Market Matters

April 30, 2014

Equity market performance was muted in April given high valuations and weak earnings growth, while bonds rallied despite generally positive macro data; commodities and real estate continued their rebound after a disappointing 2013.

Markets again confounded the consensus in April, as equities struggled to keep pace with fixed income assets. Investors across all markets had a significant amount of news flow to digest, from quarterly earnings releases to macro data to events in the Ukraine. We don't find recent equity performance surprising given stretched valuations in markets like the United States; fixed income markets, on the other hand, appear increasingly frothy and investors should avoid segments that increasingly seem to be decoupling from fundamentals.

US equities returned just 0.7% for the month. While headlines that 75% of S&P 500 companies have met or exceeded earnings forecasts looked encouraging, it is worth remembering expected growth was just 1.7% (year-over-year). M&A activity has also bolstered bullish sentiment, as a handful of large transactions in the health care and cable industries boosted the value of deals by around 50% from year-earlier levels. Dampening sentiment was significant volatility in biotech and internet stocks, which after a robust start to 2014 have suffered significant recent declines, wrong-footing a number of hedge funds. US macro reports were mixed; while news in areas like jobs

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

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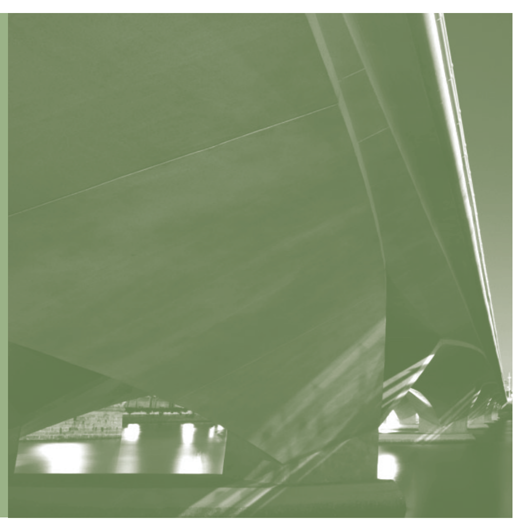
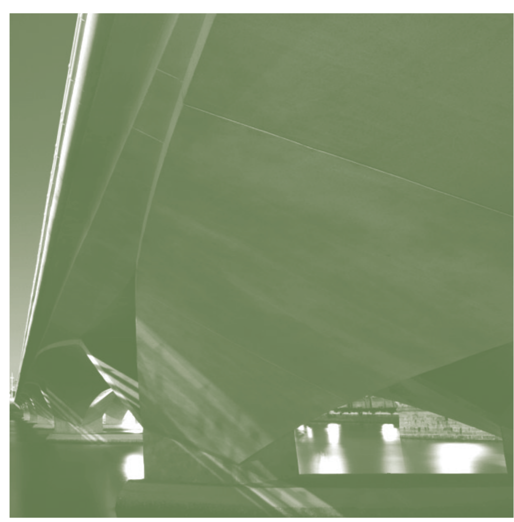




and durable goods has been positive, other data releases like first quarter GDP growth (just 0.1%) disappointed. Many believe the disappointing first quarter growth was weather related and expect a rebound; in April the IMF confirmed its 2014 growth forecast at 2.8% and the Federal Reserve deemed the recovery strong enough to forge ahead with further tapering.

European earnings releases have been more lackluster, with the majority of companies having missed estimates. Even after dipping in 2013, the consensus now expects just an 8% earnings rebound in 2014, with companies guiding downward and blaming in particular lower revenue and exchange rate volatility from emerging markets. Despite this, European stocks returned 1.8%, helped by a 6.1% return from energy stocks, which had lagged in prior months. European equity valuations remain reasonable and improving macro data have raised hopes that earnings growth will follow. The Eurozone composite PMI rose to 54 in April, the highest level in three years. Meanwhile UK GDP growth in the first quarter came in at 3.1% on an annualized basis, the strongest since before the financial crisis. Recovery in the periphery is also ongoing, albeit from a low base, though it is worth asking whether sentiment is getting ahead of fundamentals. For example, while Spain posted 0.4% growth in the first quarter (the best since 2008), the decision by junk-rated Portugal to exit its IMF/EU–sponsored bailout has raised eyebrows. April brought news that Eurozone consumer prices have risen just 0.7% over the past 12 months, barely assuaging ongoing fears about deflation.

Emerging markets stocks were basically flat for the month, though this masked significant dispersion across countries. “Fragile 5” countries, which suffered last year from concerns about budget and current account deficits, continue to rebound—Indonesia returned 3.2% (16.7% year-to-date) and Turkey was up 6.4%. In contrast, Russian equities dropped another 5.3% as tensions with Ukraine escalated and analysts took a knife to earnings forecasts given the assumed impact of threatened economic sanctions. Chinese equities (-2.3%) also suffered as data continued to reflect the government’s effort to rebalance its growth model. GDP growth in the first quarter was just 5.7% on an annualized basis and metrics such as credit creation are also starting to decelerate. China bulls argue that the government has ample room to stimulate should activity over-correct, while bears argue April’s mini-stimulus (involving additional spending on transportation and affordable housing) will be to little avail.

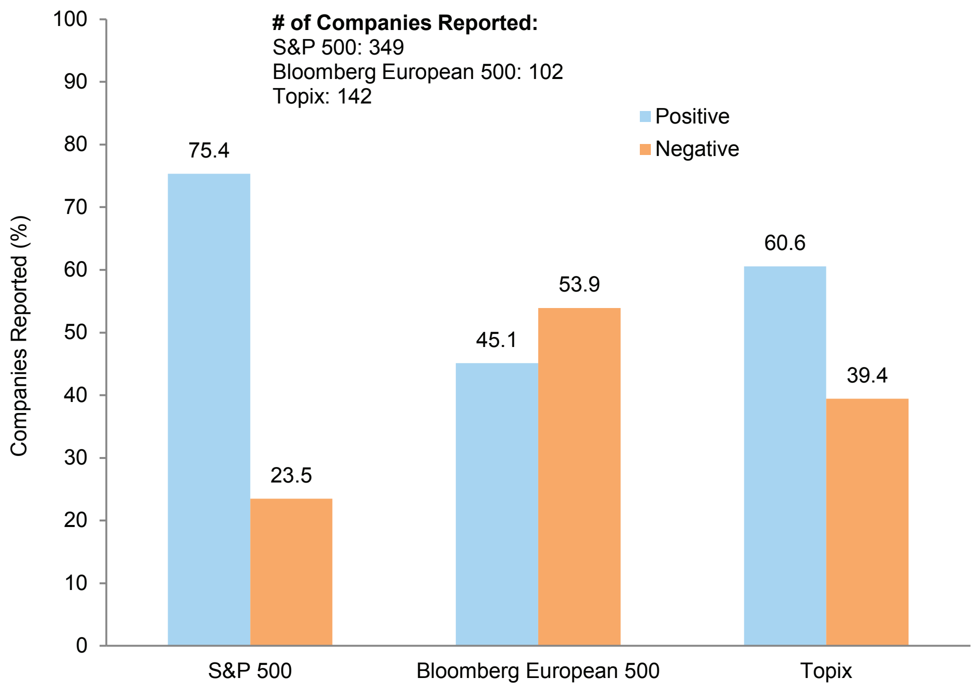
Japanese equities (-3.4%) suffered another disappointing month and have now massively underperformed developed world peers on a trailing 12-month basis (1.0% versus 16.2%). Foreign investors continue to abandon the market; despite increasing pressure on local institutions like the Government Pension Investment Fund to increase equity holdings, domestic investors don't seem to want to pick up the reins. While economic data have in general improved, significant foreign (and apparently local) skepticism remains about whether this is sustainable. For example, inflationary pressures may fade given the yen has consolidated against the US dollar, and April's increase in the VAT simply may have brought forward consumption. The elephant in the room remains massive sovereign debt levels. Still, expectations for Japanese corporate earnings growth in 2014 are similar to those in other markets, and the majority of firms have recently beaten or met expectations.

Fixed income returns were healthy across segments. The benchmark Barclays US Aggregate Bond Index returned 0.8% (2.7% year-to-date), slightly beating US high-yield's 0.6% return (3.6% year-to-date). Energy Future Holdings, the biggest leveraged buyout in history, filed for bankruptcy, impacting nearly $50 billion in liabilities. While this will send index default rates higher, it had been well telegraphed to markets for some time and was largely anticipated by bond and loan prices. Lower yields (US high-yield bonds offer just 5.0%) and weakening underwriting standards may be of more immediate concern to investors. For example, roughly one-third of year-to-date leveraged loan and high-yield bond issuance has financed acquisitions or leveraged buyouts, up from 26% last year, and nearly half of leveraged loans are being structured as "covenant lite." European sovereign bonds returned 1.0% for the month, as many yields on peripheral sovereign bonds fell to new lows and bond markets reopened to formerly shunned borrowers like Greece and Portugal.

Real assets enjoyed another strong month. Tension between Russia and Ukraine boosted prices of commodities like industrial metals and wheat, while weather and harvest–related concerns impacted everything from coffee to cattle. The DJ-UBS commodity index returned 2.4%, bringing its year-to-date total to 9.6% as the drag from negative roll returns fades and investors continue to return to the asset class. Real estate investments are enjoying a similar rebound; US REITs and Eurozone property securities returned 3.0% and 3.7%, respectively. Some US housing data were softer in April, as home sales fell and affordability deteriorated, though many analysts dismissed the sales data as a statistical aberration and noted mortgage rates have recently declined. ■

First Quarter Earnings Surprises: US, Europe, and Japan

First Quarter 2014

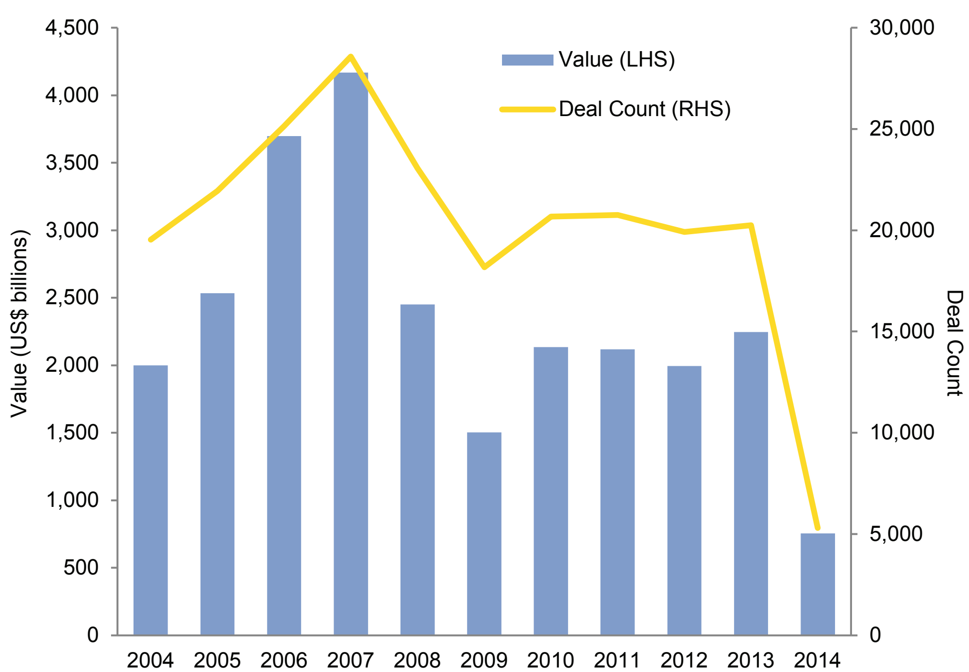


Sources: Bloomberg L.P., Standard & Poor's, Thomson Reuters Datastream, and Tokyo Stock Exchange Group, Inc.

The majority of US and Japanese firms are beating estimates while Europe again has disappointed; meanwhile expected EPS growth is declining across most markets

Global M&A Value and Deal Count

2004–14



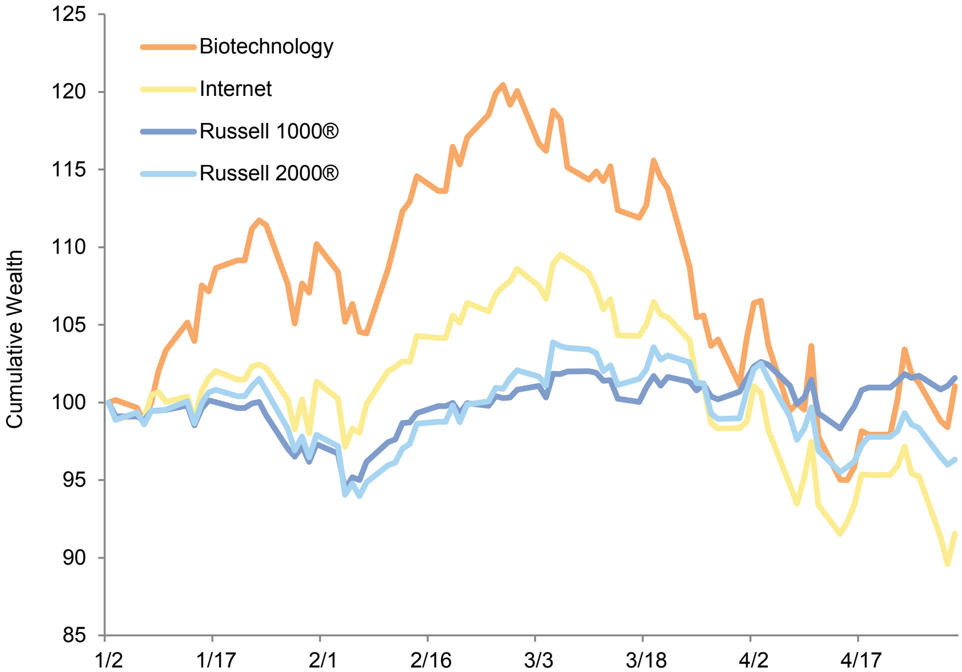
Source: Bloomberg L.P.

Note: Data for 2014 through first quarter.

The value of global M&A deals has increased thanks to a handful of large health care and cable transactions, but remains below pre–financial crisis levels and regulatory scrutiny is increasing given industry consolidation

US Sector Performance

January 1, 2014 – April 30, 2014

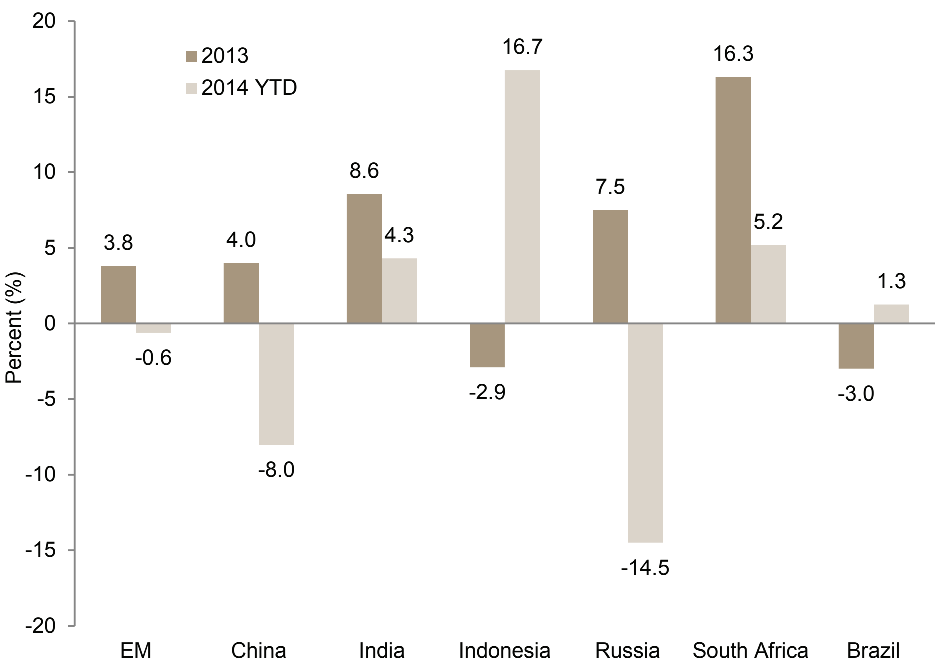


Sources: Dow Jones Indexes, Frank Russell Company, Nasdaq OMX, and Thomson Reuters Datastream.

After a subdued start to 2014 large-cap stocks are again outperforming; highflying biotech and Internet stocks have in recent weeks surrendered earlier outperformance

Emerging Markets Performance

As of April 30, 2014 • Local Currency

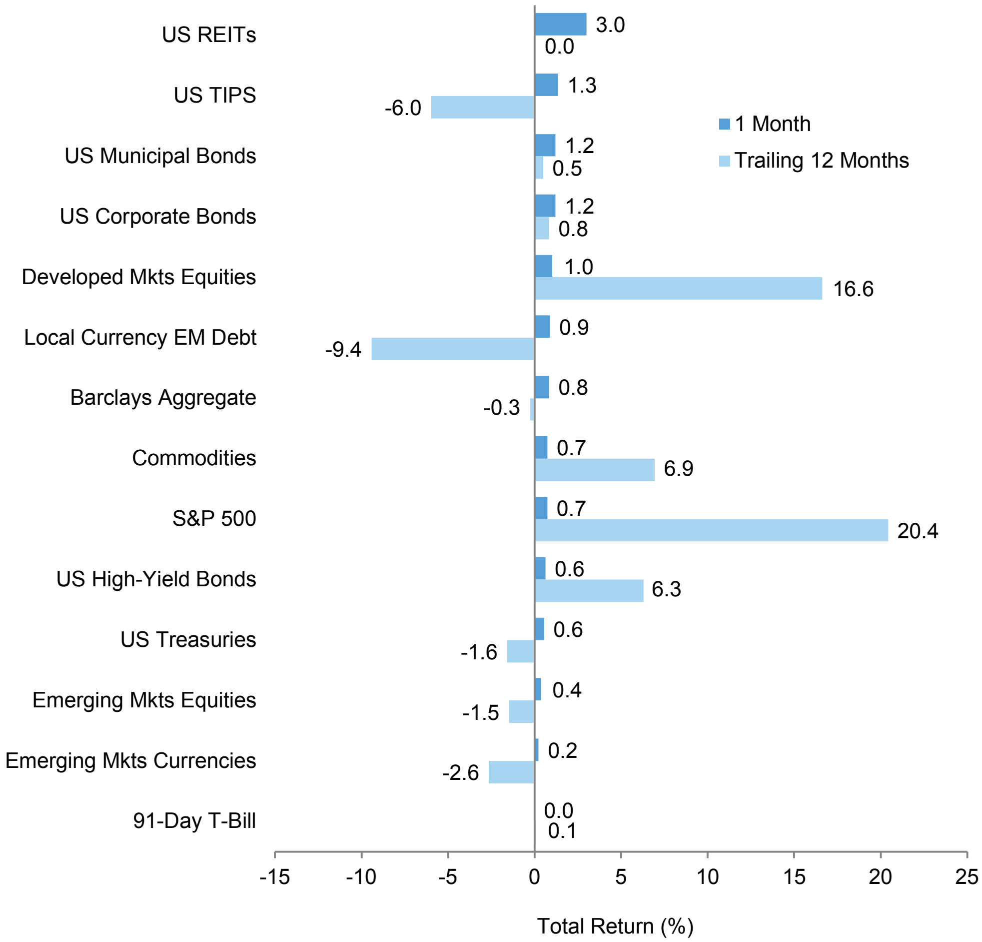


Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

EM stocks are flat year-to-date but some of the so-called Fragile 5 have more than recouped earlier losses as valuations reassert themselves and concern over upcoming elections fades

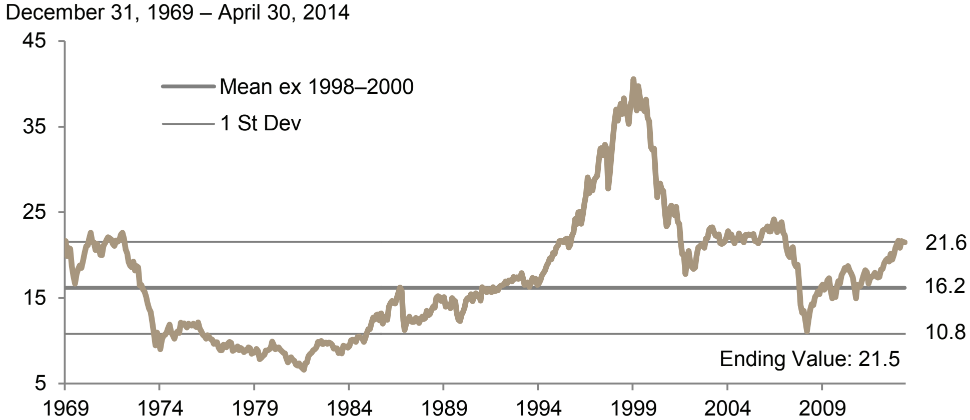
Index Performance (US$)

As of April 30, 2014



MSCI US Composite Normalized P/E

December 31, 1969 – April 30, 2014



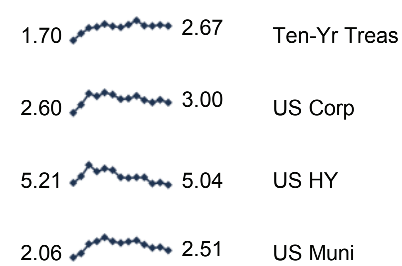
Sources: Barclays, BofA Merill Lynch, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

US equities and bonds generated similar returns in April, confounding equity bulls; commodities and real estate also had a strong month as investors rotated back into "real assets"

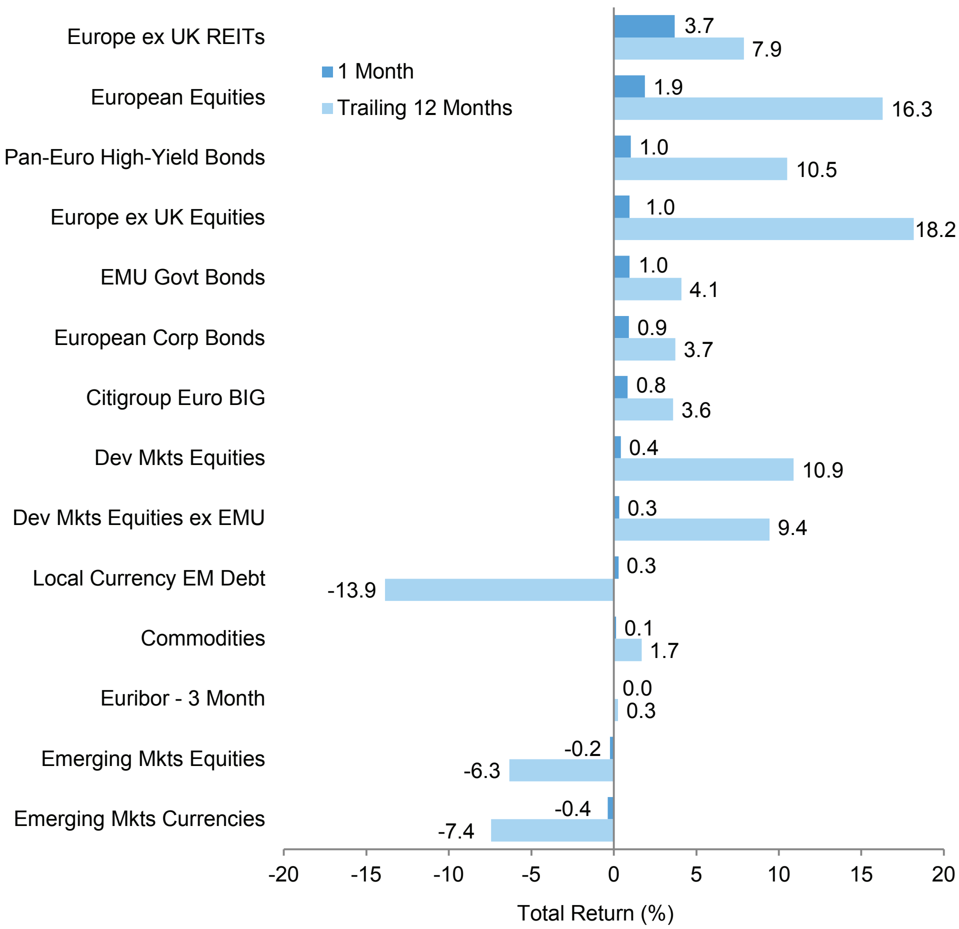
Fixed Income Yields

April 2013 – April 2014



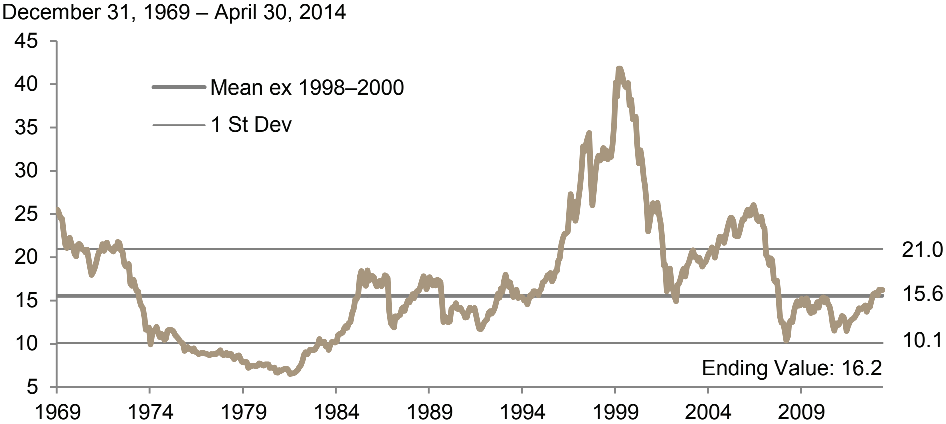
Index Performance (€)

As of April 30, 2014



MSCI Europe ex UK Composite Normalized P/E

December 31, 1969 – April 30, 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.

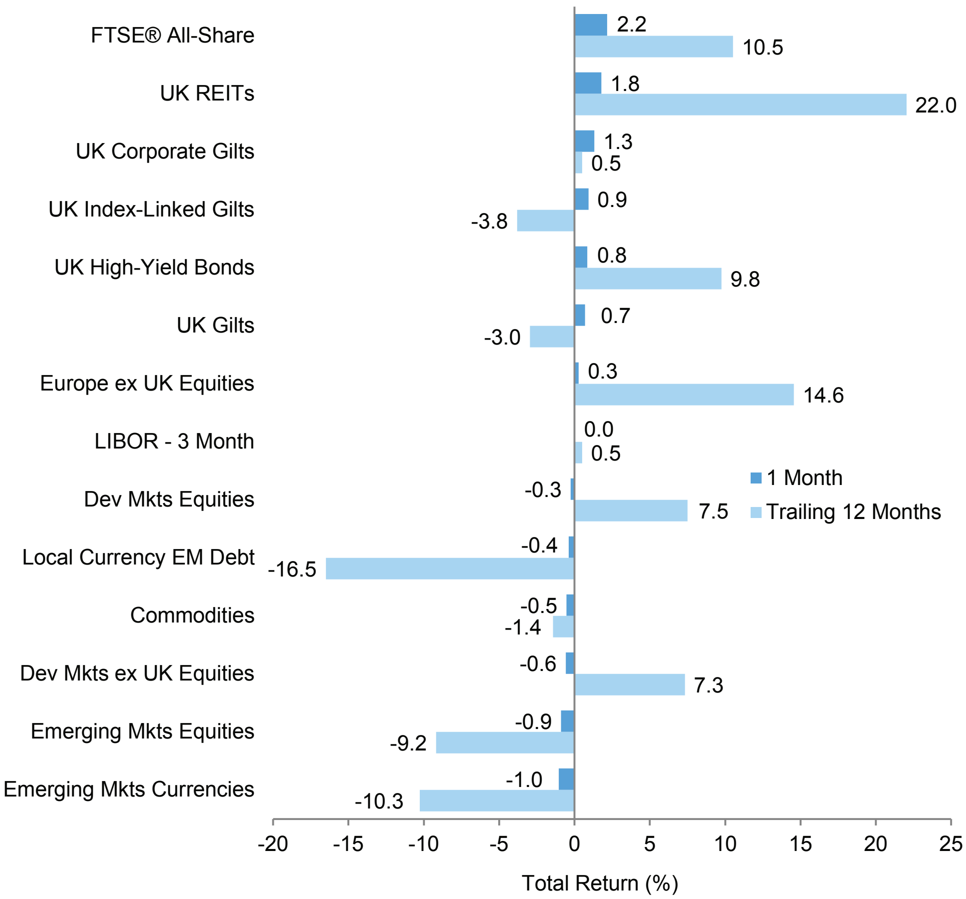
European equities outperformed in April despite weak earnings releases as macro data continued to improve; slow but steady growth and dampened inflation pressures also have lit a fire under sovereign bonds

Fixed Income Yields

April 2013 – April 2014

Index Performance (£)

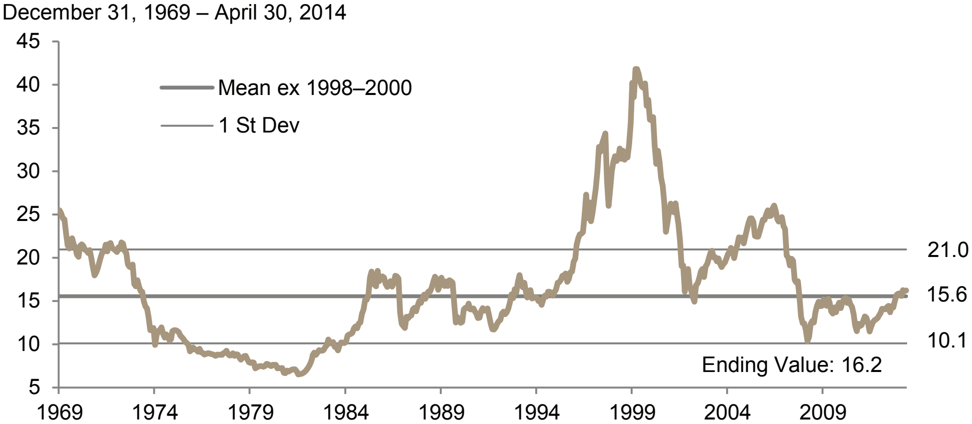
As of April 30, 2014



Stronger UK macro data have meant trailing fixed income returns have lagged those of Eurozone peers; equities fared well as the heavily weighted energy sector rebounded on healthier earnings

MSCI Europe ex UK Composite Normalized P/E

December 31, 1969 – April 30, 2014



Fixed Income Yields

April 2013 – April 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.
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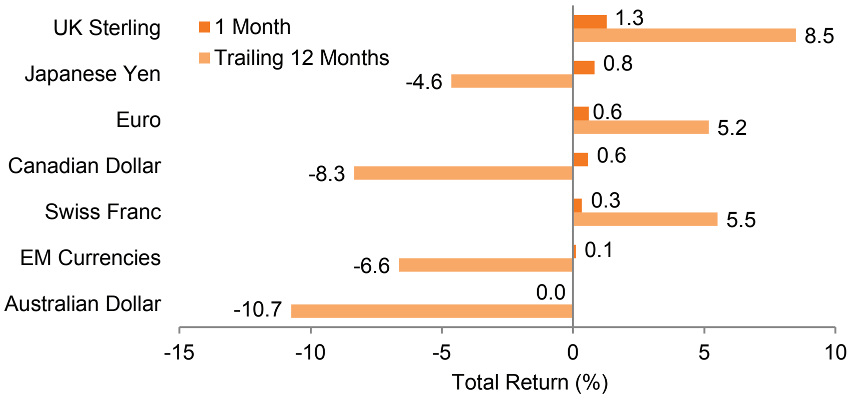
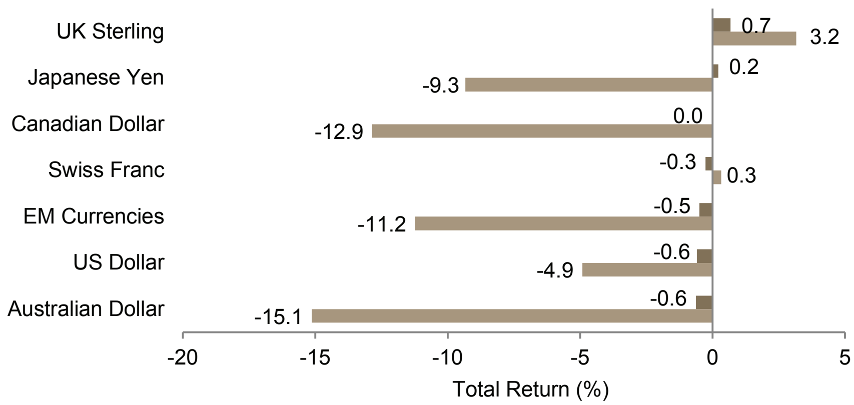
Currency Performance

As of April 30, 2014

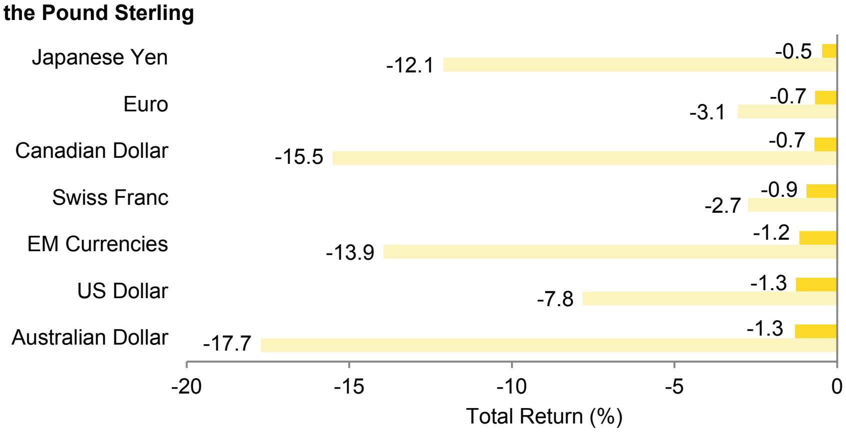
Versus the US Dollar



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.

Despite mostly positive economic data (and forecasts), the US dollar has slipped year-to-date against peers like the euro and pound as US rates have fallen; the euro has been supported by improving terms of trade and a soaring current account surplus

EM currencies were flat as some of the recent balance of payment improvement reversed for countries like Brazil; the pound was slightly stronger on better economic data

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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