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Market Matters

June 30, 2015

The second quarter ended on a downbeat note for most global equities, as Greece's failure to reach a deal with its creditors sent reverberations through markets. Central banks were key players throughout the quarter, with the European Central Bank (ECB) launching its quantitative easing program, the June US Federal Reserve communiqué reassuring investors, and the People's Bank of China trying to contain a potential stock market bubble. Global bond markets in general suffered worse losses than equities, as record low yields in Europe proved vulnerable to improving economic data. Certain currency and commodity markets experienced reversals, with US$ strength and oil price weakness seeming to abate, at least for now.

US economic data releases during second quarter showed a positive trend but did not signal any near-term risks of overheating. Housing, retail sales, and personal spending data strengthened, confirming that consumer confidence is improving. Recent payroll gains have been stronger following lackluster numbers in March and April, with the June unemployment rate dipping to 5.3%. On the other hand, wage growth remains sluggish and continues to weigh on inflation, suggesting labor market slack remains in some parts of the economy. The still-tepid manufacturing sector may be part of the problem, as the strong dollar has continued to weigh on both manufacturing output and business spending. During the June Fed meeting, Chair Janet Yellen cited the

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

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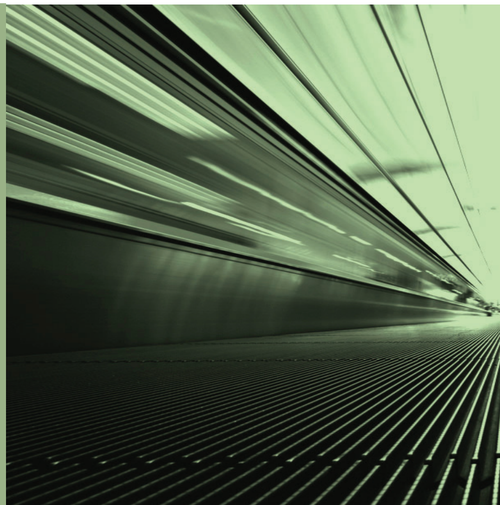
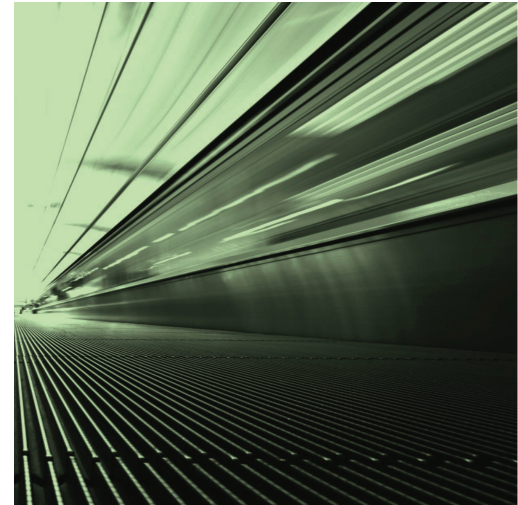




strong dollar in observing that growth has come in below expectations and that inflation remains limited; the first rate hike in nine years is now unlikely to occur until September at the earliest.

Cheered by dovish Fed commentary, US equities posted a small gain (0.3%) despite stretched valuations and decelerating earnings. Growth indexes slightly outperformed their value counterparts; small-cap stocks also modestly outperformed despite heady valuations. The Nasdaq and Russell 2000® reached all-time highs in June, driven by a frothy biotechnology sector that has rallied more than 44% during the last 12 months and over 21% year to date. Health care sector outperformance was driven by both an increase in mergers & acquisitions as well as a favorable Supreme Court ruling upholding the Affordable Care Act. Health care is just one of three sectors (the other two are financials and consumer discretionary) forecast to generate double-digit earnings growth in 2015, partially offsetting a further sharp decline in energy sector earnings. Along those lines, overall S&P 500 earnings for second quarter are expected to decline for the first time since 2012.

European equities (-3.9%) suffered losses in the second quarter as Greece was unable to strike a deal with its European creditors over new bailout terms. The Greek government has announced it will put the issue to a popular vote, increasing uncertainty as to eventual outcomes and whether Syriza will be in office much longer. Europe ex UK equities declined 4.4% despite improving economic data out of the core Eurozone countries. UK equities fared better but still suffered losses (-2.8%) as Greek developments overshadowed a market-friendly election result and an accommodative Bank of England. Both regions posted better returns for the quarter in US$ terms as the greenback weakened against both the pound and the euro. Despite recent price declines, STOXX Europe 600 estimated earnings growth of 9% for the full calendar year still compares favorably with that of the S&P 500 (1%), supporting an overweight allocation to Europe ex UK relative to US equities when coupled with more attractive valuations. Positive earnings momentum in Germany and France could also be an important driver of relative performance going forward.

Japanese equities (5.2%) were one asset class whose strong recent performance continued unabated through the second quarter, with the Nikkei 225 Index at one point in June reaching its highest level since 1996. First quarter annualized GDP growth of 3.9% far exceeded expectations; more recent data suggest that second quarter growth may be more modest. Earnings growth in Japan has been impressive, but the ongoing Japanese stock rally also has been fuelled by local institutions increasing their allocations to equities given

growing evidence that government-led governance reforms are changing corporate behavior in areas like cash allocation policies, cost controls, and board independence. Perhaps not surprisingly, earnings revision momentum for Japanese equities is positive and is set to accelerate.

Emerging markets equities (0.8%) were no strangers to the quarter's volatility but managed to slightly outperform developed markets equivalents (-0.7%). Overall emerging markets performance in second quarter was boosted by commodity-sensitive Latin America (3.3%), while emerging Asian markets (0.2%) lagged despite China's (6.2%) continued outperformance. Chinese A-shares (12.8%) continued their dramatic ascent for much of the quarter before experiencing a sharp 22% correction in late June. Chinese authorities seem of two minds about the recent equity volatility—on one hand curbing some speculative excess in areas such as margin lending but on the other boosting liquidity after recent stock market drops. Still, overall emerging markets valuations remain attractive, and earnings trends appear positive, at least for Asian countries.

Global bonds sold off, particularly at the long end of the curve, as economic data started to improve and deflation fears eased. This was especially true in the Eurozone, where volatility was also fuelled by limited liquidity and stretched positioning. The yield on the ten-year German bund soared almost 60 bps on the quarter (and over 90 bps on a trough-to-peak basis), triggering losses of 4.6% and 5.4% on German bunds and Eurozone sovereign bonds, respectively. This in turn hurt the relative attractiveness of US Treasuries and UK gilts, which sold off in sympathy. US Treasuries declined 1.6% overall, with long-term Treasuries suffering their worst quarterly performance (-8.3%) since 1981. US investment-grade credits (-3.2%) traded down with their sovereign equivalents, while US high-yield bonds (0.0%) proved more resilient. US tax-exempt bonds (-0.9%) also fared reasonably well, though a late-June announcement by Puerto Rico's governor that its $72 billion of debt was not repayable was just starting to reverberate through the market.

The multi-year US$ bull market took an overdue breather, with disappointing economic data early in the quarter and stretched positioning likely contributing to the reversal. Such mid-cycle corrections are not uncommon when reviewing past dollar bull markets. The dollar peaked in mid-March and began to weaken just after the ECB formally launched its bond buying program, falling 2.9% for the quarter. US$ weakness versus the euro, specifically, continued until late in June, when rising hopes for a Greek debt deal led some investors to re-enter their longer-term euro shorts used to fund allocations to higher-yielding assets.

Inflation-sensitive assets were not immune from the interest rate and currency moves and experienced mixed results. The weaker dollar likely boosted demand for some commodities from international buyers, driving prices higher, particularly for energy products. The price of WTI crude rallied 35% from its mid-March low before stabilizing around $60/barrel for the last two months. The energy-heavy S&P GSCI™ Index rallied 8.7%, while the more diversified Bloomberg Commodity Index gained 4.7% in second quarter. On the other hand, global natural resources equities and MLPs declined 3.1% and 6.1%, respectively. REITs globally sold off in response to substantially higher bond yields; US REITs posted their worst quarterly return (-9.1%) since third quarter 2011. ■

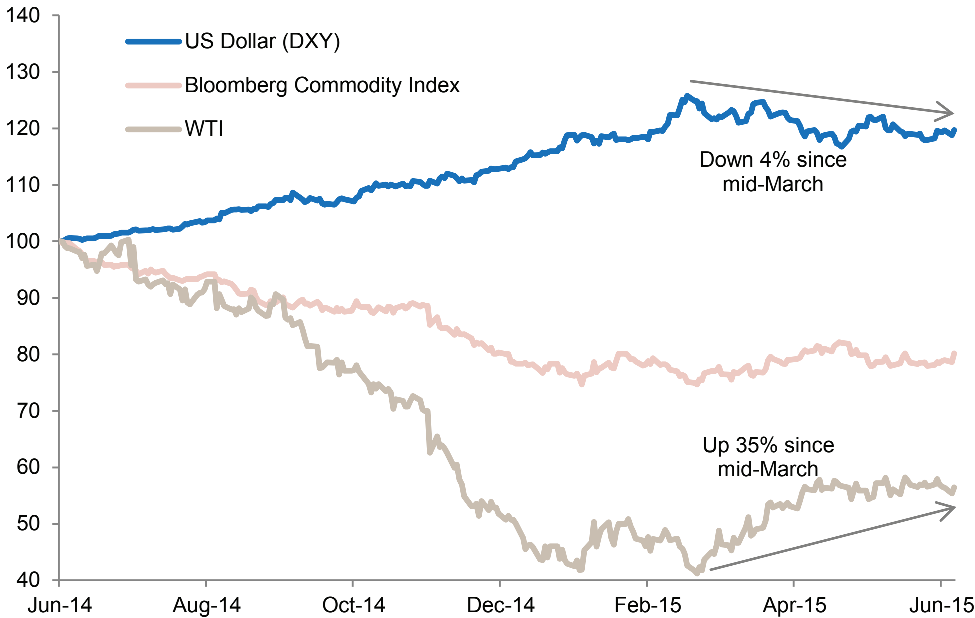
Access additional exhibits on market performance via the Market Update category on our **Exhibit Finder** application

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**

Cumulative Wealth of the US Dollar vs Various Commodities

June 30, 2014 – June 30, 2015 • June 30, 2014 = $100

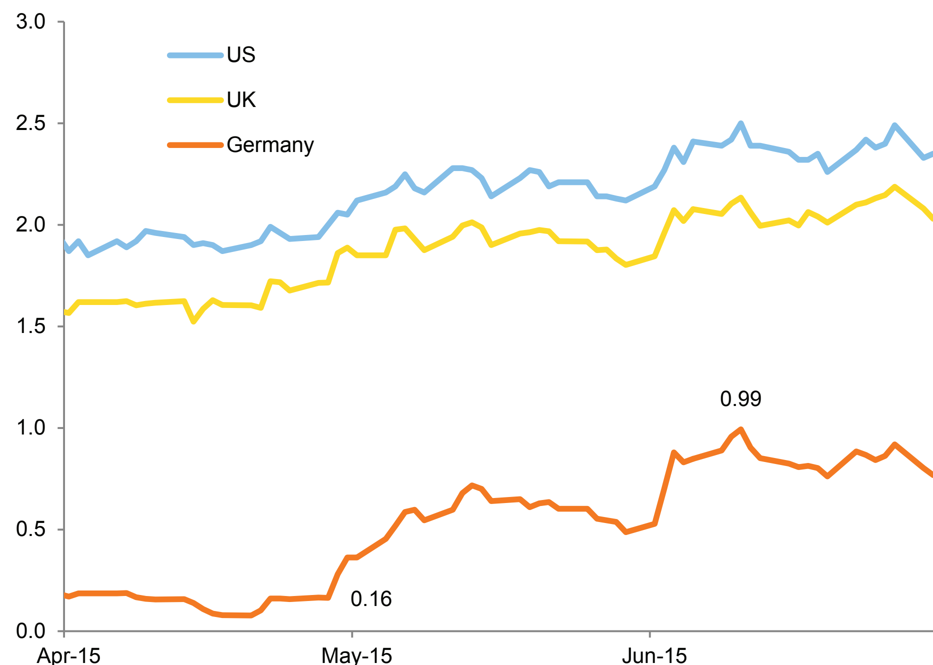


Sources: Bloomberg L.P. and Thomson Reuters Datastream.
Note: The DXY Index measures the value of the US dollar relative to a basket of other developed markets currencies.

Recent US$ strength and oil price weakness abated in Q2 as conflicting data releases and stretched positioning led some market participants to unwind their directional trades

Ten-Year Government Bond Yields

April 1, 2015 – June 30, 2015 • Percent (%)

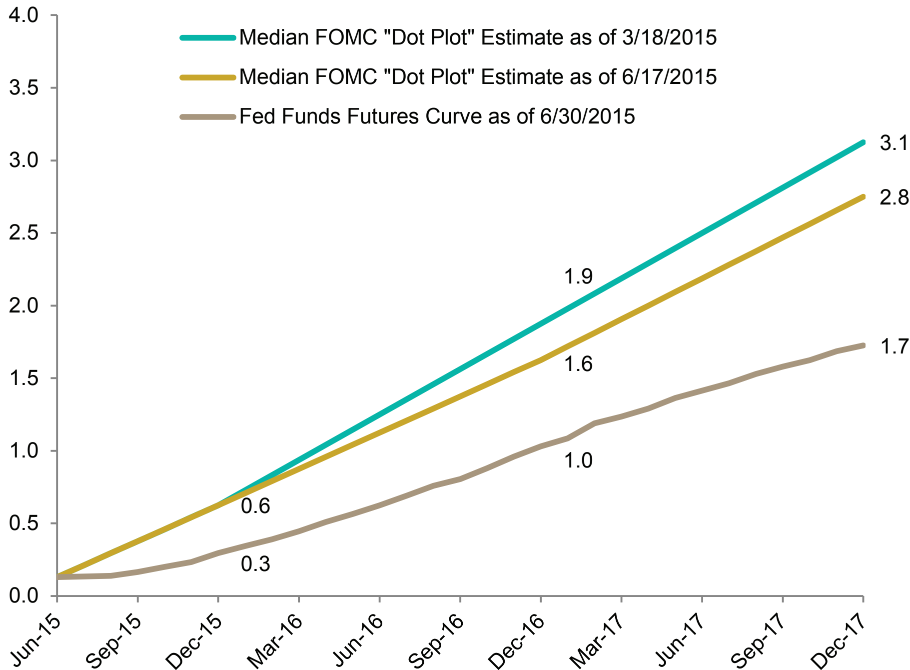


Sources: Federal Reserve and Thomson Reuters Datastream.

Bond market volatility picked up in Q2 as a combination of falling deflation fears and rising market technical pressures led German bund yields to spike, in turn reducing the relative attractiveness of US Treasuries and UK gilts

Fed Funds Futures Expectations

Percent (%)

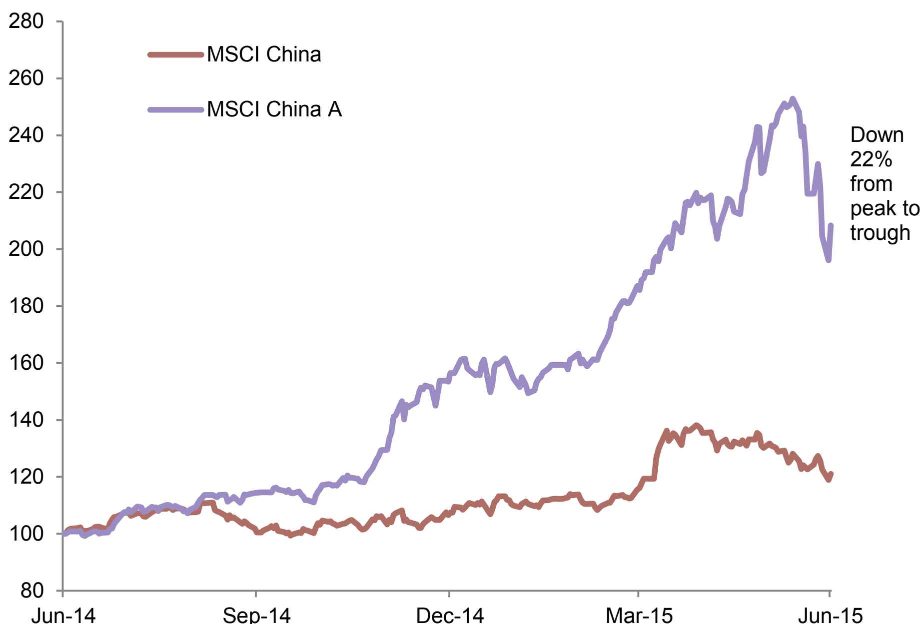


Sources: Bloomberg L.P. and Federal Reserve.

The June FOMC meeting confirmed what the Fed Funds futures curve has been suggesting all along: that the Fed's exit from its zero interest rate policy will be more deliberate and gradual than past tightening cycles

MSCI Price Levels

June 30, 2014 – June 30, 2015 • June 30, 2014 = 100 • Local Currency

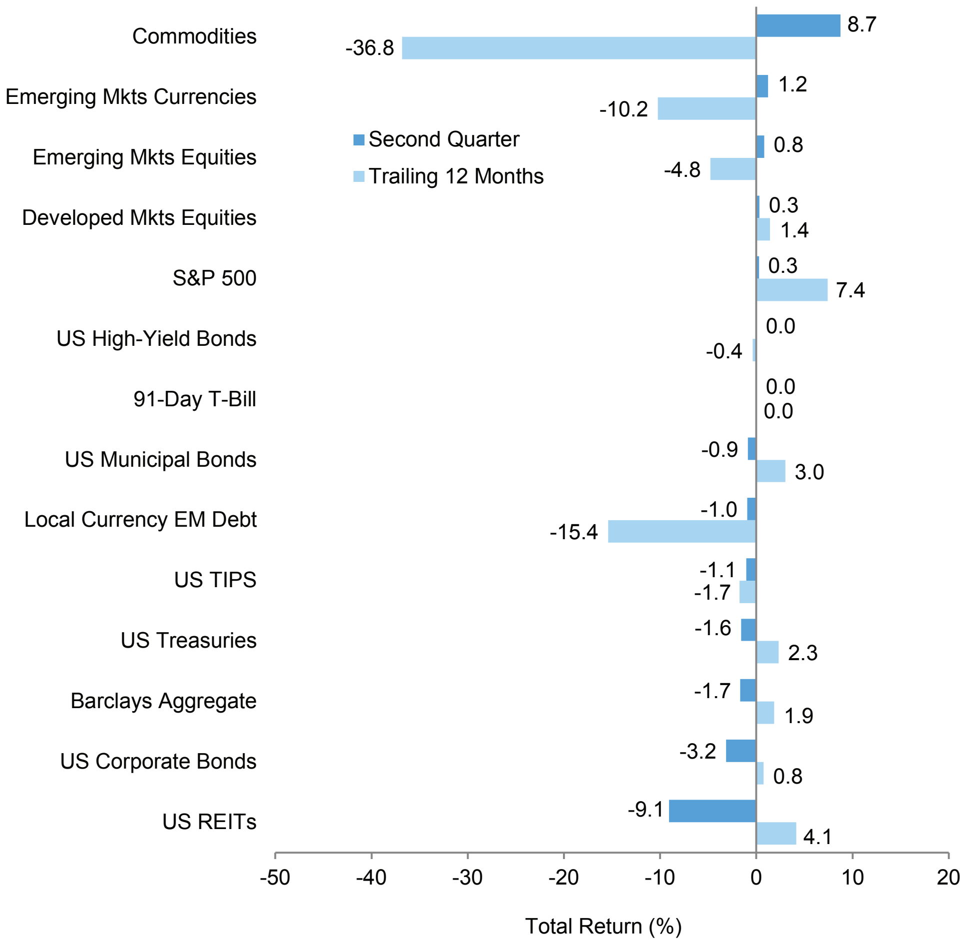


Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Data are daily.

The policy-fueled ascendance of Chinese A-shares continued unabated until June, when the Chinese government cracked down on unregulated margin lending. A sharp market correction ensued, prompting policymakers to ease liquidity further in support of domestic asset prices

Index Performance (US$)

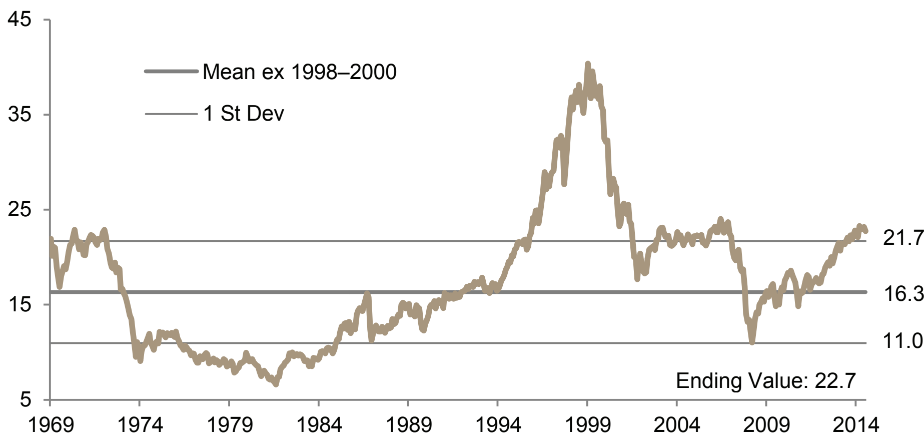
As of June 30, 2015



Commodities outperformed in Q2 as the combination of a weaker dollar, declining rig counts, and stretched positioning drove an oil price recovery. Equities provided muted gains as the S&P 500 was barely positive, with foreign equities slightly outperforming in US$ terms. Bonds and interest rate–sensitive REITs and MLPs suffered losses as US yields rose in sympathy with German bunds

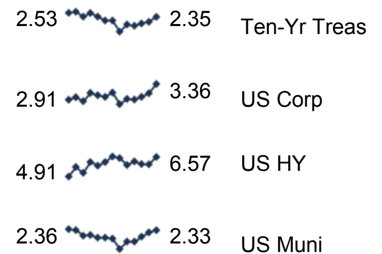
MSCI US Composite Normalized P/E

December 31, 1969 – June 30, 2015



Fixed Income Yields

June 2014 – June 2015

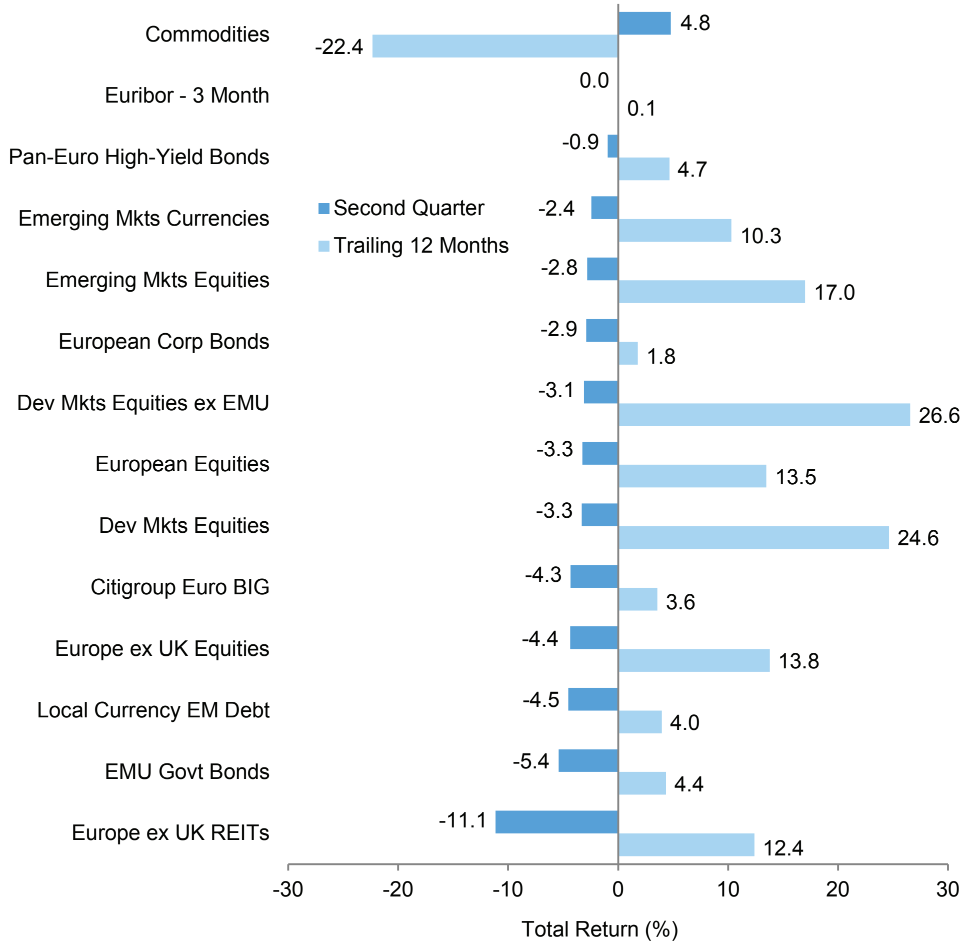


Sources: Barclays, BofA Merill Lynch, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

Index Performance (€)

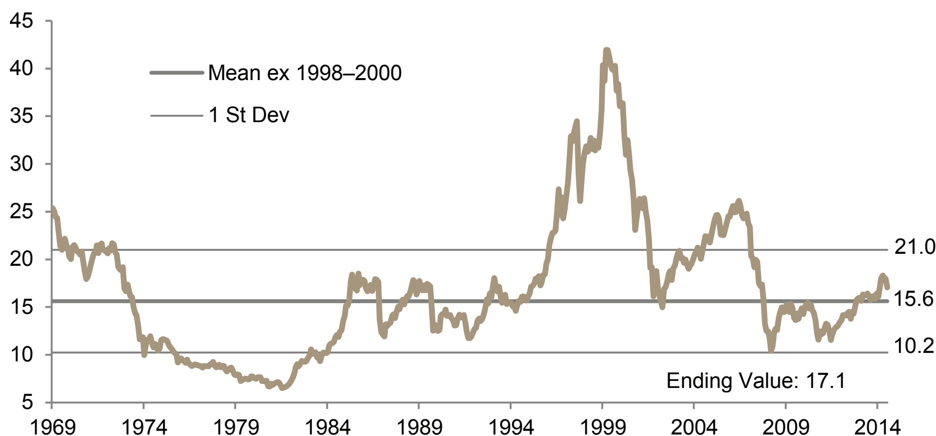
As of June 30, 2015



European investors suffered losses across most asset classes, giving back some of the strong gains generated over recent quarters. Continental equities sold off after the Greek negotiations broke down, while foreign equities were hurt by a stronger euro. Meanwhile, bond markets succumbed to better economic data and overbought conditions, and higher rates took the shine off local real estate

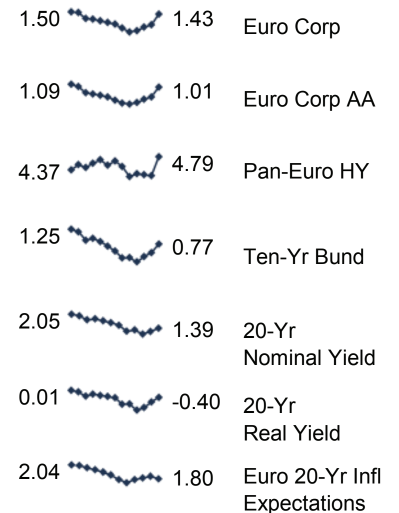
MSCI Europe ex UK Composite Normalized P/E

December 31, 1969 – June 30, 2015



Fixed Income Yields

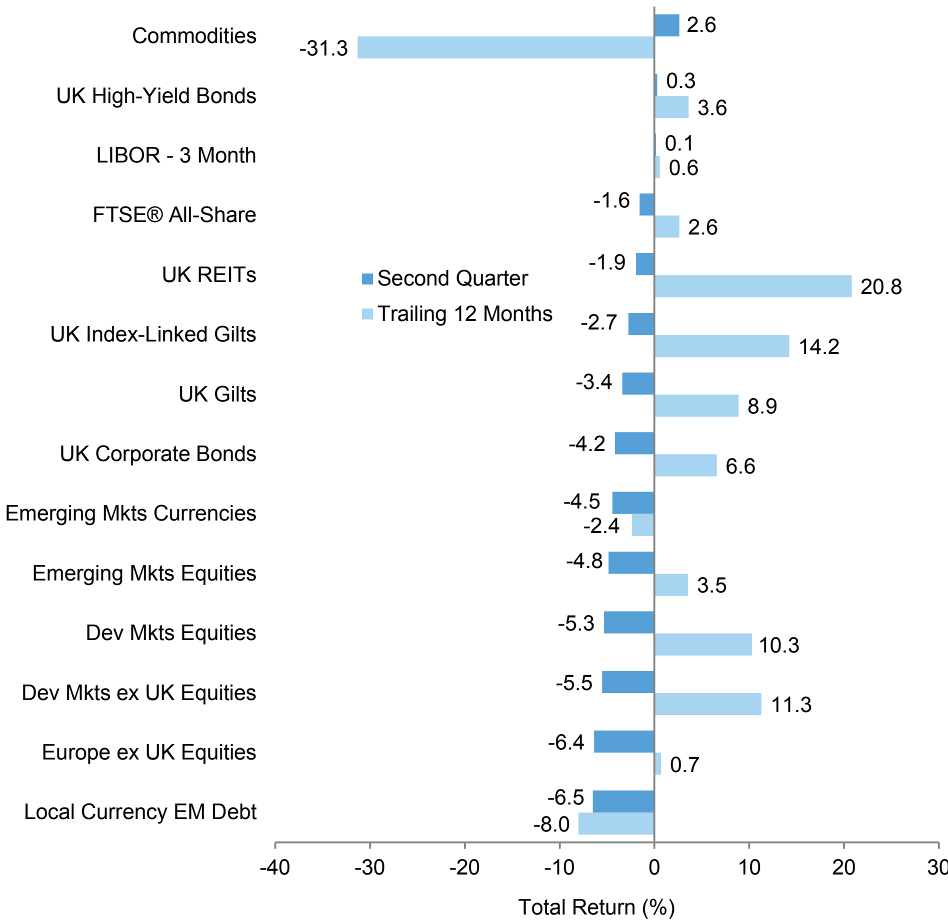
June 2014 – June 2015



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 (£)

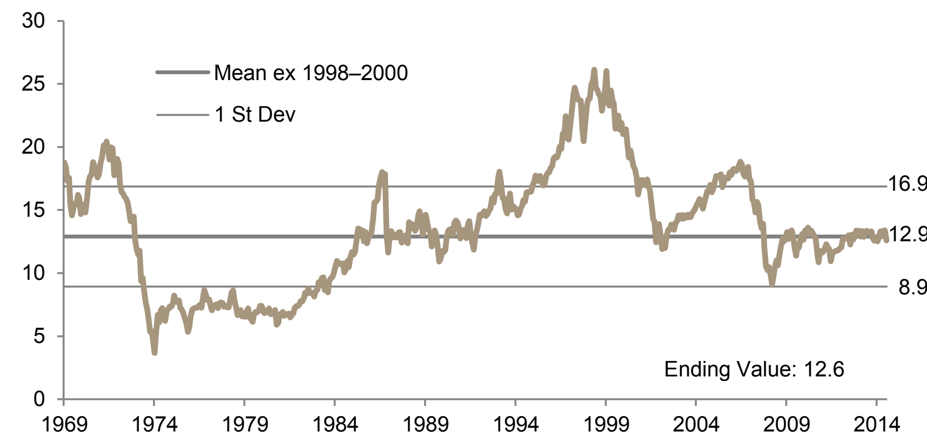
As of June 30, 2015



A strong pound meant that UK equities outperformed global peers in sterling terms. Bond yields rose despite sluggish inflation as the Bank of England signaled continued policy accommodation. Gilts and investment-grade credits underperformed equities, while high-yield bonds outperformed

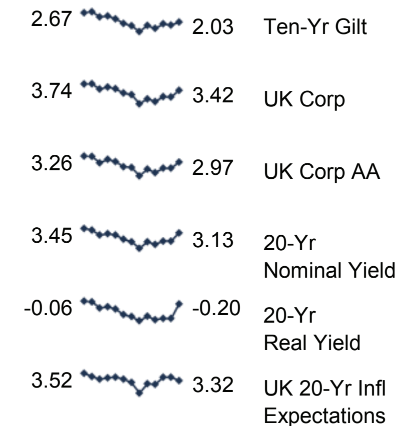
MSCI UK Composite Normalized P/E

December 31, 1969 – June 30, 2015



Fixed Income Yields

June 2014 – June 2015



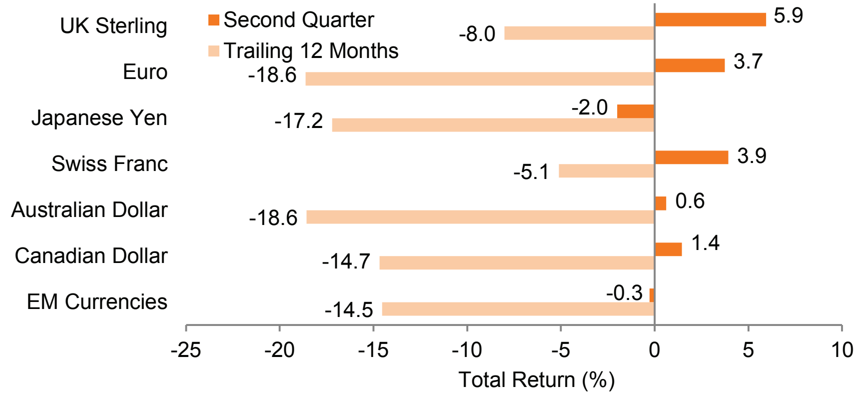
Sources: Bank of England, Barclays, BofA Merrill Lynch, EPRA, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

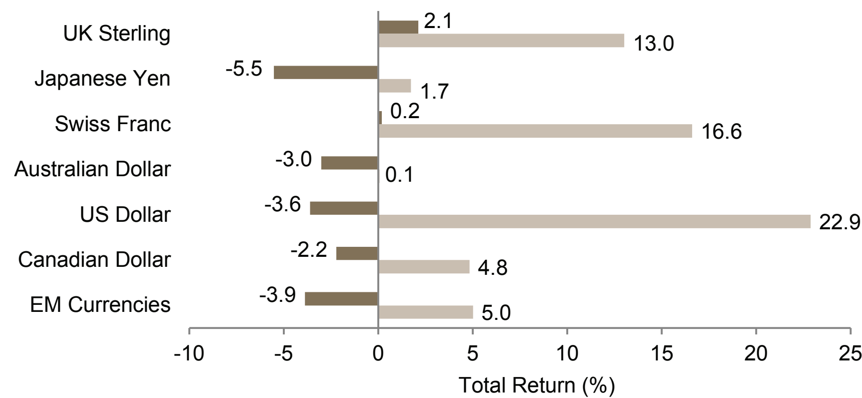
Currency Performance

As of June 30, 2015

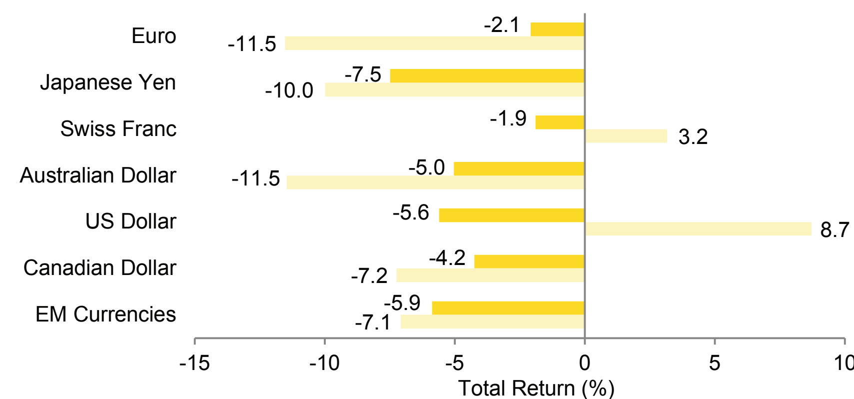
Versus the US Dollar



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 dollar weakened against most major currencies, with the exception of the yen, after the timeline for an initial Fed rate hike was pushed back; dollar strength over the last 12 months remains a dominant theme

The euro recovered some ground against most developed and emerging markets currencies. Somewhat counterintuitively, the euro strengthened in response to the breakdown of talks between Greece and its creditors

Sterling strengthened from oversold status versus all major and most emerging markets currencies in response to a positive election result. That said, renewed weakness can't be ruled out when considering a sluggish economy, a growing current account deficit, and a central bank reluctant to raise 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.

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