



August 24, 2015

MARKET UPDATE

GLOBAL ECONOMIC CHALLENGES REAWAKEN MARKET VOLATILITY

WHAT HAS HAPPENED?

In the two weeks since China devalued its currency, asset prices globally have undergone sharp declines—in stocks, bonds, commodities and many currencies, especially among emerging markets. The sell-off in global markets accelerated last Friday and continued Monday, with global and regional indexes nearing or entering their first correction (a drop of 10% from the most recent peak) in several years.

It is likely that we will see more volatility in the coming weeks, until greater clarity surfaces concerning China's economic growth, as well as growth and fiscal policy changes elsewhere. But concern over China's future economic growth is foremost in investors' minds, and the lack of transparency on this issue may well continue to fuel increased volatility in global markets.

OUR PERSPECTIVE

In the short term, the current disruption in markets will have a negative impact on most assets other than safe-haven investments. But the continued prospect for economic growth, especially in the US, bodes well for the longer-term outlook.

For some time, we have been expecting an increase in volatility. While it is extreme at the moment, the sharp uptick appears even more outsized because volatility has been unusually subdued for several years, with the last market correction for the S&P 500 having occurred in mid-2012.

Most importantly, recent data point to a continued economic recovery in the US, including near-record housing starts, low unemployment, stable core inflation and solid job creation. However, should volatility continue in the markets and fuel a prolonged retreat from risk assets, the US economic recovery could be threatened.

As for the global economy, we see continued growth, although the composition of that growth will change in terms of countries and sectors that are laggards or leaders. One key driver of this change is commodity prices, which have been driven even lower in recent weeks. This will likely be a boon for most developed markets, but a challenge for emerging-market (EM) countries that depend heavily on exporting commodities.

Consequently, while caution is critical in the short term, we still see economic growth—particularly in the US—as providing potential opportunities.

FIXED INCOME: CAUTIONS AND OPPORTUNITIES

While our outlook for fixed income remains defensive, we are finding opportunities for interest-rate exposure in countries likely to keep rates low due to economic pressures (like commodity based economies) or because of massive QE programs in place. Conversely, we prefer to take our credit exposure in countries where we have a higher degree of confidence in the economic recovery, like the US. We believe this environment illustrates the benefits of a global, diversified and balanced approach.

For some time now, we have been cautious regarding the riskier parts of fixed-income markets—underweighting areas such as energy and mining bonds, and sovereigns with outsize risks (e.g., Chile, Russia). High-yield and EM bonds have been particularly hard hit recently, but we have been positioning even these investments with a more defensive and diversified approach. With regard to currencies, we still generally favor the dollar and a few select foreign currencies such as the Indonesian rupiah and the yen. Within EM FX, we are generally cautious, especially in Asia. We continue to urge fixed-income investors to remain defensive by being global, diversified, avoiding overcrowded areas of the credit spectrum (such as CCC-rated bonds and bank loans), and maintaining a balance between interest-rate and credit risks.

Furthermore, we have been monitoring liquidity issues for several years, and our investments remain defensively positioned for this risk as well.

EQUITIES: A LONG- AND SHORT-TERM VIEW

Equity markets have been on a strong upward trend for many years now on the back of improving corporate profits and valuation expansion. Our outlook for equities remains favorable for the intermediate term, but with more tempered expectations for returns over the next five years. With the across-the-board selling we are seeing now, many of our teams are also seeing opportunities to add to our positions in select companies we already favor—which, in many cases, have limited exposure to the key concerns right now of China and energy issues.

We have emphasized the need to actively seek companies that can continue to grow earnings on their own, rather than relying on a better-than-expected economic outlook. This is reflected in the tilt toward high-quality companies with organic opportunity or companies that have it within their own control to improve profitability. On the cautious side, we largely underweight energy, materials and credit-related financials.

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A WORD ABOUT RISK

Market Risk: The market values of the portfolio's holdings rise and fall from day to day, so investments may lose value. **Interest-Rate Risk:** As interest rates rise, bond prices fall and vice versa—long-term securities tend to rise and fall more than short-term securities. The values of mortgage-related and asset-backed securities are particularly sensitive to changes in interest rates due to prepayment risk. **Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or principal—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered and the bond's value may decline. **Allocation Risk:** Allocating to different types of assets may have a large impact on returns if one of these asset classes significantly underperforms the others. **Foreign (Non-US) Risk:** Non-US securities may be more volatile because of political, regulatory, market and economic uncertainties associated with such securities. Fluctuations in currency exchange rates may negatively affect the value of the investment or reduce returns. These risks are magnified in emerging or developing markets. **Derivatives Risk:** Investments in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market. **Leverage Risk:** Trying to enhance investment returns by borrowing money or using other leverage tools may magnify both gains and losses, resulting in greater volatility. **Below-Investment-Grade Securities Risk:** Investments in fixed-income securities with lower ratings (commonly known as "junk bonds") tend to have a higher probability that an issuer will default or fail to meet its payment obligations.

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