

Investment Matters™

2015 Outlook

Themes for 2015

Executive summary

1. With the Federal Reserve (The Fed) now officially on the sidelines, equity market criteria shifts to an improving economy and revenue-based corporate earnings growth. While companies will have to deliver on the top line, there is still a meaningful upside for those who do.
2. The year-end decline in oil prices is likely overdone, but newly established levels below \$80 will be additive to global economic growth.
3. Declining interest rates represented a big surprise in 2014; however, we believe the risk of rising yields still persists in 2015 and recommend investors stay short on the curve.
4. Historically low credit spreads and default rates within High Yield could rise due to the impact of lower oil prices in the energy sector but that will likely prove opportunistic for the rest of the market.
5. China, Europe, and Japan are likely to benefit from the combined tailwinds of more accommodative monetary policy and lower oil prices.
6. Inflationary trends in the U.S. remain benign; however, this risk should not be ignored and warrants protective action.

About the author

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Tom is responsible for overseeing the investment and mutual fund product development functions and sub-adviser selection process. He will also actively publicize Transamerica's investment thought leadership and products to advisors, clients, and the media. Tom has more than 25 years of investment experience and has managed large mutual funds and sub-advised separate account portfolios.

Tom comes to Transamerica from Curian Capital, the investment management subsidiary of Jackson National Life, where he was a client portfolio manager focusing on enhanced risk-adjusted strategies incorporating multiple asset classes and alternative investments. Tom was previously a senior portfolio manager with Invesco Funds Group, Inc. and Munder Capital, where he managed some of the firm's largest mutual funds with several billion dollars in assets under management. Tom holds a bachelor's degree in political science from Tulane University and an MBA in finance from the Wharton School at the University of Pennsylvania. He has earned the right to use the Chartered Financial Analyst® (CFA) designation.



Making the Handoff



In the 1972 Summer Olympics, top-ranked United States sprinter Eddie Hart was given an incorrect start time for his qualifying heat and was therefore eliminated from competition, denying him the opportunity to run against the Kremlin-proclaimed world's fastest man, Russia's Valeri Borzov. Days later, Hart's only vindication remained in the finals of the quarter-mile relay, where he would anchor head-to-head against Borzov. Protecting a lead of about five meters, Hart's teammate Gerald Tinker blazed around the corner of the track at a sub-ten-second velocity as both Hart and Borzov looked forward with their left arms extended behind them. For anyone who remembers watching that race, and unfortunately I'm old enough to say that I still do, your heart dropped into your stomach: With human speeds of about 25 miles per hour and a gold medal at stake, Tinker approached Hart and was fully expected—without missing a stride—to hand off the baton.

Take that image and replace Tinker and Hart with the Fed and our economy. Therein lies the question facing financial markets in 2015.

Before I create too much suspense with this analogy, I should probably divulge that Tinker's handoff to Hart was executed flawlessly, allowing Hart to maintain and, upon the closest of examinations, perhaps even expand his lead on Borzov, clinching the gold for this U.S. relay team, which set a world record in the process. Of course it is also important to note that such a successful handoff was fully expected at that moment 42 years ago, much as it is again today.

The fact that stocks presently remain close to all-time highs serves as evidence that markets not only expect the U.S. economy to improve but to exceed current expectations. Much of this is based on a renewed sense of optimism closing out 2014 in which GDP growth for the final two quarters (4.6% in 2Q and 5.0% estimated for 3Q) hit its highest six-month rate since 2003, and jobs growth pierced the 300,000 level in the final report of the year with revisions showing a solid trend of gains above where we began 2014. Coming off an unexpectedly weak 1Q of negative GDP growth (albeit weather-induced, many would argue) and with 4Q still pending, the year will likely average out slightly north of 2%. Skeptics might say nothing has changed while optimists will clearly point to a rising trajectory for the year ahead.

Like just about all economic numbers, the upshot in the second half GDP is open to interpretation as to what is sustainable and what is not with inventory build and government spending taking center stage in that debate. However, what is far less open for debate is the premise that in order for stocks to maintain current valuations and optimally move higher, GDP growth will have to stabilize above 3%, with consumer spending being its dominant driver. Given the precipitous decline in oil that began this past summer and its potentially favorable impact on discretionary spending, this now seems more achievable than it did several months ago.

Should 2015 bear witness to this leg up in GDP growth and should it in fact be consumer driven, the following catalyst necessary for stocks to keep moving higher will be increasing revenue growth rates throughout corporate America. The fact remains that S&P 500® earnings growth since 2008, now sporting a five-year annualized growth rate of about 16% since the depths of the Great Recession, has for the most part been created through peak margin expansion and balance sheet management as sales growth for this same time frame has averaged only about 4%. I am of the school that margins and balance sheets can take stock multiples higher but they can't keep them there. For that we need good old-fashioned sales growth, the kind that makes investors look at an income statement and say, "Yeah, they can keep doing this for a while."

The next piece to the puzzle will then reside in the companies who achieve that sales growth to also recognize the sustainability of their earnings power and increase job hiring. They must also do so responsibly to ensure that the competitive nature of potential wage growth does not create inflation, and in the event it does, we will also need a Federal Reserve who won't be shy to raise interest rates, as much of a taboo as this generation of easy money investors might view that to be.

But these are all issues for the final leg of the relay. For now we are merely looking for the handoff.

U.S. stocks can still move higher in 2015 and beyond but will do so for different reasons than we have seen in recent years.

For more than five years, the Fed has provided so much liquidity that pretty much any bull need only grab the closest raft for a pleasant ride and any bear seeking to swim upstream has promptly drowned.

The floodgates are closing now, and so where does that leave stocks amidst a new and more neutral current?

In my opinion, we are looking at your classic good news versus bad news market environment. First the bad news: Earnings growth has been strong but revenue growth has not. Now the good news: Repeat that same sentence spoken with a more optimistic tone.

In other words, market bears will claim that the earnings growth achieved over these past five years cannot be sustained at current levels of sales growth, and this in and of itself is a recipe for declining stocks. S&P 500 average sales growth of 4–5% will no longer result in double-digit earnings growth because the margin expansion from corporate cost cutting and the shrunken balance sheets from record stock buybacks have run their course. So sales growth and earnings growth will converge and they will do so with earnings coming down to meet sales, which of course will not be good for stocks.

On the other hand, the bulls take this same predicament and lick their chops. If balance sheets and income statements have been primed to create double-digit earnings growth off of low single-digit sales growth, imagine where earnings could go if and when companies actually hit high single-digit revenue growth. The potential bottom-line impact of growing revenues combined with the better rationalized cost structures and lower share counts present not only a tremendous opportunity for stocks but also the profile behind a second leg up in a long-term bull market.

So where do we shake out in this debate? More in the bullish camp, though the road to higher stock prices will not be traveled without risk and a fair amount of casualties left on the side of the road. Basically, more so than any other we've seen since the Great Recession, 2015 will be a year to focus on what stocks you own and why you own them.

Given this landscape, here are the key points to be aware of and that we will be following for stocks in 2015 and beyond:

1. **Continued improvement in the economy** as measured by 3% or better GDP growth driven by consumer spending. Wage growth will also have to walk a fine line in being strong enough to boost momentum but not too strong to stoke inflationary fears.
2. **Potential outperformance of small-cap stocks** given their lag in 2014, their positioning in higher growth sectors and their opportunity to exceed earnings estimates as economic growth accelerates.

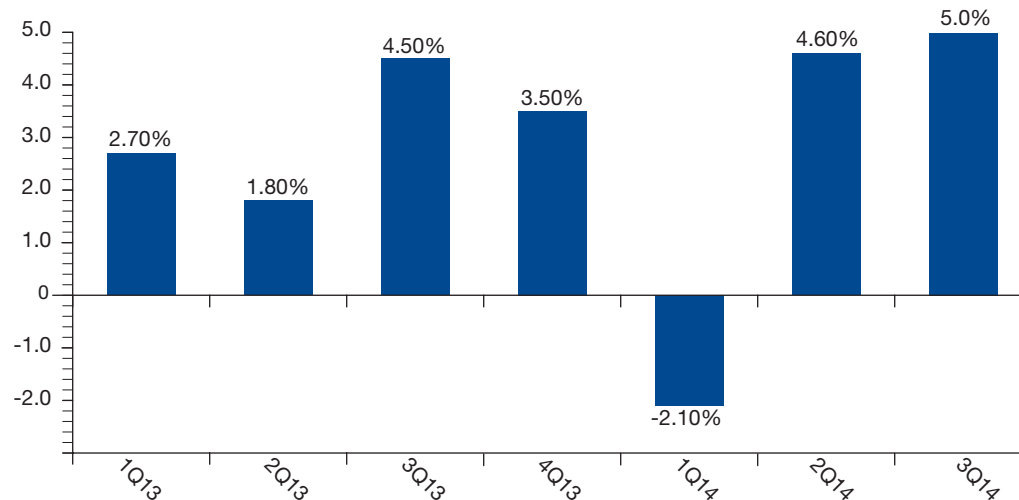
3. **Currently attractive risk profiles of higher dividend stocks** as measured by their wherewithal to continue raising shareholder payouts during improving economic conditions.
4. Most importantly, the **ability of companies with anticipated premium earnings growth to successfully meet or exceed those expectations** through revenue-based as opposed to margin or balance sheet criteria.

While this last point may seem somewhat basic, it is at the heart of what we believe will be necessary to continue generating positive returns within a stock market returning to traditional fundamental and valuation-driven metrics and characteristics. The Great Recession and financial crises of six years ago combined with the Fed's unprecedented quantitative easing (QE) policies since 2008 have in many ways muddled the waters; however, we believe clarity is returning. It's no longer about defining what will move stocks in the future but how what will move them can be achieved and which companies can do that.

Key takeaway:

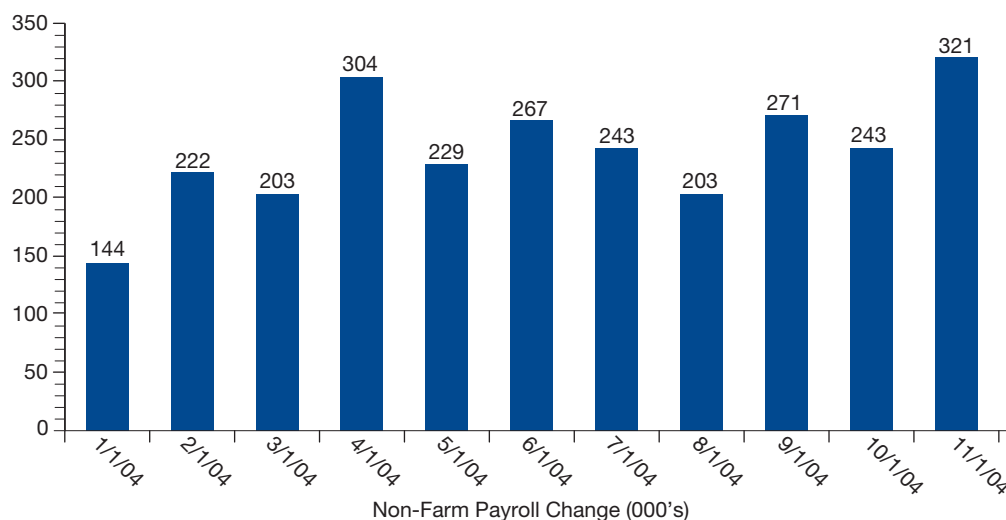
2015 will be a year to focus on what stocks you own and why you own them.

Figure 1: **GDP Growth Rate**



Source: Bureau of Economic Analysis

Figure 2: **Non-Farm Payroll Growth**



Source: Bureau of Labor Statistics

The year-end drop in oil appears overdone, but sustained lower prices will be additive to global growth.

Sometimes a revolution has unexpected effects. Case in point—George Washington had planned on resuming his career as a farmer following the British surrender in 1783.

The North American shale oil production and fracking “revolution” of recent years has now triggered its own chain of unintended events with possible dramatic impacts to the energy sector and global economy in 2015. This of course pertains to OPEC’s decision to let production run in 4Q14 following an initial decline in crude prices over the summer, resulting in a precipitous \$50 decline by mid-December from peak June \$100-plus levels, all in the attempt to regain global market share and price the shale producers out of business.

This of course begs two questions: How low can oil prices fall? And what will be the economic impact assuming prices stabilize at a level materially below the century mark we have become accustomed to?

The answer to the first question as to how low oil might eventually fall is of course anyone’s guess; however, we do feel the current sell-off is overdone for a variety of reasons. First and foremost OPEC has taken a major gamble in their production strategy in that they have challenged the fracking companies to see who will blink first, and when all is said and done we think probability weighs that it will be OPEC. Here’s why we say that:

There is a difference between the breakeven price of oil at which new projects are launched and the shutdown price at which existing facilities close production. The breakeven price is roughly believed to be somewhere in the mid to high \$60 area, or about \$5–\$10 or so higher than where prices have fallen as of the middle of December. So we could see a reduction in the rate of shale oil production but not the absolute levels of production, which is what has incented OPEC to let production run in the first place.

The price level necessary to force the shutdown of existing wells, hence reducing current absolute levels, is much lower and of course varies company by company and project by project. However, based on reports throughout the fracking industry, in many cases such a price point could be below \$40. So there could be close to another \$20 before shale producers blink.

The OPEC charge has also been led by its dominant cartel member, Saudi Arabia who is in reality much better prepared to withstand sustained lower prices than is a smaller member nation such as Venezuela. So issues of cartel solidarity could come into play as well. Finally, while the shale producers are battling these lower prices to maintain profitability and determine expansion strategies, the OPEC countries may wind up battling them to preserve their national economies. So the balance of urgency could shift quickly in a big way.

The dynamics of oil prices are complicated and hard to predict. The duration of how long OPEC will let production levels run is also difficult to forecast. However, we believe there is likely a strong case that oil prices are overdone at this point, and while not perhaps returning to the \$100 mark, will bounce somewhat higher than current levels and therefore potentially represent attractive

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opportunities in the stocks of energy-related companies. That having been said, the shale industry will have to display adept financial management to avoid some degree of damage to their balance sheets perhaps resulting from previously unforeseen defaults and diminishing sources of financing. Their ability to do this will go a long way toward ensuring that OPEC blinks first.

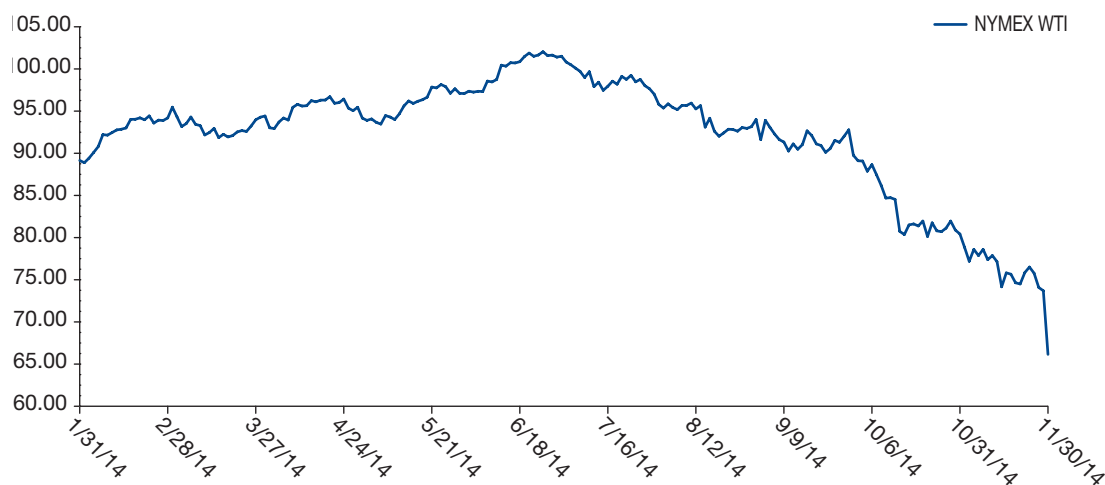
The second question as to what might be the impact of sustained oil prices well below recent levels is likely the more far reaching one. The conceptual impacts are clear: lower oil prices mean less money spent by consumers at the gas pump, which means more money spent elsewhere in the economy. It means lower operating costs for airlines and other transportation companies and all else being equal less pressure on Central Banks throughout the globe to raise interest rates. In a lot of ways it's like a tax cut, without the political wrangling of course.

Quantifying the financial impact of all this is educated guesswork at best and throwing darts in the dark at worst but for the oil importing regions of the world such as the U.S., Europe, Japan, and China it's clearly a tangible positive. So much so there may be up to a half a point upside in GDP revisions for these countries, assuming oil stays somewhere near these fresh lows. A bounce to the \$80 plateau would still probably result in higher overall growth rates for these regions all else being equal.

It is also essential to realize though, that at its core, this unexpected drop in oil prices is a zero-sum game. For every buyer of oil there is a seller and for every importer there is an exporter. One needs only to think of Russia and how these new prices will affect their economy and as some might shudder to think, their international motives as well. So the jury is still out as to where the chain of events will lead from here.

However as we stand now, the decline in oil is presenting two distinct opportunities: that of its recovery and a newly sustained price higher than today but lower than we thought it would ever be six months ago.

Figure 3: Crude Oil's 2014 Decline



Source: NYMEX West Texas Intermediate Crude Oil

The bond market fooled almost everyone in 2014 though the risk of rising interest rates still persists.

A year ago we would have been hard pressed to find anyone predicting a decline in bond yields during 2014. In fact, the conclusion that rates would increase and that all fixed income portfolios should reduce duration seemed so close to unanimous at the year's outset that I have affectionately termed the rising rates forecast to be the "Dewey Defeats Truman" trade of 2014. In other words, it was believed to be such a foregone conclusion that its story was written before it happened and then, of course, it didn't happen.

So why didn't it happen and moreover why did rates actually decline in 2014?

A few quick explanations:

1. **Economic uncertainties here in the U.S.** peaking after the surprisingly weak 1Q negative GDP report.
2. The **implementation of negative deposit rates by the European Central Bank (ECB)** in June as part of their effort to revive decelerating growth which in the process helped make U.S. Yields appear more attractive in relative terms.
3. **Bank of Japan's massive increase in QE** announced the last day of October increasing their asset purchasing activity more than 20%.
4. For the most part **non-threatening headline inflation data throughout the year**, though we believe conditions remain cautionary.

Of course this is all hardly the optimal backdrop to warn against rising rates again in 2015 but history will tell you that four years after Governor Dewey's prematurely declared victory referenced above the Republicans did in fact regain the White House (admittedly Thomas Dewey was no Dwight Eisenhower and Adlai Stevenson was no Harry Truman but that's beside the point). So here we go again, this time with more spirit: The risk of rising interest rates remains a concern as we enter 2015 and investors should focus on the shorter end of the curve.

As the bond market readjusts to the post QE world we believe it will show a higher sensitivity to positive economic news. While the Fed's bias will likely remain to err on the side of "lower for longer" in regard to keeping short-term rates at zero ultimately post QE market dynamic will dictate the yields on longer-term maturities and, therefore, the risk of not only higher rates but a steeper yield curve is still evident. The question is what catalysts would likely awaken such dynamics. Here are a few we have identified:

1. **A third consecutive quarter of 3% plus GDP growth, which could occur in 1Q15 when fourth quarter GDP is initially reported.** Given how recent estimates have tended to underestimate growth and the fact that oil prices will have averaged close to the entire 4Q approximately 25% below their peak summer prices, we see this as a realistic possibility.
2. **Action by the Fed at or before their June 2015 meeting, which has become the inflection point of speculation as to when monetary policy will officially shift back to positive short-term interest rates.** While we view the probability of a pre-June rate increase as being remote, we do believe a mid-year hike would still be a wake-up call to the bond market. It is also important to remember, since it has been eight years since the Fed has taken any hawkish action, that once it does the market will immediately shift the debate as to whether the increase is one time in nature or a series of hikes has begun.
3. **Accelerating wage growth in the labor market is at this point a wildcard that could play a role in rising rates during 2015.** So far, despite the improving employment picture over the past few years real wages have remained stagnant; however, should the labor market heat up this could change rapidly. Rising wages are viewed as the front-end cause and effect of inflation and identifying this would likely result in the Fed acting sooner rather than later as well as the long end of the yield curve reacting accordingly.

In summary, we believe the effects of U.S. monetary policy over the past six years is now close to or right at the tipping point by which zero interest rates shift from helping borrowers to penalizing savers and this could manifest itself in the form of rising rates over the upcoming year.

Key takeaway:

The risk of rising interest rates remains a concern as we enter 2015 and investors should focus on the shorter end of the curve.

Historically low credit spreads and default rates could see an increase due to falling oil prices but if so this will likely be an opportunity outside of the energy sector.

High yield and other spread-based fixed income markets will likely take on a high profile emphasis in 2015 and here we believe we could see diverging trends between the energy sector and the rest of the market from the falling oil prices experienced in 2H14. While the historically low credit spreads witnessed throughout the aggregate market should reflect the benefits to most high-yield borrowers of declining oil prices, approximately 17% of overall issuance does reside in the energy sector, so any increase in default rates in this area could wind up having a spillover effect.

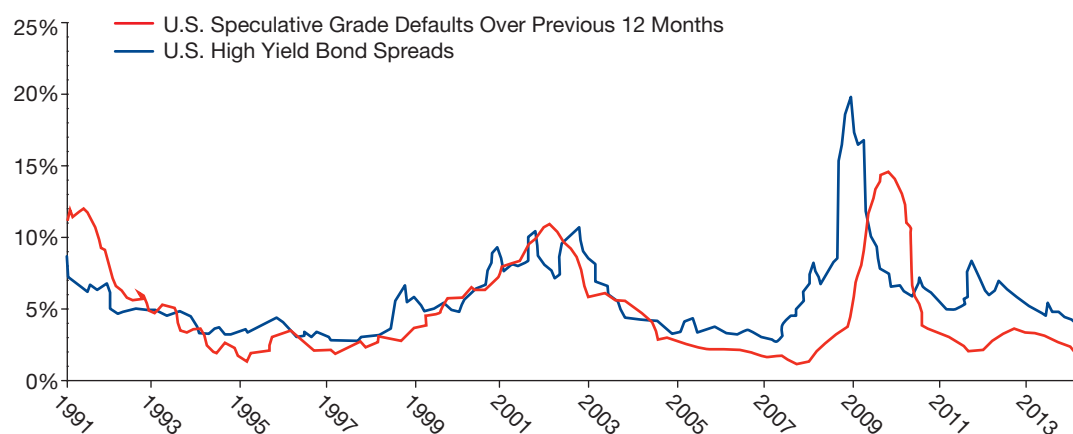
Should oil prices persist in the sub \$60 level some high-yield energy issues, particularly the frackers, could be pressed to restructure their debt or even default. Should default rates in this area balloon to 10%, a level we feel contingent upon sub \$60 oil prices prolonging into 2Q15, the overall high-yield default rate could increase from its present level of about 2% to approximately 4%. This would still be low by historical standards; however, under such circumstances credit spreads would probably rise throughout the entire market. Should that in fact come to fruition it would likely represent strong buying opportunities for issues outside of the energy sector.

In summary, we believe the overall U.S. credit cycle remains favorably disposed to spread-based markets though energy prices could create volatility. For the most part, balance sheets remain flush with cash and interest coverage ratios are still tangibly higher than at the recovery's outset. These are all factors that should only improve with the economy and the decline in oil prices.

Key takeaway:

We believe the overall U.S. credit cycle remains favorably disposed to spread-based markets though energy prices could create volatility.

Figure 4: **High-yield spreads are well above default rates**



Through March 31, 2014

Source(s): BofA Merrill Lynch, Credit Suisse, Moody's Investors Service

China, Japan, and Europe could benefit from both accommodative monetary policy and lower energy prices.

It was just a few months ago that based on recessionary fears in Europe, Japan's continuous challenges, and the slowing rate of growth in China that when it came to developed nations the U.S. was said by many to be "the best house on a bad block." That may still be the case but if so these others could be breaking ground on some decent renovation.

I say this because we could be entering 2015 with two separate and distinct tailwinds behind these three regions in the form of accommodative monetary policy and lower oil prices. Such a combination could provide a rare double catalyst unseen since the early days of 2009 when global markets were at their nadir.

In late October, almost to the day that our Federal Reserve officially ended QE, the Bank of Japan considerably raised the stakes on its asset purchases to an annual amount of 80 trillion yen (approximately \$700 billion) from its previous level of about 65 trillion. The impetus behind this surprise move was in the words of Bank of Japan (BOJ) Governor Haruhiko Kuroda to show "unwavering determination to end deflation." With inflation threatening to dip below 1% in Japan and a downwardly revised economic growth forecast of .5%, the BOJ also extended its timeline by which to reach a 2% inflation rate to indefinite from a two-year target.

The European Central Bank (ECB) also appears at this time to be a prime candidate for QE during 2015. At his early December press conference ECB President Mario Draghi stopped short of formally declaring QE but reiterated his own mandate of 2% inflation and with estimated balance sheet capacity of 1 trillion Euros (\$1.25 trillion), consensus is developing that the ECB could be purchasing assets as soon as late January. The ECB has forecast .7% inflation and less than 1% growth for the upcoming year, which makes the January time table seem reasonable.

Fears of sub 7% GDP growth resulted in the Peoples Bank of China's (PBOC) first rate cut in more than two years at the end of November. Reductions in their benchmark one-year loan rate (6% to 5.6%) and benchmark one-year deposit rate (3% to 2.75%) represent hard action that this central bank is also concerned about declining inflation and a cooling economy. Consensus expectations call for more rate cuts throughout 2015.

What is interesting here is that all three of these countries are net importers of oil and therefore stand to benefit from the recent price declines in energy costs. For the first time since early 2009 these markets are likely to see a dual combination of accommodative monetary policies and lower oil prices, and this unexpected mix could have powerful market impacts. With these two distinct catalysts at their backs the markets of these countries could see economic recovery and re-acceleration discounted at a much faster pace.

Key takeaway:

For the first time since early 2009 these markets are likely to see a dual combination of accommodative monetary policies and lower oil prices and this unexpected mix could have powerful market impacts.

U.S. inflation trends appear benign but structural risks remain.

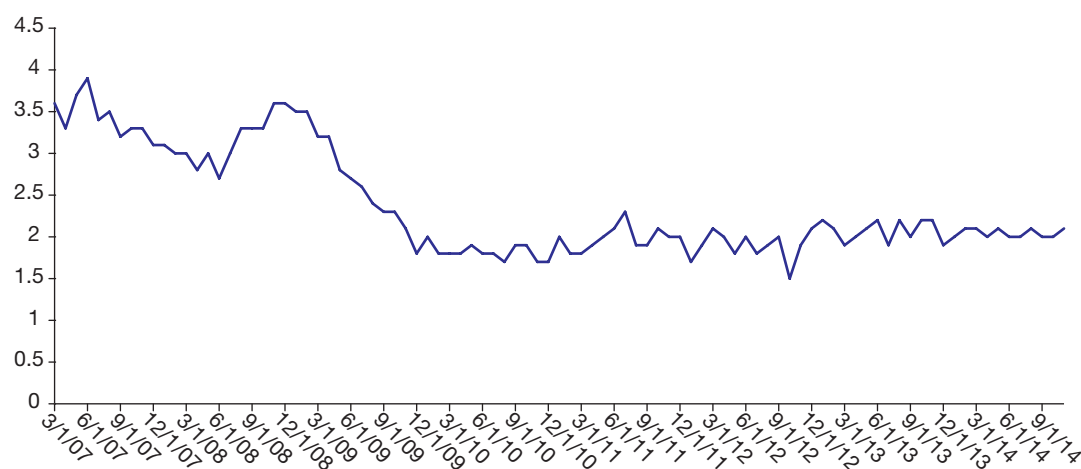
In the U.S., headline numbers over these past few months present the argument that our Fed may also be having real difficulty achieving their 2% inflation target that is viewed by many as a prerequisite to raising short-term interest rates and real evidence that we have fully and successfully conquered the deflationary risks of the Great Recession. Since mid-2014 we have seen CPI tracking at the 1.7% level, wage growth hovering in the 2% range, declines in the five-year TIPS breakeven to below 1.5%, and of course the \$50 plus decline in the price of crude oil.

So is the U.S. right there with China, Europe, and Japan in the need to create inflation? I would argue just the opposite, which is that despite recent data, rising inflation is a real risk to current markets.

The issue in my opinion remains a structural one. We are dealing with the aftermath of \$4 trillion of newly printed dollars over the past six years, more than half of which has yet to be disseminated into the economy. We also have a labor pool that has become increasingly weighted toward the long-term unemployed and that possesses a greater disparity of technological skills between the young, and the not so young, meaning wage competition could heat up for those deemed most worthy as soon as companies decide to ramp up hiring. These are inherently different inflationary risks than we've ever seen before and their potential impact cannot be measured by traditional monthly metrics.

It is important to differentiate between inflationary trends and inflationary risks. For several months now, inflationary trends have declined. However, a strong case can still be made that two separate inflationary risks remain concerning. These risks follow a parallel track of potentially rising wages and close to \$3 trillion in excess bank reserves yet to be filtered into the economy as a direct result of the Fed's recently completed QE policies.

Figure 5: **Year-over-year change in average hourly nominal earnings**

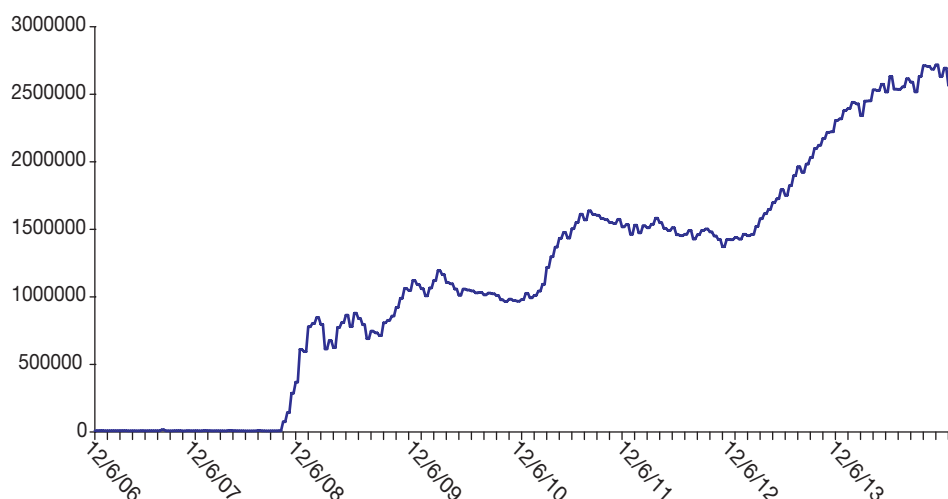


Source: EPI analysis of Bureau of Labor Statistics' Current Employment Statistics

Flat wage growth has played a key role in the reduced CPI levels we have been experiencing. Despite falling unemployment, actual compensation levels for U.S. workers have remained close to unchanged as companies have sought to keep their labor costs as low as possible through the hiring of part-time workers who not only cost less in dollar terms but in many cases do not receive benefits. Since full-time workers are competing against this group they are willing to accept lower pay. Without a meaningful increase in national pay levels, corporations have little pricing power for products and services because they know that demand will be tenuous. Hence a cycle of price stagnation ensues.

At the point that real competition evolves for full-time workers, increasing wages could well break the logjam of this price stagnation. Companies will then charge higher prices as they pass on the costs of labor to their consumers. When this occurs it tends to accelerate quickly. The fact that our Labor Participation Rate is at a near 40-year low (62.8% as of the end of November) could likely impact rising wages as well.

Figure 6: **Federal Reserve Excess Reserves**



Source: Federal Reserve

In regard to the excess bank reserves created by QE the risk is also one that could accelerate quickly. As mentioned in our mid-year update, *Uncharted Waters*, should an additional \$3 trillion or so in cash be distributed into the economy too rapidly we will simply have too much money chasing too few goods and services, which is classic backdrop for inflation. The Fed knows this and has a vested interest in keeping this money from entering the economy too speedily. (This of course stands in distinct contradiction as to one of the major reasons why QE was first implemented six years ago which was to incent banks to start lending again and put fresh money to work growing the economy.) At the point that these financial institutions will seek higher

Key takeaway:

At the point that real competition evolves for full-time workers, increasing wages could well break the logjam of this price stagnation.

rates of return on their capital, perhaps the opportunistic result of an improving economy, these reserves could be put to use. The Fed may have tools to manage this potential situation, such as increasing the interest rate on these reserves or converting them into longer-term fixed maturity deposits, however, this is not a scenario they have had to deal with before at this magnitude and therefore it is a risk.

We are not arguing with the more benign inflationary trends experienced in 2H14; however, we do believe structural risks remain and feel investors should continue to account for this in their portfolios.

How to Position for 2015

Based on our outlook for the 2015 and beyond we would recommend investors focus portfolios on some of the following themes:

- In the equity markets look for large-cap growth stocks to achieve appreciation with earnings growth as small-cap stocks could see multiple expansion. We think higher dividend stocks should also benefit from increasing payouts.
- We like select opportunities in the international equity markets and suggest portfolios overweight the oil importing regions of Europe, China, and Japan.
- We still believe the risk of rising interest rates remains imminent and recommend investors stay short on the curve and keep durations below benchmark levels.
- We believe opportunities remain to realize yield with spread-based fixed income issues such as high-yield, global, and emerging markets bonds, though sector exposure will play a larger role than in recent years.
- Despite the seemingly calm environment, we still recommend TIPS and other inflation-protected strategies as structural risks remain.

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Investments in global/international markets involve risks not associated with U.S. markets, such as currency fluctuations, adverse social and political developments, and the relatively small size and lesser liquidity of some markets. These risks may be greater in emerging markets.

Alternative investment strategies may include long/short and market neutral strategies; bear market strategies, tactical strategies (such as debt and/or equity; foreign currency trading strategies, global real estate securities; commodities; and other non-traditional investments).

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