CAMBRIDGE ASSOCIATES

Market Matters

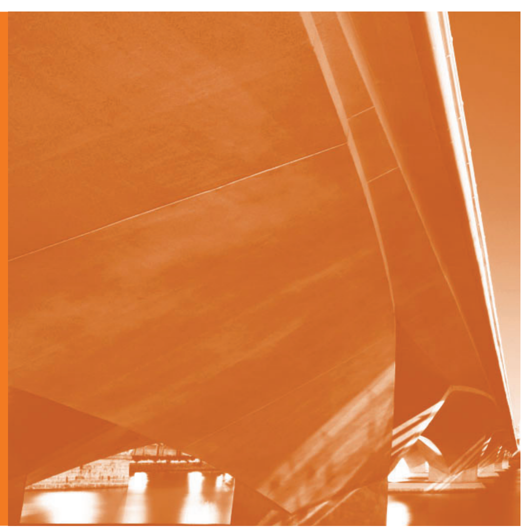
February 28, 2015

February saw some global stock indexes reach 15-year highs and European bond yields fall to historical lows. Economic data were mildly positive, though European sovereign debt stress is back (it never really went away) and many emerging markets countries are easing monetary policy to relieve the stress of high debt levels. Crude oil staged a minor recovery as planned capital expenditures and rig counts fell, though gold moved in the opposite direction as the dollar remains ascendant and investor demand is plunging.

Diverging monetary policy continued to be one of the big drivers across markets in February, impacting everything from exchange rates to investor portfolio allocations. Oil prices stabilized somewhat in the month; the recent dramatic decline is being reflected in readings for inflation, earnings, and returns for different asset classes. Developed markets equities that benefit from these trends again outperformed (5.9%), while emerging peers trailed (3.3%) though dispersion was high across countries, particularly in emerging Europe. Meanwhile, bonds suffered a small reversal despite strong technicals as economic data were mildly positive and oil prices rose.

Lackluster earnings reports could not prevent US equities (5.7%) from playing catch up with developed peers. With fourth quarter reporting nearly complete, S&P 500 fourth quarter earnings growth looks to be around 3.7% (year-over-year), and 2015 expected growth has fallen to less than 3%. The energy sector shoulders much of the blame, along with other themes such as

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



the strong US dollar depressing the value of foreign profits. Recent equity performance has outpaced earnings growth, resulting in stretched valuations. US stocks trade at a decade-high 17 times forward earnings and, at late 2007 levels, normalized multiples look even richer. One reason forward multiples look so expensive may be that while the pain from lower oil has already been priced into earnings forecasts for the energy sector, the benefit may not yet be fully reflected in estimates for others like consumer cyclicals.

Headlines suggested that US economic data disappointed, but a closer look reveals the recovery remains intact. Despite news that fourth quarter GDP growth came in slightly below initial estimates at 2.2% annualized, 2014 full year growth was in line with recent averages and employment gains have been robust. This is feeding through to better retail sales figures (excluding gasoline), and signs of upward pressure on wages and incomes. Federal Reserve Chair Janet Yellen's testimony to Congress was viewed as neutral for the interest rate outlook, though her mention of diminished slack in the labor market may mean hikes are more imminent than some suspect.

Despite a minor re-escalation of peripheral debt stress, European stocks (6.1%) again generated strong returns and are now up an impressive 10.2% year-to-date. Europe ex UK equities (7.4%) outperformed UK (3.3%) peers in local currency terms and posted better earnings data; pound strength equalized returns for the two regions in euros and sterling. Around 55% of European companies have beaten expectations during the current earnings season, but blended growth is coming in around 15% year-over-year as financial sector earnings recover. European earnings are expected to grow 4% this year—though there may be upside given ongoing euro weakness. European equities' strong start to the year has pushed our normalized P/E ratio to around 10% above its historical average, though valuations remain compelling on a relative basis.

Macro data in Europe continue to suggest growth is slowly accelerating and have been supportive for markets. Manufacturing data have been strengthening for several months, and consumer confidence is rising in several countries. The flipside is that sovereign debt stresses remain, as illustrated by February's tensions between Greece and the "Troika." The European Central Bank's expanded bond purchases are now an important firewall that may help prevent contagion, though volatility is likely to rise if the two sides continue to find difficulty in deciding on terms under which the current bailout will remain in place.

Japanese equities (7.9%) were among the best performers globally for the month, boosted both by decent earnings results and by the expectation of

9% earnings growth in 2015—among the highest across developed markets. Macro data continue to be mixed, though last month brought news that exports are finally rebounding, boosted by the cheap yen. Despite generating attractive returns in recent years, strong profit growth in Japan has meant that valuations remain attractive on a relative basis. Japanese equities trade around 15 times forward earnings and remain among our most preferred markets.[1] Looking across other major markets, emerging stocks (3.3%) rebounded, with index heavyweights China (3.3%) and Taiwan (3.3%) setting the pace. Brazil (9.6%) rebounded in spite of a ratings downgrade for scandal-plagued Petrobras raising fears over debt servicing costs. Adding to long-standing concern over lower commodity prices in emerging markets are more recent worries over rising debt levels. To help soften the impact, China again cut key lending and savings interest rates in February. Inflation, which has fallen back to 2009 levels, has made this a more palatable option.

Declines across global fixed income markets helped to offset gains from surging stocks in diversified portfolios. Perhaps due to a sense that yields had compressed to unsustainably low levels, US Treasuries sold off and benchmark indexes such as the Barclays Aggregate (-0.9%) suffered minor losses. The exception was high-yield bonds, both in the United States (2.4%) and Europe (2.6%), given resurgent investor inflows and ebbing fears over energy sector defaults (at least in the near term). Demand for higher-yielding bonds is being boosted by benchmark rates, which remain near zero in many regions. February saw German bunds issued with negative yields for the first time and some high-quality corporate bonds in Europe are starting to trade with sub-zero yields. European banks have few attractive choices for investing their deposits and other investors seem to anticipate that yields may fall further from here and generate mark-to-market gains. For now, speculating on this outcome has a clear financial cost.

Oil mounted a minor recovery in February, as global energy companies continued to slash forecast capital expenditures and the number of rigs operating in the United States plunged. Natural resources equities rose 5.5% and are back in the black for 2015, though master limited partnerships (2.1%) could not fully recover from January's losses. The 4% decline in gold prices and weakness in other precious metals helped to cap gains for commodity futures (2.6%). The World Gold Council reported that global investment demand for gold fell to 905 tons last year, a 44% drop from 2012 levels, though appetite from other sources like jewelry and central banks has been firmer. ■

[1] Please see Wade O'Brien et al., "Japan: Micro More Compelling Than Macro," Cambridge Associates Research Note, February 2015.

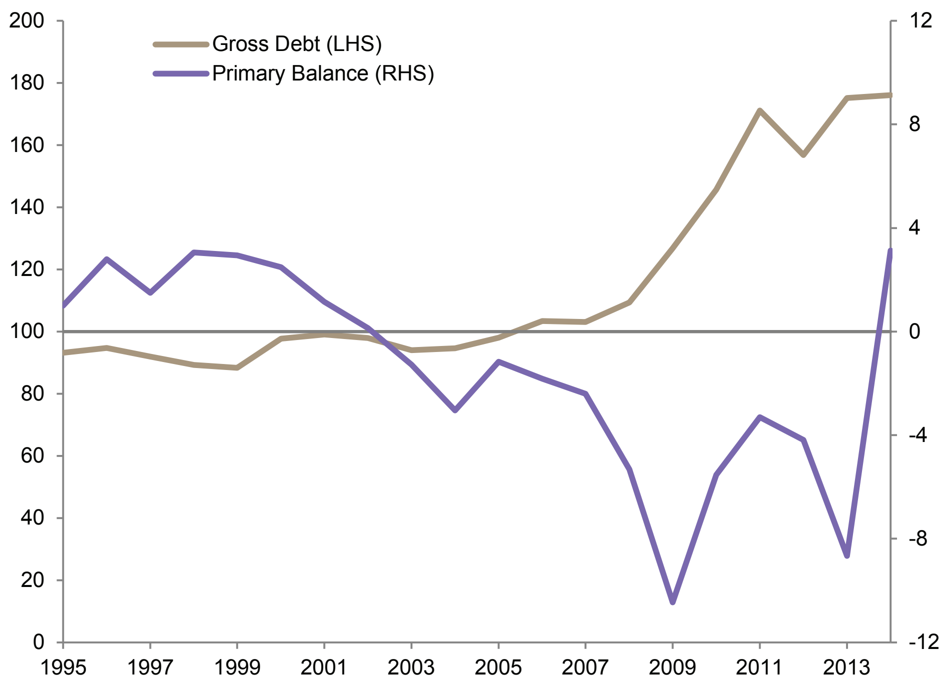
Access additional exhibits on market performance via the Market Update category on our **Exhibit Finder** application

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

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

Greece's Fiscal Position as a Percentage of GDP

1995–2014 • Percent (%)

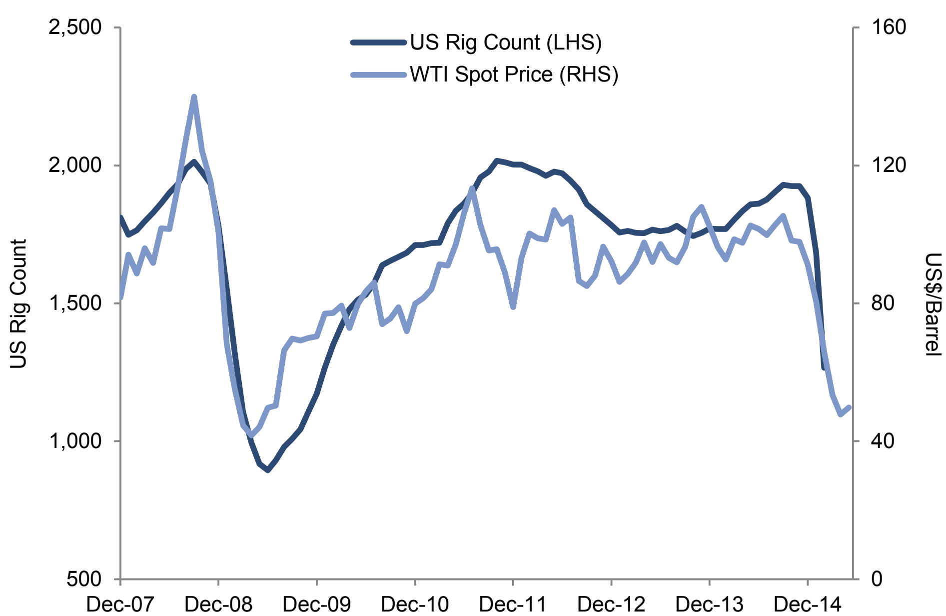


Sources: Bloomberg L.P. and OECD.

The collapsing Greek economy has caused the debt/GDP ratio to soar, but the government has returned the current account to surplus, seemingly boosting its negotiating position with creditors

Baker Hughes US Rig Count vs WTI Spot Price (Three Months Ahead)

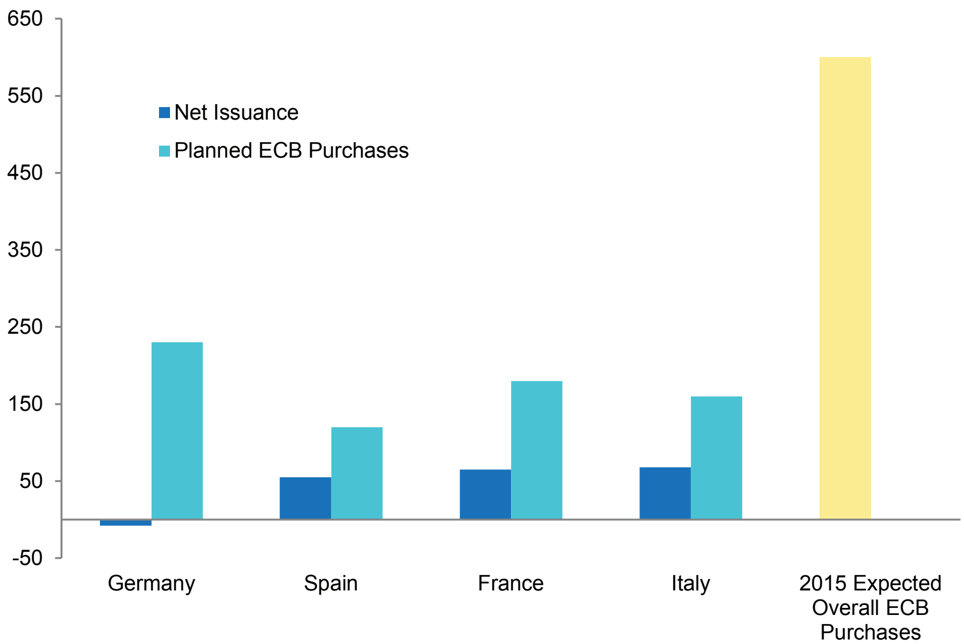
December 31, 2007 – February 28, 2015



Sources: Baker Hughes Incorporated, Bloomberg L.P., BMO Capital Markets, and Thomson Reuters Datastream.
Notes: WTI spot price data are graphed three months ahead of the rig count data. For example, the December 31, 2014, data show the rig count as of December 31, 2014, and the WTI spot price as of September 30, 2014.

As oil prices have collapsed, companies have responded by slashing capital expenditures and reducing the number of rigs in operation

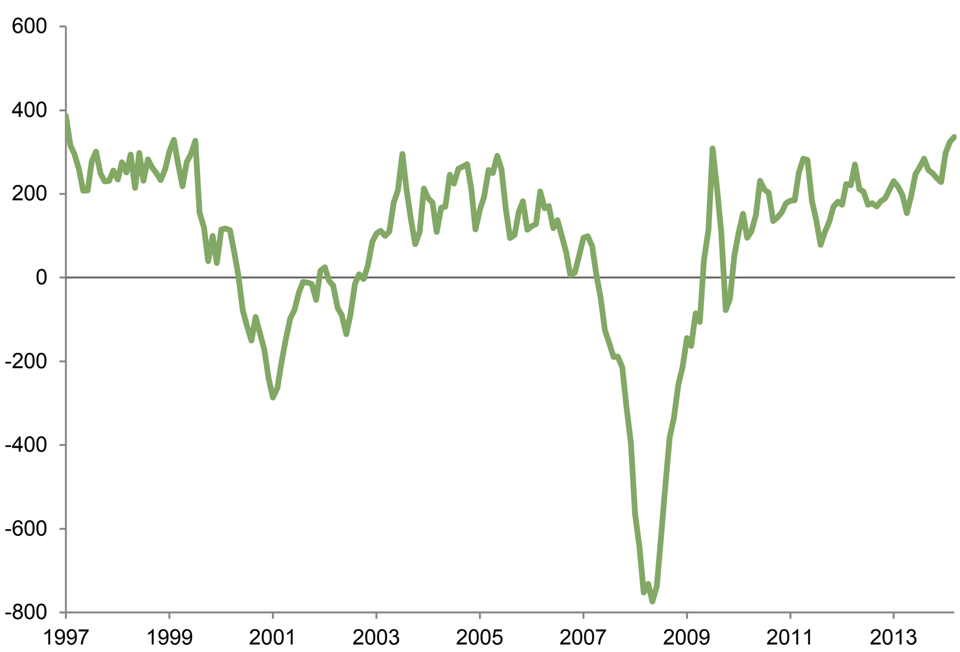
2015 Net Issuance of Sovereign Bonds vs Expected 2015 ECB Purchases
€ billions



Source: Lombard Street Research.
Note: Net issuance of sovereign bonds based on estimates provided by Lombard Street Research.

One of the reasons Eurozone sovereign yields have plunged is that planned ECB purchases will greatly exceed expected net issuance for many countries

US Employment Gains
November 30, 1997 – January 31, 2015 • Thousands (000s)

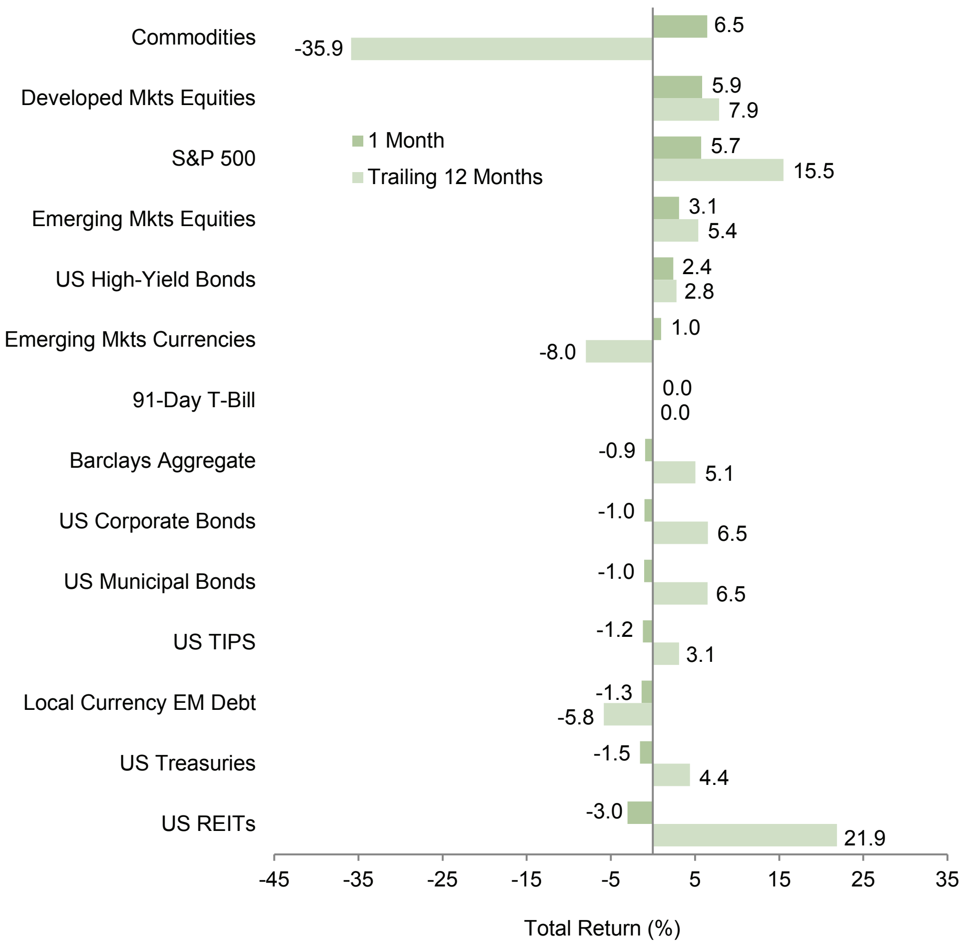


Sources: Thomson Reuters Datastream and US Department of Labor - Bureau of Labor Statistics.
Note: Data series is a rolling three-month average of non-farm payroll additions.

Despite headlines about lackluster US economic data in February, key metrics like job creation are strongly rebounding and rising wage pressures, if sustained, could force the Fed's hand

Index Performance (US$)

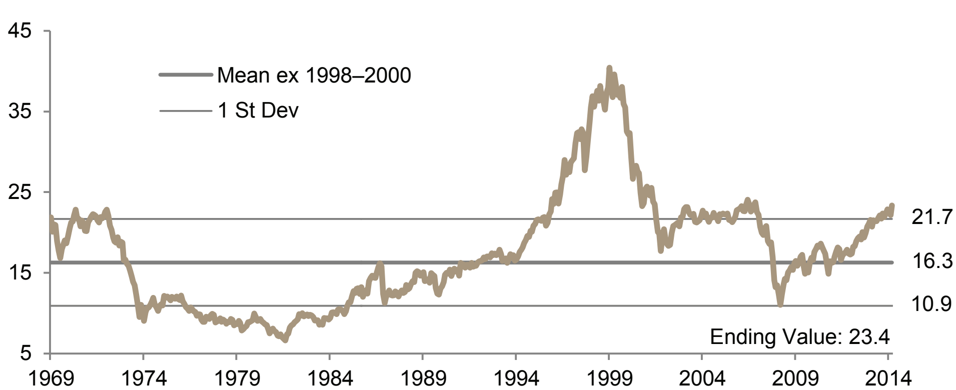
As of February 28, 2015



Despite strong returns, US equities trailed Eurozone and Japanese peers; fixed income suffered as higher commodity prices and wage pressures meant the Fed may not be able to postpone rate hikes indefinitely

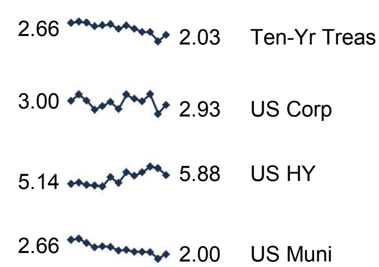
MSCI US Composite Normalized P/E

December 31, 1969 – February 28, 2015



Fixed Income Yields

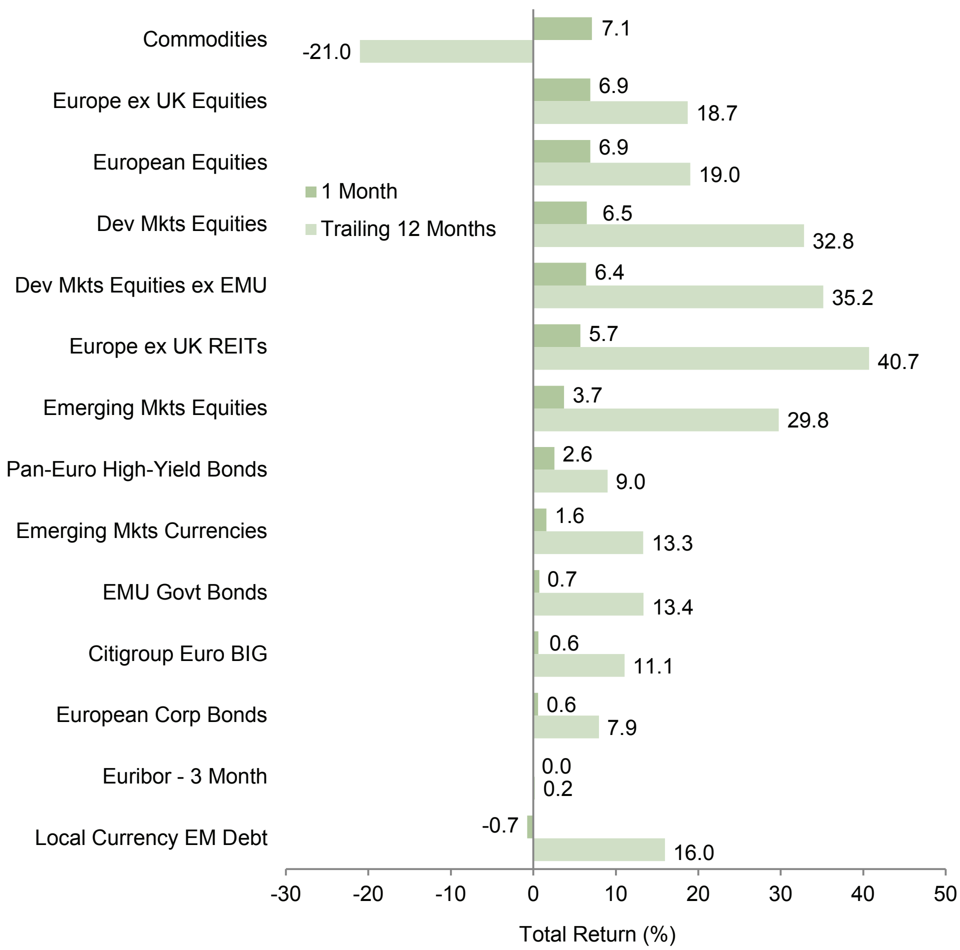
February 2014 – February 2015



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.

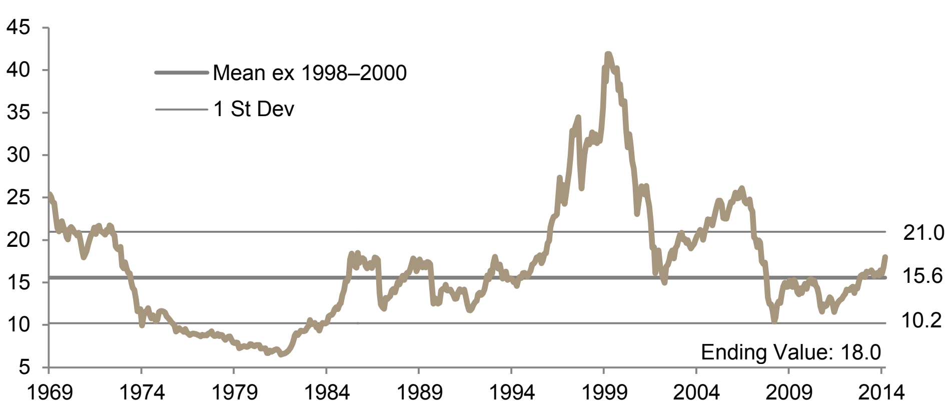
See last page for notes.

Index Performance (€)
As of February 28, 2015

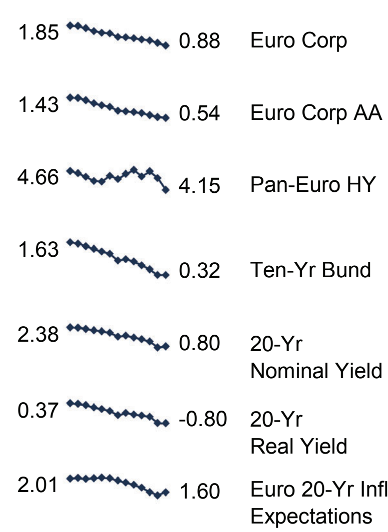


Eurozone equities returned nearly 7% but valuations still remain attractive; high-yield bonds outperformed other types of fixed income in part because low/negative benchmark yields in the Eurozone are serving to cap returns

MSCI Europe ex UK Composite Normalized P/E
December 31, 1969 – February 28, 2015



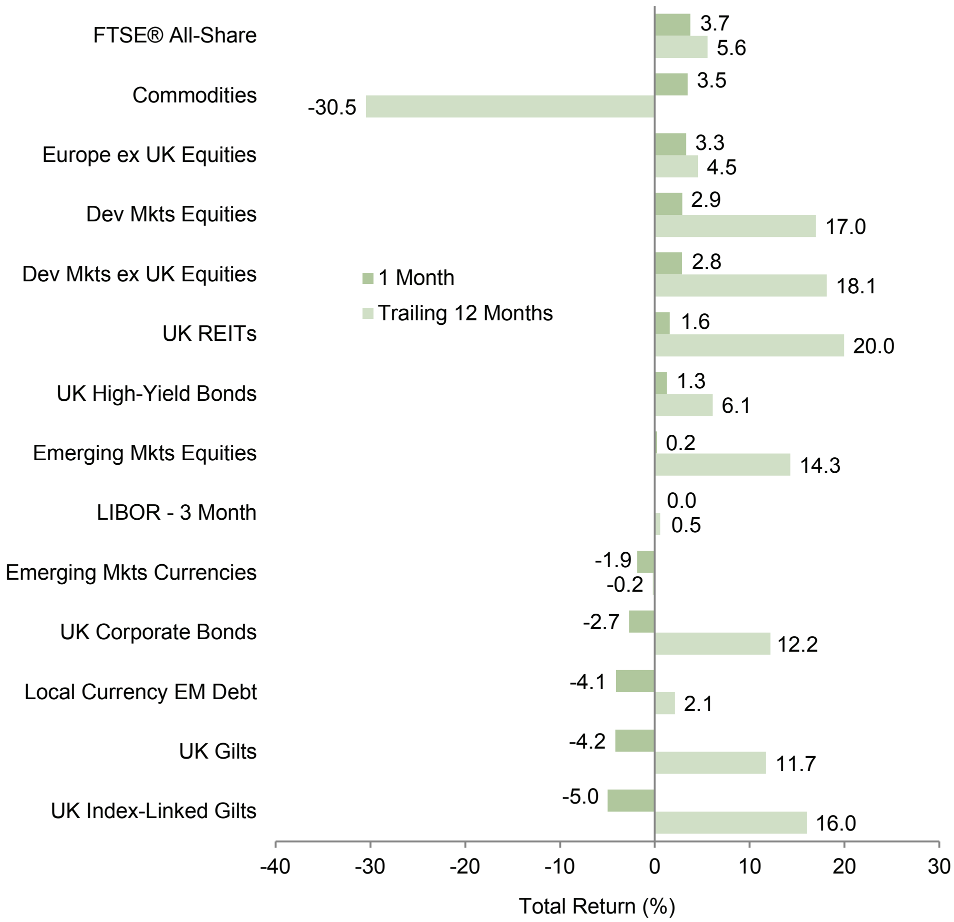
Fixed Income Yields
February 2014 – February 2015



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 (£)

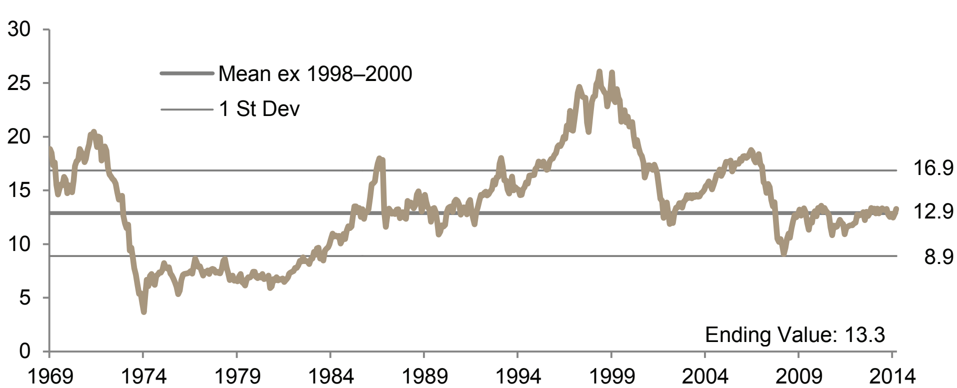
As of February 28, 2015



Returns for domestic UK equities have exceeded those of peers (on an unhedged basis) due mainly to the pound's strength against currencies like the euro. The flipside of healthier economic data was that yields on UK gilts soared, generating losses across a variety of fixed income categories

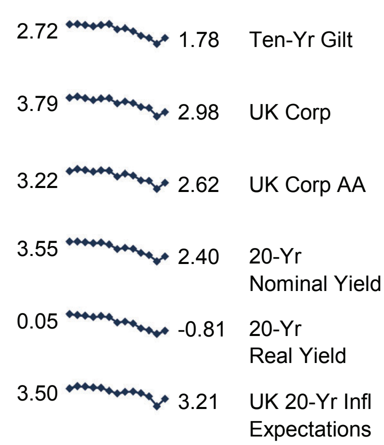
MSCI UK Composite Normalized P/E

December 31, 1969 – February 28, 2015



Fixed Income Yields

February 2014 – February 2015



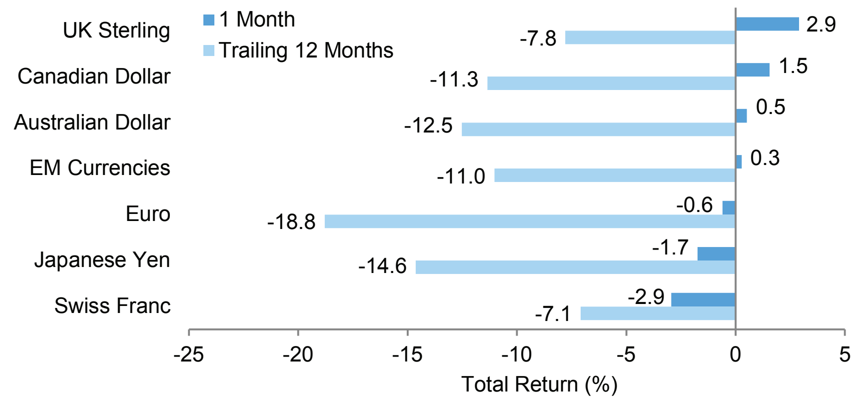
Sources: Bank of England, Barclays, BofA Merrill Lynch, EPRA, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

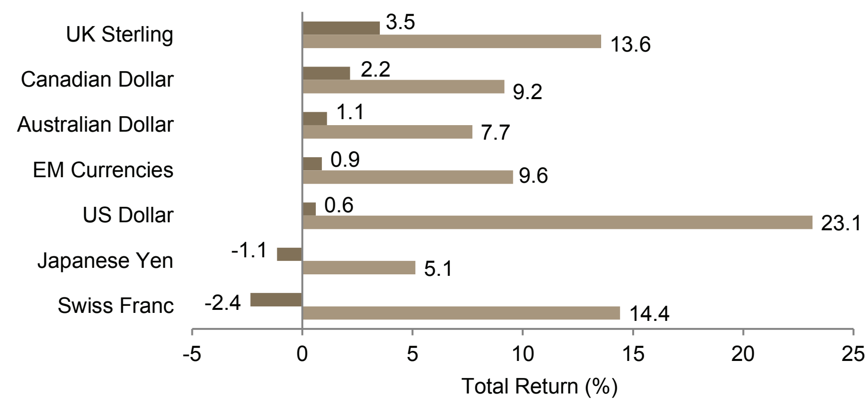
Currency Performance

As of February 28, 2015

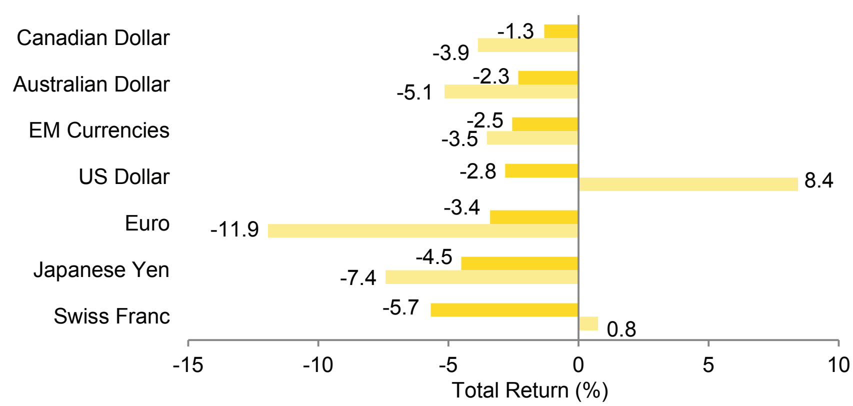
Versus the US Dollar



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 to strengthen, albeit at a slower pace, against the euro and yen but gave up some ground against the Australian and Canadian dollars as Federal Reserve Chair Janet Yellen's testimony seemed to ease concerns about an imminent rate hike

The euro regained some ground against the Swiss franc but still has fallen over 14% over the past 12 months given the Swiss National Bank's surprise move in January

The pound rallied against both developed and emerging peers as economic data were more robust than expected

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.