 

Five Key Questions for 2015

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Will US equities continue to outperform global peers in 2015?

Is the macro environment in Europe getting worse and what does this mean for equity investors?

What will diverging global monetary policies mean for currency and fixed income markets in 2015?

Should investors position for rising commodity prices in 2015?

What events could roil markets in 2015?

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Five Key Questions for 2015

2014 has been a perplexing year for many investors. Investors that were underweight fixed income because of fears over Federal Reserve tapering missed out on healthy gains, as did those that were underweight US stocks given concerns over valuations and stretched margins. Rising volatility and disappointing returns from some alternative asset classes have added further insult to injury, probably causing some investors to question why they bothered adding complexity to their portfolios in the first place!

Unfortunately, 2015 may prove no less vexing. As always, we don't think "this time is different"—we continue to believe valuations and earnings growth will be the main drivers of equity returns (at least over the intermediate and long term), and starting interest rates will continue to determine bond returns. However, in regions where fundamentals are weak and monetary policy is expected to boost economic activity and earnings, the risk exists that these "beggar thy neighbor" approaches cancel one another out. October's volatility reflected what happens when elevated macro uncertainty and geopolitical tensions collide with stretched valuations, and could foreshadow things to come. A more optimistic spin is that these economic and policy divergences should create tactical investment opportunities, and valuations are not stretched to the same degree for all assets. Weighing the macro, micro, and "known unknowns," portfolios may struggle to generate returns next year comparable to those in 2013 or even perhaps the last 12 months.

In this piece we briefly review the year nearly past and then provide our thoughts on five key questions for 2015: Will US equities continue to outperform? Is the macro environment in Europe getting worse? What impact will diverging monetary policy have on currencies and bonds? Should investors position for rising commodity prices? And what are the events that could roil markets in 2015?

Looking back and looking ahead

2014: Recap

Heading into 2014, the consensus was that a synchronizing global growth cycle, led by the United States, would see a variety of economic data points improve. Stronger US growth would then give the Fed a green light to taper its bond purchases, causing rates to rise and the dollar to strengthen. The Eurozone and Japan would not keep pace but would see improvement over their recent histories; 1% growth was expected for the former and even more for the latter. Accommodative monetary and fiscal policies were viewed as keys to recovery for these regions, as were structural reforms that would boost corporate profits. Chinese economic expansion was expected to be far stronger at 7.4%, but this belied significant skepticism in the market about the toll from rebalancing and unsustainable real estate trends. At the end of 2013, asset allocators favored stocks over bonds and, within this framework, developed markets over emerging markets given Fed tapering and a belief that higher US rates would lead to emerging markets capital outflows. According to Bloomberg, nearly all economists called for rising US Treasury yields; the median expectation last December was for the ten-year Treasury yield to rise by year-end 2014 to 3.0%.

As often happens, things worked out slightly differently, though to varying degrees. US economic growth thus far has indeed exceeded that in other developed regions, but despite the second and third quarters together representing the strongest six months of growth in over a decade, a weak first quarter means growth for 2014 is now expected to be in line with recent averages. According to the International Monetary Fund's (IMF's) latest economic forecasts, the US economy will expand 2.2% in 2014, exactly the same pace as 2013 and just a touch below 2012's 2.3%. The Eurozone did manage to exit recession in the first quarter, but then saw growth promptly flat line in the second quarter. While financial headlines have warned of a Eurozone "growth scare," if 0.8% annual growth is delivered rather than the 1.1% predicted in January this could hardly be characterized as a major miss given *negative* growth the previous two years. Crashing inflation numbers in the Eurozone are, however, a real threat—the most recent data show consumer prices increased by just 0.3% (year-over-year) in October. Meanwhile Japan, which restored inflationary pressures in 2013 and had a surge in first quarter growth, saw activity promptly collapse in the second quarter as the higher consumption tax took effect, and may grow around 1.0% in 2014 versus the expected 1.5%. Finally, China seems to again have defied the skeptics and growth expectations have remained fairly steady around 7.3%, though in part this is because the government was forced along the way to resort to a number of "mini stimulus" measures such as easing lending restrictions and reducing certain interest rates.

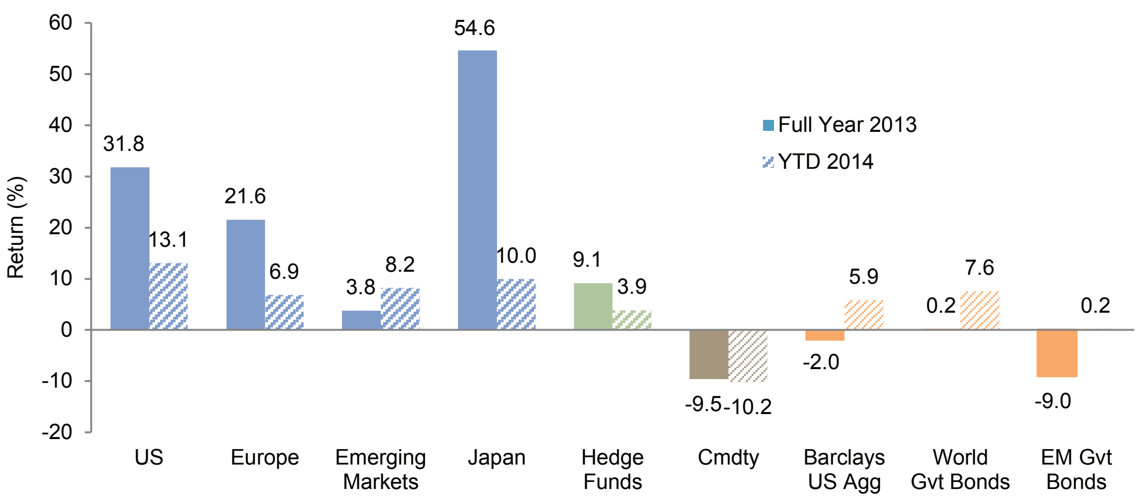
Thankfully we are not in the difficult business of economic forecasting but do offer asset allocation advice based on valuations and return potential, factoring in potential for alpha across asset classes. Looking back, our suggested portfolio tilts have had a mixed track record in 2014, although most of our views have a longer time horizon than one year.[1] Holding equity allocations at targets seems accurate, as stocks have been volatile but fared better than bonds and diversifiers (Figure 1). Within this bucket we suggested an underweight to US equities in favor of an overweight to Europe and emerging markets[2]; the former was close at mid-year but has steadily faded, and the latter was profitable only briefly (emerging markets equities heavily outperformed in July). Other positions we've advised fared better in 2014. For example, our suggestion to underweight US small caps in favor of quality stocks worked very well; year-to-date through the end of November, the Russell Top 200®

[1] Our views on individual asset classes can be found in our monthly *Asset Class Views* publication; our quarterly *VantagePoint* publication provides the view of our Chief Investment Strategist on asset allocation and portfolio construction.

[2] Please see Celia Dallas et al., "Emerging Markets: Navigating Through Rough Waters," Cambridge Associates Market Commentary, February 2014, and Wade O'Brien et al., "Slowly But Surely: Investors Should Stay the Course on European Equities," Cambridge Associates Research Note, June 2014.

"Holding equity allocations at targets seems accurate, as stocks have been volatile but fared better than bonds and diversifiers."

Figure 1. Global Asset Class Performance
As of November 30, 2014 • Local Currency



Sources: Barclays, Bloomberg L.P., Hedge Fund Research, Inc., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Asset classes represented by: MSCI US Index ("US"), MSCI Europe Index ("Europe"), MSCI Emerging Markets Index ("Emerging Markets"), MSCI Japan Index ("Japan"), HFR Fund Weighted Composite Index ("Hedge Funds"), Bloomberg Commodity Index ("Cmdty"), Barclays US Aggregate Index ("Barclays US Agg"), Citigroup World Government Bond Index ("World Gvt Bonds"), and JP Morgan Government Bond Index - Emerging Markets Global Diversified Index ("EM Gvt Bonds"). Total returns for MSCI developed markets indexes are net of dividend taxes. Total returns for MSCI emerging markets indexes are gross of dividend taxes. Data for hedge funds are as of October 2014.

Looking back and looking ahead

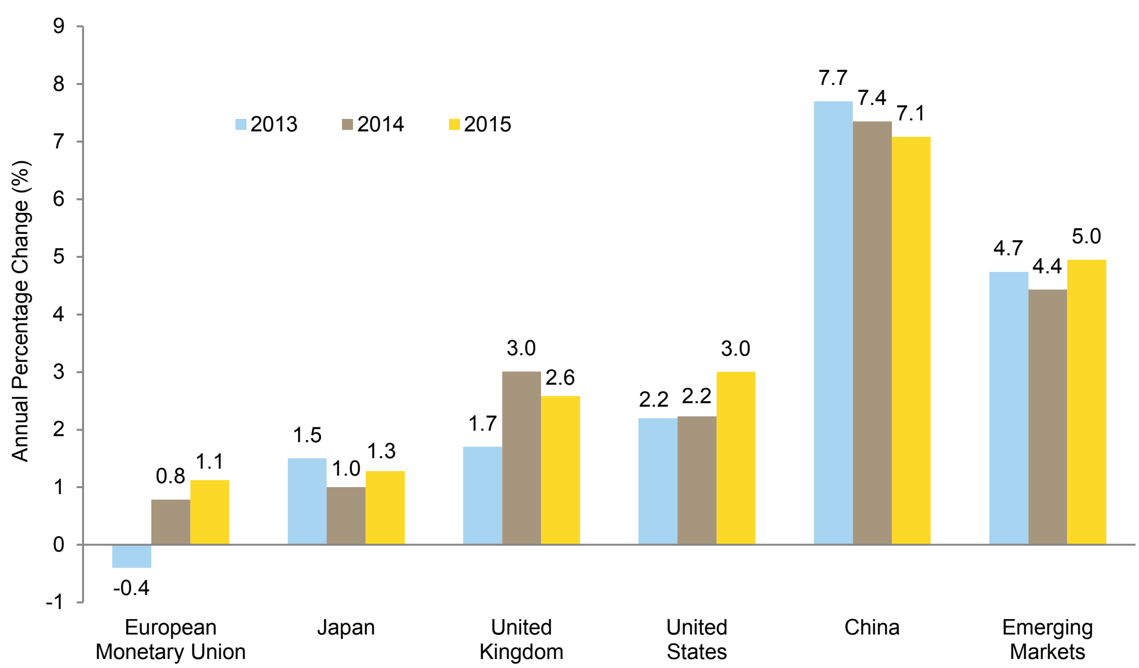
"Economic forecasts are similar to where they were 12 months ago ... and equity valuations are also similar to where they were last December."

Growth Index had outperformed the Russell 2000® by over 1,000 bps. We cautioned that most credit assets were unattractive compared with high-quality equities or defensive strategies such as long/short hedge funds. High-yield bonds have massively trailed stocks; in long/short, as always, manager selection has proved key. Like the consensus, we suggested being underweight duration going into 2014 with the rationale that current yields suggested low intermediate-term returns; while we have missed out on reasonable returns for the year, the current 2.2% yield on ten-year US Treasuries is likely to weigh on returns going forward.

2015: More of the Same?

Economic forecasts are similar to where they were 12 months ago. The US economy is (again) expected by the consensus to grow 3% and Japan and the Eurozone are (again) expected to grow around 1% (Figure 2). Meanwhile, China is (again) expected to gradually decelerate yet still post over 7% growth, though some emerging markets regions (like Latin America) may pick up the pace. The consensus is (again) expecting ten-year US Treasury yields to rise (this time to 3.2%), and (again) for the dollar to rise against the euro and the yen (current forecasts versus the US dollar

Figure 2. Consensus Real GDP Forecasts
2013–15



Sources: Consensus Economics and Thomson Reuters Datastream.
Note: Country forecast data are as of November 2014.
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are 1.20 and 116, respectively). Finally, equity valuations are also similar to where they were last December given a combination of lackluster returns and subdued earnings, and most strategists continue to recommend stocks over bonds with some disagreement about regional tilts.

However, we would be remiss if we did not highlight that several things have changed over the course of 2014 that have the potential to impact return patterns next year. Monetary policy divergence, while not a new theme,[3] has had a pronounced impact on certain currency pairs in recent months. Bond markets also are pricing in this theme to a greater extent; by the end of 2015 ten-year German bund yields are expected to be around 200 bps lower than US equivalents. Commodity prices built on their 2013 weakness and have fallen around 10% since the start of 2014, which will continue to impact profit margins, trade balances, inflation statistics, and a variety of related asset classes including inflation-protected securities, natural resources equities, and select emerging markets equities. Looking at equities more broadly, earnings growth is converging across regions, but this may obscure more concerning dynamics such as rising corporate leverage and thin liquidity.

Given this backdrop, we have identified five key questions for 2015. How these questions are answered will go a long way toward determining portfolio returns, though this is of course not an exhaustive list. As was the case in 2014, markets have a funny way of introducing unexpected developments.

"As was the case in 2014, markets have a funny way of introducing unexpected developments."

[3] In fact, this topic was a key part of our 2014 outlook: Celia Dallas et al., "Our View on 2014: It's All Relative," Cambridge Associates Market Commentary, December 2013.

Will US equities continue to outperform global peers in 2015?

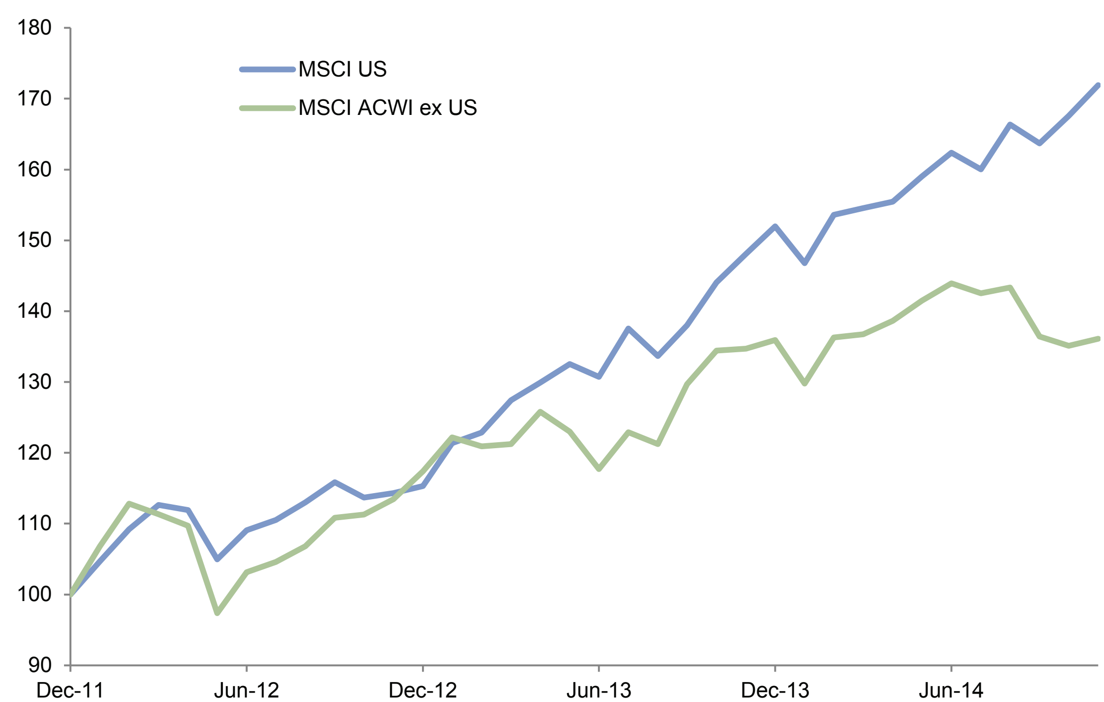
Unlikely. US equities strongly outperformed international peers in 2013 (Figure 3), as investors ignored earnings growth only slightly above that seen in other markets while multiples rerated higher. For 2014 year-to-date, US equities have outperformed by a smaller degree; the S&P 500 has returned 14% while the MSCI World and Emerging Markets indexes were up 11% and 8%, respectively. Converging regional earnings growth and higher valuations (Figure 4) have dampened US equity outperformance. This trend should continue in 2015, as earnings growth is expected to be similar across regions, relative valuations have grown more stretched, and red flags about the quality of US corporate earnings are rising.

Earnings growth in the United States for 2015 is predicted to again surpass its 6.3% long-term average, but predictions are more modest for domestic GDP growth—a decoupling that can be explained in several ways. One is the growing reliance of US companies on higher margin foreign markets, which helps explain why margins stand 25% above their historical average.[4] Another is weak wage growth in the United States due to elevated jobless-

[4] For more on this, see Bob Sincerbeaux, "Have Lofty US Corporate Profit Margins Finally Turned a Corner?," Cambridge Associates Research Brief, October 13, 2014.

Figure 3. Cumulative Wealth of US and Global ex US Equities

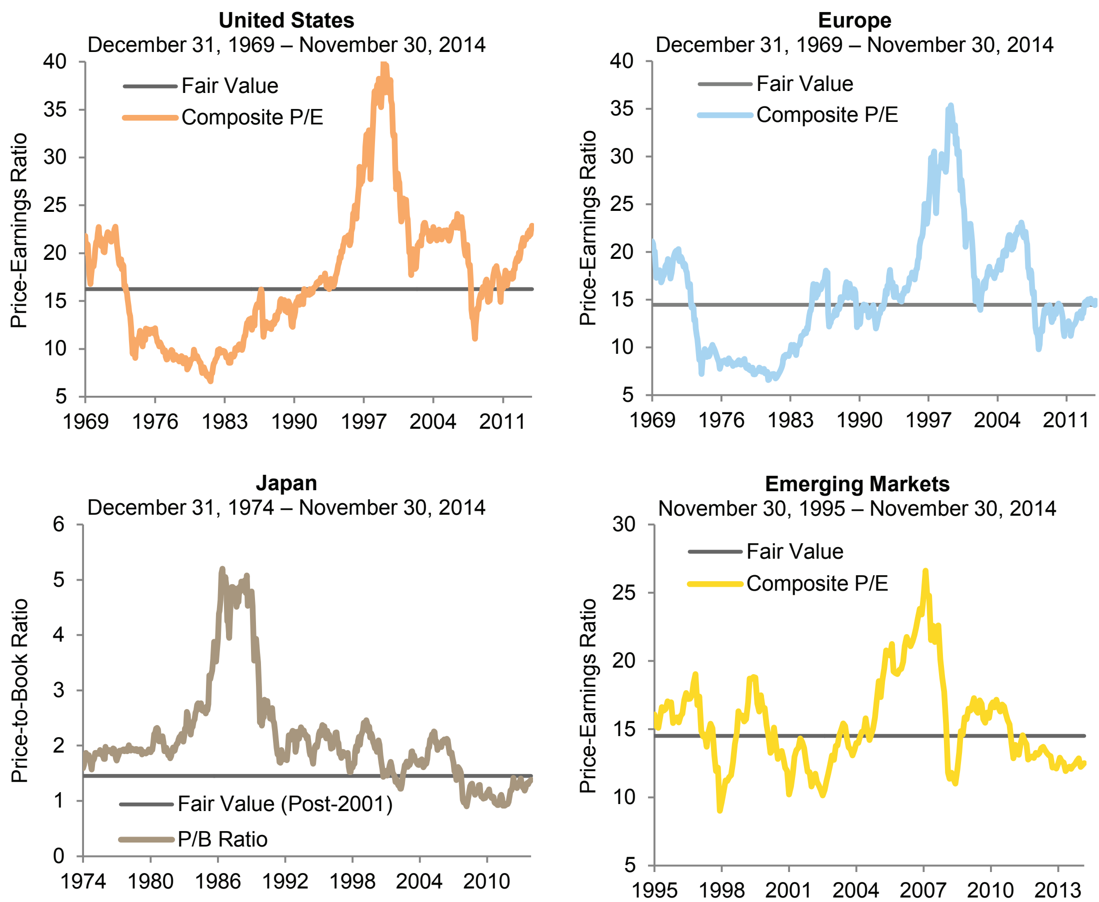
December 31, 2011 – November 30, 2014 • December 31, 2011 = 100



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

"Converging regional earnings growth and higher valuations have dampened US equity out-performance."

Figure 4. MSCI Equity Valuations



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

Notes: The composite normalized price-earnings 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 (the level of earnings based on a linear regression of real earnings growth), and return on equity (ROE)–adjusted earnings (adjusts current earnings for the ratio of current ROE to long-term average ROE).

ness, though some signals suggest the labor market may be tightening. Whether this development leads to wage inflation remains to be seen. Finally, the growing practice of using share buybacks to boost *per share* earnings growth has by some estimates contributed 25% to 30% of recent earnings per share (EPS) growth.[5]

[5] For more on this, see Alex Jones, "Yakety Yak, Just Buyback," Cambridge Associates Research Brief, September 12, 2014.

S&P 500 companies will spend over *90%* of earnings in 2014 (over $950 billion) on share buybacks and dividends, a statistic that should raise several flags for investors. Corporations are increasing their share buybacks despite the massive run-up in stocks over the past five years, begging the question of whether some are once again misallocating capital by making

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"Though earnings forecasts are almost always too high, the market's tolerance for disappointment may be fading as stocks get more expensive."

equity purchases following a rising equity market. Rating agencies, credit investors, and even equity investors themselves may eventually tire of a practice that limits investment and reduces balance sheet flexibility. While capital expenditures have only declined slightly in recent years and US corporate leverage has actually fallen, the risk is that interest rates rise and some of the debt issued to finance buybacks eventually becomes more expensive. In 2014, US companies turned to other tools such as acquisitions and tax inversions to boost earnings, but if regulatory scrutiny continues to tighten, these earnings drivers too may become less potent.

These stretched fundamentals help explain why US earnings growth may drop to 6% this year. The bar is also higher for US earnings growth given a higher base. Though earnings forecasts are almost *always* too high, the market's tolerance for disappointment may be fading as stocks get more expensive. One potential positive wildcard for earnings next year is energy prices (more on this later). Given around 5% of US household spending goes to gasoline, a *sustained* 30% drop in crude prices will serve as a massive tax cut and could boost consumption, which is around 70% of the US economy. Another wildcard is the strength of the US dollar, which could reduce the value of overseas sales for US companies. Over the last several weeks, a variety of blue chip US companies have all sounded the alarm over the impact of cheaper currencies on future profits.

The flipside of underweighting US stocks is determining what to overweight. Valuations for other developed and emerging markets peers look more compelling (Figures 4 and 5), and earnings growth is expected to be similar across regions (Figure 6). Further, developed markets companies in Japan and Europe have not used high levels of buybacks to boost EPS growth in the same way as US peers; should this change, earnings estimates could increase. Balance sheets in other markets reflect these dynamics; for example, Japanese companies now sit on $2.3 trillion in cash, roughly 50% more than US equivalents.

Japanese stocks are around 15% cheaper than US equities based on a trailing price-earnings basis and around 50% cheaper when comparing price-to-book ratios. Japanese earnings may continue to receive a boost from further yen weakness given currency translation effects, though a renewed focus on shareholder returns by many Japanese companies is also helping. The recent drafting of the Stewardship Code and creation of the JPX Nikkei 400 has galvanized management attention, as qualifying for listing may attract the attention of the main Japanese government pension fund, which is ramping up its purchases of domestic equities. A number of other domestic institutions are expected to follow suit, in part because infla-

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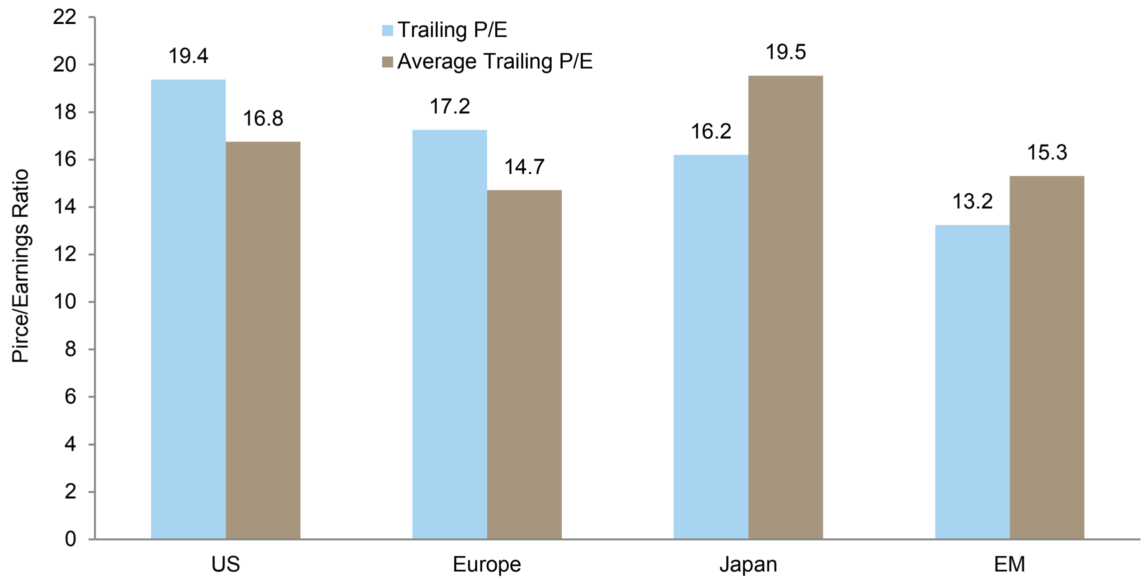
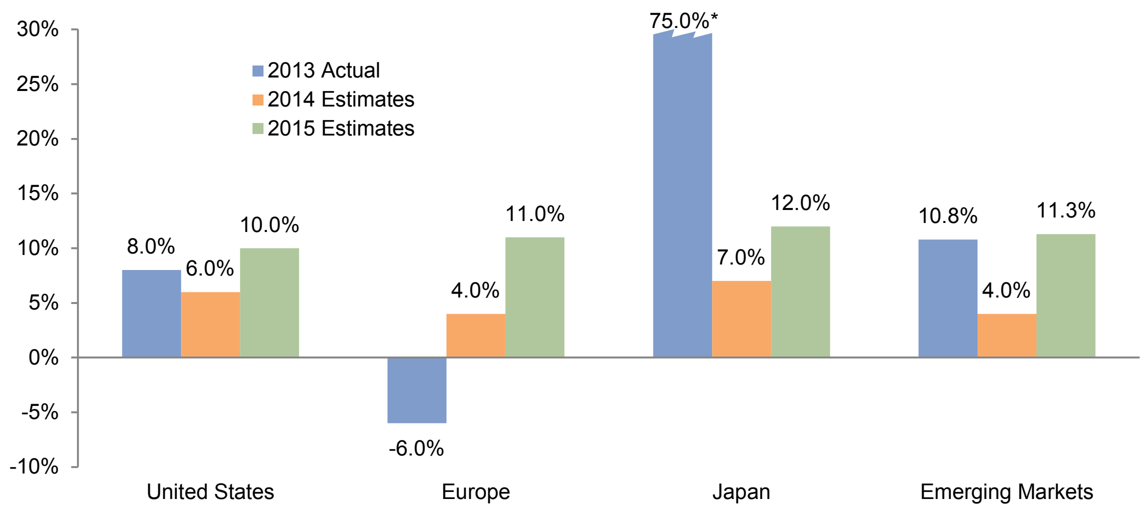
Figure 5. Regional Equity Valuations
December 31, 1969 – November 30, 2014



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

Figure 6. Earnings Growth Expectations
As of November 30, 2014



Source: J.P. Morgan Securities, Inc.
Note: Japan EPS growth estimates are for its fiscal years ending March 2015 and March 2016, respectively.
* Actual 2013 EPS growth for Japan equal to 75%, graph capped at 30% for scaling purposes.

Will US equities continue to outperform global peers in 2015?

tion will weaken real bond returns. Downside risks can't be ignored, though some macro risks such as high debt burdens and demographics may have a long fuse. In the near term, the bigger risk for the success of Abenomics may be that households have not fully shared in the recent benefits, which could lower political support but also reduce earnings for companies that focus on domestic consumers.

European equity valuations have barely moved over the course of 2014 and are roughly 35% cheaper than US equivalents on a normalized basis and around 15% cheaper using forward earnings.

As the flip-side to US$ strength, European earnings should get a boost from currency weakness, which boosts the value of their foreign sales, as well as a recovering financial sector that may post smaller write-offs. Around 30% of expected earnings growth this year will come from the heavily weighted financial sector, although much of this is not coming from new lending as much as lower write-offs from a handful of firms that took extensive provisions for nonperforming loans in 2013. In the third quarter, for example, European financial earnings were up 30% year-over-year as some of these institutions returned to profitability. Low interest rates reduce debt servicing costs and should boost margins in some sectors, but whether this is enough to offset flagging domestic appetite remains to be seen.

None of this is to downplay the risks for earnings. Stagnant domestic economies are not fertile ground for margin expansion, and the large exposure of European firms to emerging market revenues may be coming full circle as emerging markets growth cools. Financials are under an increasing amount of regulatory scrutiny, which raises costs and restricts their ability to conduct some businesses. Charge-offs may continue for past sins. Some of the companies with the weakest earnings (like utilities and telecoms) don't actually have high international sales and some of their reduced profitability may be structural, though consolidation in the case of the former may boost margins.

Is the macro environment in Europe getting worse and what does this mean for equity investors?

We don't think the recent data or political tensions in the Eurozone reflect a marked change in the underlying health of its economies (or lack thereof) and continue to find European equities attractive based on valuations.[6] This said, we recognize investors are increasingly concerned about the potential for stagnation and deflation in the Eurozone, and thus may demand a bigger discount to hold European stocks. Whether the current discount between European equities and US peers will close due to improving fundamentals/earnings in the former or the realization that stretched valuations will cap further upside in the latter is an open question. However, as both are plausible, we continue to suggest overweighting European stocks.

Disappointing economic activity in the Eurozone certainly has drawn a fair amount of scrutiny in recent months. GDP growth flat-lined in the second quarter and rebounded only modestly in the third quarter, while inflation has dropped to just 0.3%, fuelling concerns over disinflation and debt sustainability. These data come against a backdrop of rising political tension between European Union members over deficit targets and the related surge in popularity of extremist political parties, as well as deteriorating relations with key trading partners like Russia.

[6] For more on this topic and misplaced comparisons between Europe and Japan, please see Wade O'Brien, "Are European Equities About to Suffer a Japan-like Lost Decade?," C|A Answers, October 28, 2014.

Though clearly negative for sentiment, weak growth is hardly new news and has been present since the outset of the sovereign debt crisis; the Eurozone economy has effectively flat-lined since 2008. The diverging growth prospects across member states and resulting political frictions are also not surprising and context is important. For example, while extreme political parties in Greece are gaining traction, what matters more for investors in European or international equity funds is that the country's tiny equity market was demoted to emerging markets index status and its debt is primarily held by official institutions like the IMF. In addition, not all of the news from the periphery is negative; for example, Ireland has exited its bailout and Spain recently raised its growth forecast.

Eurozone policymakers retain some fiscal and monetary flexibility to reduce stresses, though they may wait for times of maximum stress in the market to use these tools, increasing investor angst. Total Eurozone sovereign debt levels remain in line with those of global peers as fiscal policy in aggregate has been tighter than in other regions since the financial crisis, leaving room for at least some countries to stimulate. The European Central Bank (ECB) has thus far resisted buying sovereign bonds, but is doing everything else in its power to keep rates low and try to boost lending activity. The ECB has cut benchmark rates effectively to zero, is

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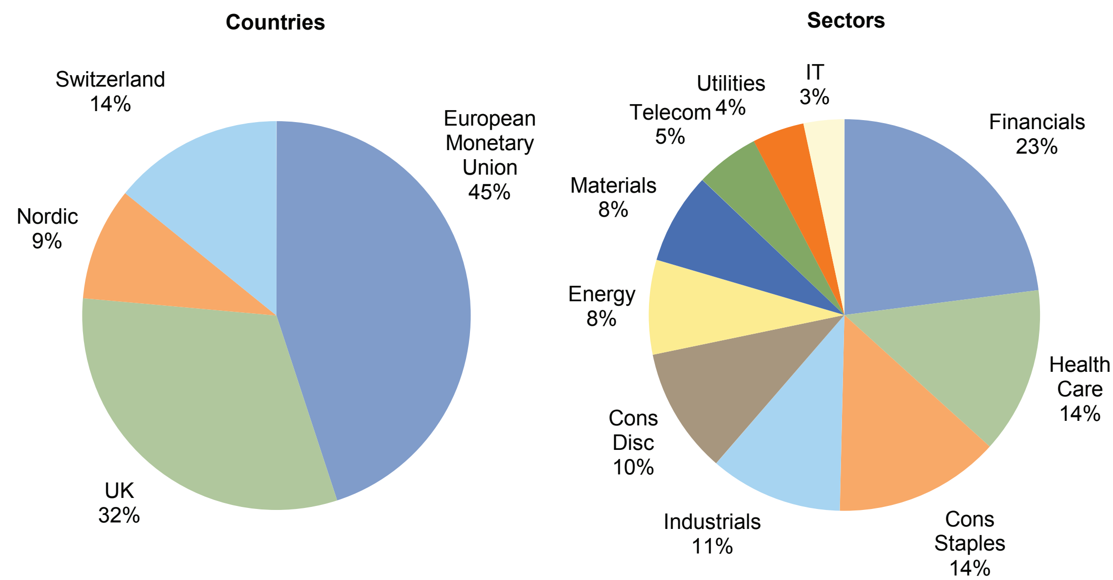
Figure 7. MSCI Europe Regional and Sector Weights
As of November 30, 2014



Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

charging banks to park cash with it, and is expanding its asset purchases in an effort to increase its balance sheet by around 50% to €3 trillion. Low rates may not spur credit growth when households are deleveraging and banks are capital constrained, but they do increase debt affordability, an indirect, though weaker, form of stimulus.

We continue to find European equities attractive based on valuations and earnings potential. The macro picture could be better, but investors under-weighting European stocks on macro grounds may be overlooking that European Monetary Union countries only contribute 45% of MSCI Europe market cap (Figure 7). Macro data from non-Eurozone countries have been healthier. For example, UK growth has recently been similar to that of the United States and countries like Norway and Switzerland have far lower debt levels. In any case, links between economic growth and shareholder returns or earnings are nebulous over short- and intermediate-term timeframes. For example, the cumulative return for the S&P 500 since the start of 2012 has been 75%, roughly ten times the expansion in the underlying economy. Of course, this statistic alone should raise eyebrows.

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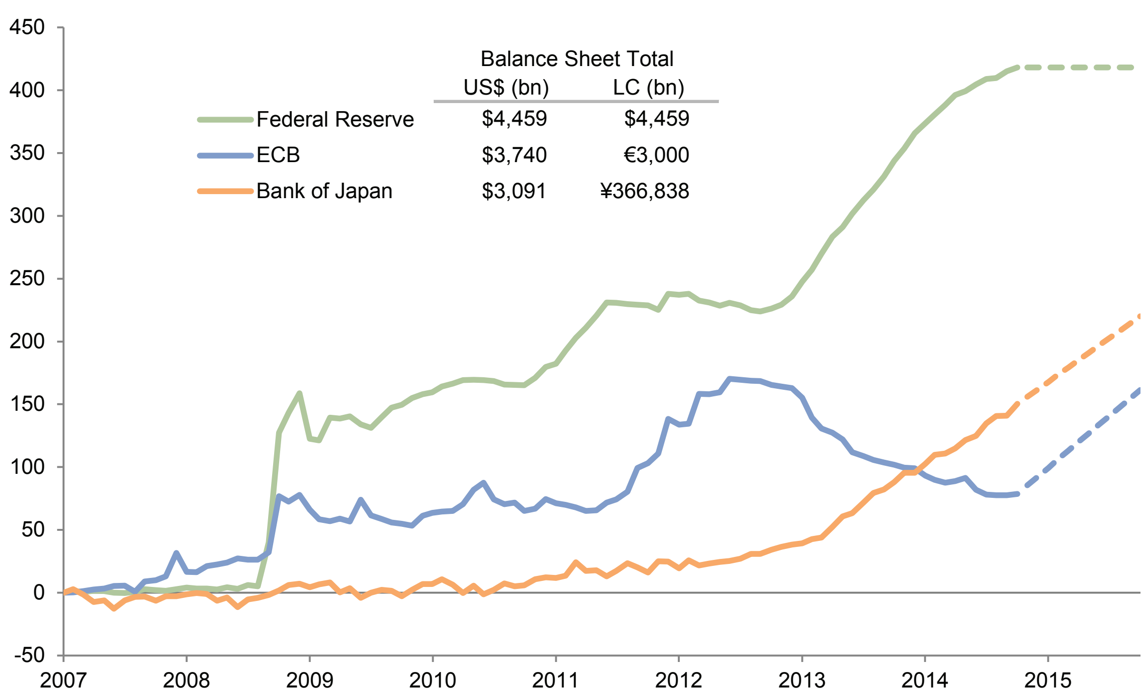
What will diverging global monetary policies mean for currency and fixed income markets in 2015?

Some currencies are likely to continue depreciating over the course of 2015, and yields on developed markets bonds are likely to remain suppressed due to the direct and indirect effects of quantitative easing programs in Europe and Japan.

As 2014 draws to a close, one of the biggest stories in financial markets is diverging monetary policies across the world's central banks. The ECB cut interest rates twice (to effectively zero) over the summer, began charging banks for the privilege of holding their deposits, and stated its intention to increase its balance sheet by around €1 trillion. However, it lags behind the Bank of Japan (BOJ), whose main base rate has been near zero for an extended period and in October announced its intention to (again) dramatically increase its QE activities (Figure 8). Conversely, in October the Fed concluded its asset purchase program and has raised its targets for the benchmark Federal Funds rate at the end of 2015. Meanwhile, emerging markets countries are responding in a variety of fashions—some have cut interest rates in an attempt to also depreciate currencies and maintain exports while others have been forced to prop up currencies (mainly by selling FX reserves) given the unde-

Figure 8. Central Bank Balance Sheet Expansion

December 31, 2006 – October 31, 2015 • Local Currency



Source: Thomson Reuters Datastream.

Note: Projections begin after October 31, 2014.

What will diverging global monetary policies mean for currency and fixed income markets in 2015?

"Dollar strength seems likely to persists for some time, given that currency trends can last for extended periods and that higher relative US real rates will be supportive."

sired side effects of weak currencies like rising inflation.

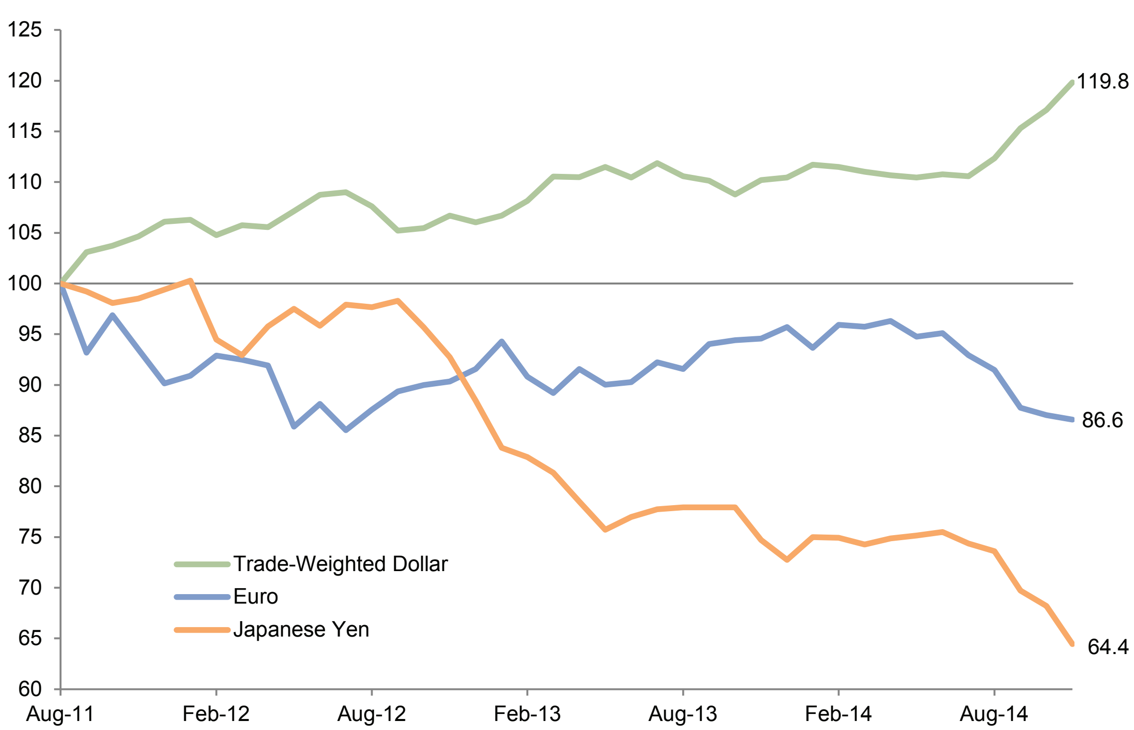
The foreign exchange markets have recently seen large moves given changing monetary policy, as well as diverging growth and inflation trends across regions. Overall, the US dollar has risen around 8% on a trade-weighted basis since early July (Figure 9), reflecting appreciation against a basket that is roughly equal parts developed and emerging currencies. Looking at individual pairs, the euro and the yen have recently been standout developed markets losers, though they have shined compared to the Russian ruble, which is down 33% year-to-date. Other emerging markets currency depreciations have in some cases been capped by previous movements; for example, the Brazilian *real*, the South African rand, and the Turkish lira all fell between 15% and 25% against the US dollar in 2013.

Dollar strength seems likely to persist for some time, given that currency trends can last for extended periods and that higher relative US real rates will be supportive.[7] Exact dollar performance in 2015 is hard to predict, but valuations may prove an imprecise guide. For example, after

[7] For more on this topic, please see Stephen Saint-Leger et al., "US Dollar Strength: Here to Stay?," Cambridge Associates Research Brief, October 24, 2014.

Figure 9. Depreciation of Major Currencies vs the US Dollar

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



Source: Thomson Reuters Datastream.

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"While disinflationary pressures may be slightly more acute in places like the Eurozone, they will also be present and enhance inflation-adjusted yields in the United States."

another 11% drop year-to-date and a cumulative *35%* decline against the US dollar since the start of 2012, the yen now appears slightly undervalued by several metrics. Still, with the BOJ aggressively in easing mode, all forecasts are for further yen weakness in 2015. In a similar vein, the fact that many emerging markets currencies have fallen 30% to 40% cumulatively against the dollar in recent years has improved valuations and suggests further downside risks are limited. However, many forecasts are for further currency weakness given that lower commodity prices put pressure on balance of payments and slower growth may cause many countries to cut interest rates. Some emerging markets countries also may be forced to weaken their currencies to avoid exporters being disadvantaged relative to Japanese competitors; we note in recent weeks movements from the Chinese and Korean central banks on this front. This could be the first whiff of the feared currency wars discussed over the past few years and is an area we intend to watch closely.

At first blush, bond markets seem to be struggling to process the message that monetary policies are diverging. Eurozone and Japanese interest rates are declining as one would expect, and ten-year government bond yields in both of these markets are now below 1%. This will likely substantially limit further price gains, though downside risks also seem to be limited given ongoing quantitative easing. The curious thing is that US yields *are also falling*—despite the Fed telegraphing its intention to hike rates.

This seeming paradox can be explained several ways. Lower interest rates in other markets increase the relative attractiveness of owning US Treasuries. Many of the forces that limit inflationary pressures are global, including elevated debt levels, which reduce aggregate demand and lower commodity prices.[8] So while disinflationary pressures may be slightly more acute in places like the Eurozone, they will also be present and enhance inflation-adjusted yields in the United States.[9] Finally, the policy and technical backdrop for interest rates within the United States may be more dovish than commonly perceived.

The Fed's dual mandate includes both inflation and the health of the labor market. Job growth in the United States has picked up this year and average non-farm payroll growth has been the best in 15 years. But, the underlying quality of these jobs has been lacking as evidenced both by the categories of jobs seeing the highest gains (service sector, etc.) and the lack of underlying wage pressures. Notwithstanding some recent signals that wage pressures might be building in the United States, the Fed may be reluctant to hike short-term rate hikes given knock-on effects on longer-term rates and the potential

[8] For more on this topic, please see Eric Winig et al., "Money, Money Everywhere ...," Cambridge Associates Research Brief, November 14, 2014.
[9] According to JPM Asset Management, roughly 80% of the recent decrease in Eurozone inflation rates is due to falling food and energy prices.

What will diverging global monetary policies mean for currency and fixed income markets in 2015?

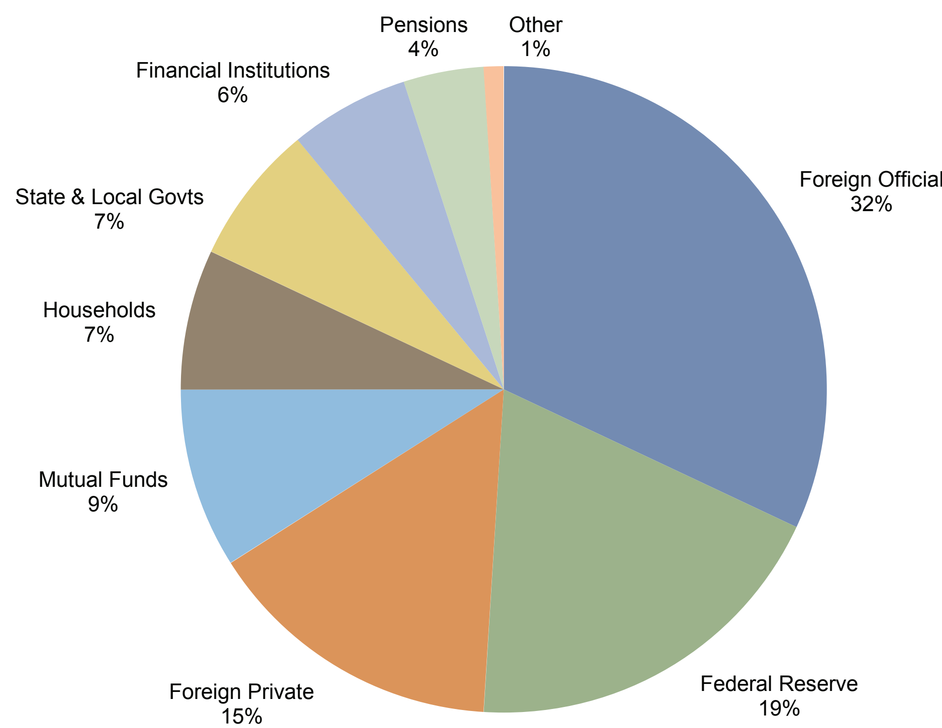
"Even if the Fed lifts the Fed Funds rate as quickly as it currently forecasts, factors may limit the increase in yields on longer-duration bonds."

impact of the latter on real estate and auto markets—important drivers of employment.[10]

Even if the Fed lifts the Fed Funds rate as quickly as it currently forecasts, certain technical factors may limit the increase in yields on longer-duration bonds. Demand today and going forward for long-dated fixed income assets from domestic buyers like pension funds exceeds supply. This helps explain why corporates, emerging markets sovereigns, and others obtain extremely low interest rates when issuing 30-year or even 100-year bonds. Foreign buyers such as central banks own nearly 50% of outstanding US Treasuries, while state and local governments and the Fed itself own another 25% (Figure 10). These investors purchase Treasuries for a variety of reasons, including managing foreign exchange reserves and exchange rate policies. As a result, they seem unlikely to suddenly dump Treasuries, *ceteris paribus*, even if short-term rates rise. This is especially true of non-Japan Asian central banks, which control a large share of the world's currency reserves, as yen weakness puts their exports at a disadvantage.

[10] For more discussion about the direction of short-term interest rates, please see Sean McLaughlin and Eric Winig, "Is the Market's Expectation for the Pace of Future US Policy Rate Increases Correct?," C|A Answers, October 14, 2014.

Figure 10. Ownership of US Treasuries
As of Second Quarter 2014



Sources: Federal Reserve and US Department of Treasury.

Should investors position for rising commodity prices in 2015?

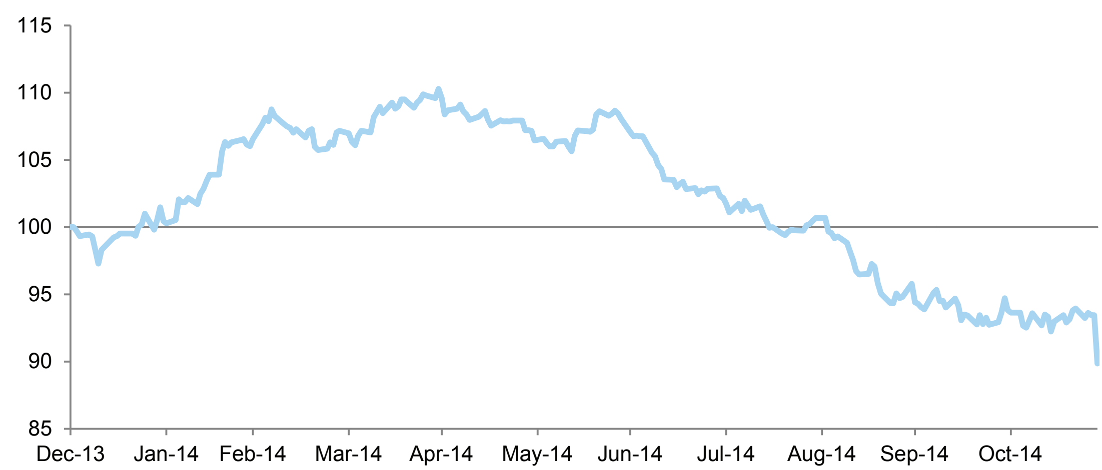
While commodity prices have softened in recent months, downside risks remain and investors should not position for a large sustained rally in commodity prices during 2015. Commodity prices had fallen around 10% year-to-date through the end of November (Figure 11), similar to the decline in 2013. The strong US dollar has come into play, as has slightly slower growth. However, for several commodities the bigger culprit is supply, surprising both for structural and tactical reasons.

Oil prices have led the commodity sell-off, falling around $30 per barrel since this summer to roughly $70 today. Supply has exceeded expectations, both from the conflict-ridden Middle East but also the United States, which continues to undergo a shale revolution. US production of crude oil has soared around 50% over the past three years to 9.0 million barrels/day. Meanwhile, the International Energy Agency has cut its forecasts of global oil demand since this summer, though its current 2014 forecast of 92.4 million barrels per day is more or less unchanged from January.[11] Rumors that Saudi Arabia and other OPEC members may be starting a price war to discourage investment in lower cost US shale also have taken their toll.

Industrial and precious metals have also endured a difficult spell.[12] Concerns about slowing Chinese growth and excess stockpiles impacted metals like copper, while gold has moved inversely to the dollar and suffered from expectations of rising interest rates. In October, holdings backing GLD, the main US gold exchange-traded fund, fell to

[11] For more on the oil market, please see Sean McLaughlin et al., "Oil Prices Can't Find Their Footing, Even Amid Geopolitical Turmoil," Cambridge Associates Research Brief, October 30, 2014.
[12] For more on this topic, see Alex Jones, "Ore: What Is it Good For? Iron Ore's Plunging Prices and the Impact on the Major Miners," Cambridge Associates Research Brief, November 24, 2014.

Figure 11. Bloomberg Commodity Total Return Index Performance
December 31, 2013 – November 30, 2014 • December 31, 2013 = 100



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

Should investors position for rising commodity prices in 2015?

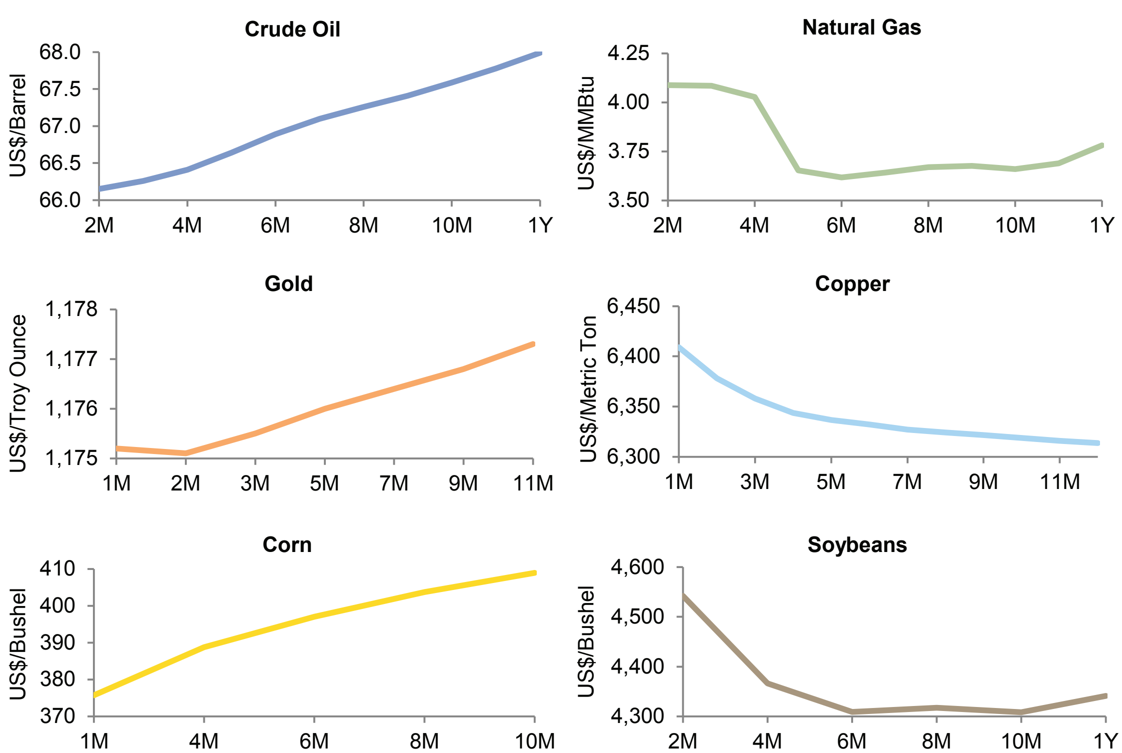
"The bullish case for commodities is one of accelerating global growth, potential supply pressures that have simply been deferred or delayed, and OPEC producers eventually agreeing to stabilize prices in order to balance budgets."

741 tons, the lowest level in six years, though declining Asian demand (in part because of import restrictions and in part because investors that bought on the dip last year are "once bitten twice shy") may be an additional swing factor.

Many forecasters and speculators expect further price declines, though not all forward curves are downward sloping (backwardated) and some commodities are expected to recover next year (Figure 12). The bullish case for commodities is one of accelerating global growth, potential supply pressures that have simply been deferred or delayed, and OPEC producers eventually agreeing to stabilize prices in order to balance budgets.[13] Marginal cost curves could provide a natural floor under commodity prices; it seems illogical for producers to sell commodities at a loss for extended periods. Fears over a China slowdown may also be overblown; its *rate* of GDP growth is expected to slow (from around 7.4% this year to around 7% in 2015), but this growth is coming off a much higher base—the economy did after all double between 2007 and 2012.

[13] At the end of November OPEC producers failed to agree on cutting production quotas, triggering a significant drop in crude prices.

Figure 12. Selected Commodity Futures Curves
As of November 30, 2014



Source: Bloomberg L.P.
1873m

Should investors position for rising commodity prices in 2015?

"The bearish case for commodities is multifaceted: US energy supply surprises to the upside, marginal cost curves drop, Chinese demand slows, and capacity is overbuilt."

The bearish case for commodities in 2015 is multifaceted. US energy supply may continue to surprise to the upside; marginal cost curves may be dropping as producers become more efficient and adept at using new technologies. Some OPEC producers may be in no position to attempt to discourage new supply; they will produce at any spot price as energy exports are a main source of revenue and economic growth is lackluster. China, which has accounted for over 40% of global demand in recent years for commodities like copper and iron ore, is rebalancing and may have already built the infrastructure it will now grow into over several years. Meanwhile, Western mining firms, which have spent over $120 billion in capital expenditures in recent years, may be willing to produce at a loss to discourage other supply and recover at least some of their sunk costs. Emerging markets countries like India may continue to discourage gold imports, which puts pressure on current account deficits. Finally, excess investment in recent years in the mining sector is only now starting to come on stream, increasing supplies and lowering prices.

Commodity prices are difficult to forecast given the vagaries of weather (on agriculture), growth, regulations, OPEC dynamics, transparency over stockpiles, etc. Given an equally convincing bearish argument, we don't believe investors should aggressively position for rising prices and should hold commodities to the same standard as they hold other assets in their portfolios.[14] If negative roll yields and zero percent collateral yields lead to low returns for commodity futures, they may not be worth holding even if spot prices do tick back up, as the opportunity cost of holding them may end up outweighing any future benefit.

Should commodity prices stay low, global growth is likely to receive a boost and investors should think about impacts across their portfolios. Lower commodity prices will boost disposable income and likely consumption across developed markets. Equity market implications are nuanced and will be driven by factors such as valuations and index weights. For example, US and European stock indexes have around an 8% weighting for energy stocks, while Japan has virtually none. Emerging markets as a whole have a 9% weighting, but individual country weights vary significantly, from above 50% in Russia to below 5% in Malaysia, South Korea, and Taiwan. To the extent that some of the large emerging markets exporters increase interest rates as stretched budgets and terms of trade result in currency weakness, domestic growth could suffer. Conversely, emerging markets commodity importers that have faced previous balance of payments strain may see some relief going forward, boosting their currencies and local debt.

[14] For more on this please see Meagan Nichols and Eric Winig, "Time to Get Real About Real Assets," Cambridge Associates Research Report, May 2014.

What events could roil markets in 2015?

A long list of market dynamics and events could disrupt markets in 2015, but by definition the ones that are *least* expected have the *greatest* potential to disturb markets. October may have offered a preview of what could most spook investors, as stretched valuations combined with uncertainty about the end of quantitative easing, thin liquidity, and geopolitical unknowns triggered a surge in volatility. Some of the risks that persist into 2015 have existed for some time (e.g., Eurozone politics and Middle East strife), so the market *may* have relatively more sensitivity to some than others.

Global surge in QE has unintended consequences. One of the biggest risks for 2015 may be that some of the extreme monetary policy of the past several years runs into unexpected problems or generates unanticipated consequences. For example, while most central bankers are currently worried about disinflation and thus attempting to devalue currencies, current policies may prove *too* successful. Domestic investors would then see currency depreciation as a one-way bet and attempt to move massive amounts of capital offshore, putting pressure on a country's balance of payments. That country's central bank would then increase quantitative easing and simply monetize debt issuance to keep rates low, but this could let a dangerous inflationary genie out of the bottle.

A separate risk is that "currency wars" escalate as some countries fight erosion of their export competitiveness. While some countries have the reserves and economic strength to participate, casualties are likely and impacts on asset classes will vary. For example, emerging economies that accept high inflation as a trade-off for cheaper currencies may trigger negative real returns for local bondholders or, even worse, have a hard time repaying hard currency debt. Finally, the world's central banks have now purchased over $10 trillion of assets since the financial crisis. While default rates on sovereign bonds are likely to remain nonexistent, problems could arise if corporate, asset-backed, or other default rates start to tick up.

Escalating tensions with Russia. Tensions between Russia and the West over Ukraine have recently been overshadowed by other dynamics but retain the potential to generate market volatility in 2015. A recent speech by Vladimir Putin that discussed Russia's resentment at the United States' expanded sphere of influence probably marks a 15-year low in relations between the two countries, and reduces the likelihood of future cooperation on a range of issues including the Middle East. Sanctions imposed after the Crimean invasion are taking their toll on Russia's economy, as are plunging oil prices. Russian companies have been cut off from Western capital markets and are unable to refinance existing external debt. Russia's usually

What events could roil markets in 2015?

"China is not a new 'unknown' but how its leaders manage the ongoing rebalancing of the economy will continue to create possible risks in 2015."

fortress-like sovereign balance sheet is starting to reflect the strains of its attempt to staunch capital outflows; in the last several months the government has spent around $70 billion of its $500 billion in foreign exchange reserves before reducing efforts to protect the ruble against the dollar. Meanwhile, inflation is rising and the economy is flat-lining; the consensus expects a recession in 2015. Rating agencies are contemplating sovereign bond downgrades. While this would not impact a huge amount of sovereign debt (as Russian sovereign debt to GDP is fairly low), it would have knock-on effects on financial and natural resources firms that are large issuers of external debt. Mitigating forces include naturally recurring sources of hard currency revenue for commodity producers (given sales of oil, natural gas, etc.). However, financial companies and others will be more adversely affected and could see downgrades or even defaults. Russia could potentially retaliate via escalating its own set of sanctions, but the greater threat may be further saber rattling and military maneuvers that could inadvertently escalate and spook markets given the difficulty of forecasting outcomes.

China struggles with the right policy mix. China is not a new "unknown" but how its leaders manage the ongoing rebalancing of its economy will continue to create possible risks in 2015. The government has many conflicting goals, which include boosting consumption and thus discouraging saving while at the same time ensuring that refinancing risks don't rise and wasteful investment tapers off. Chinese households save the equivalent of nearly 50% of GDP and place these funds in low-yielding savings accounts (among other places) that help explain the abundance of credit (and thus investment). In 2014 Chinese equity prices have oscillated as the government intermittently threatened to allow market-based solutions to these imbalances only to back down and resort to one-off "mini stimulus" packages. China's growth rate is likely to again slow in 2015, and how the government responds will have enormous implications for markets. For example, betting on the reminbi to appreciate has been a one-way bet for years given China's trade surplus and large foreign reserves.[15] Going forward, if interest rates are cut further to make debt burdens more affordable or if the government responds to the global race to devalue currencies for trade advantage, the currency will start to weaken. In a similar vein, Chinese banks are more profitable than many global peers in part because the government has artificially suppressed the default rate on nonperforming loans. If more defaults are viewed as desirable in an attempt to discourage excessive borrowing and investment, this could have enormous implications for local and international

[15] For more on this please see Aaron Costello et al., "Escalator Up, Elevator Down? Recent RMB Weakness" Cambridge Associates Research Brief, March 2014.

What events could roil markets in 2015?

credit markets.[16] The hard landing scenario in China, while possible, seems unlikely given the government has numerous levers to cushion the rebalancing blow—but clearly which tools it uses may trip up consensus positions and also trigger volatility in the markets.[17]

Politics and other factors. Markets have for the most part navigated political events (such as the Scottish referendum) calmly in 2014. However, others such as the Brazilian elections and Occupy Hong Kong protests surprised to the downside and at least temporarily caused equity markets to sink. Looking forward to 2015, geopolitical risks are numerous across regions. While this list is by no means exhaustive, among the major geopolitical risks that concern us are:

- Tensions in the Eurozone between core and peripheral countries, both over topics such as the right amount of fiscal austerity but also over the terms of previous bailouts as some will need to be renegotiated.
- The upcoming elections in the United Kingdom that could see coalitions splinter and eventually give voters the opportunity to vote on European Union membership.
- The rise of ISIS in the Middle East and the potential for violence to again escalate in several countries.
- Recent US elections, which raise the risk of political stand-offs between the president and Congress over budgets and servicing the nation's debt.
- Growing evidence of corruption in countries like Brazil and Mexico, which is shaking confidence about transparency and the claim of investors on underlying assets and cash flows.

"Looking forward to 2015, geopolitical risks are numerous across regions."

[16] Some analysts believe recent announcements about deposit insurance in China could foreshadow forcing banks to take further write-downs on nonperforming loans and could even signal that some small banks will be allowed to fail.
[17] For more on this please see Aaron Costello et al., "China: Prepare for Stress," Cambridge Associates Research Note, October 2014.

What to focus on for 2015

The valuations and macro backdrop heading into 2015 is somewhat similar to that which prevailed at the end of 2013, but with important differences. Divergent monetary policy is aggressively being priced in across currency and bond markets; cheaper currencies and lower rates in some regions will impact corporate earnings and debt affordability. Commodity prices have fallen, and natural resources equities and some emerging markets currencies have immediately moved to price in the likely economic impact. Should commodity prices stay low, some sectors, like consumer staples, could see offsetting benefits. Meanwhile, equity valuations are similar to year-end 2013 but the potential for earnings growth is shifting across regions. Overall, returns for diversified portfolios in 2015 are likely to be lower given low yields across fixed income markets and stretched valuations for US equities. In our opinion, investors might mitigate this by favoring equities over fixed income and within equities underweighting the United States.

Some equity investors may point out that similar signals and positioning 12 months ago delivered unsatisfactory returns in 2014—true enough. *Short-term* returns can be driven by a number of factors including the macro environment, liquidity, earnings, and valuations; over the *long run*, the evidence is quite clear that valuations are the main driver. In the short term, looking at both the numerator *and denominator* can enhance the usefulness of valuations. European and Japanese economic growth is likely to be weaker than that in the United States, but *earnings* growth should compare favorably given global revenue exposure, operating leverage, and margins. Companies in these regions may also start to become more shareholder-friendly and boost payouts.

Fixed income investors likely face a disappointing year. In the United States, ten-year Treasuries, which yield 2.2%, seem unlikely to generate reasonable *intermediate-term* returns, and higher-beta credit brings a separate set of issues. The current 6.1% yield on high-yield bonds offers little cushion if defaults rise from historically low levels, though today's yield is nearly twice that on offer from investment-grade bonds. Still, despite expected Fed hikes, US fixed income assets will be supported by strong demand. After $130 billion of issuance in November, US investment-grade corporate bond issuance reached a record $1.1 trillion in 2014. The story is similar for European and Japanese bonds, where starting sovereign yields are even lower but central banks are expected to demonstrate strong demand. Though some of the expected impact of policy divergence may be priced in to developed and emerging markets currencies, US$-based investors should think twice about holding foreign bonds with historically low yields without currency hedges in place.

What to focus on for 2015

Given that the US dollar may continue to strengthen given better growth, higher real rates, and a smaller trade deficit as domestic oil production rises, US investors should consider tactically hedging much of their currency exposure to international assets. This should both protect against the depreciation that other central bankers desire as well as cushion downside risk in a scenario where global equities sell off and the dollar becomes a safe haven. Where a portfolio includes active managers that are unable or unwilling to currency hedge, investors must ask whether the alpha available via these managers will offset any currency depreciation they might suffer.

The macro environment could prove vexing again in 2015. The Eurozone and Japan may just barely avoid falling back into recession and many emerging markets will struggle with weaker commodity prices. However, investors should largely resist using macro data alone to drive asset allocation decisions. Skittish investors that trimmed US stocks after a weak first quarter of GDP growth missed out on healthy gains when data improved as the year progressed, while those that went underweight Japanese stocks after their second quarter data softened scrambled to reverse this position when profits, policy, and data started to improve in the third quarter. Where macro data are likely to prove softest in 2015, monetary policy may continue to support asset prices, both in developed and emerging markets. Investors should also stay the course if geopolitical events trigger market volatility, assuming fundamentals for asset classes have not changed. The potential for subdued returns across many assets as well as for volatility suggests that the opportunity cost of holding larger cash positions has been reduced, though those choosing this option need to have the appropriate policies and managers in place to take advantage if fundamentally attractive assets become temporarily available at lower prices.[18] Other investors can position for this possibility by choosing more tactically minded managers, keeping in mind of course the disappointing recent performance for many. ■

[18] For further thoughts on holding cash, or increasing sovereign bond allocations, please see Eric Winig et al., "Why Not Hold Cash: The Sequel," Cambridge Associates Research Note, October 2014.