Market Matters

December 31, 2014

Plunging commodity prices were a key driver of asset prices during the fourth quarter, though regional economic and earnings growth as well as diverging monetary policy also came into play. It was a happy holiday for investors in US equities, which benefitted from robust economic and earnings data, as well as those with exposure to Japanese stocks, which also posted strong earnings and where the government doubled down on expansionary monetary policy. European and emerging markets equities were flat, though in the case of latter this masked divergence between commodity importers and exporters. Fixed income markets ended the year on a high note, helped in Europe by dovish ECB comments and globally by limited inflationary pressures, though there were losses in select markets like US high yield. REITs did well in the quarter and were a star performer for the year, somewhat offsetting the damage in real asset portfolios from assets like natural resources equities and commodity futures.

Broad equity market indexes ended the year on a positive note in fourth quarter, though this masked divergence across markets. US and Japanese equities outperformed European peers, while flat equity returns in emerging markets reflected a healthy gain for Asia that was offset by losses in Latin America and Europe, the Middle East & Africa. Bond markets posted healthy gains across the globe given weak inflation data and accommodating central

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

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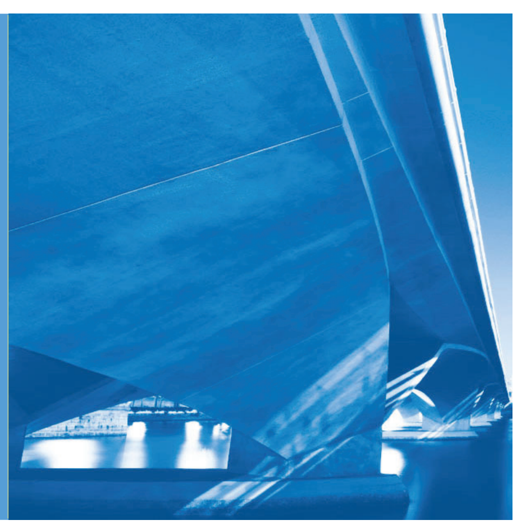

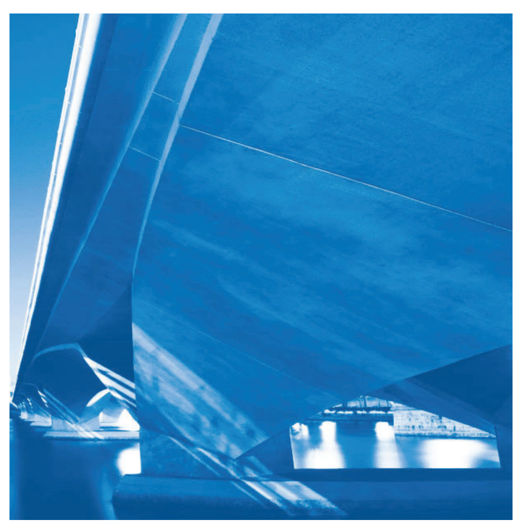

banks, with certain exceptions such as US high-yield bonds and emerging markets debt. Key stories for the quarter included the roughly 40% plunge in oil prices, which cascaded across asset classes including commodity futures and natural resources equities, the somewhat-related ongoing ascendance of the US dollar, and market jitters in October (which now seem a distant memory) that included a mini "flash crash" for yields on US Treasuries.

The macro backdrop for US risk assets remains favorable. US economic releases gathered momentum, with final estimates for third quarter GDP growth coming in at 5%, the best in 11 years. A variety of other US data points have also impressed, including rising wages, employment, and consumer confidence. The S&P 500 Index returned 4.9% for the quarter, boosted by this data and reasonable earnings releases. The calendar year 2014 index return of 13.7% was less than half that seen in 2013 but still above long-term averages; expected 2014 earnings growth of around 9% means short-term valuations haven't shifted significantly. Despite October's volatility (when over $940 billion of US Treasuries exchanged hands in a single day), US fixed income markets also posted strong gains as demand remained firm and lower commodity prices helped dampen inflation. The benchmark Barclays Aggregate Index returned 1.8% for the quarter, taking its 2014 gain to 6.0%; tax-exempt bonds (1.4%) fared similarly well and outperformed for the year (9.1%).

Japanese equities (6.7%) also performed strongly in the quarter, benefitting from the Bank of Japan's October announcement that it would expand quantitative easing efforts as well as news that the main government pension fund (GPIF) would double its holding of domestic equities. Looser monetary policy could be justified by disappointing economic data; GDP shrank at nearly a 2% pace in the third quarter, far worse than initially expected. In December Prime Minister Shinzō Abe called national elections that were viewed as a referendum on Abenomics; his victory is a positive signal for markets that economic policies are likely to remain accommodating for several more years. Micro data have also been supportive. Japanese earnings growth has been robust and is now back to levels seen pre–global financial crisis. An upcoming tax cut for Japanese companies will add a further boost to corporate bottom lines when it becomes effective on April 1.

A variety of macro and micro concerns led to a flat performance for European equities in the quarter (with unhedged US$ investors faring far worse given further euro depreciation). Downgrades to economic growth forecasts and idiosyncratic geopolitical events such as the Greek elections weighed on sentiment. High weightings in various European indexes for energy (down

15% in fourth quarter) and materials stocks (-1.5%) also hurt given the commodities sell off and subsequent cuts to earnings forecasts. Analysts are also concerned about the impact of rapidly decelerating emerging markets on European exporters, offsetting some of their enthusiasm over the assumed benefit from weaker currencies. This is especially true for the financial sector, where a number of banks saw their shares plunge given worries over lending to Russian corporates whose credit quality has been impacted by the commodity-induced recession. In contrast to equities, European fixed income enjoyed a robust quarter given softer inflation and growth numbers, as well as comments by European Central Bank President Mario Draghi that (seemed to) pave the way for outright purchases of sovereign bonds early in 2015. Euro government bonds returned 2.6% for the quarter (finishing 2014 up 12.4%); sterling inflation-linked bonds returned an astounding 8.3% (18.8% in 2014) as UK inflation fell to a 12-year low.

Weaker oil prices heavily weighed on commodities (-12.1%) during the quarter, as well as assets like MLPs (-12.3%) and natural resources equities (-12.0%). US high-yield bonds were down slightly (-1.0%), though the heavily weighted energy sector saw a much greater decline (-10.6%). While it is somewhat unclear why oil prices have fallen so far, so fast, key events during the quarter included OPEC's inability to agree to production cuts despite flagging demand as well as statements by Saudi officials about tolerating lower prices for an extended period—interpreted as a shot across the bow for surging higher-cost US shale producers. In the meantime stockpiles are growing as production surprises to the upside in countries like Russia and Libya; the consensus seems to be that it could take some time for the market to balance as lower prices eventually discourage further investment and thus supply.

Trends across emerging markets assets in fourth quarter reflected perceptions about winners and losers from cheaper oil. Emerging markets equities were essentially flat, but performance was disparate across regions, and unhedged US$ investors suffered from currency depreciation. Emerging Asian equities (2.1%) fared best, as energy importers such as India and South Korea will benefit from lower prices and stronger US growth should mean increased demand for exports. In contrast, Latin American equities (-6.1%) suffered given the importance of commodities to countries like Brazil and Mexico, as well as some company-specific issues (e.g., Petrobras). Russian equities (-5.9%) continued to suffer from both lower oil prices (energy companies contribute more than 50% of market cap) as well as the impact of sanctions on its rapidly decelerating economy. In a similar vein, while Asian currencies like the Indian rupee and South Korean *won* suffered 2% to 4% declines against the US dollar in fourth quarter, currencies like the Brazilian *real* (-8%) and Russian ruble (-34%) suffered far greater losses. The ruble's decline was also due to uncertainty over whether the central bank would refrain from further support for the currency due to diminishing foreign exchange reserves.

Finally, a recap of the fourth quarter would be incomplete without a few words about property securities, which soared given lower interest rates and in the case of the United States, improving sentiment about the economy. US REITs returned 12.8% for the quarter, taking their return for 2014 to 28.0%. European REITs fared nearly as well, returning 8.3% (25.7% for the year). Concerns are growing that lower cap rates and dividends will cap future returns, though bulls have highlighted that stronger economic growth means rising occupancy rates and rents. ■

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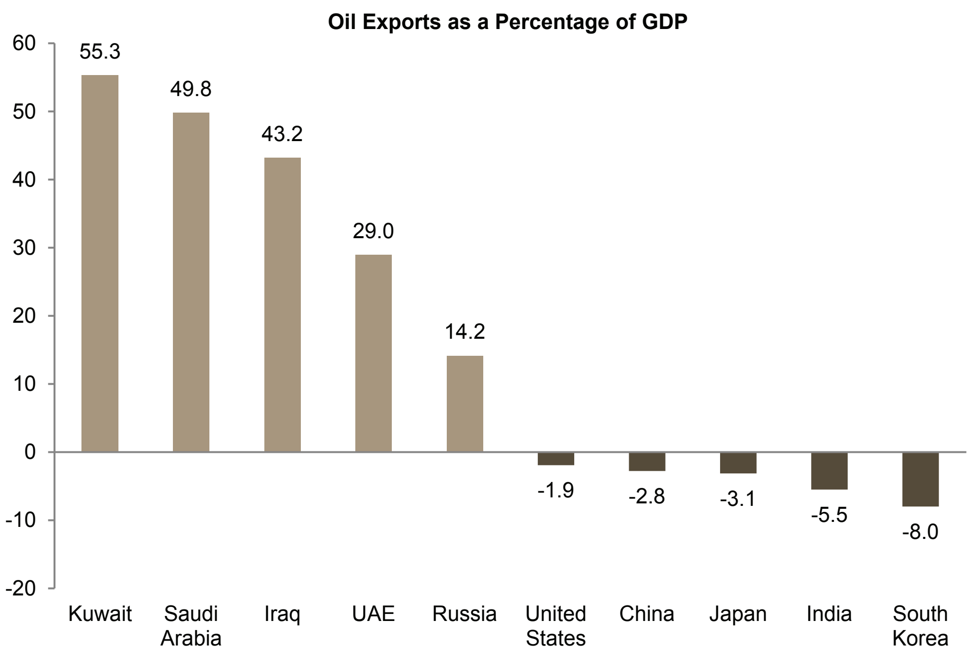
For our views on specific asset classes, read **Asset Class Views**

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

Oil Vulnerability

2012 (Latest Available)



Sources: International Monetary Fund, Thomson Reuters Datastream, and *The Wall Street Journal*.

Note: Figures calculated by multiplying the barrels per day imported or exported by 365 days and the average 2012 oil price (US$/BBL), and dividing it by the annual 2012 GDP. Negative numbers represent net oil importers.

Equity and currency returns in the fourth quarter reflected perceptions about winners and losers from lower oil prices; stock markets of frontier and EM oil exporters suffered heavy losses while those of DM importers fared much better

Cumulative Wealth of the Russian Ruble vs USD and MSCI Russia Index

January 1, 2014 – December 31, 2014 • December 31, 2013 = $100

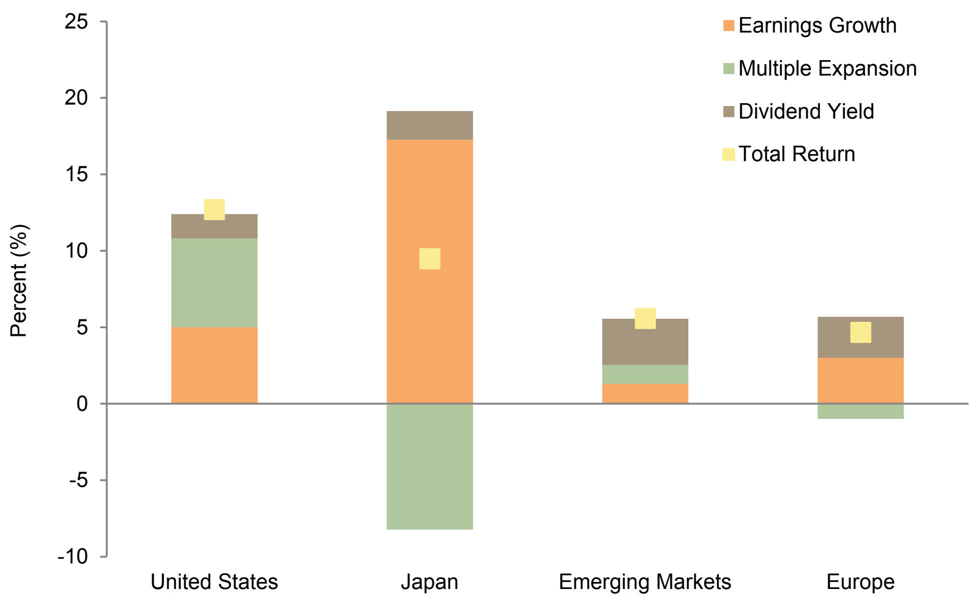
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: MSCI Russia Index is shown in US Dollars.

Investors fled Russian equity markets in the fourth quarter as lower oil prices are causing earnings estimates for energy companies (50% of index market cap) to plunge; the ruble also fell as the central bank suggested it would pull back support given diminishing (but still sizable) foreign exchange reserves

Equity Returns by Source

As of December 31, 2014 • Local Currency



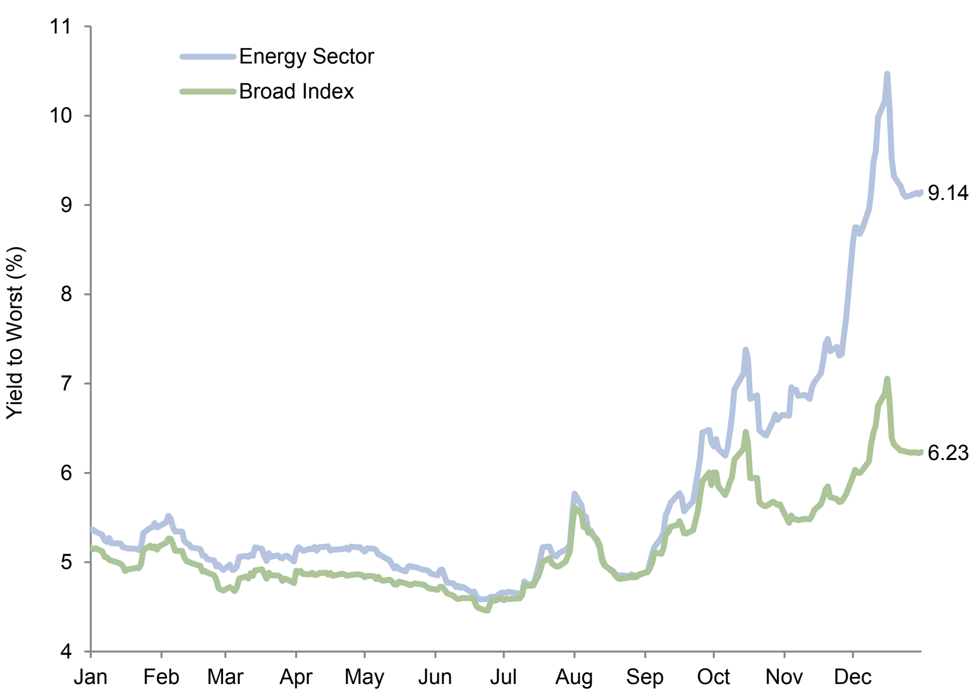
Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Earnings growth is based on aggregate 12-month trailing earnings for Japan and J.P. Morgan's estimates for the United States, emerging markets, and Europe. Dividend yield is the 12-month total return minus the 12-month price return. Multiple expansion is derived from earnings growth, dividend yield and total return.

US equities again outperformed European equivalents in 2014 despite earnings growth that is expected to be fairly similar; meanwhile, Japanese shares again re-rated lower in part because previous valuations had been elevated

Yields for J.P. Morgan High-Yield Bond Index and the Energy Sector

January 1, 2014 – December 31, 2014

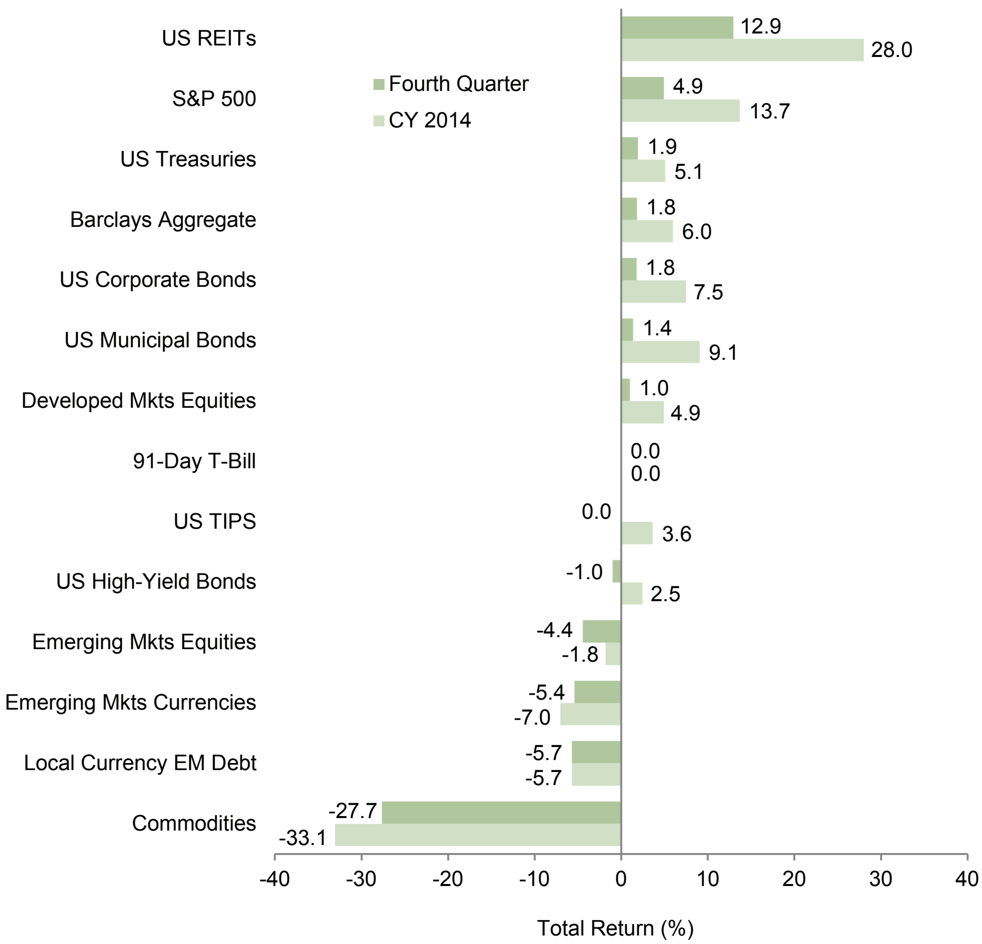


Source: J.P. Morgan Securities, Inc.

US high-yield bonds suffered a mild 1.0% loss in the fourth quarter as yields backed up around 50 bps; however, energy bonds (-10.6%) suffered more as lower oil prices mean default risks are rising for some companies

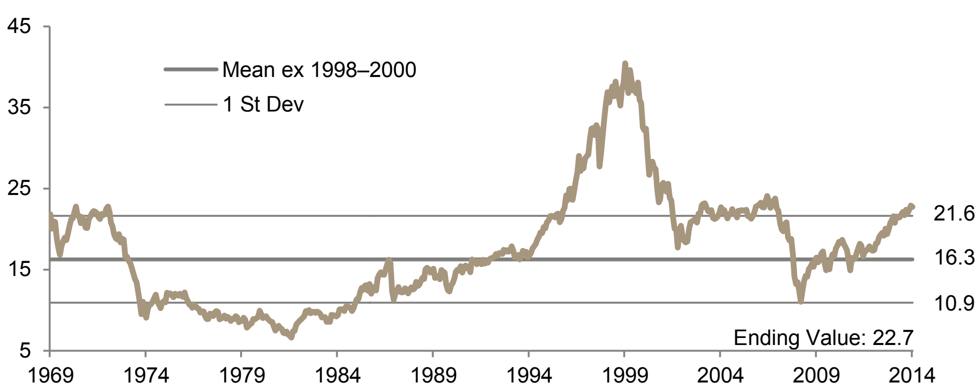
Index Performance (US$)

As of December 31, 2014



MSCI US Composite Normalized P/E

December 31, 1969 – December 31, 2014



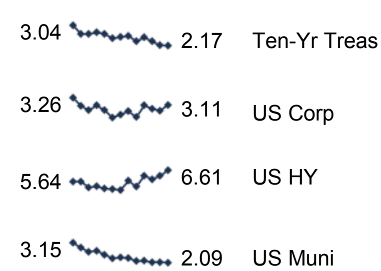
Sources: Barclays, BofA Merill Lynch, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

US REITs enjoyed a strong quarter as investors sought yield amid a falling interest rate environment; real estate is also expected to benefit from a resurgent US economy. Emerging markets assets suffered large losses in US$ terms as the dollar rose and lower commodity prices weighed on currencies like the Brazilian *real* and Russian ruble

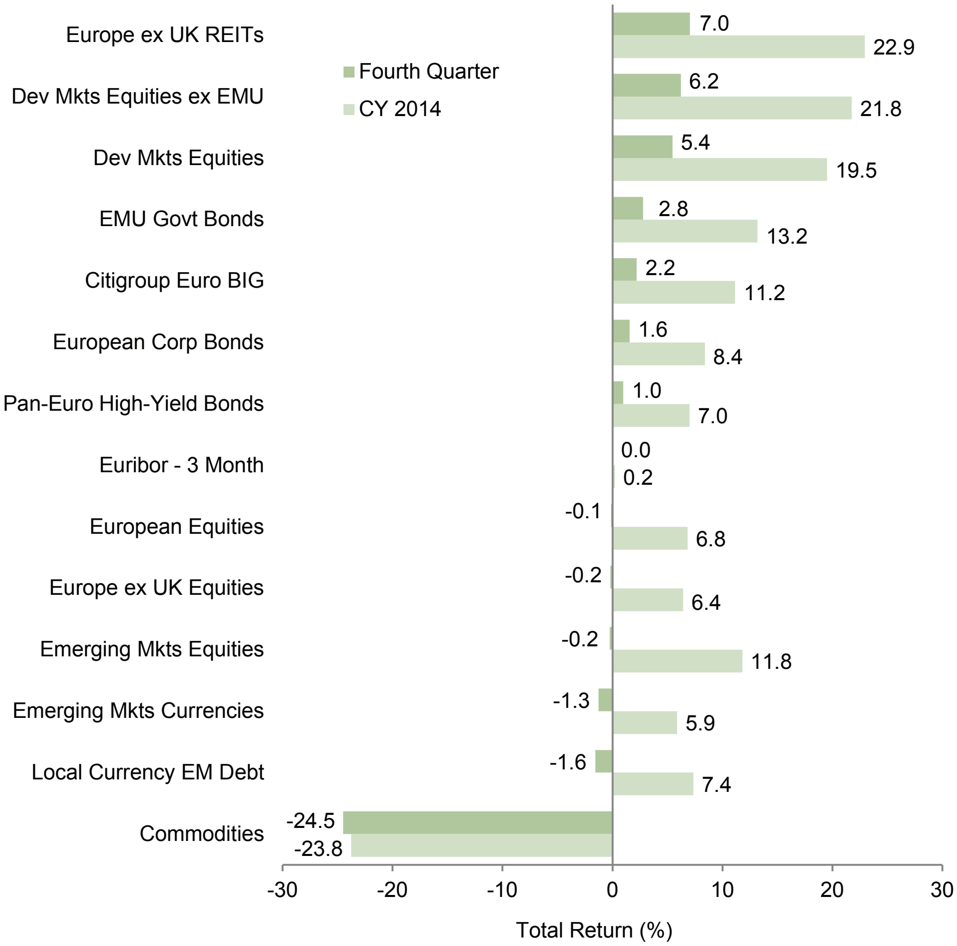
Fixed Income Yields

December 2013 – December 2014



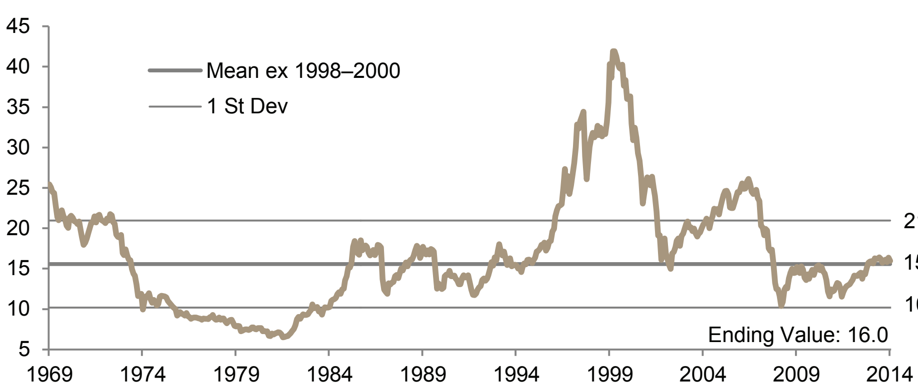
Index Performance (€)

As of December 31, 2014



MSCI Europe ex UK Composite Normalized P/E

December 31, 1969 – December 31, 2014

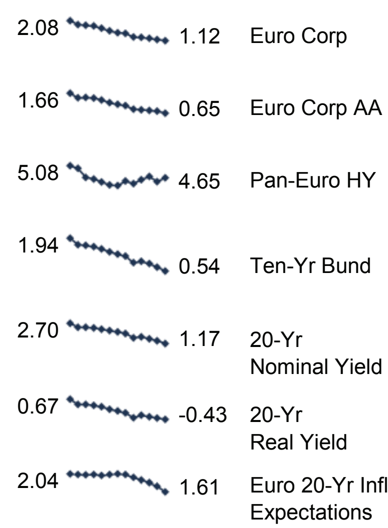


Sources: Barclays, Bloomberg L.P., BofA Merill Lynch, Citigroup Global Markets, EPRA, FTSE International Limited, MSCI Inc., J.P. Morgan Securities, Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express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

For both the quarter and 2014, euro-based investors were handsomely rewarded for owning equities from developed markets outside the EMU; EMU fixed income assets enjoyed decent returns in the quarter to cap a strong year as ECB President Draghi suggested that outright purchases of sovereign bonds could occur should inflation and asset purchase goals continue surprising to the downside

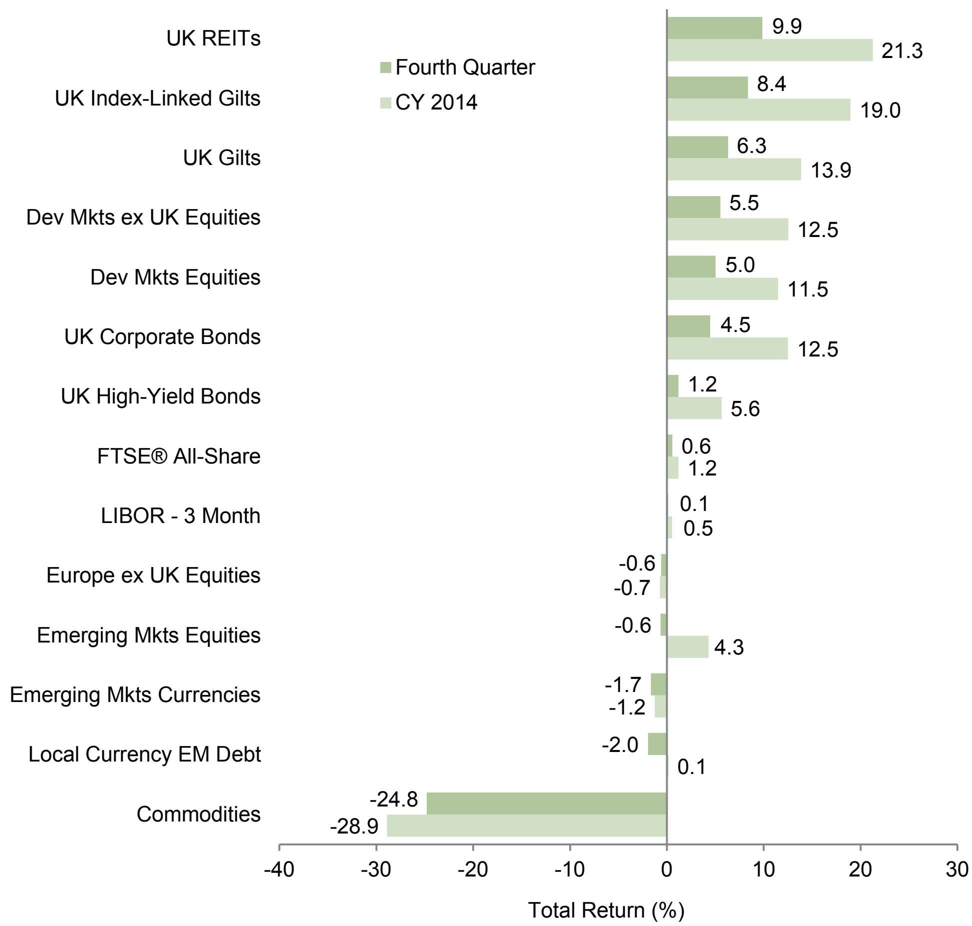
Fixed Income Yields

December 2013 – December 2014



Index Performance (£)

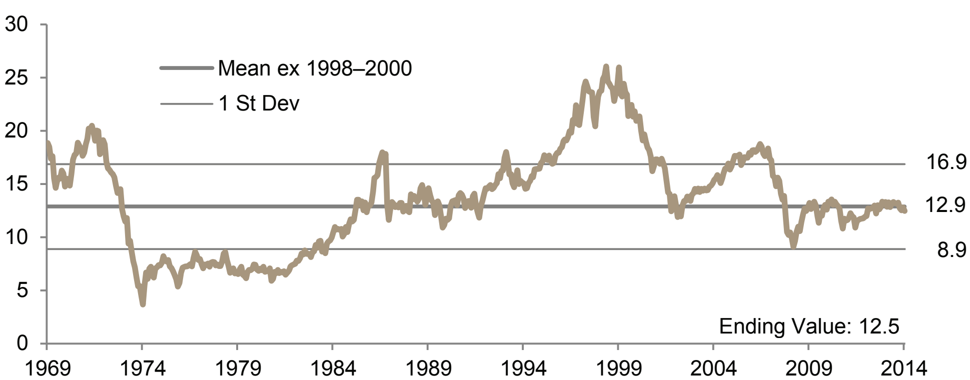
As of December 31, 2014



UK REITs were boosted by the search for yields as inflation and interest rates fell; these dynamics also generated a strong bid for gilts and linkers. The FTSE had a disappointing fourth quarter (and 2014) as the heavily weighted energy and materials sectors were weighed down by lower commodity prices

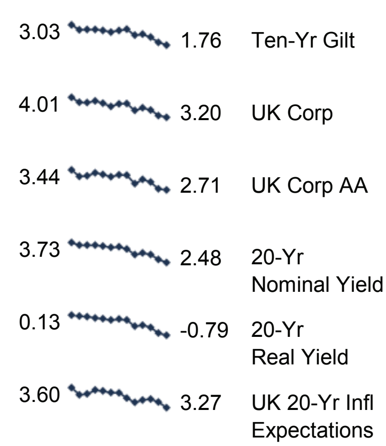
MSCI UK Composite Normalized P/E

December 31, 1969 – December 31, 2014



Fixed Income Yields

December 2013 – December 2014

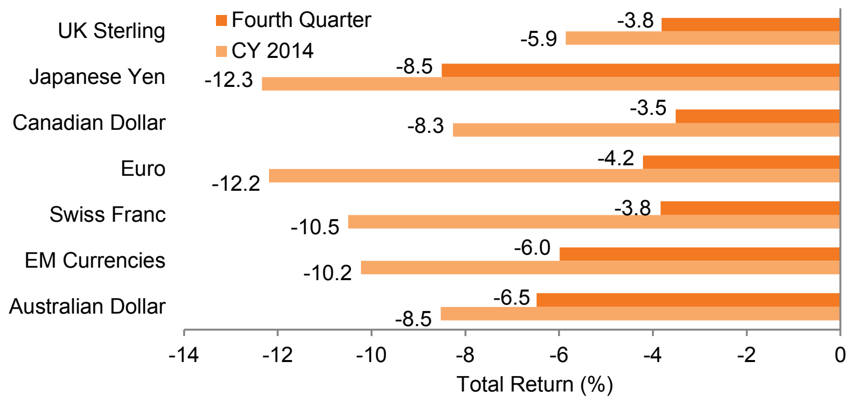


Sources: Bank of England, Barclays, BofA Merrill Lynch, EPRA, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.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

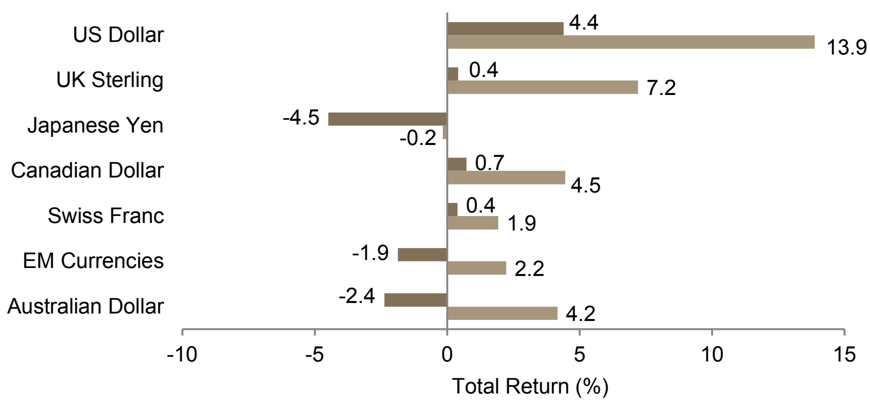
Currency Performance

As of December 31, 2014

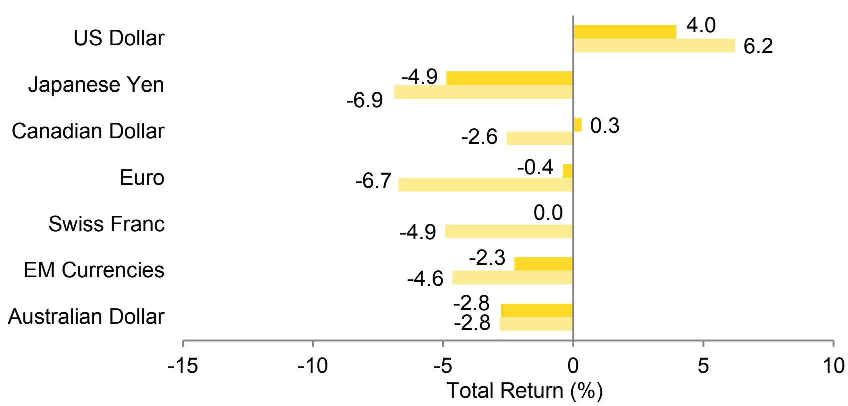
Versus the US Dollar



Versus the Euro



Versus the Pound Sterling



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

The US dollar continued its ascendance against developed and emerging currencies in the fourth quarter as US economic data surprised to the upside and expectations are growing that US monetary policy will diverge from peers in 2015

The euro gained against the yen in the fourth quarter after the BOJ committed to further easing; however, for full-year 2014 it was essentially flat—belying some arguments that Eurozone exporters are suffering relative to Japanese peers

Sterling fell against the dollar as UK inflation touched a 12-year low; against other currencies it was better supported given higher relative real rates

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.

Fixed Income Yields
US fixed income yields reflect Barclays Municipal Bond Index, Barclays US Corporate High Yield Bond Index, Barclays US Corporate Investment-Grade Bond Index, and the ten-year Treasury.

European fixed income yields reflect the BofA Merrill Lynch Euro Corporate AA Bond Index, BofA Merrill Lynch Euro Corporate Bond Index, Barclays Pan-European Aggregate High Yield Bond Index, Bloomberg Twenty-Year European Government Bond Index (nominal), ten-year German bund, 20-year European Inflation Swaps (inflation expectations), and the real yield calculated as the difference between the inflation expectation and nominal yield.

UK sterling fixed income yields reflect the BofA Merrill Lynch Sterling Corporate AA Bond Index, BofA Merrill Lynch Sterling Corporate Bond Index, UK ten-year gilts, and Bank of England 20-year nominal, real, and zero coupon (inflation expectations) yields.