CAMBRIDGE C|A ASSOCIATES

Market Matters

November 30, 2014

Markets maintained a positive tone in November, continuing their recovery from a sell-off, which had lasted through mid-October. Earnings and economics releases supported developed equities, while bonds were buoyed by dovish central banker comments and weak inflation data across many countries. Crucial to the latter has been a decline in oil prices to a four-year low, which accelerated during the final days of the month after OPEC members resisted calls to implement production cuts.

November's news flow did little to challenge the prevalent "Goldilocks" narrative of economic growth being fast enough to allow for earnings expansion but slow enough to justify ongoing dovish monetary policy. Strong US growth data were something of an exception—revised estimates showed that the US economy expanded at a 3.9% annualized pace during the third quarter, capping the best six months of growth in over a decade. Still, inflation in the United States is subdued, and certain labor data (like wages) look less robust. The European releases suited the narrative; the Eurozone economy grew at a modest 0.8% year-over-year pace and UK growth, while much stronger, was not accompanied by rising price pressures. News that Japan's economy shrank at a 1.6% annualized pace in third quarter, far below expectations, generated little positive spin, though its impact was cushioned by the Bank of Japan's pre-emptive announcement in late October about expanded asset purchases. European Central Bank officials followed suit in November and said they were prepared to do more if inflation and asset

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

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purchase targets were missed; the former looks increasingly likely given recent news that consumer prices are growing just 0.3% on an annual basis.

Equity markets benefited from this macro backdrop but also positive earnings announcements. The S&P 500 returned 2.7%, boosted by releases that showed third quarter earnings growth of 11% (year-over-year). Losses on energy stocks (-8.5%) were offset by strong gains in sectors like information technology (5.3%). Elevated valuations remain a headwind for US stocks, though price-earnings multiples have not rerated much higher year-to-date as a 14.0% index return is not that dissimilar from the 9% expected earnings growth. Still, looking ahead to 2015, the strong dollar poses a risk as roughly 33% of S&P (40% for MSCI US) revenue comes from overseas. European equities (3.7%) benefited from even more robust earnings announcements and displayed similar sector trends; losses on energy stocks (-6.1%) were offset by strong gains in sectors like consumer discretionary (8.1%). Japanese stocks (6.2%) outperformed as the micro picture looks far more robust than the macro. Japanese corporate profits are soaring as the weak yen flatters offshore earnings; after a 5.5% tumble in November, the yen is now down 11.4% year-to-date against the US dollar. The flipside of yen depreciation is that Japanese import costs are soaring and pinching some consumers, though the impact is being mitigated for now by the recent sell-off in oil.

Emerging markets stocks posted minor gains in local currency terms (1.1%), lifting their year-to-date return to 8.2%. Offshore investors have seen far smaller gains given currency depreciation; in November emerging markets equities returned -1.1% and -0.6%, respectively, in US dollar and euro terms. Falling commodity prices are impacting emerging markets equities, cushioned in some cases by reasonable valuations. For example, Brazilian equities (0.1%) actually posted a minor gain in November while Russia was down just 0.2%, despite escalating tensions with Ukraine and the fact that commodity exports account for roughly half of government revenues. Asian economies should benefit from weaker commodity prices, though stocks are failing to benefit where growth concerns are mounting. Some countries are cutting interest rates both to boost growth and to offset the impact of the cheaper yen on their exporters; Chinese equities (1.6%) benefited as the government cut key interest rates for banks and depositors. While this reflects slower Chinese growth and ebbing inflationary pressures, it will assist many companies that are struggling with elevated debt burdens.

Global fixed income markets posted gains as developed markets sovereign bond yields fell to an 18-month low. Issuers are capitalizing on these low yields; November's nearly $130 billion of US investment-grade supply brought the year-to-date total to a record $1.15 trillion. US ten-year Treasury yields declined to below 2.2% and generated healthy gains for broad market indexes; the Barclays Aggregate returned 0.7%. US high-yield bonds (-0.7%) were excluded from the party as energy bonds returned -3.5% given concerns over debt sustainability if oil prices remain low. Oil & gas producers make up just over half of the energy high-yield issuer universe, but refiners and pipelines should be somewhat more insulated from lower oil prices. Technicals in the high-yield market have deteriorated; year-to-date, over $13 billion has been withdrawn from high-yield mutual funds and exchange-traded funds, and in November a variety of issues were either postponed or restructured to offer higher yields. In Europe, sterling-denominated bonds outperformed as yields on ten-year gilts fell over 30 bps and stand below 2%. Economic growth figures in the United Kingdom suggest a healthy expansion, but its quality is in question and belied by weak inflationary data. The 11% year-to-date return on sterling corporate bonds is roughly four times that of UK stocks.

Following news that OPEC members had rejected a 5% cut to their 30 million barrel per day production quota, crude oil fell another 11% and ended the month down 18%. This weighed on energy equities and bonds, as well as assets like MLPs (-2.6%). Gold fared better and was up 1.4%, though a Swiss referendum on increasing their central bank's holdings failed and could remove one leg of recent support. Property securities fared far better given lower interest rates, with Europe ex UK (3.8%) and UK REITs (5.4%) outperforming North American (2.3%) peers. ■

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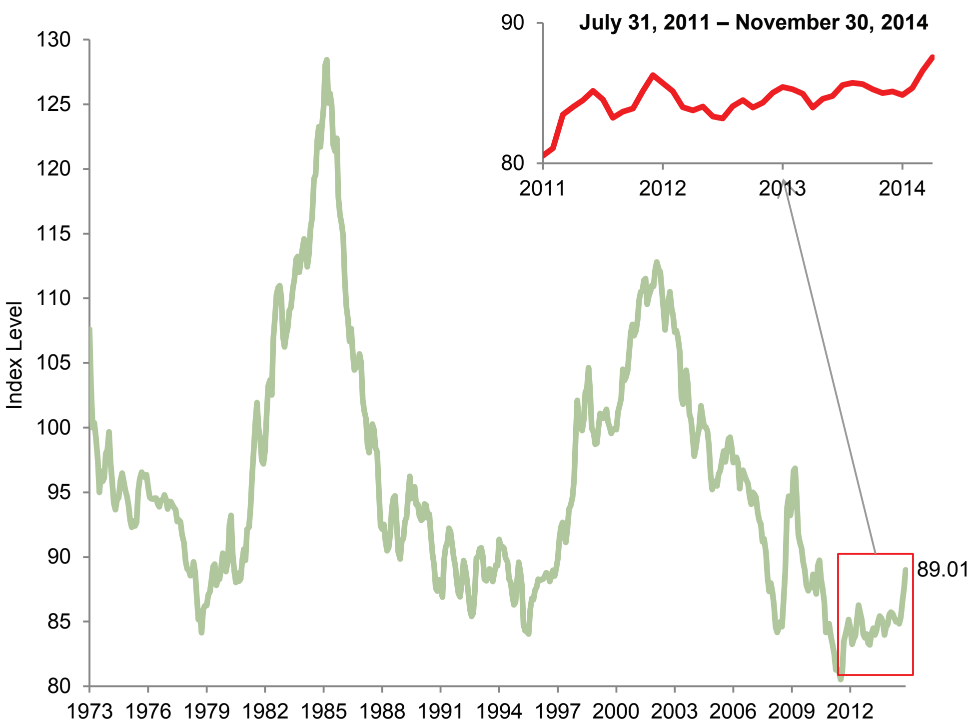
For our views on specific asset classes, read **Asset Class Views**

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

Real Trade-Weighted Value of the US Dollar

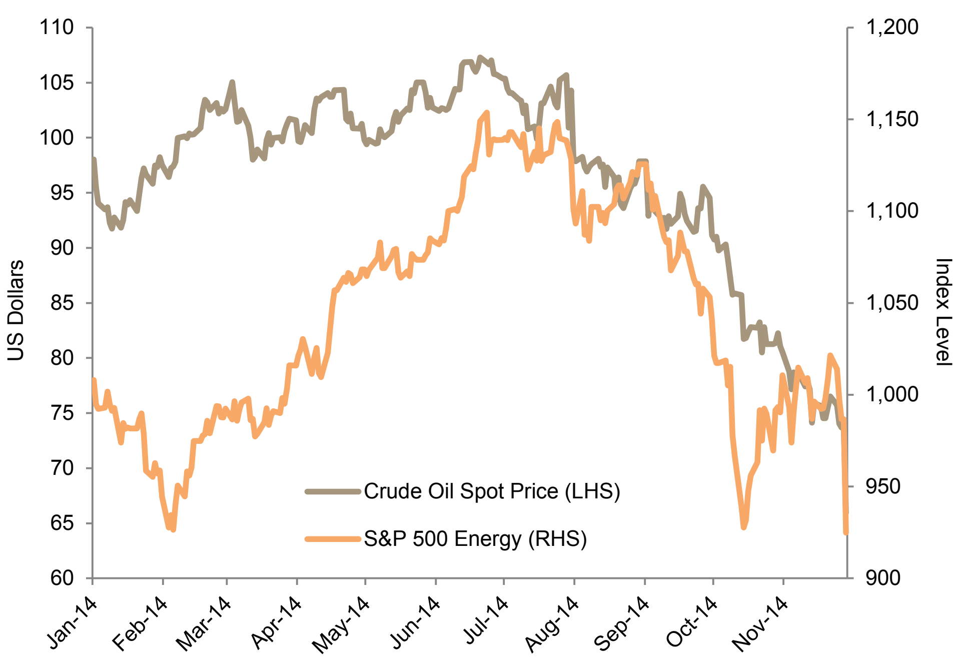
January 31, 1973 – November 30, 2014



The dollar continued to gain against developed and emerging peers in November as US growth is significantly outpacing that of global peers and monetary policy is turning less dovish

Crude Oil and Energy Stocks

January 1, 2014 – November 30, 2014



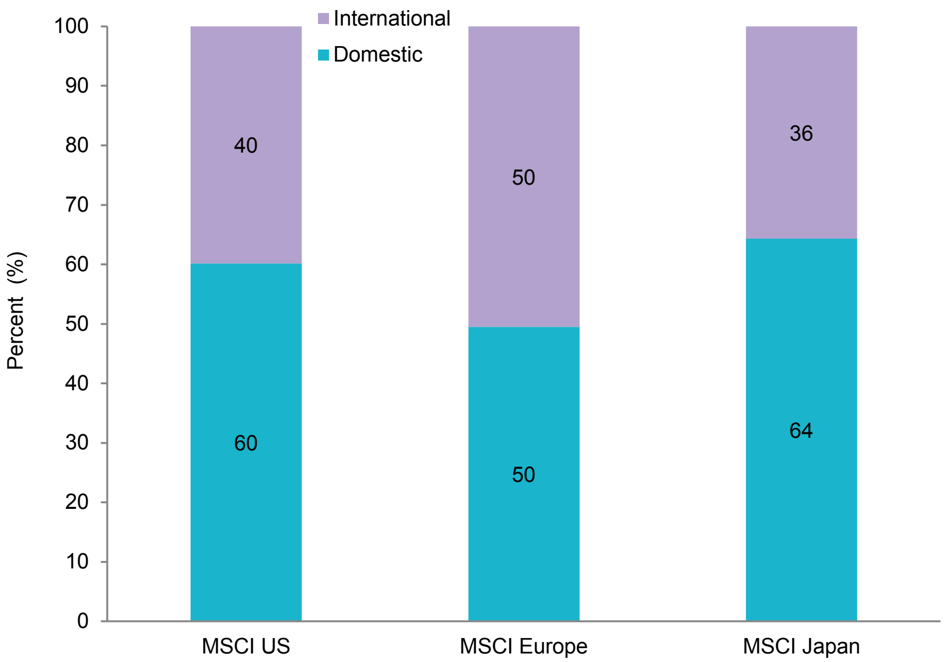
Sources: Standard & Poor's and Thomson Reuters Datastream.

Note: Data are daily.

Crude oil plunged in November given supply concerns as OPEC members failed to agree to cut production quotas; energy stocks were the worst-performing sector across developed and emerging indexes

Revenue Breakdown by Region

As of December 31, 2013

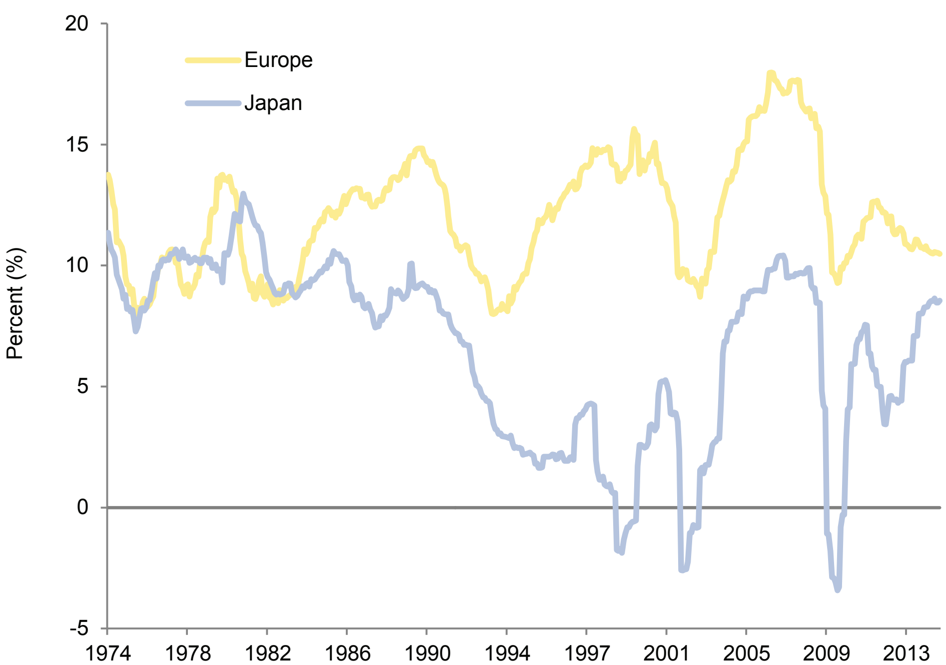


Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

The high reliance of European and Japanese companies on foreign markets is turning into an earnings tailwind as currency depreciation boosts the value of these foreign sales; conversely, some US companies are starting to caution that the stronger greenback might impact 2015 revenues

MSCI Europe and Japan Return on Equity

December 31, 1974 – November 30, 2014

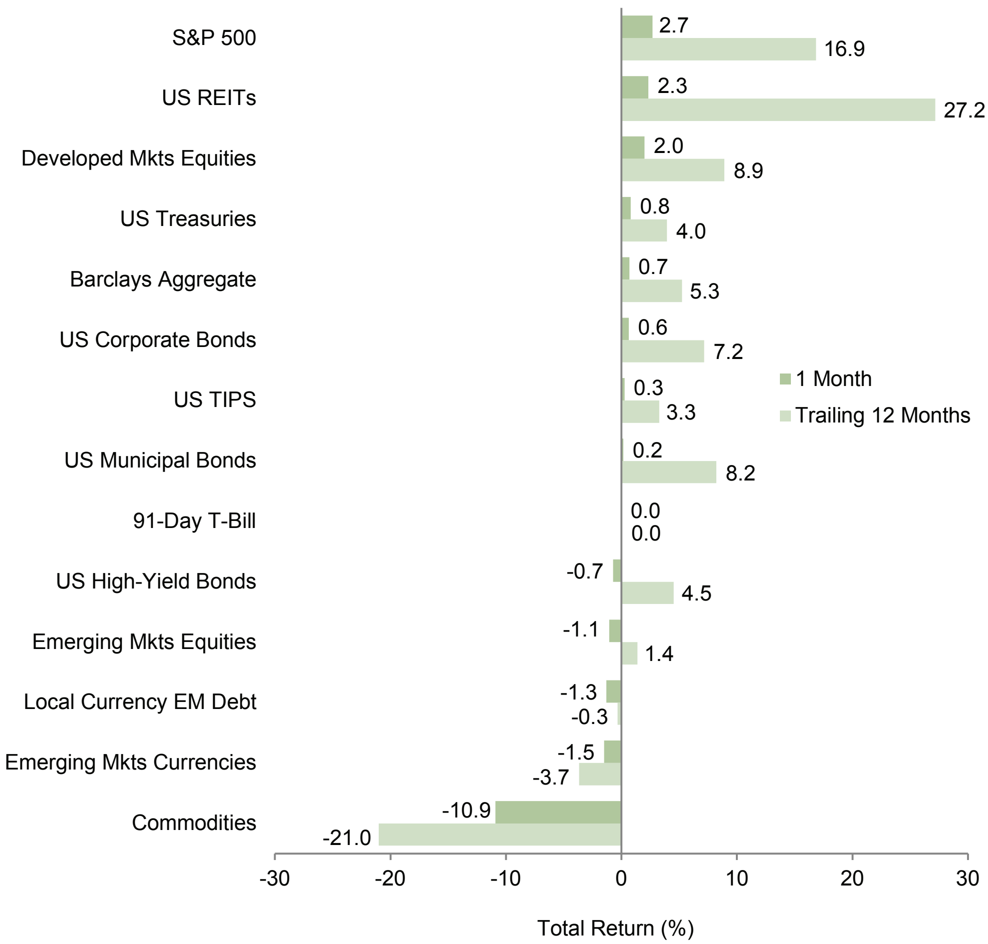


Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Japanese corporate profitability is soaring as the yen boosts the value of foreign sales and as the government encourages management teams to think more closely about shareholder returns

Index Performance (US$)

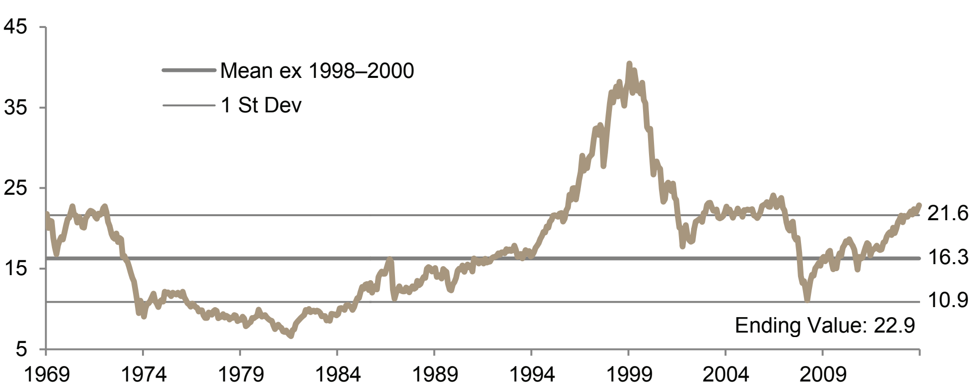
As of November 30, 2014



US equities posted strong gains as third quarter earnings growth was robust and macro data surprised to the upside; weaker oil prices weighed on a variety of asset classes including commodities and high-yield bonds

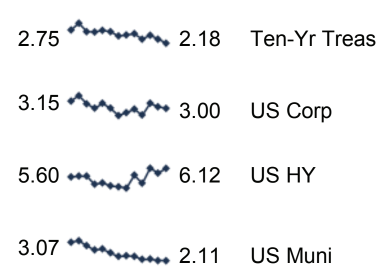
MSCI US Composite Normalized P/E

December 31, 1969 – November 30, 2014



Fixed Income Yields

November 2013 – November 2014

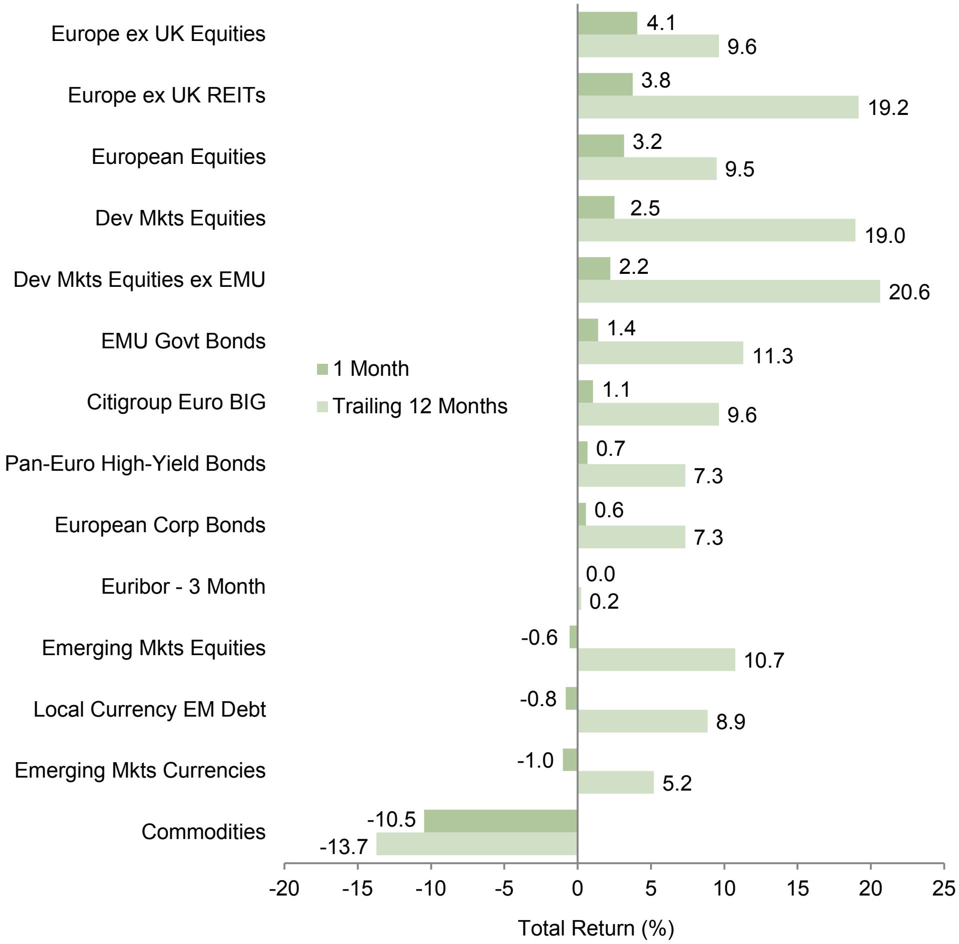


Sources: Barclays, BofA Merill Lynch, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

Index Performance (€)

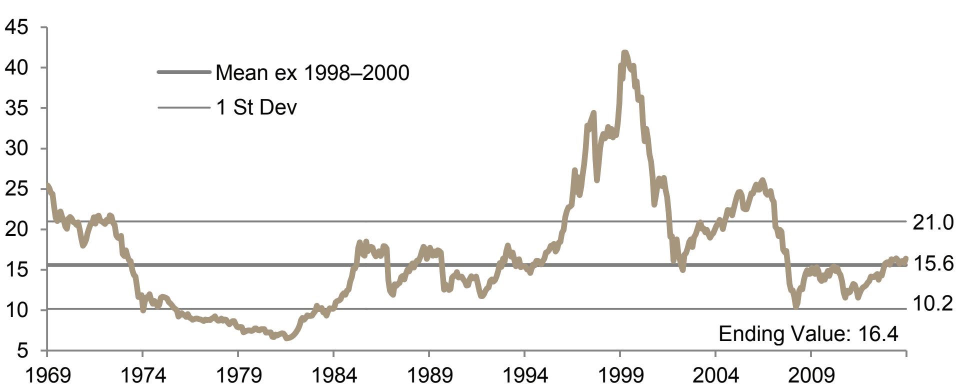
As of November 30, 2014



European equities posted strong returns as a positive earnings season wrapped up; European Central Bank indications that it would expand QE efforts should inflation continue to disappoint were greeted favorably across both equity and debt markets

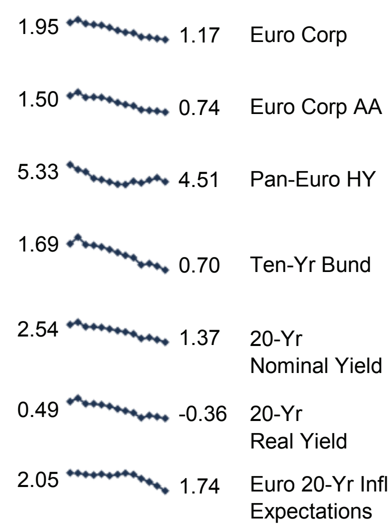
MSCI Europe ex UK Composite Normalized P/E

December 31, 1969 – November 30, 2014



Fixed Income Yields

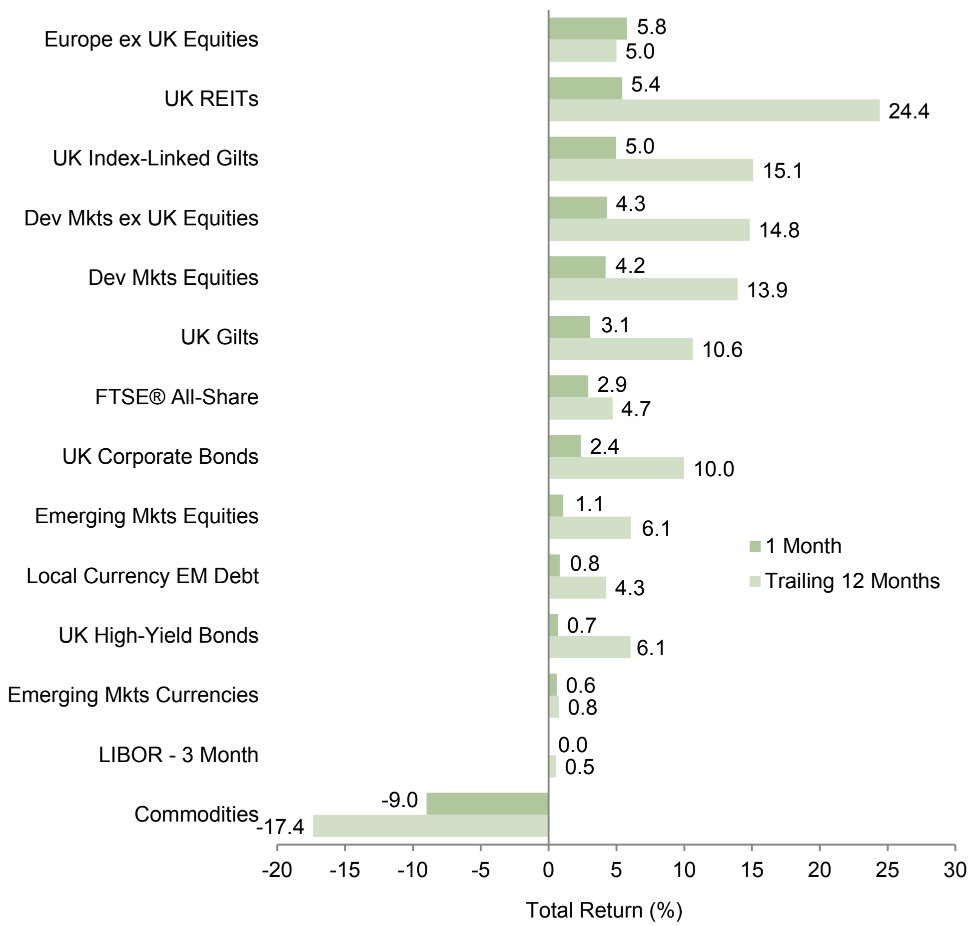
November 2013 – November 2014



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.

Index Performance (£)

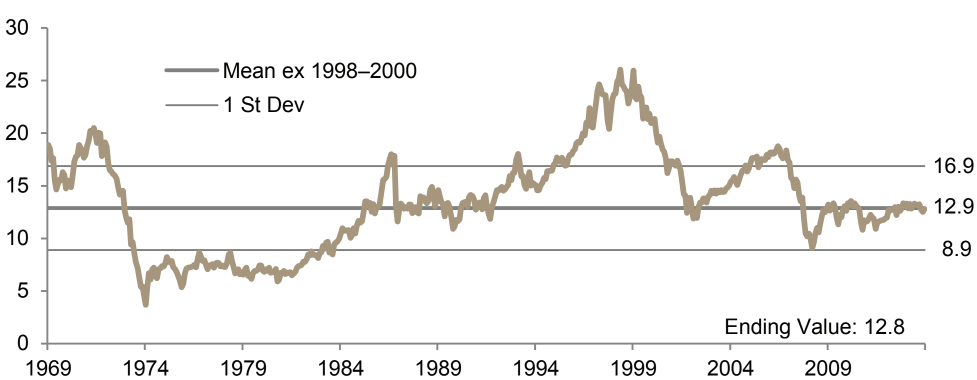
As of November 30, 2014



Gilts returned over 3% as data showed consumer prices increased by just 1.3% and analysts questioned the strength of the recovery; lower yields dragged down the pound against developed markets peers and boosted returns for unhedged sterling investors across a variety of foreign stock and bond markets

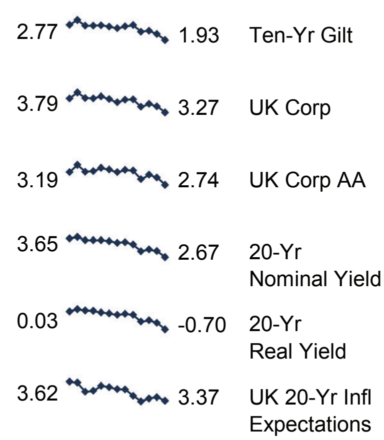
MSCI UK Composite Normalized P/E

December 31, 1969 – November 30, 2014



Fixed Income Yields

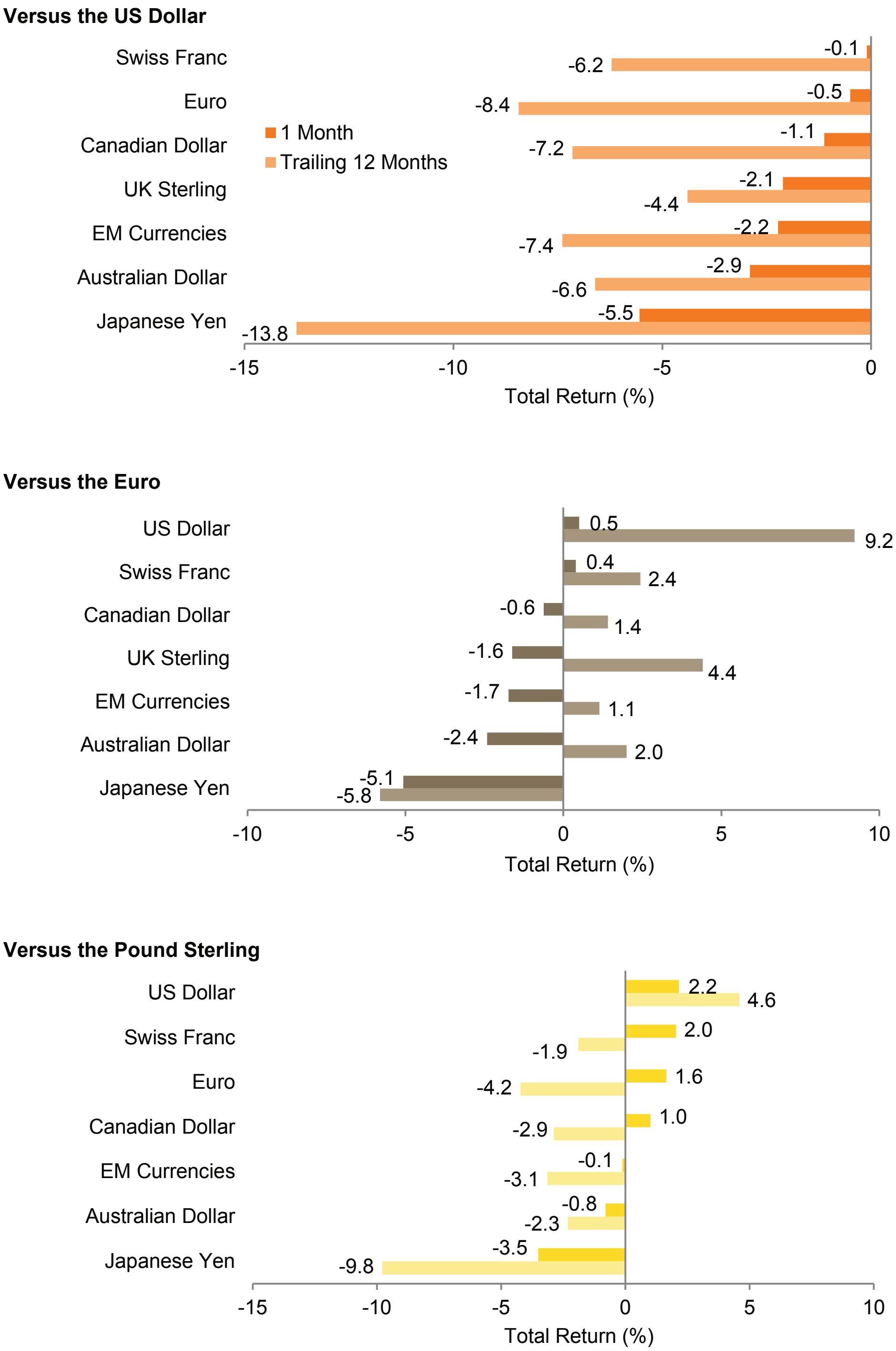
November 2013 – November 2014



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 November 30, 2014



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

The yen depreciated over 5% against the US dollar as the Bank of Japan is expanding its asset purchases amid lackluster growth and inflation; emerging markets currencies also fell as many emerging markets central banks are cutting rates given slower growth, lower commodity prices, and the threat of losing export share to Japan.

The euro continued to slump against the US dollar as the European Central Bank suggested it was considering outright purchases of sovereign bonds; the Australian dollar posted large losses against many developed peers as plunging commodity prices are causing growth and inflation forecasts to be questioned

Exhibit Notes

Real Trade-Weighted Value of the US Dollar
Sources: Federal Reserve and Thomson Reuters Datastream.
Notes: The index is based on a basket of foreign currencies weighted by the dollar amount of trade with the United States. The index represents the monthly trade-weighted average. Real trade-weighted value is rebased to 100 in March 1973.

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.