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# 2015 Mid-Year Outlook: The Beat Goes On

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Investors can excuse themselves for feeling whipsawed. It's a policy-driven world and to modify the famous quote from the late economist Paul Samuelson, the stock market has now predicted three of the last zero rate hikes. See the 2013 taper tantrum, early-2014 market correction, and the late 2014 dollar surge as examples.

As recently as the beginning of the year, the consensus was convinced that by now the U.S. Federal Reserve would have embarked on its much-anticipated tightening cycle. The greenback had surged against most major currencies, U.S. equities were outperforming international markets, the price of oil (which trades in dollars) had plunged, and U.S. Government bond yields were retesting the low levels last hit in early 2013. No sooner had investors put on their short oil positions, currency hedged their international equity exposures and added duration to their fixed income allocations, than U.S. economic activity began to disappoint and the consensus pushed out their expectations for rate hikes into late 2015 or beyond. The reality is, as I have said time and again, that alas there can be no decoupling in a deleveraging world.

Where does that leave us now? The consensus now loves international equities, is quite cautious on U.S. equities, hates bonds, and has expectations for future inflation, presumably because the Fed is on hold, that we think are now too high. The next few months are poised to bring a reversal of what happened in the second quarter. The recent weakness in the U.S. dollar now has the U.S. economy surprising on the upside while

European activity modestly disappoints. Don't be surprised if U.S. equities outperform over the next few months. As for oil and for bonds, the threat of inflation has been greatly exaggerated. For tactical bond investors, not only are 10-year U.S. Treasuries and German bunds not the "shorts of a lifetime," but these investors may also even stand to benefit in the coming months from increasing their interest rate sensitivity. Near-term tactical talk aside, for investors it is far more important to get the big calls right. Everything else will take care of itself.

What are those big calls?

1. We are in a slow growth world with little inflation in sight.
2. The Fed, much to the consternation of this dove, will raise interest rates at some point, but the tightening cycle will be glacial with many fits and starts along the way. Policymakers around the world are just getting started. Interest rates will remain low globally for the rest of my career.
3. The usual trappings of the end of a cycle are nowhere in sight. By my assessment, the credit cycle, which is a harbinger of future economic activity, is also just getting started. Ultimately this will be the longest cycle on record. Given that, I continue to favor global equities over bonds and credit over treasuries. This has been the call for over six years now and will likely be so well into the future.

# Growth

Asset Allocation Views for Investors with a Growth Objective (May 31, 2015)

	Less Favorable	Neutral	Favorable
Regional			Developed Markets Equity Emerging Market Equities U.S. Equities
Market Capitalization		U.S. Large Cap	U.S. Small Cap
Style		Value	Growth
Other Sources of Growth	High Dividend Equity	MLPs Commodities Global REITs EM Credit	Global High Yield Credit

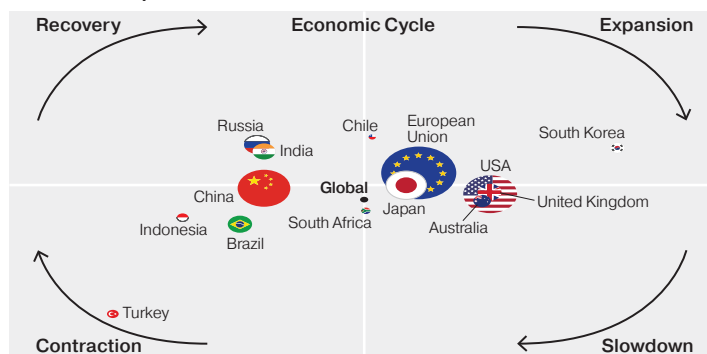
For investors with a growth objective, we continue to favor equities over most other asset classes. Our positive view on global equities stems from the fact that most major economies continue to enjoy low interest rates and unprecedented monetary policy support. Valuations remain reasonable and global growth appears to be strong enough to support corporate earnings but not so strong as to bring forth inflation and meaningful policy tightening.

## Regional

Specific regional calls are somewhat less enticing as international valuations are back in line with long-term averages. In a world where growth is scarce, investors will need to find it and pay up for it regardless of where the companies are domiciled or where revenue is generated. Globally, stocks continue to look cheap relative to almost any other asset class.

Risk assets tend to track the business cycle stages (expansion, slowdown, contraction, recovery) in fairly straightforward ways, with some of the best performance coming when economies are in the recovery and expansion quadrants.

### Leading Indicators in Europe and Japan Signal Continued Economic Expansion



Source: Oppenheimer Global Multi Asset Group proprietary research, 5/31/15. **Past performance does not guarantee future results.**

## U.S. Equities

Don't be surprised if U.S. equities outperform over the next few months. Investors' appetite in early 2015 for U.S.-dollar denominated assets proved untimely as the stronger dollar provided a

strong headwind to U.S. economic activity and to corporate earnings. Already the recent weakness in the U.S. dollar has offset some of the weakness and has helped U.S. economic activity to surprise on the upside. Growth is likely to recover in the second half of the year.

Valuations may appear modestly extended on an absolute basis but continue to be attractive given the current interest rate and inflation environment. And while there will be much handwringing over the timing of the Fed's first rate increase, the Fed tightening cycle promises to be glacial.

## Emerging Market Equities

Our favorable stance on emerging market equities is generally policy driven, as lower inflation rates across much of the emerging world provide cover for policymakers to take necessary steps to stimulate growth.

Emerging market secular growth trends are slowing, but leading indicators for larger economies like India and China are pointing towards further recovery from last year's slowdown. Ironically, the big emerging market outperformers of the first half of 2015 are companies more widely associated with the old Chinese-growth trajectory. These include, but are not limited to, companies in the commodities sector as well as companies in heavily regulated industries like financials, which are home to many state-owned enterprises.

We firmly believe that trend will not continue, and we focus instead on what we believe will be the drivers of emerging market growth in the future. We continue to favor companies that stand to benefit from financial liberalization, improved logistics and distribution systems and companies with monopolistic-like characteristics in industries as wide ranging as e-commerce, modern retail, media, private health-care and education.

## International, Developed Market Equities

For the first time since the financial crisis, international companies are now expected to post higher earnings growth than the companies of the S&P 500 Index.<sup>1</sup> Investors have taken notice, driving once-low valuations in international developed and emerging markets back in line with their 20-year averages. While the trajectory of developed market equities remains sound, valuations are no longer as cheap as they once were and as a result any decline in positive surprises in the Eurozone could trigger some underperformance relative to the United States and the emerging markets.

# Income

Asset Allocation Views for Investors with an Income Objective (May 31, 2015)

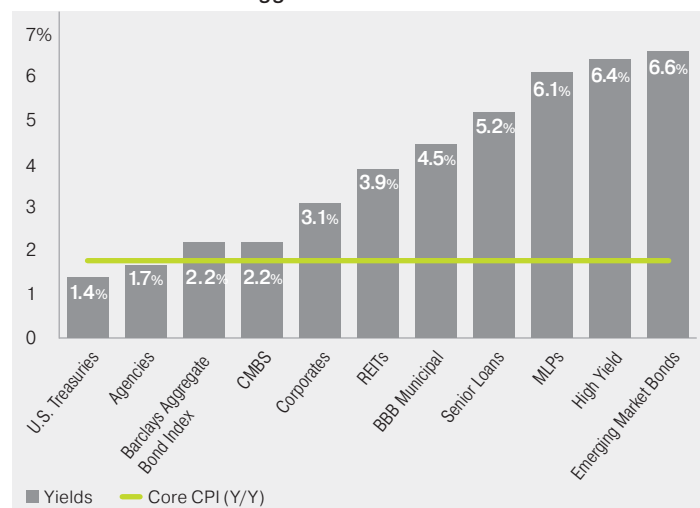
	Less Favorable	Neutral	Favorable
Government-Related Bonds	TIPS		
	Developed Government		
	EM Local Government		
Credit		Global Investment Grade	EM USD-Credit
		Municipal Bonds	Global High Yield
			Senior Loans
Other Sources of Income		MLPs	
		Global REITs	
		Cat Bonds	
		High Dividend Equity	

With global deleveraging and central bank repression likely to keep interest rates low for the foreseeable future, we believe investors will be continuing to pay up for real income wherever they can find it. That is at least until the seeds of the next major credit event have been sowed (i.e., tight monetary policy, flattening yield curve, excessive valuations, and deteriorating macro and corporate fundamentals).

High yield credit, senior loans and high yield munis all look attractive for investors seeking income today, especially relative to government bonds.

## Government-Related Bonds

### Traditional Sources Struggle to Deliver Real Income



Sources: Barclays Live, Bloomberg, Credit Suisse and JPMorgan, as of 5/31/15. Asset classes are represented by the following indices (in the order they appear on the chart): Barclays U.S. Aggregate, U.S. Treasuries Index, Agencies Index, Aggregate Index, Commercial Mortgage-Backed Securities Index, Corporate Grade Bond Index, FTSE NAREIT Equity REIT Index, Merrill Lynch BBB Municipal Bond Index, Credit Suisse Leveraged Loan Index, Alerian MLP Index, JPMorgan High Yield Bond Index and JPMorgan GBI-EM Global Diversified Index. Index definitions can be found on the last page. **Past performance does not guarantee future results.**

## Credit

### High Yield and Senior Loans

Sound corporate fundamentals, easing lending standards and continued low interest rates all contribute to a very strong backdrop for credit.

Senior loans in particular, offer a compelling value for investors given the current conditions of spreads over LIBOR of 492 basis points,<sup>2</sup> few upcoming maturities and low net new issuance. Senior loans have the added benefit of very low duration which may benefit investors if rates go back up in the near term.

High yield bonds also look attractive for income seeking investors. After an energy-related selloff in the high yield market earlier in the year, high yield bonds are trading at attractive spreads over treasuries of 522 basis points.<sup>3</sup> Maturities have also been extended far into the future as companies have locked in low borrowing rates and reduced debt servicing costs.

### Municipal Bonds

High yield municipal bonds have continued to outperform in 2015 relative to their investment-grade peers, as a risk appetite has returned to the municipal market. Issuance has remained very low by historical standards and that has provided positive price support for the market.<sup>4</sup> We remain favorable on high yield municipal bonds as a source of tax-free income in a yield-starved world, especially in the context of improved underlying state and local government finances.

## Other Sources of Income

### Master Limited Partnerships

From an income perspective, we are neutral on MLPs. The asset class still provides a very attractive income stream, but alternative equities like MLPs are likely to add more equity market beta to portfolios than bonds. While long-term correlations to energy prices for MLPs are low, in the near term a stronger dollar and volatility in oil markets could make for a bumpier ride for MLPs. The fundamentals for the asset class remain strong longer term, however, as U.S. energy production has continued to grow even after entering a lower oil price regime.

# Diversification

Asset Allocation Views for Investors with a Diversification Objective (May 31, 2015)

Less Favorable	Neutral	Favorable
Gold	Cat Bonds	Alpha Strategies
	Commodities	
	Loans	
	REITs	
	MLPs	

Investors have sought out strategies that historically have lower correlations and low beta to both stocks and bonds as a way to mitigate tail risks in the market today. Diversifiers also can have the added benefit of delivering positive total returns in a variety of market environments. We continue to favor alpha strategies over gold and MLPs because the current market environment today provides more opportunities for alpha managers to thrive.

## Alpha Strategies

Alpha strategies are less reliant on economic growth or market direction to generate return and are driven more by manager skill and active management. These include alternative strategies like Equity Market Neutral, Global Macro, Equity Long/Short, Currency, and Relative Value. For alpha strategies to be attractive, market returns across and within asset classes must be differentiated. The recent differential in monetary policy among the developed world's central banks has created compelling value opportunities for alpha strategies. In the post-financial-crisis world, high correlations among almost every asset class made exploiting macro-driven strategies difficult. The new paradigm will likely boost the diversification

benefit and return potential of alpha strategies as managers exploit divergences like the performance of European and U.S. equities throughout 2015.

## Catastrophe Bonds

Cat bonds are typically among the best diversifying asset classes because they are linked to physical systems (the weather and geology) rather than economic and behavioral systems, and they typically act as a low correlation diversifier to traditional risk assets in portfolios. Cat bond spreads are tight by historical standards, however, as investors have sought out income from a variety of fixed income instruments in a low rate world and there have been few natural disasters to trigger principal losses in the bonds.

## Real Estate Investment Trusts

REITs generally offer sound diversification benefits because they trade primarily on the basis of local real estate fundamentals, rather than on broad macro conditions, and also because they tend to move in line with inflation. We currently classify REITs as neutral because they embed tail risk that may make them sensitive to interest rates.

# Real Return

Asset Allocation Views for Investors with a Real Return Objective (May 31, 2015)

Less Favorable	Neutral	Favorable
TIPS	REITs	Commodities
	Gold	

Inflation-protecting assets are generally less attractive in a world where the velocity of money is declining and spare capacity remains as a result of underemployed global workers. For investors seeking real returns, we favor commodities over Treasury Inflation Protected Securities (TIPS).

## Gold

Gold has continued its recent run of middling performance despite continued low rates in the developed world, which are normally supportive of gold's price. Gold remains overpriced compared to the current rate of inflation, but we are neutral on the asset class because it provides a nice option on inflation in a time of easy monetary policy globally.

## TIPS

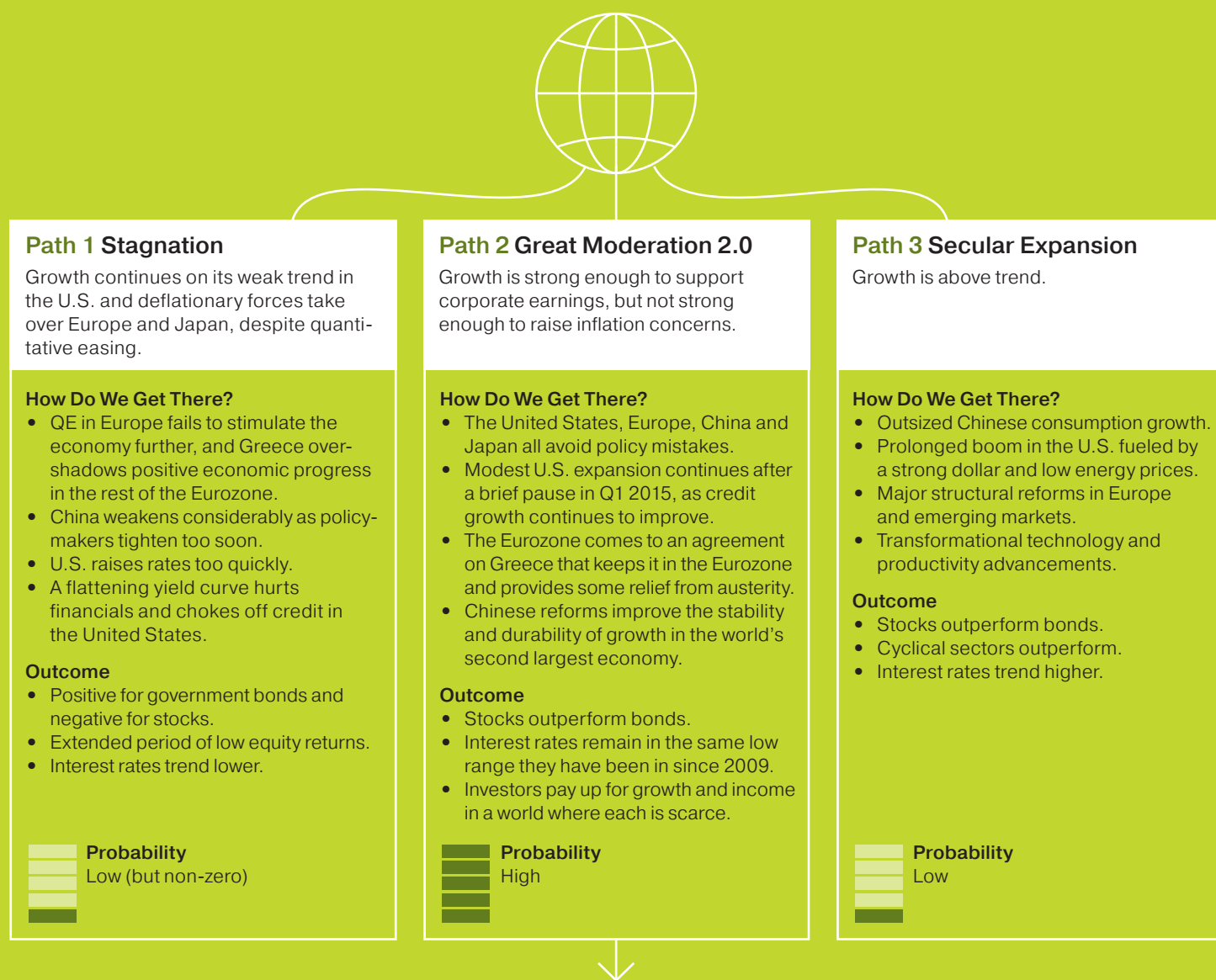
Investors are willing to accept virtually no yield in TIPS in the belief that the expected protection against inflation is worth the tradeoff. We believe it isn't. Like gold, TIPS provide a nice option on inflation but add interest rate sensitivity to portfolios.

## Commodities

Commodity prices have rebounded during the first half of 2015 after a very weak 2014.<sup>1</sup> The asset class still looks favorable from a historical valuation standpoint, especially relative to inflation, but some of the near-term return potential is now likely behind investors. The markets continue to appear well balanced from a supply/demand perspective. The excessive pessimism surrounding crude oil has subsided and much of the negative price momentum in commodities has ended.

# Where Do We Go from Here?

The global economy has made progress in the first half of 2015, following the middle path we outlined in our beginning of the year outlook. The second half of 2015 will likely look similar but tail risks remain. Below we outline the implications for financial markets.



## Likely Outcome: the Middle Way

In the aggregate, I believe that the middle way is still the likeliest path forward through the rest of 2015. The first half of the year has followed this path, even if investors felt whipsawed by individual asset classes.

I have little doubt that the United States will continue to grow despite a slow Q1 of 2015. The conditions that informed our view at the beginning of the year are still present, including the start of a more robust credit cycle, a benign Fed in no rush to raise rates, and a slow growth world with little inflation in sight. Regardless of the timing of the first Fed rate hike (likely late 2015 or beyond), a flattening yield curve is still years away.

Global growth will remain slow and steady for the foreseeable future. Policy easing in the Eurozone, Japan and China will likely help support growth even while the United States begins to gradually tighten. Ultimately this will be the longest cycle on record. Given that, we continue to favor global equities over bonds and credit over treasuries. This has been the call for over six years now and will likely be so well into the future.



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1. Source: FactSet, 5/20/15.
2. Source: Credit Suisse, 5/31/15.
3. Source: JPMorgan 5/31/15.
4. Source: The Bond Buyer, 5/31/15.

#### Index definitions

The S&P 500 Index is a market capitalization weighted index of the 500 largest domestic U.S. stocks.

The Barclays Aggregate Bond Index is an index of U.S. Government and corporate bonds that includes reinvestment of dividends.

The Barclays Aggregate U.S. Treasuries Index represents public obligations of the U.S. Treasury with a remaining maturity of one year or more.

The Barclays Aggregate Agencies Index, Agency Mortgage-Backed Securities (MBS) and Commercial Mortgage-backed Securities (CMBS) Index represent the U.S. Government Related-Agencies, U.S. MBS and CMBS components of the Barclays U.S. Aggregate Bond Index, respectively.

The Barclays U.S. Corporate Investment Grade Index represents investment-grade corporate bonds within the Barclays Aggregate Bond Index.

The Barclays High Yield Bond Index covers the universe of fixed rate, non-investment-grade debt.

The JPMorgan GBI-EM Global Diversified Index tracks total returns for local-currency-denominated money market instruments in the emerging markets.

The JPMorgan Domestic High Yield Index tracks the investable universe of domestic below-investment-grade bonds in the United States.

The Credit Suisse Leveraged Loan Index is a composite index of senior loan returns representing an unleveraged investment in senior loans that is broadly based across the spectrum of senior bank loans and includes reinvestment of income (to represent real assets).

The FTSE National Association of Real Estate Investment Trusts (NAREIT) Equity REITs Index is an index consisting of certain companies that own and operate income-producing real estate that have 75% or more of their respective gross invested assets in the equity or mortgage debt of commercial properties.

The Merrill Lynch BBB Municipal Bond Index is an index designed to measure the performance of below-investment-grade municipal bonds. BBB is the highest grade of rating by Moody's that is considered below investment grade.

The MSCI EAFE Index is designed to measure developed market equity performance, excluding the U.S. and Canada.

The MSCI Emerging Market Index is a free-float weighted equity index designed to measure the equity market performance of the emerging markets.

The MSCI Europe Index is a free-float weighted equity index designed to measure the equity market performance of the developed markets in Europe.

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Energy infrastructure companies are subject to risks specific to the industry such as fluctuations in commodity prices, reduced volumes of natural gas or other energy commodities, environmental hazards, changes in the macroeconomic or the regulatory environment or extreme weather. MLPs may trade less frequently than larger companies due to their smaller capitalizations which may result in erratic price movement or difficulty in buying or selling. Additional management fees and other expenses are associated with investing in MLP funds.

**Municipal bonds** are subject to default on income and principal payments. **Event-linked securities** otherwise known as Cat Bonds are fixed income securities for which the return of principal and interest payment is contingent on the non-occurrence of a trigger event that leads to physical or economic loss. If the trigger event occurs prior to maturity, event-linked securities may lose all or a portion of their principal and additional interest. **Investments in real estate companies**, including REITs or similar structures, are subject to volatility and other related risks including loss in value due to poor management, lowered credit ratings and other factors.

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