Global Growth Divergence in 2015

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“With the US economy gathering momentum and Europe relying on ECB action to progress, a theme of divergence will feature strongly in 2015.”
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Investors were reminded in 2014 that financial markets rarely run a smooth course. With the US economy gathering momentum and Europe relying on ECB action to progress, a theme of divergence will feature strongly in 2015. Overall, we expect the economic pick-up predicted in 2014 to now materialise in 2015. However, there are risks to the downside and investors may need to think a little smarter and look a little harder when investing in the coming year.

2014 in Retrospect

There was plenty for investors to digest in 2014. In a year that stubbornly refused to unfold along predicted lines, there were moments that caused many to pause and reassess. It proved to be a year that confounded the consensus expectation from the off and ended with the US effectively de-coupling from much of the rest of the world.

Widely expected to hit the year running, the US instead faltered at the first hurdle as weather disruptions caused Gross Domestic Product (GDP) to contract by more than 2%. Throw in a eurozone recovery that faltered prematurely, a Japanese economy that went into reverse after a sales tax hike, and those of an optimistic persuasion were on the back foot from early on.

A shifting geopolitical landscape became an unexpectedly central feature of the year. The startling pace at which ISIS militants grabbed territory served to illustrate just how quickly the terrain can change. Tensions in Ukraine surged as Russia annexed Crimea and provided support for east Ukraine separatists, something that did not play well in the US or Europe; subsequent tit-for-tat sanctions ensured that the economic impact was felt beyond the disputed borders.

Diverging Returns

Unsettled by weak economic data and rising geopolitical tensions, investors sought greater security and the 2013 trend towards higher bond yields was broken. Eurozone bond yields, of both the core and the periphery, dropped to record lows as the threat of a triple-dip raised expectation that the European Central Bank (ECB) would ease monetary policy, which it duly did.

Meanwhile, many stock markets saw advances that were buoyed by effervescent corporate profitability levels, although a spike in volatility in October threatened to vanquish gains. There were significant performance differentials by stock, sector and country through 2014 – investors were selective, and cautious with it, wherever they operated.
Overall, the global economy disappointed in 2014. But why? The upbeat growth predictions for the United States, Europe and Japan stumbled, set off course by harsh weather, geopolitical rumblings, and unexpectedly large household and corporate reactions. Consequently, the year proved to be little more than a re-run of 2013 in terms of growth.

More Than One Statistic

But reducing the year to a single statistic masks important developments on relative performance and economic policy. The US, eurozone and Japan all lost momentum during the first half of 2014. But the US has bounced back robustly, allowing the Federal Reserve (‘the Fed’) to end bond purchases, while the eurozone and Japan are struggling to regain impetus, obilging both the ECB and the Bank of Japan (BoJ) to ease. Indeed, economic performance and monetary policy began to de-couple in the second half of the year, which manifested itself across a number of asset classes, but most obviously in the foreign exchange market.
2015 in Prospect

Global growth should accelerate on improvements in both the advanced and developing economies in 2015. Within the former, the US, Europe and Japan should all enjoy somewhat stronger growth, although the extent of each region’s contribution will vary. The large advanced economies will continue to de-couple in 2015, with growth accelerating to around 3.0% in the US, while languishing near 1.0% in both the eurozone and Japan.

Emerging markets will be more reliant on the likes of the US to fuel growth in the coming year, even as growth in EM continues to outpace developed markets at a headline level. Overall, emerging economies are likely to enjoy a modest acceleration in growth, notwithstanding risks that are skewed to the downside.

Large Advanced Economies Continue to De-Couple in 2015

3.2% USA

~1.0% EUROZONE & JAPAN

GROWTH ACCELERATING AWAY IN THE USA

The Real Global Growth Engine – United States

There are substantial grounds for optimism about America’s prospects:

- Fiscal drag (government spending cuts and/or tax increases) that hinders economic growth will be further reduced in 2015.
- Household fundamentals are sound; while wage growth remains anaemic, consumer confidence has improved and balance sheets have been repaired amid falling unemployment and rising equity and home prices.
- Capital expenditure regained momentum in the second quarter of 2014, and new orders – a leading indicator of capital spending – continue to trend higher.
- The trade deficit has narrowed as energy imports have fallen while overall exports have continued to grow.
Admittedly, residential construction continues to lag, but with the economy firing on all the other cylinders, growth appears poised to accelerate to 3.2% from the lackluster 2.0% that has defined the recovery so far. Recent data has offered encouragement – the finalised GDP growth reading of 4.6% for Q2 outstripped consensus expectations and while the third quarter was always going to struggle to match that pace, the reported expansion of 3.9% topped forecasts and firms up expectations for 2015.

The Consumer is (always) the Key

Consumer spending accounts for about two-thirds of US GDP, so sluggish wage growth, depressed confidence and deleveraging associated with balance sheet repair represented a considerable headwind for the economy in the early stages of the recovery. That has changed and car sales – an important indicator of consumer financial health and confidence – are now back at pre-recession levels. And what is perhaps even more impressive is that auto companies are reaching these sales levels without employing the type of incentives that featured in pre-recession times.

On the Move – the Fed in 2015

When the Fed ended its asset purchase program in October, we officially entered ‘the considerable period of time’ before the first rate hike. Based on comments by Chairman Yellen, considerable period equates to about six months, which suggests a mid-2015 start. But, the ‘lift-off’, and subsequent speed of tightening will be data dependent: the better the economy, the sooner the lift-off and steeper the trajectory; the worse the economy, the later the lift-off and flatter the trajectory. It is worth keeping an eye on the Fed’s dot chart to get a sense of thinking within the Fed. There are clearly diverging opinions on when the Fed might reach its longer run target level for the federal funds rate.

Inflation at Bay

Subscribers to a quicker tightening scenario have been labelled ‘inflationistas’, who worry that the scale of accommodation to date could bring about a racier pace of inflation than commonly expected. But, these threats appear exaggerated.

In the first instance, there are few signs of upward pressure on wage rates, even with a headline unemployment rate that has fallen below 6.0%. This gives some credence to Yellen’s stated belief that there is greater slack in the labour market than the headline jobless number might suggest. Moreover, even if it is painting an accurate picture, there were two periods in the last 15 years when the unemployment rate was close to 4% without an accompanying spike in inflation. Hence, it seems the Fed is right to maintain a slow and gradual approach towards monetary tightening.

As the above chart illustrates, wage inflation remains benign, providing the Fed with a sufficient enough cushion to avoid tightening too quickly and stifling progress.
False Start in Europe...

Not many people expect Europe to grow at the pace of the US; it’s been a long time since it has. And while economic growth will accelerate in 2015, the de-coupling witnessed in the second half of 2014 will continue. This divergence also extends into Europe, as the United Kingdom continues to out-perform its near-neighbours. The eurozone economy will not only fail to keep pace with the US and UK, but monetary policy will diverge as the Fed and Bank of England raise administered rates while the ECB holds the line in an attempt to stimulate growth and stave off deflation.

ECB President Mario Draghi can be credited with talking markets back from the brink in 2012 when he committed to doing ‘whatever it takes’ to protect the euro. He can certainly bring the full resources of the ECB to bear if the potential break-up reflects stresses caused by long-term interest rate divergence within the region, but there are structural issues that cannot be resolved in this way.

UK OUTPERFORMS ITS NEIGHBOURS IN EUROPE

While economic growth will accelerate in 2015, the de-coupling witnessed in the second half of 2014 will continue.

Different Speeds

One such issue is that of competitiveness within the euro area, which is amply illustrated in the output price chart. This shows the evolution of output prices in the region’s three biggest economies and the clear advantage that German industry has over its neighbours.

The red line shows that the prices of goods and services produced in Germany have risen by about 15% since the inception of the eurozone in January 1999, while the green and blue lines show that prices have risen by about 25% and 35% in France and Italy, respectively.

This marked divergence of competitiveness has led to a marked divergence of economic performance, as revealed by the paths of industrial production in the above chart. German industrial production has risen by approximately 20% since the inception of the eurozone, while French and Italian production have fallen by around 10% and 20%, respectively.

A solution to this problem involves squeezing the price lines together, i.e. restoring relative competitiveness. Normally, the burden of such an adjustment would be thrown on the exchange rate.

The deutschmark would rise, pushing the red line up, while the franc and lira would fall, pushing the green and blue lines down. But, of course, that is impossible given those exchange rates no longer exist. A second way is to raise the price level in Germany (raise inflation for some period of time) and/or lower the price levels in France and Italy by creating deflation, via high unemployment. That is the underlying rationale for the austerity programs. But, as the graph here shows, there has not been much progress, so the problem persists, with no obvious mechanism for fixing it (or at least fixing it quickly) in sight.
Out of Sync

This competitive divergence hampers synchronicity – member economies growing simultaneously – and hinders the growth of the overall region. Hence, growth will accelerate only slightly next year, leaving it not much above 1.0%. This improvement notwithstanding, there are some serious issues that need addressing. The labour market is weak, inflation is edging towards deflation territory and private sector credit is still shrinking.

In short: a modest cyclical recovery is occurring against the backdrop of structural flaws that Mario Draghi cannot rectify. Moreover, weak and uncompetitive countries are having to internally devalue via austerity, while the more competitive countries are not adjusting.

A strong case can be made for stimulating German domestic demand. This would raise German prices, helping to act as an engine for wider regional growth. But Germany seems determined to avoid much of any stimulus, opting instead to maintain a pattern of fiscal surpluses, thereby increasing the risk that the eurozone might morph into Japan, an economy beset by low growth and deflation for more than two decades.

Abenomics at Work in Japan

In Japan, inflation finally reared its head in 2013 and 2014. But that reflected a combination of one-off factors, the sharp depreciation of the exchange rate following the adoption of Abenomics in early 2013 and the three percentage points increase in the consumption tax on 1 April 2014. The latter was also followed by a sharp slump in economic activity in Q2 and Q3, leading Japan into its fourth recession since 2008. The unexpected contraction triggered Prime Minister Abe’s decision to call a snap December election to delay the second sales tax increase and restore the mandate for Abenomics. We expect growth for 2014 to now come in at just 0.7%. However, we believe that the economy will ultimately prove resilient enough to absorb the effects of the hike, although growth in 2015 may not improve much.

Prime Minister Abe has doggedly maintained his pursuit of stronger long-term growth and an end to deflation. The fiscal and monetary stimuli applied thus far have bolstered growth, partially via yen weakness, but a sustained improvement remains dependent on structural reforms. Moreover, to keep inflation on track will require higher wages, something corporate Japan cannot be counted on to deliver.

Emerging Economies

Investors in emerging market assets had something of a bumpy ride through 2014, and while at a headline level the outlook is more positive for the year ahead, the risks to economic activity are generally to the downside. Output growth is expected to accelerate from 4.1% in 2014 to 4.7% in 2015, but prospects vary significantly by region and are inextricably bed up with developments in the advanced economies, particularly in the eurozone.

Among the principal risks that could negatively impact emerging economies in 2015 are:

- An unanticipated slowdown in China, with negative effects on Asia and commodity producers.
- A 1994/1995 style sell-off in the US Treasury market, which could potentially lead to capital flight from emerging markets with weak policy frameworks and potential contagion.
- Negative spillovers from a potential deterioration in any of a number of geopolitical risks.

These are important to more than just emerging market investors as emerging economies currently represent roughly 50% of the world economy, on a purchasing power parity basis, and their share of global output continues to grow. In 2014, growth was nearly 2.5 times faster than that of developed markets. China, the world’s second largest economy, now represents roughly 12% of global output in nominal terms, and is larger than the three other BRICs combined.
The Chinese Economy in 2015

The Chinese economy is expected to grow by about 7% in 2015, a level that Chinese officials have indicated is acceptable as a medium-term growth rate. Since announcing the multiple initiatives of the Third Party Plenum (which, among other measures, allocated market-based activities a ‘decisive’ role in the economy), China’s leadership has advanced many policy measures designed to make the economy more flexible and to promote consumption. These may reduce growth in the short term but should lead to a more sustainable pattern of output in the medium term.

Analyst concerns that the Chinese economy is vulnerable to a hard landing should difficulties in the ‘shadow banking system’, local government debt, or property sector materialise were somewhat assuaged by recent measures to address fiscal issues, local finances and land reform.

China’s Foreign Exchange Reserves Continue to Grow

Recent data coming out of China demonstrates continued expansion in the manufacturing sector, but high variability among sectors. For example, China’s export growth remains robust, and China’s foreign exchange reserves continue to grow, now standing at roughly $3.9 trillion.

Source: SSGA. As at 28 November 2014.

Kinks in the Line

But worries persist. Overcapacity exists in several basic industries and property prices in a growing number of cities have been falling. Against this backdrop, producer price inflation turned more negative in August and September. The government indicated in October that it does not plan to introduce substantial policy stimulus in the near term, although there has been a series of measures to modestly loosen monetary policy since June 2014. Furthermore, if domestic demand were to drop significantly in 2015, we think it likely that additional stimulus measures – both monetary and fiscal – would be forthcoming. Indeed, in November, the People’s Bank of China surprised the market by easing policy.

In 2015, Chinese policymakers will focus on implementing the initiatives of the Third Party Plenum and Fourth Party Plenum which, in October 2014, announced additional measures to fight corruption, strengthen law and order, reform the tax system, and reduce pollution, among others. The ongoing anti-corruption campaign and institutionalisation of powers accumulated by President Xi over the past 15 months will be important initiatives in 2015.

Growth Predictions for Japan

2015 1.0%
2014 0.7%

Growth Predictions for Emerging Markets

2015 4.7%
2014 4.1%

Growth Predictions for India

2015 6%
2014 5.1%

Source: SSGA. As at 28 November 2014. The above predictions are estimates based on certain assumptions and analysis made by SSGA.

There is no guarantee that the estimates will be achieved.
Beyond China – Emerging Asia

The political dynamic in India changed significantly in 2014 when Prime Minister Modi gained an absolute majority in parliament, something that should facilitate measures to promote foreign direct investment and to render the economy more competitive. Considered more market-friendly for his reform-oriented campaign platform, Modi is likely to oversee an economy growing from 5.1% in 2014 to 6% in 2015, while inflation should fall to 6%.

Growth in Emerging Asia outside China and India is still expected to quicken in 2015. A pick-up in US economic activity should benefit the region’s technology sector in particular, which account for about a fifth of Association of Southeast Asian Nations (ASEAN) exports. Lower oil prices will also provide a tailwind for firms and consumers although commodity exports, which account for roughly 17% of ASEAN GDP, are expected to remain flat in dollar terms given recent price weakness. Improving domestic demand is expected to drive faster growth in South Korea, Indonesia, Philippines, and Thailand.

Growth in the Chinese Economy

Latin America – Picking Up

Brazil had an eventful year in 2014, with street protests in the build-up to, and during, its hosting of the World Cup highlighting issues the world’s seventh largest economy has yet to effectively tackle. The economy should emerge from near-recession conditions in 2014, and while high real interest rates will restrain growth, consensus expectations are for the economy to grow by 0.6% in 2015. Disappointingly, this is still less than half of Brazil’s potential growth rate.

The removal of electoral uncertainty should help to clarify the policy environment for investors in the real economy, but inflation continues to be a concern. It is thus difficult to envisage the central bank cutting its administered rate of 11.25% in 2015, and the domestic policy environment, as well as commodity price conditions, is likely to restrain growth.

That challenging commodity price environment will also have some impact on Mexico. But with oil now accounting for just 13% of Mexico’s total exports, the negative effect of oil price declines is likely to be more than offset by the stepping up of economic activity in the US (as seen in vehicle sales) and continuing liberalisation of the economy. The Mexican economy is expected to grow 3.2% in 2015, up from 2.3% in 2014. Activity is also expected to accelerate in Peru and Colombia.

Emerging Europe/Middle East/Africa

South Africa and Turkey will likely lead the way in Emerging EMEA, but there will likely be a divergence of economic performance through the region amid several uncertainties.

Weak oil prices and the impact of sanctions raise a question mark over projected Russian growth of -0.8% in 2015. A flight of capital and rumours of capital controls added to a general sense of uncertainty in 2014. The Russian policy response has been to let the exchange rate depreciate and to support firms with official finance. Inflation is running around 7.5% and the consensus is that credit conditions will remain tight.

Turkey has enjoyed brisk growth in recent years, and while that is expected to accelerate to 3.3% in 2015, inflationary pressures limit the scope for interest rate cuts. Alongside the troubles in nearby Syria, the potential for escalating conflict with internal Kurdish opposition cannot be discounted. Furthermore, Turkey, along with emerging markets in Central and Eastern Europe, would be hurt in the event of a significant downturn in Europe.
sanctions. But Libyan output actually fields and how Russia would respond to ISIS to over-run the southern Iraqi oil about Libyan output, the potential for 2014 was artificially boosted by worries it now appears that demand in early short time almost certainly involves some reduction in demand. However, the scale of price decline in such a evolution of prices over the longer term, destined to play a larger role in the end of November. Supply is now slide took the price to just $70 at the first half of 2014, before a 37% December and fiscal deficits will likely reinforce further depreciate in 2015, thereby exacerbating inflationary pressures. They have strengthened their policy frameworks, and a violent unwind of foreign capital flows is unlikely, albeit something that cannot be completely discounted. The currencies of the ‘fragile five’ (Brazil, India, Indonesia, South Africa, and Turkey) that exhibit both current account and fiscal deficits are likely to remain under pressure. The IMF revised down its global growth projections. Growth in 2015 would rise by 0.8% in China but for the world as a whole. Growth would rise by 0.5% in the US, 0.3% in the eurozone and 0.1% in Japan, while among the developing economies, there are clear winners and losers; growth increasing 0.8% in China but falling 4.1% in Russia. Oil at $70 also exerts downward pressure on headline inflation; the energy component accounts for 9% of US CPI. This would have a moderating effect on the US inflation rate, while potentially pushing headline eurozone inflation below zero. This downward adjustment in inflation expectations has resulted in lower global bond yields and pushed out market expectations for when US policy tightening might start.

### Emerging ex Asia Growth Forecasts

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<th>BRAZIL</th>
<th>MEXICO</th>
<th>SOUTH AFRICA</th>
<th>TURKEY</th>
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<tr>
<td>2014</td>
<td>0.2%</td>
<td>2.3%</td>
<td>1.3%</td>
<td>3.0%</td>
<td>0.6%</td>
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<tr>
<td>2015</td>
<td>0.6%</td>
<td>3.2%</td>
<td>2.3</td>
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<td>-0.8%</td>
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Source: JP Morgan. As at 28 November 2104. The above forecasts are estimates based on certain assumptions and analysis made by JP Morgan. There is no guarantee that the estimates will be achieved.

### The Oil Change

Brent crude oil prices trended in a narrow band around $110 a barrel in the first half of 2014, before a 37% slide took the price to just $70 at the end of November. Supply is now destined to play a larger role in the evolution of prices over the longer term, but the scale of price decline in such a short time almost certainly involves some reduction in demand. It now appears that demand in early 2014 was artificially boosted by worries about Libyan output, the potential for ISIS to over-run the southern Iraqi oil fields and how Russia would respond to sanctions. But Libyan output actually rose, ISIS never made it to Baghdad, and Russia kept pumping, a combination that both removed the ‘extra’ demand and created additional supply. Evidence of slowing growth from Europe, Japan and China has further weighed on oil prices, and a downdraft in Brent output was validated when the IMF revised down its global growth projections and OPEC decided in November not to cut production.

The futures market suggests that prices will remain near the current $70 a barrel level through 2015, which imparts upside risk to our growth projections. Growth in 2015 would rise by 0.4% in the advanced economies, 0.3% in the developing ones, and 0.3% for the world as a whole. Growth would rise by 0.5% in the US, 0.3% in the eurozone and 0.1% in Japan, while among the developing economies, there are clear winners and losers; growth increasing 0.8% in China but falling 4.1% in Russia. Oil at $70 also exerts downward pressure on headline inflation; the energy component accounts for 9% of US CPI. This would have a moderating effect on the US inflation rate, while potentially pushing headline eurozone inflation below zero. This downward adjustment in inflation expectations has resulted in lower global bond yields and pushed out market expectations for when US policy tightening might start.

### Geopolitical Risks in 2015

Few of the geopolitical flashpoints that erupted in 2014 will simply dissipate with the turn of the calendar. History shows that equity markets can be resilient to geopolitical shocks, certainly in comparison with major global economic down drafts, but the short-term impact can be substantial. Potential risks lie in a widening conflict in the Ukraine and/or the Middle East, a global ebola pandemic, a mishandling of the situation in Hong Kong (which could hit foreign direct investment into China), a breakdown of the Iran nuclear talks, or a flare-up of the eurozone crisis.

Oil price declines are generally a plus for economic activity, with net importers from Europe to Japan to Emerging Asia benefiting; Russia and the Gulf Cooperation Countries (GCC) countries lose out in this scenario. On the other hand, a severe disruption to deliveries from the Persian Gulf would weigh more heavily on emerging markets.

### The Outlook

That the global economy didn’t kick on in 2014 may instil some scepticism among investors about 2015’s prospects. However, we are confident that the pick-up will materialise, although the diverging fortunes of the US and Europe could threaten the most upbeat forecasts. In a likely scenario that sees the US de-coupling from much of the rest of the developed world, global economic growth will thus be largely reliant on outcomes in the US and China. The wobble on financial markets in October came at a time of both geopolitical and economic anxiety; sentiment can change rapidly.

In its recent World Economic Outlook, the IMF reduced the medium-term growth forecast for emerging markets by 1.5% relative to pre-crisis years. China’s rebalancing, slower world trade growth, increased financial frictions, slower productivity growth, and demographics all contribute to this assessment. In 2015, accelerating growth in the US and stable growth in China (together roughly 35% of the global economy) should facilitate an expansion of economic activity for both developed and emerging markets, provided geopolitical conditions do not deteriorate markedly.

### US Interest Rates and Emerging Markets

Emerging market policy makers have had time to prepare for what is likely to be a gradual pace of US interest rate increases. Investor reaction to the initial taper comments back in 2013 illustrated how sensitive emerging markets are to tighter US monetary policy.

Asian economies in particular benefit from a high level of reserves; some are likely to modestly tighten policy in 2015 as output gaps narrow and US policy firms. The impact on Asian firms and consumers (both of which have borrowed heavily in recent years) should be modest, although the situation merits close monitoring.

The currencies of the ‘fragile five’ (Brazil, India, Indonesia, South Africa, and Turkey) that exhibit both current account and fiscal deficits is unlikely, albeit something that cannot be completely discounted.
Divergence and Investment Opportunities

We are upbeat about prospects for 2015. However, in a year when economic fortunes and central bank policies will diverge, it will be important to be positioned in a way that recognises the challenges and identifies where the potential opportunities lie. However, this is rarely as intuitive as one might think — cheap does not always imply value and expensive may not mean overpriced. We believe one of the keys to successful investing is finding a path that effectively balances risk and return objectives.

At SSGA, we have identified what we believe will be important themes to consider through 2015, and we lay out a roadmap to help with navigation through the changing landscape. Adopting the appropriate strategies can make that journey all the smoother.

**Getting the Big One Right**

*Equity Market Risk*

Long periods of low volatility may have left investors complacent but with equity indices at all-time highs and bond yields at all-time lows, risk aversion has spiked sharply upwards. Savvy investors need to get the balance right and implement risk protection that can let them access upside in 2015 while protecting against coming volatility.

**Shifting Gears in a Two-Speed Market**

*Equity Valuation Differentials*

Improving economic and earnings environments bring opportunities, even in expensive markets. The US is fully valued but continued strong growth in 2015 may see it maintain that value, even as diverging interest rates reshape the investment landscape. European market valuations indicate good upside potential if an earnings recovery materialises.

**What Emerging Market Reform Can Deliver**

*Emerging Markets*

We’ve observed that investors sifting developing markets for opportunities are favouring those countries where reforms are on the agenda. Recognising where the reformers are and how reforms boost competitiveness and improve earnings potential can help pinpoint prospects for the considered investor.

**It’s All Relative**

*Fixed Income & Currency*

Sovereign rate differentials between those regions with loosening central bank monetary policy and those that are in tightening mode are likely to continue to provide some of the biggest opportunities for fixed-income investors in 2015. More than this, diverging global monetary policy and interest rates will impact almost every asset class in 2015.

**The Macro is Not the Market**

*European Financial Landscape*

Europe’s structural problems are legion and well known. But tailwinds are also rising. The ECB is in play and measures such as the Asset-Backed Security Purchase program are moving the dial. We believe Europe has pockets of value, the challenge, as ever, is finding them. Investors will have to tease apart the macro from the market and operate selectively.
For much of 2014 markets were somewhat tamed by central banks. The potent combination of forward guidance and centralising monetary policies has largely met their goal of market stability via ultra-loose and accommodative monetary policy, and we find ourselves amidst a low-volatility, low-volume, low conviction bull market.

The S&P® 500 Index has almost tripled since the depths of the financial crisis and sovereign bond spreads have collapsed well beyond pre-crisis levels. The Chicago Board Options Exchange Market Volatility Index® (VIX) — a measure of equity volatility — has been low since the start of 2012, at or below pre-GFC levels.

**The Dangers of Complacency**

A blip in late October 2014 may well have given some investors pause for thought but for some time now we have asked: Are investors conditioned to a low volatility environment and possibly too complacent?

Low volatility combined with the need for higher yield has driven investors further up the risk spectrum and complacency could ultimately spell trouble for many and precipitate the next market correction.

And, it is not just US equity volatility that has been low — European equity, interest rate and foreign exchange volatility levels are also at near-decade lows.

**What Could Go Wrong?**

Volatility is driven by uncertainty and — through coordinated monetary policy, together with bond purchases and more recently forward guidance — uncertainty has indeed been extraordinarily low. However, we expect volatility to rise as the advanced economies follow increasingly divergent paths with their monetary policy.

The US and the UK are already deliberating on their tightening paths, while the ECB is only just in preparatory stages. This could well be enough to force volatility from its subdued state, but there are other risks on the horizon that could cause a more sudden rise.

**KNOW WHERE YOUR RISK LIES:**

**Equity Risk Dominates the Traditional 60/40 Balanced Portfolio**

This means that the true portfolio risk is highly concentrated and highly correlated. It also means that investors may not be realising the true level of protection they require.

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**Average risk 85%**

*Based on a rolling 5-year risk allocation of a 60% Equity / 40% Bond portfolio average spanning 1981-2012. Source: SSGA. As at 28 November 2014. For illustrative purposes only.
Reflecting on 2014 market performance and considering traditional valuation metrics, there is indeed cause to pause and take stock. And it is not just recent market performance that suggests caution. As well as the VIX other risk metrics, such as the Merrill Option Volatility Estimate Indices, have fallen to very low levels not seen since 2007, prior to the Great Financial Crisis.

SSGA’s MRI† spent most of 2014 indicating very low risk, even spending a fairly unprecedented three months in the Euphoria regime (indicating extreme complacency towards risk) before moving sharply into High Risk in October, a portent, perhaps, of things to come.

Fundamentals may also present potential pitfalls. From eurozone deflation concerns to geopolitical issues in Ukraine or the Middle East, spats between China, Vietnam and Japan are causing concern, and China’s shadow banking sector also casts a pall.

US valuations are at the higher range of what we would consider to be fair value. European valuations look better but we believe that, in the short term and on a risk-adjusted basis, it may well be worth adopting a more prudent stance.

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1SSGA’s Market Regime Indicator (MRI) uses a mix of inputs, such as equity and currency volatility and bond spreads to monitor market conditions.
Investors are well aware of the deleterious effects of drawdowns and typically adopt protective strategies to avoid them. Geopolitical risk is undoubtedly a factor in some drawdown events, but just how important is it over meaningful time periods? We looked back at the major (greater than 20%) drawdowns over the last 50 years and found that only one was geopolitical and multi-year in nature: the 1970s oil crisis.

A major event like 9/11 might be expected to have severe long-term effects. In fact, investment wise it barely even maps since we were already in a bear market from the highs of early 2000. Even the Asian Crisis and Russian Default didn’t get to -20%. A host of other geopolitical events — such as the recent Ukraine crisis, the Arab Spring and the first Gulf War — all have impact but what seems clear is that the markets typically shrugged them off in short order.

Rapid Recovery
Not only do geopolitical events tend to show lesser impact than market-based events, the market also tends to recover more quickly from geopolitical events. Consider again 9/11: on 10 September the S&P 500 closed at 1,092, it reached an intraday low of 965.80 on 21 September (down 12%) but had fully recovered by the end of October. Of course, the Fed had taken decisive action but the point is that the impact was, indeed, short term.

The Takeaway
Be realistic about the effect of geopolitical risks — they may not have the lasting long-term effects that many ascribe to them. However, many investors cannot bear even short-term drawdowns and avoiding or severely limiting drawdowns makes sense in terms of time to recovery. In any case, market-based events can and typically do affect portfolios deeply and broadly over the long term. The right protection strategy should help defend against both types of risk.

Geopolitical & Market Events: Their Drawdown Effect

Source: SSGA. As at 28 November 2014. The information contained above is for illustrative purposes only.
When to Start, What to Do?
Although we note the risks that stem from high valuations and the propensity for geopolitical instability to change the investment landscape, we also recognise in our conversations with clients that there is a concern that adopting a ‘defensive’ stance risks missing continued upside potential. This is particularly the case against a backdrop of ultra-low interest rates and Quantitative Easing (QE).

Getting the Balance Right
However, we believe that there are ways to optimise the balance of needs through a variety of overlay and direct investment strategies. In particular, investors could consider a Target Volatility Trigger (TVT) framework, which seeks to provide downside protection and yet leaves potential for upside participation; or asset allocation strategies which dynamically allocate according to the prevailing market conditions, and can be good way to help provide downside protection and potential alpha generation. Overlay programs using listed futures and options to create put-spread or put-spread collar strategies have also historically provided downside protection.

Timing is Critical
Aggressive de-risking can prove costly should the markets continue to rise, and yet a ‘defensive’ stance risks missing continued upside potential, particularly against the backdrop of ultra-low interest rates and QE.

In light of this, we believe that implementing downside risk protection while costs are low may make sense. Our experience has been that it is always better to start implementing portfolio protection decisions when others are greedy, when there is time to consider alternatives and also when the cost of implementing these decisions is low.

When markets are in crisis mode — as they were in September 2008 and August 2011 — it is often, quite simply, too late.

Range of Strategies Available

- **Target Volatility Triggers** can provide a stable volatility level in the portfolio.
- **Market Regime Aware Investing** via Dynamic Asset Allocation Funds.
- **Derivatives Overlays** Option-based overlays and volatility futures.
- **Alternative strategies** Liquid alternatives, such as Managed Futures and Global Macro and advanced beta equities, such as Managed Volatility.
Where Equity Investors Should Look for Value

The sustained advance of many of the world’s stock markets appeared at times to falter in 2014 amid various economic, geopolitical and corporate issues. However, it seems premature to declare that this equity rally has run its course. The operating environment may be changing though amid deviating economic prospects and central bank policies in 2015.

The last five years has featured all manner of market-moving events against a backdrop of historically low interest rates. Now that rates are set to rise (in the US and UK at least), does logic dictate that equities will struggle to make further progress?

New Territory

While not suggesting ‘this time is different’, we are in an environment where some central bank rates will be increasing from never-before-seen levels. And there are also plenty of cash-rich balance sheets out there; higher rates will impact companies in different ways.

An interest rate regime that significantly stifles corporate profits seems unlikely and the Fed’s tightening can be viewed as a vote of confidence in the US economy; a robust economy is typically positive for earnings. Further easing in Japan and the eurozone in late 2014 highlights the diverging paths investors must negotiate.

Moreover, while interest rates are an influence on equity prices, they are not the only factor. Investors, as ever, must determine what’s already in the price.

Finding Value

There are several lenses through which to view relative equity valuation differences. One model employed by our Quantitative Equities Team produces a relative-value ranking of countries based upon top-down analysis of rates, inflation, and risk premiums; and bottom-up analysis aggregating security attractiveness across multiple dimensions within countries. (See Global Map).

Continental Europe appears more attractive on this measure, and even though economic prospects may be decoupling from a resurgent US, there is much to support the thesis of European investment opportunities ahead. Traditional valuation measures also indicate potential upside and our Fundamental Equity Team has been finding value opportunities in Europe and Asia, in particular.

Investor Preferences

One feature of the recent rally has been a preference for defensive-type equities — investors favoured bond-like stocks in the utilities, consumer staples and telecom sectors, attracted by consistent earnings streams and dividends – appealing characteristics in a low-growth, low interest rate world. But that environment is evolving.

When analysing relative attractiveness across countries or sectors, it can be instructive to look at differences in proxies for inflation and reported interest rates, as well as other factors, and their potential impact on equities. The evidence on historical relationships between rising yields and equity markets is mixed, but some meaningful insights have been gleaned at the sector level.

Equity Sensitivity to Interest Rates

Sometimes equities fall when bond yields rise and sometimes they don’t. The pace of interest rate increase, inflation and economic growth may be factors, as might the idiosyncratic growth characteristics that apply to some companies and industries.

A measure of the sensitivity of groups of securities to rising interest rates was described in 2007 by Reilly, Johnson and Wright as ‘Empirical Equity Duration’.1 They used monthly data for a range of periods up to November 2003, thereby capturing the whole dot.com boom and bust period. They analysed the effect of rate changes on sectors and industries by estimating Empirical Duration (ED) for each sector by regressing security price returns on interest rate changes.

In general, an increase in interest rates results in lower stock prices, expressed by a negative ED (sector returns are inversely related to yield changes, and vice-versa). Thus, an expectation of rising yields might bode well for sectors with strong positive ED estimates.
Empirical Duration

Over the period October 1989 – November 2003, the study’s authors calculated positive Empirical Duration for four S&P/Global Industry Classification Standard (GICS) economic sectors: Information Technology, Consumer Discretionary, Materials, and Industrials. And the sectors that tended to do worse in a rising rate environment? Utilities, Healthcare, and Consumer Staples.

One difficulty with trying to assess the likely reaction of equities to changes in interest rates is a lack of consistency. The ED is not stable over time, and significant changes in the sign of the duration were only observed in extreme market crashes like 2001–2003 (both interest rates and equity prices fell in a very short time period, and was reflected in a sign change of the ED).

Although the study is not too recent, the observations offer an indication of how sectors historically behaved when rates are changing. The interest rate environment of recent times makes comparisons difficult, particularly as rates will move modestly over the next couple of years. Clearly, investors may want to reflect on the impact of rate changes, but doing the due diligence at a stock, sector and country level can help establish, in the context of all the factors that influence valuations, where potential opportunities lie.

Where in the World?

The current circumstances are unlike those that prevailed prior to 2007/2008, and a closer look at valuations and returns provides a slightly more nuanced narrative to one that simply states equities are back to where they were pre-Lehman.

Much of the MSCI World Index’s recovery has been driven by the US market turnaround, as is evident when valuation metrics are charted. (See Global Charts on the next page).

New US market highs were driven by both earnings growth and multiple expansion; as a result, the market stands on an above-average multiple of record earnings. The case for US equities must therefore depend on either continued earnings growth or multiple expansion from this reasonably demanding starting point.

<table>
<thead>
<tr>
<th>S&amp;P/GICS Economic Sectors¹</th>
<th>Empirical Duration Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Utilities</td>
<td>-3.39</td>
</tr>
<tr>
<td>Healthcare</td>
<td>-2.45</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>-2.19</td>
</tr>
<tr>
<td>Financials</td>
<td>-1.71</td>
</tr>
<tr>
<td>Energy</td>
<td>-1.38</td>
</tr>
<tr>
<td>Telecom Services</td>
<td>-0.56</td>
</tr>
<tr>
<td>Industrials</td>
<td>0.85</td>
</tr>
<tr>
<td>Materials</td>
<td>1.79</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>2.00</td>
</tr>
<tr>
<td>Information Technology</td>
<td>4.00</td>
</tr>
</tbody>
</table>

At 14x earnings, Europe trades at a discount to the US, but in the context of its historic average, it’s difficult to make the case for a multiple-driven rally in Europe. However, the earnings denominator potentially offers an opportunity. Europe’s Earnings Per Share (EPS) recovery has been relatively weak, de-coupling from the US. If a stronger earnings recovery materialises then European equities should deliver healthy returns.

The Asia Pacific (ex Japan) offers a different picture again. Earnings have enjoyed a recovery comparable to that in the US. In contrast to the US, however, multiples have compressed over this period. Today’s Price to Earnings Ratio (PER) of 11x is below its historic average and at a discount to other regions. This suggests a lack of confidence in the sustainability of the denominator. Multiples are likely to expand should that confidence return.

**DuPont Analysis***

<table>
<thead>
<tr>
<th></th>
<th>Japan</th>
<th>APAC</th>
<th>Europe</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>NET INCOME/ PRE-TAX PROFIT</strong></td>
<td>Current</td>
<td>10 YR Avg</td>
<td>Current</td>
<td>10 YR Avg</td>
</tr>
<tr>
<td></td>
<td>63%</td>
<td>53%</td>
<td>78%</td>
<td>76%</td>
</tr>
<tr>
<td><strong>PRE-TAX PROFIT/EBIT</strong></td>
<td>128%</td>
<td>107%</td>
<td>180%</td>
<td>154%</td>
</tr>
<tr>
<td><strong>EBIT/SALES</strong></td>
<td>6%</td>
<td>6%</td>
<td>7%</td>
<td>8%</td>
</tr>
<tr>
<td><strong>SALES/ASSETS</strong></td>
<td>30%</td>
<td>32%</td>
<td>23%</td>
<td>24%</td>
</tr>
<tr>
<td><strong>ASSETS/EQUITY</strong></td>
<td>5.4</td>
<td>5.7</td>
<td>5.8</td>
<td>5.7</td>
</tr>
</tbody>
</table>

Source: SSGA. As at November 2014. The information contained above is for illustrative purposes only. *The DuPont Analysis separates Return on Equity into three elements — enabling analysts to understand the source of superior (or inferior) return by comparison with companies in similar industries, or between industries.
Whither Japan?

The profile of the recovery in earnings since the Great Financial Crisis is not dissimilar to the European experience, and a valuation of 14x earnings is not obviously cheap; so why does Japan merit special mention?

Japanese corporate profitability has paled in comparison to international peers for many years, but it would seem the current administration is committed to closing the gap.

The RoE chart of the various markets over the last decade highlights that Japanese companies have consistently underperformed their global peers on this metric.

Cutting Taxes and Costs

A DuPont break-down of RoE is an interesting prism through which to weigh up the levers available to drive an improvement in RoE.

Increasing leverage (Assets/Equity) through buybacks, dividends or M&A is often cited as the quick fix, but the data suggests Japan is not an outlier on this metric.

Japan’s high corporate tax rates stand out versus peers, and have therefore been a significant factor. The effect of the recent tax reduction to 35.6% can be seen (Net Income / Pre-Tax Profit (NI/PTP). A further reduction to 30% is being mooted, but is contingent upon finding alternate revenue streams.

Operating margins (Earnings Before Interest and Taxes (EBIT)/Sales) is the other major category where Japan is the outlier. A weaker yen may help some – but not all companies are exporters and most are vulnerable to higher input costs. Real progress on this front will require a dose of self-help – management initiatives to enhance the long-term earnings power of their businesses.

The challenge is clear. An improvement in RoEs can drive earnings. Share prices should follow should the multiples move to reflect an assessment that the improvements will prove to be enduring.

INVESTMENT IDEAS

- Go where the value is: US earnings and multiples are at multi-year highs; better opportunities can be found in Europe and Asia.
- In Europe, adopting active quantitative and/or fundamental approaches helps to filter the large cap opportunity set. A strategic allocation to small caps may take longer to pay off, depending on the pace of recovery.
- Negative views on stocks could be captured by allocating to strategies with a short equity component.
Emerging markets (EM), a bona fide disappointment in 2013, have returned to favour after a temperamental start to 2014. One of the biggest spokes in the wheel of the turnaround has been the impact of elections on sentiment. In a particularly active year for elections, a large percentage of emerging markets’ voters went to the ballot box with a clear appetite for reform. Incumbents were actively challenged and potential change in political regimes in India, Brazil, Indonesia, Turkey and Egypt helped to boost returns for the reformers.

Post the financial crisis, the slow pace of reform in many developing markets had been, to a certain extent, overlooked by investors’ desire to get a piece of the EM growth story. Investors were arguably too forgiving of the failures to increase competitiveness in return for that growth. This changed in 2013 when an improving US economic growth dynamic developed, alongside plans to scale back QE, posed specific challenges for EM.

The Lure of Reform

Heading into 2015, the narrative is once again of divergence, but it is the overall prospects for developed markets that appear relatively more inviting. Diverging fortunes compel investors to be more selective in where they place their investment dollars. And it means that governments in emerging markets have to work harder to make their investment proposition more appealing.

The lure of reform is attractive for the ‘reformer’ as it holds the potential for new and sustainable sources of growth. Economic reforms that are market friendly can drive greater competitiveness of firms and boost earnings growth, underpinning the potential for better returns from equity and debt investments, which in turn act as a draw for investors.

Aligning Interests

What the elections of 2014 tell us is that the wish for more market-friendly policies is not just the preserve of investors. The interests of the average EM worker are increasingly aligned with those of investors.

Given that many EM governments typically subsidise prices to help people avoid the worst of fuel and food price inflation, that voters would effectively ask for market reforms speaks volumes. The EM voting population has experienced at first-hand how the build-up of subsidies in the system has reduced investment in human capital and driven burgeoning fiscal deficits and the calls for change are getting louder.

Reformers Given Mandate

In mid-2014, India’s voters granted Narendra Modi a parliamentary majority to enact the reforms that will help the country to the next stage of its development. Modi overturned India’s long-reigning political dynasty on the basis of pledges to boost the economy and create jobs through intense economic reform; India’s stock market generated strong gains on the promise this presented. Interestingly, markets rallied in a similar manner in 2009 when the Congress Party last notched a national victory. Then the hope was for political stability.

Indonesia’s election of a president with few ties to a much-maligned political establishment represents a significant shift. Ordinary people were enthused by Joko Widodo’s reputation for honesty, getting things done and reducing bureaucracy during his time as governor of Jakarta. Pledges to invest in infrastructure and tackle corruption resonated with voters and should have positive long-term economic benefits if implemented successfully. Among his early moves was the November reduction of fuel subsidies that pushed prices up by about 30%.

On average, EM politicians are staying in their posts longer

... giving new reforming leaders more time to make changes stick.

Source: Eurasia Group. As at 28 November 2014. For illustrative purposes only.
China in Transition
Bricks and Clicks

China is undergoing historic change as it slowly opens its financial markets to the world and rebalances the economy towards domestic consumption. So far, policymakers have had early success at maintaining the delicate balance of reform and economic growth, although downside risks exist if the government mishandles the transition. China’s long-term potential continues to appeal.

Short-Term Headwind: Debt and the Housing Market

Real Estate Investment as Share of China GDP

Debt-to-GDP levels in China have jumped to the 250% range as it has tapped credit to stimulate the economy in recent years. A significant challenge facing China is the build-up of private debt, while investors have concerns about what risks may be hidden in the shadow banking sector.

Could the Chinese Housing Market Trigger a Debt Crisis?
Recent weakness in the residential market is worrying because real estate investment represents about 15% of China GDP, and falling house prices could saddle banks with bad loans.

The authorities are trying to encourage the re-allocation of capital into services industries and infrastructure in order to help sustain a consumer-led economy. But slowly deflating housing bubbles without consequences are something of a rarity, and China’s financial sector could get caught if a worst-case scenario unfolded.

Long-Term Tailwind: The Rising Consumer

Despite the perils China faces in the transition, investors remain attracted to the potential of Chinese consumers and a rising middle class.

That helps explain why investors are enthusiastic about e-commerce firms such as Alibaba, Baidu, Tencent and JD.com. These are well placed to take advantage of the explosion of online shopping in China. While these firms will need to beef up their logistics networks, the size and growth of Chinese online retail sales paint an upbeat picture.

China has the largest number of internet users in the world, and nearly half of them shop online. Chinese e-commerce sales totalled $120 billion in 2011 and are projected to rise as high as $395 billion in 2015 and $648 billion in 2020. Also, China’s online retail sales posted the world’s highest growth rate between 2003 and 2011 at a compound annual growth rate of 120%, compared with 17% for the US.

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Reform Pledges No Guarantee of Victory

Even the mere possibility of reform can be enough to drive sharp market movements, as clearly evidenced by the experience of Brazil in 2014. With an interventionist president at the helm of a struggling economy, the MSCI Brazil Index has lagged the broader EM Index each year since 2010.

Up until President Dilma Rousseff’s marginal re-election at the end of October, Brazil’s stock market would typically rise when opinion polls showed her losing to more market-friendly and reform-minded opponents. The hope and expectation is that Rousseff will take on board some of the reforms proposed and tackle inflation, improve competitiveness and address infrastructure deficits.

This emerging markets election cycle is largely complete and the focus for investors is shifting away from the hope of reforms to the specificity of reforms. Reform-related cash flows can only materialise if new reforms are sustainable. Stability will play a key part and voters are increasingly prepared to keep politicians in office for longer than in the past in order to give them time to make changes stick.

Pressure on Margins

Source: SSGA, Credit Suisse. As at December 2013.

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Why Investors Should Care About Reform

1. Gains from Investment in People

Labour market reforms make it easier for companies to invest. Rigid labour laws discourage free movement of capital and encourage greater hiring of contract labour. Lower investment in labour detracts from a country’s competitiveness. For example, India has lost out on manufacturing investment in part because of the costs and bureaucracy surrounding the hiring and firing process.

Government interference can distort labour prices, something that was in evidence during the GFC. For example, pay hikes for China’s state employees put pressure on private industry to follow suit, with the negative consequences for margins that it entails. India’s minimum wage is tied to inflation, which in itself has the potential to stoke a wage inflation spiral.

Private industry must compete for labour and that compresses margins, as the above chart illustrates. Reforms that make it easier and cost effective to create a skilled workforce are positive for the economic and corporate bottom line. These can typically drive increased productivity and boost real GDP growth.

2. Dividend from Infrastructure Investment

High inflation limits state funds for investment. Many emerging market governments subsidise food and fuel costs to ensure a minimum standard of living. Absorbing higher prices shields consumers from higher prices but reduces the amount available for investment.

Investment in roads, ports and railways has long-term benefits that outstrip those of subsidies. India/Indonesia are taking advantage of lower oil prices to slowly deregulate fuel prices, which should reduce the fiscal burden. This in turn frees up capital that could be invested in infrastructure, improving accessibility and making it easier to transport goods efficiently.

3. Corporate Governance/SOE Reform

Aligning the interests of management teams with those of shareholders provides scope for enhanced return potential. Greater recognition for the rights of minority shareholders should help entice foreign investment to those countries where majority owners, often the state, have run business enterprises with agendas that limit the case for private investment at a country or company level. Key amongst these are state-owned enterprises (SOEs).

Of similar companies in the same industry, majority state-owned entities typically trade at a discount to publicly-owned firms. The financials sector in many emerging markets is a good example of this. All too often, the heads of these institutions are political appointees or bureaucrats who may not be the best candidate to run such a business.

When combined, these types of reforms can improve both the top and bottom line for corporates.

4. Performance

Equity valuations are compelling in many cases, but investors remain to be convinced, not least because of the comparative opportunity in developed markets. Consumer staples have been a stand-out performer in EM, contributing handsomely to EM returns, but it is increasingly clear that a focus on reforms could help drive greater interest in the likes of financials and industrials. Increased recognition of non-performing loans on bank balance sheets is a step forward in this regard.
### A Leap Forward – What is Needed

<table>
<thead>
<tr>
<th>OLD MODEL</th>
<th>CHINA</th>
<th>BRAZIL</th>
<th>INDONESIA</th>
<th>INDIA</th>
<th>MEXICO</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>FUTURE MODEL?</th>
<th>CHINA</th>
<th>BRAZIL</th>
<th>INDONESIA</th>
<th>INDIA</th>
<th>MEXICO</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>REFORMS NEEDED</th>
<th>CHINA</th>
<th>BRAZIL</th>
<th>INDONESIA</th>
<th>INDIA</th>
<th>MEXICO</th>
</tr>
</thead>
<tbody>
<tr>
<td>More consumption, slowly open the capital accounts, further interest rate liberalisation, increased social security programs.</td>
<td>Better infrastructure planning, less state meddling in the private sector. Encourage savings to lower real rates and current account deficit.</td>
<td>Reduce subsidies Greater investment in Infrastructure Labour reform</td>
<td>Further reduce price distortion, infrastructure bottlenecks, reform of the bureaucracy.</td>
<td>Reforms in energy, fiscal, labour markets all in progress.</td>
<td></td>
</tr>
</tbody>
</table>

Source: SSGA as of 28 November 2014.

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**INVESTMENT IDEAS**

- Reforms create divergence in performance; EM cross-country correlations are at an all-time low. **An active approach allows for selective weight allocations.**
- **Tilt towards value for exposure to reformers.** Value has lagged and poor performing state-owned entities are most likely to benefit from reform.
- **Active small-cap** provides good access to the EM reform agenda and divergence in EM economies.
- **Active stock selection,** balanced towards value-oriented companies where the manager can identify better growth prospects, is another alternative.
Sovereign rate differentials between those economies with loosening central bank monetary policy and those that are moving towards tightening mode and we believe they continue to provide some of the biggest opportunities for fixed-income investors.

The US and the UK are, for example, expected to see official rates rise next year following improved economic data. At the same time, the central banks of key markets such as the eurozone and Japan are targeting increased policy accommodation to address slowing growth and deflation risks.

The resulting divergence in sovereign rate trajectories lends itself to carry trades to take advantage of rate de-coupling. However, the strategy implications reach much further than carry and touch a broad range of asset classes.

**The US Higher Rate, Higher Demand Cycle**

In October, the US Federal Reserve (the Fed) ended its Quantitative Easing (QE) program, marking an important turning point after six years of low rate, ultra-loose monetary policy in the US. However, Treasury rates did not shoot higher with this development. In fact, we saw the opposite occur. When global growth concerns in mid-October spawned the highest levels of US equity volatility since 2012, the 10-year Treasury tumbled below the milestone 2% level due to a flight to quality. At the start of December, the 10-year stood at 2.3%.

But as low as yields are in the US, rates elsewhere are even lower. For example, in June, Spanish 10-year yields dipped below US yields for the first time since April 2010, and currently, 10-year Spanish yields lag US yields by about 38 basis points (bps).

Higher yields in the US have prompted robust flows into US Treasury bonds, as foreign investors have sought out higher yields in the US versus near-zero or even negative short-term rates elsewhere.

**Policy Divergence Already Playing Out**

The market’s response to monetary policy divergence has already begun to play out, evidenced by increasing spread gaps between yields in the US and the rest of the world. The gap between 10-year German yields and US yields is currently about 150bps, up from -6bps three years ago. For the Japanese Government Bond (JGB) 10-year yield, the gap is now nearly 180bps, or over 100bps higher than three years ago.

We expect the US yield premium to increase even further. Japan’s massive asset purchases, announced in October, will pressure JGB rates even lower. In the eurozone, the ECB’s balance sheet has grown at a much slower clip than other regions since the GFC. Given slack in the eurozone economy and a dovish stance from ECB President Mario Draghi, the ECB is expected to turn up the stimulus spigot and push yields lower via asset purchases.

Going forward, increased demand from foreign investors attracted by relatively higher rates in the US could essentially dampen how much Treasuries yields rise — at least until we near the time of actual rate hikes. Over the next year, we expect short-term Treasury rates will move higher relative to 10-year and 30-year yields.
## ECB Balance Sheet Expansion Since the GFC is Significantly Below Other Regions

<table>
<thead>
<tr>
<th>Country</th>
<th>Central Bank Balance Sheet Expansion Since August 2008 (% of GDP)</th>
<th>Peak Budget Deficit, from 2007 (% of GDP, annualised basis)</th>
<th>Latest Budget Balance (% of GDP, annualised basis)</th>
<th>Reduction in Budget Balance from Peak Level (% of GDP, annualised basis)</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>341</td>
<td>-9.8</td>
<td>-3.5</td>
<td>6.3</td>
</tr>
<tr>
<td>EUROZONE</td>
<td>17</td>
<td>-6.4</td>
<td>-2.9</td>
<td>3.5</td>
</tr>
<tr>
<td>FRANCE</td>
<td>—</td>
<td>-7.2</td>
<td>-4.3</td>
<td>2.9</td>
</tr>
<tr>
<td>GERMANY</td>
<td>—</td>
<td>-4.1</td>
<td>0</td>
<td>4.1</td>
</tr>
<tr>
<td>ITALY</td>
<td>—</td>
<td>-5.3</td>
<td>-3</td>
<td>2.3</td>
</tr>
<tr>
<td>SPAIN</td>
<td>—</td>
<td>-11</td>
<td>-7.1</td>
<td>3.9</td>
</tr>
<tr>
<td>UK</td>
<td>314</td>
<td>-10.8</td>
<td>-6.4</td>
<td>4.4</td>
</tr>
<tr>
<td>JAPAN</td>
<td>145</td>
<td>-9.3</td>
<td>-9.3</td>
<td>0</td>
</tr>
</tbody>
</table>

*Budget balance is the difference between government receipts and spending. A positive budget balance indicates a government budget surplus, while a negative budget balance indicates a budget deficit.

## Don’t Fall Flat

In 2014, the US yield curve has flattened, driven by a decline in long-dated bond yields — also known as a ‘bullish’ flattening. This has occurred because short-end rates have risen only modestly, while the long end of the curve has actually come down. In the coming months, we expect the yield curve to continue to flatten, but more likely due to a ‘bearish’ flattening; foreign investment will keep the long-end well-bid while short-term yields rise in anticipation of an eventual Fed rate hike.

One possible way to take advantage of this curve trajectory is a barbell strategy, where you underweight the short end of the Treasury curve and overweight the long end.

The barbell strategy, along with an outright short duration position, are two common approaches designed to capitalize on rising short-term rates. However, the short duration position is only profitable when rates actually go up. Therefore, we prefer the barbell, which could be achieved, for example, by underweighting 2- to 5-year Treasuries and overweighting 30-year Treasuries (while keeping the duration neutral).

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**Bullish Flattening Has Been Driven by a Decline in Long-End Rates**

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**Bearish Versus Bullish Flattening**

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Source: US Department of the Treasury. As of 28 November 2014. The information contained above is for illustrative purposes only.
Declining Beta Could Curb Rate Interdependence

We believe it is instructive to look beyond how diverging monetary policy will affect US Treasuries. For example, how will other sovereign debt securities respond once US rates rise? Historical beta trends between the US and German bunds and JGBs can give us some insight.

The beta in this case — the magnitude of price change explained by changes in US rates — is currently positive for German bunds and JGBs. This implies that as rates rise in the US, the bund and JGB yields will also rise. This makes sense, as global rate markets have historically taken direction from the US. However, the beta between markets has shifted as monetary policies diverged.

Germany

To show the relationship between US and German sovereign rates, we run a regression of 10-year Treasury yields against 10-year bund yields using a rolling window of 4 months. A 10-year history gives an average beta of 0.70, meaning that for every 1 basis point increase in Treasury yields, there is a 0.70 basis point increase in bund yields.

![German Bund to US Treasury Beta](image)

Source: Bloomberg. SSAGA As of 17 November 2014.

The information contained above is for illustrative purposes only.

Taking a deeper look at the ‘taper tantrum’ in mid-2013 when global yields spiked, we examine the beta in September 2013 (i.e. four months later). At that time, the beta declined to 0.5, well below the long-term average of 0.70. While both Treasuries and bund yields increased, bunds increased only half as much.

By contrast, during the fixed income rally of early 2014 when global yields began their spiral downwards, the beta shot higher, reaching an annual peak of 1.68 in September. Both Treasury and bund yields fell, but bund yields fell by much more — about 111bps, versus only 63bps for Treasuries.

The upshot is that when global yields have increased, the German bund hasn’t been hurt as much — i.e. the beta has gone down. But when global yields have decreased, the German bund has actually decreased more — i.e. the beta has gone up. But why would this be?

The answer lies in part in the divergence of monetary policy in the eurozone versus the US. While the Fed is preparing to remove stimulus, the ECB stands ready to increase their accommodation. As a result, German sovereign bond yields fell more (or rose less) than historical beta would suggest.

Japan

Historically, the cross-market beta between the US Treasury and JGB markets has been lower, reflecting the long-standing economic divergence between those regions. Indeed, the beta between JGB and US Treasury rates actually became negative in late 2013 as the divergent policy stances of the Fed and Bank of Japan (BoJ) asserted itself; JGB yields declined significantly in the second half of 2013, as BoJ asset purchases forced yields down. Meanwhile, Treasury yields continued to move higher amid expectations that the Fed will begin to wind down asset purchases.

Asia ex-Japan: A Sell-Off of Local Currency Bonds

Japanese Government Bond to US Treasury Beta

![Japanese Government Bond to US Treasury Beta](image)

Source: Bloomberg. SSAGA As of 17 November 2014.

The information contained above is for illustrative purposes only.

Looking outside of Japan to China and emerging market Asia, historically, Asian economies have moved in tandem with US markets. However, more recently, this relationship has begun to break down. Institute of Supply Management numbers show US improvement in the past couple years; but Asian export growth has actually lagged over the same period.

This implies that the relationship between US and Asian economic growth is diverging. As a result, in today’s environment, Asia may fail to see the historical economic benefits from rising US growth, but it will see challenges that result from US rate hikes.

We expect that once US rates rise, we will see a sell-off in local currency bonds. Even in strongly managed economies like Singapore and Hong Kong, the rise in the ‘risk-free’ rate (i.e. the rate for short-term US Treasuries) should lead to a higher required return for Asian bonds. However, this sell-off is mitigated by the fact that Asian sovereign bond valuations are not as rich relative to US bonds in recent years. Existing Asian fundamentals can also cushion Asian markets from the impact of US rate hikes.
**Divergence Supportive for High Yield**

Historically, returns from the high yield market have proven to be resilient in a rising rate environment, since the decline in risk premium for credit risk offsets the rise in Treasury rates. However, the current record low yield environment could lead to a different experience for the high yield market if rates were to rise significantly. Therefore, the implied ‘cap’ on long-term Treasury rates from diverging monetary policy is supportive of high-yield credit.

On the surface, current junk bonds yields are worthy of a collective yawn from fixed income investors. The BoAML US High Yield Master II Index stood at a yield to worst of 6.13% at the end of November, a far cry from close to 9% yields pre-crisis in 2007, and only about 130bps higher than record lows last June.6

However, it is important to remember that junk bond yields are composed of Treasury rates plus some spread premium for credit risk. Since Treasury rates are extremely low, all fixed income asset classes that trade to the risk-free rate — including high yield — are offering offer pretty paltry yields right now in comparison to where they have been prior to the financial crisis.

However, current high-yield bond spreads of 479bps over Treasuries are significantly wider than the all-time lows of 262bps in June 2007,7 so high-yield spreads still have room to run as the US economy improves and spreads decline with credit risk also declining from an improving economy.

Therefore, we think high-yield remains an attractive asset class, but investors should take an idiosyncratic, fundamental credit risk rather than duration risk (the higher the duration, the more prices will fall when rates rise). By seeking credits such as strong CCC- and B-rated names — those that are fundamentally sound, but still offer juicier spreads than higher-rated names — investors can capitalize on spread tightening in an environment that would be healthy for corporate profiles.

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**Currency: USD Triple Double**

In basketball, players can get perennial bragging rights from scoring what they call a ‘triple double’. To claim this, a player must post double digits in three of any of the following: points, assists, rebounds, steals, or blocked shots. It turns out that with divergent monetary policy, the US dollar has its own triple double; we cite three trends that have helped bring about a double-digit (over 20%) increase in the US Dollar Index (DXY) from multi-year lows in 2008 to current levels.

**Higher Yield:** With higher relative rates in the US, more assets flow into US securities, and the US dollar appreciates.

**Better Economic Backdrop:** The US currently exhibits a better financial picture than the eurozone, where Italy is in recession and Germany is on precipice of recession. Meanwhile, growth in China is clearly slowing, Russian sanctions are taking their toll, and EMEA overall is rife with geopolitical turmoil.

**Attractive currency positioning:** The US dollar is expected to continue its upward course even after its startling appreciation over the past few years.

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**INVESTMENT IDEAS**

- **Go flat** We expect US yield curve flattening to be another symptom of global economic growth patterns, which is conducive to ‘flattener’ trades and tactical and shorter duration trades as we get nearer to rate hikes.

- **High yield and investment grade corporates** still look attractive on a relative basis.

- **Within US Fixed Income portfolios position away from the short end** it’s likely to come under increased pressure in a rising interest rate environment.

- **Favour the long end of the US Treasury curve**, where yields are closer to the long-run Fed Funds rate.

- **US Treasuries are increasingly attractive yield and currency plays for global bond investors** (until rate hikes are closer), particularly those suffering from ultra-low yields in markets like Europe & Japan.

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1Bloomberg, as of 1 December 2014.
2Barclays, as of 1 December 2014.
3Barclays, as of 28 November 2014.
4Barclays, as of 28 November 2014.
5Bloomberg, SSGA, 2 January to 10 November 2014.
6Bank of America Merrill Lynch H0A0 - HY Broad Market Index, Yield to Worst, as of 28 November 2014.
7Bank of America Merrill Lynch H0A0 - HY Broad Market Index, Spread to Worst, Treasury as of 28 November 2014.
Europe Muddles On
The recently concluded Asset Quality Review and stress tests removed a cloud that has hung over the European banking sector for years. But there is little immediate prospect it will lead to a pick-up in bank lending or an acceleration of economic growth.

Indeed, the IMF has recently downgraded the prospects of the eurozone’s three largest economies — Germany, France and Italy — and doubled the probability that the eurozone will re-enter recession in the next 6 months to 38%.

The ongoing malaise should not be too surprising. The current structure of the eurozone is fundamentally flawed, yielding stagnant or slowly growing economies, high unemployment and the possibility of outright deflation.

Moreover, with a real solution still a long way off, headwinds will remain, suggesting that the region is unlikely to thrive for some time.

The GFC effectively highlighted those structural flaws. The architects of the European project had hoped for a strong monetary union, but one main lesson of the crisis is that such a structure will never work well unless accompanied by banking, fiscal and political union.
**Pockets of Opportunity**

However, while there are many macro challenges, there are also market opportunities: with more room to grow, we believe that equity valuations are more compelling than those in the US, and some peripheral economies are showing signs of life — especially Ireland and Spain.

Moreover, the eurozone is no longer in imminent danger of breaking up. While it may not thrive, it will survive, albeit with occasional high drama and frequent government challenges.

There will be pockets of value, the challenge, as ever, is finding them. And to do so, investors will have to tease apart the macro from the market and operate selectively.

**Rising Tailwinds?**

A wave of reform and policy action could lead to an upside surprise in 2015, and might even have a more long-lasting effect on the region’s economy. The Asset Quality Review (AQR) and stress tests have restored faith in the European financial system, arguably the best development in Europe for many years.

**Asset Quality Review**

The official release of the results was somewhat anticlimactic — in the end, a net shortfall of only €9.5 billion was reported. However, this was because banks acted aggressively in anticipation of the exercise. Indeed, banks strengthened their balance sheets by €203 billion between July 2013 and August 2014 in a variety of ways — including issuing contingent convertibles (or CoCos).

European banks have clearly come a long way in restructuring their balance sheets and it stands to reason that banks held back the supply of credit ahead of gaining approval from the ECB. This seal of approval paves the way for banks to extend more credit where there is demand.

The aim of the comprehensive assessment was to strengthen the banking system, boost confidence, increase transparency, and ensure the ECB was not inheriting supervision of banks with legacy issues. And we believe it has done so.

**European Banks Have Already Made a Sizeable Balance Sheet Adjustment**

![Bar chart showing the breakdown of balance sheet adjustments](chart.png)

Source: ECB, National Competent Authorities (Supervisors). As at 28 November 2014.

The information contained above is for illustrative purposes only.
**Asset-Backed Security Purchases**

Some further good news for small and medium-sized enterprises — critical providers of employment in the region — is the ECB’s Asset-Backed Security Purchase Programme (ABSPP). This will provide much-needed liquidity to a market that ECB President Draghi has long maintained is important to the health of the region’s economy.

Businesses in Europe are much more dependent on bank lending than in the US — where capital markets have long been the main source of funding. Aware that companies need access to more diversified sources of financing; Draghi has supported the development of an ABS market and called on regulators to do the same. The ABSPP should help resuscitate a market that Draghi once referred to as ‘dead’.

**Weaker Euro**

A weaker euro should help the region’s exports. Driven by a de-coupling of ECB–FED policy, EUR/USD fell from its recent peak to a 2-year low. Moreover, SSGA’s purchasing power parity model (which determines the relative value of different currencies based on their ability to buy a market basket of goods) suggests further euro depreciation, as the pair trends towards a long-term equilibrium of around 1.20.

The de-coupling of economic performance between the US and the eurozone could even produce a short-term ‘overshooting’ of the exchange rate, with 1.10–1.15 appearing distinctly possible sometime during 2015.

The reversal of previous euro strength should translate progressively into tailwinds for globally exposed companies’ earnings and will be a positive for eurozone growth overall. We estimate that even a 10% drop from the 2014 average to 1.19 will push growth 0.7 points higher in 2015 and 0.1 points higher in 2016.

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**UK GDP Continues Its Strong Growth Trajectory**

While growth slowed from 0.9% to 0.7% in the third quarter of 2014, it became broader-based with service-sector output slowing slightly but both industrial production and construction picking up.

Even against the backdrop of diminishing global growth prospects, we expect the UK economy to continue to outperform the rest of Europe. Indeed, while growth is expected to languish around 1.0% in the eurozone, it is expected to remain close to 2.5% in the UK.

**Valuations**

In the seven years since the GFC, Europe has struggled to get valuations back and, at 11%, Return on Equity remains low against both its history and the US. It’s debatable whether Europe’s financial companies’ earnings will ever recover to their previous levels of profitability, but even adjusting for this, Europe’s non-financial companies look relatively attractive.

Having recovered much of the ground lost in the GFC, US valuations are no longer as compelling as they once were. Valued at 16 times a high earnings figure, the market is trading well above historical averages amid bullish investor sentiment.

Europe’s Price/Earnings has rerated to 14 times, but is based on what is still a depressed level of earnings, and while the strength of the recovery may be fragile, there appears to be less downside risk in these valuations.

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**US Valuations are No Longer as Compelling as They Once Were**

![Diagram showing US and Europe valuations](chart.png)

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<td>Valuations</td>
<td>14 times earnings</td>
<td>16 times earnings</td>
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Source: SSGA. As at 28 November 2014. The information contained above is for illustrative purposes only.
Dividend Yield: An Opportunity?

European equity valuation is cheap and may well remain cheap for quite some time; however, we expect next year to present dividend yield opportunities in Europe.

Despite signs of increasing M&A activity, investment opportunities remain limited, making increased dividends and buyback growth more likely.

Many European firms now present better dividend yields than European corporate bond yields. Look to industrials and consumer products as well as financials and cyclicals for strong dividend yield.

Be Smart About Currency

What effect are currency moves having on European investors' portfolios?

We believe that a fully hedged program is not flexible enough to take advantage of currency moves, which may mean missing out on the returns that dynamic hedging can access.

The 2014 year-to-date hedged and unhedged returns of MSCI US equities bear this out. Investors with dynamic hedging would have fared substantially better.
The Reform Premium

It is a fundamental truth that countries and companies that do what the markets value are rewarded with greater investment flows.

Those countries that implement reform agendas that promote growth, transparency and deregulation are typically higher up investors’ preferred list of investment destinations. Weak 2014 GDP numbers, not only encouraged the ECB to act, they also served as a warning to those countries that were lagging in implementing crucial structural reforms.

Spain

Spain has implemented arguably the most painful reforms in the region, and these are beginning to bear fruit. These measures have had a significant impact on fiscal consolidation, and wage moderation has helped Spain regain competitiveness and boost exports. Spanish nominal unit labour costs have fallen 2.7% between the second quarter of 2012 and second-quarter 2014. Spanish exports have risen as of Q3 by 65.9% since 2009. Spain’s stock market has also clearly welcomed the reversal and the market return since June 2012 is +80%, well ahead of France (+37%) and Germany (42%).

Italy

Italy is probably the country that most needs to accelerate the pace of reform. GDP growth amounts to around zero over the past decade and public debt stands at around 130% of GDP, among the highest in the region. Seemingly trapped by a deteriorating economic situation, its debt dynamics are proving difficult to reverse. After contracting by 1.9% in 2013 and an expected 0.2% in 2014, we expect the economy to grow a very modest 0.6% in 2015.

And yet, Italy has not had to request international assistance and markets have broadly welcomed Mr. Renzi’s reform plans. While Italian stocks have thus far lagged behind other major countries in the eurozone, there is real potential for recovery, if the pace of reform can be accelerated.

France

France has had a similarly slow pace of reform, but the failure of France to sufficiently reform has potentially wider implications, given its position with Germany at the heart of the eurozone. In contrast to Germany, its economic strength is more dependent on domestic consumption, which itself is supported by social transfers.

Amongst the ills of the French economy are high public spending (57% of GDP versus a eurozone average of 46%) and an inflexible labour market that contributes to high youth unemployment. The comparatively low competitiveness of French companies also explains the de-industrialisation of France and its sliding market share in international trade.

The Macro is Not the Market

Across all asset classes, we believe that the macro is not the market and, particularly, in equities it is often important to separate the macroeconomic situation from the trading opportunity. That being said, at a country level and given the eurozone backdrop, the markets have made it clear that those countries implementing reform will be rewarded.

INVESTMENT IDEAS

- **Valuations** Consider Value-Focused or Multi-Factor advanced beta strategies.
- **Dividend Yield** Look to industrials and car makers, retailers and consumer products as well as financials and cyclicals for potential strong dividend yield.
- **Be Smart About Currency** Dynamic hedging programs can help investors profit from currency movements.
- **Access the Reformers** Consider funds that target those countries that have reformed.
US Treasury bills are insured and guaranteed by the US government. If redeemed prior to maturity, they may be subject to a substantial gain or loss, pronounced for longer-term securities. Any fixed income security sold or purchased involves interest rate risks; the risk of issuer default; issuer credit risk; liquidity risk; and inflation risk. This effect is usually more pronounced for bonds with lower credit quality of the issuer.

Investments in small-sized companies may involve greater risks than in those of larger, better known companies. Investing in foreign-domiciled securities may involve risk of capital loss from unfavourable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Investing in commodities entails significant risk and is not appropriate for all investors. Commodities investing entail significant risk as commodity prices can be extremely volatile due to wide range of factors. A few such factors include overall market movements, real or perceived inflationary trends, commodity index volatility, international, economic and political changes, change in interest and currency exchange rates. Companies with large market capitalizations go in and out of favor based on market and economic conditions. Larger companies tend to be less volatile than companies with smaller market capitalizations. In exchange for this potentially lower risk, the value of the security may not rise as much as companies with smaller market capitalizations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

Although subject to the risks of common stocks, low volatility stocks are seen as having a lower risk profile than the overall markets. However, a portfolio comprised of low volatility stocks may not produce investment exposure that has lower variability to changes in such stocks’ price levels.

Although bonds generally present less short-term risk and volatility risk than stocks, bonds contain interest rate risks; the risk of issuer default; issuer credit risk; liquidity risk; and inflation risk. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to substantial gain or loss. US Treasury bills are insured and guaranteed by the US government.

The views expressed in this material are the views of SSGA Investment Management through the period ended 1 December 2014 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

All information is from Bloomberg and FactSet unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

Risk associated with equity investing include stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions.

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