

# Q2 2015 Outlook & Review

A QUARTERLY MARKET PERSPECTIVE FROM QMA'S ASSET ALLOCATION GROUP

## KEY POINTS

### On the Economy

Global GDP growth softened in the first quarter, due mainly to a slowdown in the United States and China but the risk of a sharper slowdown remains unlikely in our view.

The U.S. economy slowed significantly over the past two quarters, but we think this is due to temporary factors and expect growth to bounce back to a 3% pace over the balance of the year.

The clamp down by Chinese policymakers on corruption and excess credit growth are positive developments for the long-term but will likely further dampen short-term prospects.

Lower commodity prices continue to negatively impact Brazil and Russia. India and some of the smaller economies in Southeast Asia are bright spots in an otherwise uninspiring emerging market landscape.

The engine of global growth continues to shift away from the emerging market economies and we expect the Euro zone and Japan to see the biggest pickup in growth over the balance of the year.

If the U.S. economy rebounds as expected, the Fed should move forward with its plan to raise rates. However, this soft patch has likely pushed back a first rate hike from June to September.

The key risk to a relatively benign outlook appears to be geopolitical/political rather than economic, as the Russia-Ukraine conflict, proliferation of radical European fringe parties, and low oil and commodity prices may prove destabilizing.

### On the Market

After outperforming major markets last year (and outperforming more generally since the second half of 2011), U.S. Stocks were the big laggards in the first quarter, especially relative to European stocks in local currency.

The first quarter saw both shifts and continued developments in financial markets—commodity prices continued to fall, strong performance of REITs continued and in the United States bonds and equities provided similar returns.

We believe the U.S. dollar is in the midst of a secular bull market. However, given the strength of the dollar's ascent over the past three quarters it may need some time to correct or consolidate its gain before its next move higher.

We still expect U.S. stocks to post positive absolute gains and better relative performance to bonds over the balance of the year, but we believe the bulk of the opportunities for price appreciation will continue to be in European and Japanese equities.

Relative to the United States, we believe European and Japanese valuations are more attractive and both should see tailwinds from cheaper currencies and continued aggressive monetary policy.

Commodity prices may well be oversold but the macro-fundamentals of the space are still very poor in our view.

Within a fixed income allocation, we would stay with a pro-risk strategy—but one nuance is we favor U.S. high yield bonds over emerging market debt on better relative macro-fundamentals.

## On the Economy

For the second year in a row global GDP growth has hit a soft patch in the first quarter, due mainly to a slowdown in the United States and China. Also similar to last year at this time, business surveys in the major economies, such as purchasing managers indexes (PMIs) have moved up suggesting that growth should reaccelerate in the coming months. While the global economy still remains mired in the “new mediocre,” the risk of a sharper slowdown remains unlikely in our view, and consensus expectations of moderately accelerating growth are likely to be realized (chart 1), at least among developed economies.

China's slowdown should continue, as policymakers there clamp down on corruption and excess credit growth. These are positive developments for longer-term growth however, and should reduce the risk of a “hard landing” further down the road.

Elsewhere in the emerging world, lower commodity prices, weak productivity growth, and stretched private sector balance sheets are weighing on some of the larger “BRIC” economies, in particular Brazil. Russia's prospects look even worse as low oil prices and capital flight are likely to cause its economy to contract sharply this year. On the other hand, India stands out among the BRICs as growth expectations there are likely to improve as its new government continues steps toward structural economic reforms. Some of the smaller economies in Southeast Asia are also bright spots in an otherwise uninspiring emerging market landscape.

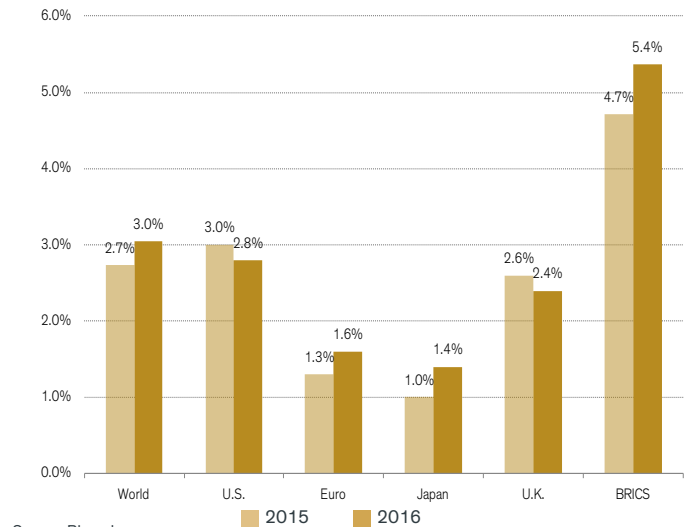
The engine of global growth continues to shift away from the emerging market economies and back toward developed markets. Rebounding from recessionary type conditions last year, the Euro zone and Japan should see the biggest pickup in growth over the balance of the year, as both are benefiting from lower oil prices, cheap currencies, and quantitative easing. The U.K. recovery should continue and growth hold steady, but a rising currency, weakening housing market, and election uncertainty are headwinds.

After experiencing very strong growth in the middle of last year, U.S. growth slowed in the final quarter and the negative trend continued into 2015—with consensus expectations of just 1.5% annualized first quarter growth. We think the majority of the slowdown has been weather related, although the surging dollar and cuts to energy capital spending also played a role. Despite the disappointing payroll report for March (which also may have been weather related), the three month moving average for monthly job growth is still solid (chart 2) and we expect growth to bounce back to a 3% pace over the balance of the year.

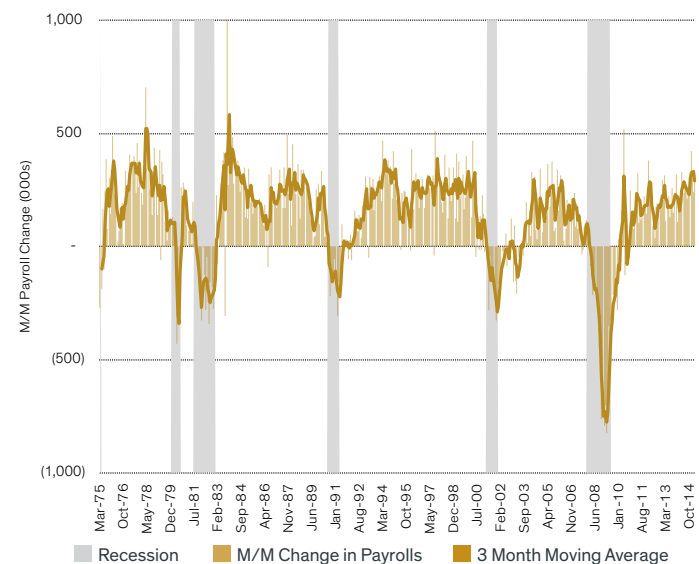
If the economy rebounds this spring as we expect, the Fed should move forward with its plan to exit its zero interest rate policy. However, this soft patch has likely pushed back a first rate hike from June to September. Markets are actually doubting whether the Fed will hike rates at all in 2015 (chart 3). Either way, the Fed will tread very carefully as the scenario it wants to avoid most is backtracking after hiking rates too swiftly.

The key risk to a relatively benign outlook appears to be geopolitical/political rather than economic. The Russia-Ukraine situation appears relatively quiet, but is more likely hibernating rather than resolved. While Europe's economics have taken a turn for the better, their politics have taken a turn for the worse as radical fringe parties have gained popularity and become an obstacle toward greater economic integration. Further, low oil prices and persistently lower commodity demand from China may prove destabilizing for Petro-states and other commodity dependant nations.

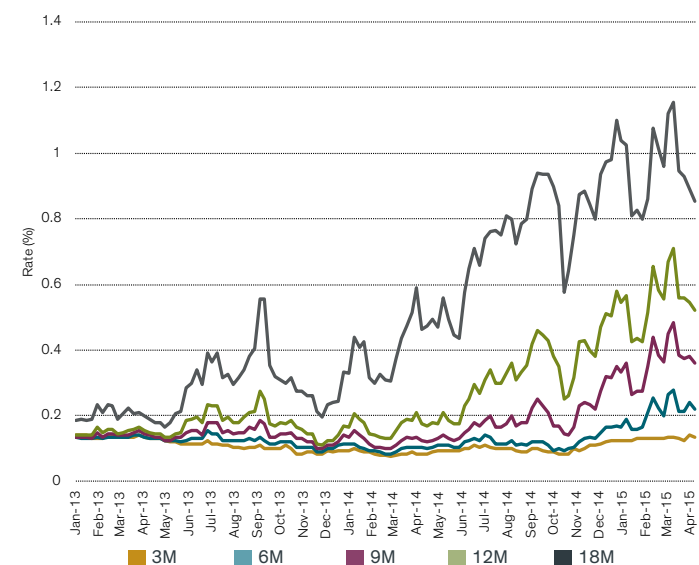
### 1 / CONSENSUS REAL GDP GROWTH FORECASTS



### 2 / PAYROLL GROWTH IS STILL SOLID



### 3 / FED FUNDS FUTURES IMPLY LOWER RATE PATH AS OF APRIL 8, 2015



## On the Market

The first quarter saw both shifts and continued developments in financial markets. Commodity prices continued to fall, though the pace of the decline was reduced from what we experienced in the second half of last year. Strong performance of REITs continued, though the group had its ups and downs during the quarter. In the United States bonds and equities provided similar returns.

The biggest shift from recent trends was the rotation in relative performance away from U.S. equities toward overseas markets (Chart 4). After outperforming major markets last year (and outperforming more generally since the second half of 2011), U.S. Stocks were the big laggards in the first quarter, especially relative to European stocks in local currency.

We had noted in last quarter's commentary that Europe and Japanese stocks could be big outperformers this year and we began shifting toward overweighting these markets early in the quarter. We implemented this view while hedging the currency exposure as we expected the dollar to continue its rise versus both the Euro and Yen. This turned out to be correct for the Euro, but the Yen stayed broadly stable versus the dollar.

We believe the U.S. dollar is in the midst of a secular bull market and we note that previous USD bull markets have lasted from five-to-seven years (chart 5). However, given the strength of the dollar's ascent over the past three quarters it may need some time to correct or consolidate its gain before its next move higher.

The strength of the dollar and lower oil prices have been weighing on S&P 500 earnings (chart 6). U.S. earnings growth expectations have been downgraded sharply recently and are now expected to expand by just 1.8% in 2015. We still expect U.S. stocks to post positive absolute gains and better relative performance to bonds over the balance of the year, but we believe the bulk of the opportunities for price appreciation will continue to be in European and Japanese equities.

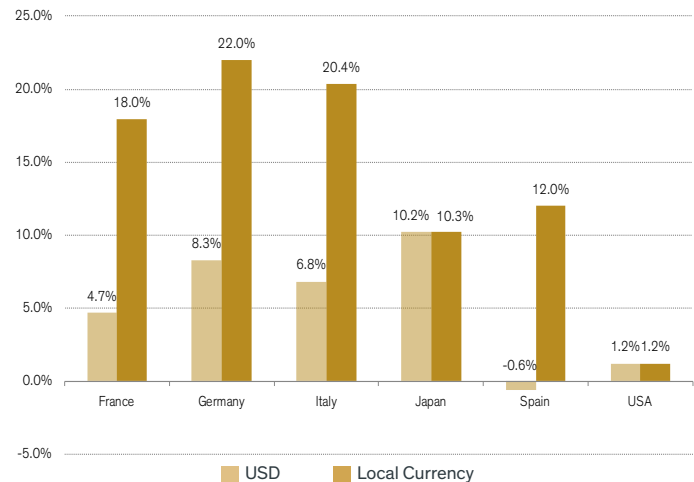
European and Japanese stocks should benefit from rebounding economies and stronger earnings growth and their economies should see tailwinds from cheaper currencies and continued aggressive monetary policy. Relative to the United States, both should benefit more from lower oil prices, and we believe European and Japanese valuations are more attractive.

Commodity prices may well be oversold but the macro-fundamentals of the space are still very poor in our view.

Within a fixed income allocation, we would stay with a pro-risk strategy—but one nuance is we favor U.S. high yield bonds over emerging market debt on better relative macro-fundamentals.

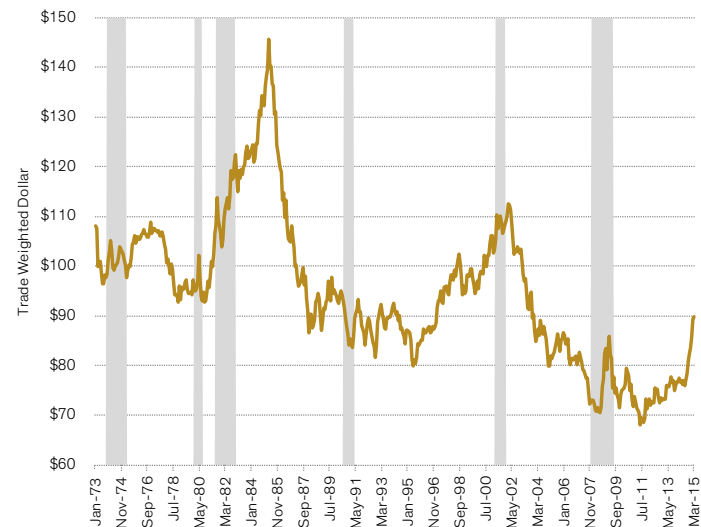
We like U.S. preferred shares as they exhibit strong yields, favorable valuation relative to other fixed income assets, and because financial sector balance sheets look strong. We are underweight Master Limited Partnerships (MLPs) in accounts where we hold them, given our still cautious view on energy, but we recognize recent improvements in valuation and are watching for signs of strengthening fundamentals.

### 4 / Q1 TOTAL RETURNS IN LOCAL CURRENCY & USD



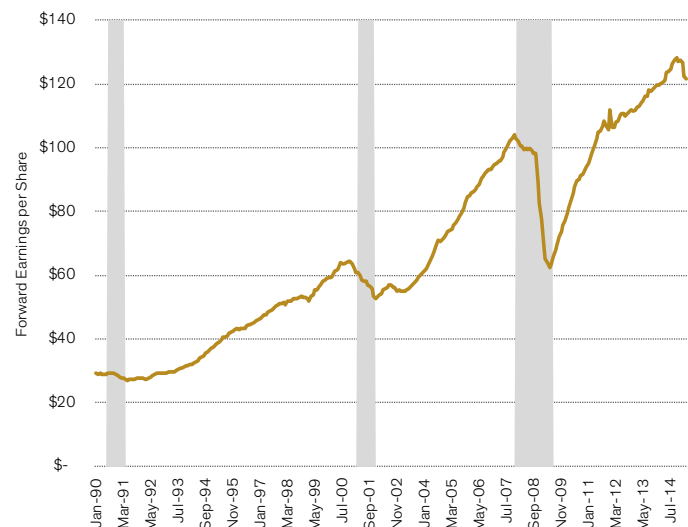
Source: Bloomberg

### 5 / US DOLLAR BULL MARKET



Source: Thompson Reuters Datastream

### 6 / S&P 500 FORWARD EARNINGS DECLINE



Source: Thompson Reuters Datastream

### Explanation of Indices

S&P 500 Index. Covers 500 industrial, utility, transportation, and financial companies of the U.S. markets. The value-weighted index represents about 75% of the NYSE market capitalization and 30% of the NYSE issues.

### Special Risks

Foreign investments may be volatile and involve additional expenses and special risks, including currency fluctuations, foreign taxes and political and economic uncertainties. Emerging and developing market investments may be especially volatile. Investments in securities of growth companies may be especially volatile. Due to the recent global economic crisis that caused financial difficulties for many European Union countries, Eurozone investments may be subject to volatility and liquidity issues. Value investing involves the risk that undervalued securities may not appreciate as anticipated. Small and mid-sized company stock is typically more volatile than that of larger, more established businesses, as these stocks tend to be more sensitive to changes in earnings expectations and tend to have lower trading volumes than large-cap securities, creating potential for more erratic price movements. It may take a substantial period of time to realize a gain on an investment in a small or mid-sized company, if any gain is realized at all. Diversification does not guarantee profit or protect against loss.

Emerging markets are countries that are beginning to emerge with increased consumer potential driven by rapid industrial expansion and economic growth. Investing in emerging markets is very risky due to the additional political, economic and currency risks associated with these underdeveloped geographic areas. Fixed-income investments are subject to interest rate risk, and their value will decline as interest rates rise. Unlike other investment vehicles, U.S. government securities and U.S. Treasury bills are backed by the full faith and credit of the U.S. government, are less volatile than equity investments, and provide a guaranteed return of principal at maturity. Treasury Inflation-Protected Securities (TIPS) are inflation-index bonds that may experience greater losses than other fixed income securities with similar durations and are more likely to cause fluctuations in a Portfolio's income distribution. Investing in real estate poses risks related to an individual property, credit risk and interest rate fluctuations. High yield bonds, commonly known as junk bonds, are subject to a high level of credit and market risks.

Investing involves risks. Some investments are riskier than others. The investment return and principal value will fluctuate and when sold may be worth more or less than the original cost.

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