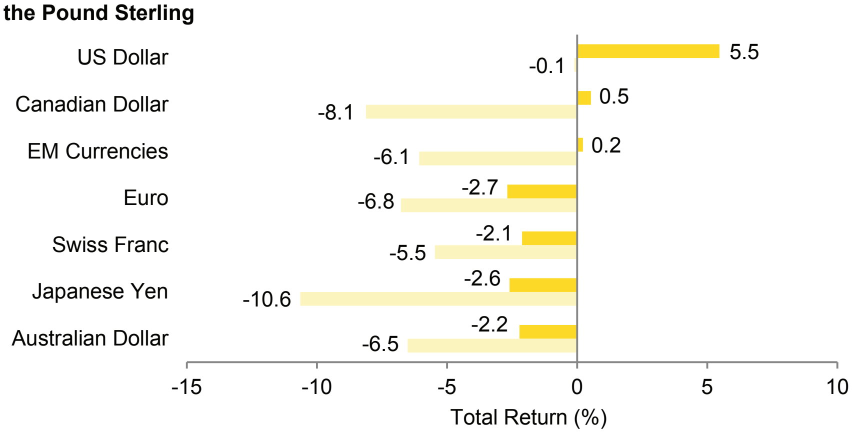
Versus the US Dollar



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.

During the quarter most major developed markets currencies sold off between 7% and 8% against the US dollar. The UK pound has held up better, supported by higher real yields.

EM currencies have also sold off against the US dollar, but performance varied across regions; Europe, the Middle East & Africa currencies like the ruble and lira plunged, but Asian currencies like the Chinese yuan have been better bid

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.