

2015 Outlook

A Mid-Year Look at our 2015 Themes

Executive summary

1. Through the first half of 2015 the U.S. economy has for the most part been disappointing though this is mostly due to transient factors such as the impacts of a higher dollar and lower oil prices. While stocks on the whole could remain somewhat trendless we continue to believe 2015 will be a stock picker's year.
2. The rebound in oil prices to the \$60 level since the start of the year amid slowing economic growth serves as proof to us that last year's sell off was supply related. We believe the broader economic tailwinds of lower energy costs will finally begin to take effect in the second half of 2015 and early 2016.
3. Interest rates saw a noticeable rise in the second quarter and we believe this represents a longer term trend of increasing bond yields. Markets in our opinion remain over focused on Fed timing and we feel the more important point is to stay short on the curve as rates are poised to move higher into 2016 and beyond.
4. As expected, high yield default rates have ticked up slightly so far this year, almost exclusively due to the Energy Sector. We believe current credit spreads continue to represent opportunities for diversified high yield portfolios.
5. International equity markets have materially outperformed the U.S. confirming our premise that accommodative monetary policy and lower oil prices would prove to be important catalysts in China, Europe and Japan. With stocks having more than doubled over the past year in China, we recommend reallocating portions of an international portfolio from this region to Japan and Europe. We view the prospect of a Greek default and Euro exit as carrying less systematic risk than most believe.
6. Efforts by central banks and pending wage growth will ultimately move headline inflation rates closer to historical averages. Against this backdrop we continue to see unique structural risks. Therefore, we recommend investors protect portions of their portfolios against future rising rates of inflation.

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 also actively publicizes 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 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.



Handoff Still in Motion



In January when we released our 2015 Market Outlook, Making the Handoff, we stated that the biggest challenge facing financial markets was a successful transition from six years of unprecedented Fed liquidity to a market led by an improving macro-economy and revenue-based earnings growth. Now at the year's midpoint, we believe single-digit gains in equities and the upward movement of bond yields back toward mid-2014 levels serves as evidence that this handoff, while far from complete, is still in motion.

The good, the bad, and optimism for the rest of 2015

U.S. Gross Domestic Product (GDP) for the first quarter of 2015 presents the clearest picture of just how muddy the economic waters appear to be so far this year. As of June's end, the twice-revised estimate of 0.2% negative growth is by our account laced with detractors that are unlikely to remain, or could reverse themselves in the quarters ahead. One might even view 1Q GDP as a "bad news, good news" type report:

- The bad news was growth was negative. The good news was that it was not nearly as negative as 1Q14 when GDP posted at -2.1% only to be followed by 2Q and 3Q reports averaging 4.8%. While we don't expect 2Q and 3Q growth rates for 2015 to post a rebound of the same magnitude, it does highlight the increasing seasonality evident in 1Q GDP numbers dating back to about 2010.

- The bad news was that lower oil prices turned energy sector capital spending and earnings growth negative and this was detrimental to the aggregate economy. The good news is we should start seeing the delayed benefits of lower energy costs for the rest of the economy in the second half of the year.
- The bad news was that the U.S. dollar's 20% increase since the middle of 2014 hurt exports and widened the U.S. trade deficit. This was the single biggest detractor to 1Q GDP with a net negative impact of 1.9%. The good news is that the dollar will have to continue to rise for exports to have the same comparative effect next year. If the dollar declines it will be a tailwind.
- The bad news was that growth in consumer spending at 2.1% was below the multi-year highs of better than 4% during 2H14. The good news was that this consumer spending growth was more than 2% higher than overall GDP. Initial indications show that on the whole, consumers chose to save rather than spend in the first quarter, perhaps a harbinger of the pending effects lower gasoline prices could have on consumer spending the rest of the year.
- Then of course there was Old Man Winter, the historical global phenomenon known to most humans for millions of years now, but only recently introduced to most economists. The bad news was, like in 1Q14, he acted worse than normal and hurt economic growth by close to 1% in aggregate. The good news is he won't be around for the rest of 2015.

So with all this bad news on record and the good news still waiting to play out, why is there reason for optimism in the second half of 2015? A few important points to consider on this front:

- When looking at rolling four quarter growth rates, GDP numbers still display decent momentum. For the four quarters ending 1Q15 GDP averaged 2.9% versus 1.9% for the same period ending 1Q14 and 1.7% ending 1Q13.
- Recent April and May data seem to be indicating renewed momentum may be in motion, as seen by stronger than expected employment, retail sales, personal income, and consumer sentiment reports.
- Signs that wage growth could be breaking out of the anemic 2% range it's been experiencing since the economic recovery began several years ago. While we view the fact that millions more Americans are working today than they were at the beginning of 2009 as a strong positive, the prospect that those millions can make more money is even better.
- Finally, the economic rebound in Europe appears to be occurring faster and stronger than expected. Perhaps this could be attributable to the premise that unlike here in the U.S. where quantitative easing (QE) goosed asset prices but its broader macro effect was far more muted, it might actually be helping to grow the economy over there. Talk about the unexpected.

So there you have it. So far 2015 has proven to be about as clear as fog in terms of the overall U.S. economy but we see visibility improving. The Fed-to-economy handoff we described six months ago still has two hands on the baton, however the prospects remain strong we will not see it drop. Furthermore, we continue to see our six investment themes defined at the year's beginning as very much in place.

U.S. stocks can move higher but for different reasons than in recent years

Perhaps the toughest quandary facing equity investors so far in 2015 has been reconciling a rising stock market, albeit a small rise at that, with declining S&P® earnings in 1Q both sequentially versus 4Q14 and annually versus 1Q14. Much of this apparent dilemma can be explained by the influence of energy company earnings on the overall market both mathematically and practically speaking.

While numbers are still being reported, it looks as though 1Q15 S&P 500® earnings will come in approximately 4% below 4Q14 and about 8% below 1Q14. The majority of this decline is attributable to energy companies which provided more than 7% of total earnings to the S&P in 4Q14 and 12% in 1Q14, in comparison to an approximately 1% detractor in 1Q15. So when looking at overall growth for the remaining nine sectors of the composite, earnings growth rates on a sequential and annual basis calculate closer to +5% and +7% respectively. Perhaps not earth-shattering but far from the wrong side of the ledger.

So the more important questions are these: First, if the true earnings growth rate for non-energy companies is somewhere in this 5 – 7% range, how much higher might those rates increase as lower oil prices filter through the overall economy and a normalization in the U.S. dollar mitigates the negative impact of declining revenues for export-driven companies? Second, whatever that expected growth rate might be, which companies can exceed it?

There is no question the equity playing field this year and in all likelihood for several more to follow will be much tougher than any we've experienced since 2008. With the Fed out of the open market there is no rising tide to lift all ships and there will be occasional treacherous ones that will sink a few here and there. As we said at the year's outset, the easy money has been made in stocks.

This becomes clear when looking at stock performance attribution over the past few years. It is interesting to note that an investor who bought into the S&P 500® at the end of 2010 and stayed there through the first quarter of 2015 now has about \$180 for every \$100 they put in at the time for an annualized return of 14.8%. Of that return, slightly more than 2.2% has come from dividends and about 6.1% has come from reported earnings growth. The remaining 6.5% has come from an increase in price-earnings multiples, or in other words nothing more than the market valuing stocks of comparable characteristics higher than it did before. On a cumulative basis, that \$180 would only be about \$140 without these rising price-earnings multiples.

Looking forward, we are not counting on anything close to this 6.5% annualized increase in valuation driving stock prices. We anticipate stock price appreciation more in line with earnings with some degree of multiple expansions for those companies beating earnings expectations.

Key takeaway:

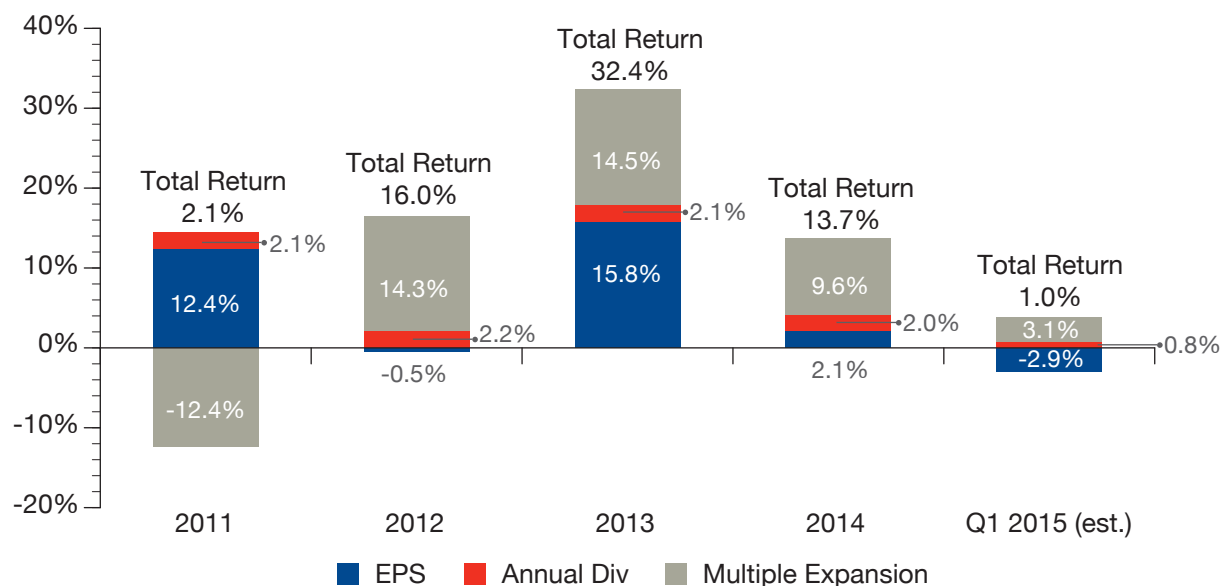
Success in equities is no longer about defining what will move most stocks but which companies can achieve the criteria that will move a more select group of them. In other words, we're back to a stock picker's market.

Therefore, we are watching for the following macroeconomic and company specific scenarios to move stocks:

1. Monthly job growth averaging in the high 200,000 plus range continues
2. Lower gasoline and energy costs help to keep consumer confidence high
3. Wage growth finally accelerates as slack in the labor market dissipates, helping to drive overall consumer spending higher and in turn accelerating GDP
4. Companies with increasing revenue growth, well-managed cost structures, and strong balance sheets will beat earnings forecasts
5. Stocks experience higher valuations and rising prices

However here is the catch. This virtuous chain of events will not happen for all stocks. It will not happen for most stocks. It will likely only happen for a small minority of stocks. So consistent with our viewpoint at the year's outset, success in equities is no longer about defining what will move most stocks but which companies can achieve the criteria that will move a more select group of them. In other words, we're back to a stock-picker's market.

Figure 1: **Multiple Expansion: A Key Driver of Returns**
Contributors to S&P 500 Total Returns 2011 – Q1 2015 (est.)



Source: Standard and Poor's

Last year's drop in oil prices appears overdone, but sustained lower prices will boost global growth

Following the precipitous decline in crude oil prices during the second half of 2014, we believed three crucial questions needed to be addressed as 2015 began:

1. Was the fall from over \$100 to less than \$45 a barrel mostly related to supply or demand?
2. Was this sell-off overdone and a meaningful rebound likely to occur in the year ahead?
3. Would these lower prices ultimately prove to be a net positive or negative to the global economy?

While volatility in the oil markets could resume, we believe the answer to the first question clearly resides in our initial premise that the almost 60% decline in crude prices experienced from June to December of last year was supply related. Our feeling at the time was that perhaps the first \$10 – \$20 may well have been demand related as data at the time coming out of Europe and China were displaying greater than expected economic weakness, however the bulk of the decline stemmed from OPEC's overt motives to let production run and challenge the North American shale producers to operate at lower price points. This of course had its most dramatic impact at the late November OPEC meeting in Vienna when the cartel unexpectedly announced they would not cut production, sending crude prices spiraling down approximately another \$40 by year's end.

We believe perhaps the most powerful evidence of the supply related over sold behavior in oil prices can be seen in the simple fact that crude prices have rebounded almost 50% from their January lows amidst what has been a first quarter of negative economic growth here in the U.S. as well as continued uncertainties in China. In our opinion, the move from the low \$40 range to \$60 through the first half of the year against the backdrop of negative GDP here in the U.S. simply is not representative of last year's price decline being demand driven.

Further bolstering the argument that supply was the culprit of last year's price decay is the correlation between this year's rebound and the reduction in North American rig counts. Since its peak in May of last year, the number of U.S. rigs exploring for oil have fallen from more than 1,500 to just over 600. While there is much to analyze in this data, and whether it represents a causation or correlation, the path of numbers makes sense to us. A 60% decline in prices was followed by a 60% decline in North American rig count, which was then followed by a 20% recovery in prices. Admittedly, it is not that simple but directionally speaking this makes great sense to us.

Obviously, the market action we have witnessed so far this year has answered the second question as to whether or not oil prices would recover which has proved consistent with our beginning of the year outlook that the 2014 sell-off was overdone and that prices would bounce higher into 2015. So while picking short-term price points in a market this volatile is somewhat tantamount to throwing darts in a dark room, if pressed we would say a modest increase to the \$65 – \$70 range would, based on current conditions, represent a fair spot for longer-term stabilization. In terms of technical analysis, this would be about a one-third retracement of the losses incurred from crude oil's \$100 plus summer high to \$40 winter low. One learns never to discount technical analysis when pressed on price predictions.

Key takeaway:

The net decline in oil prices since the summer of 2014 represents two opportunities: That of its continued recovery and of a newly sustained price level considerably lower than it was a year ago.

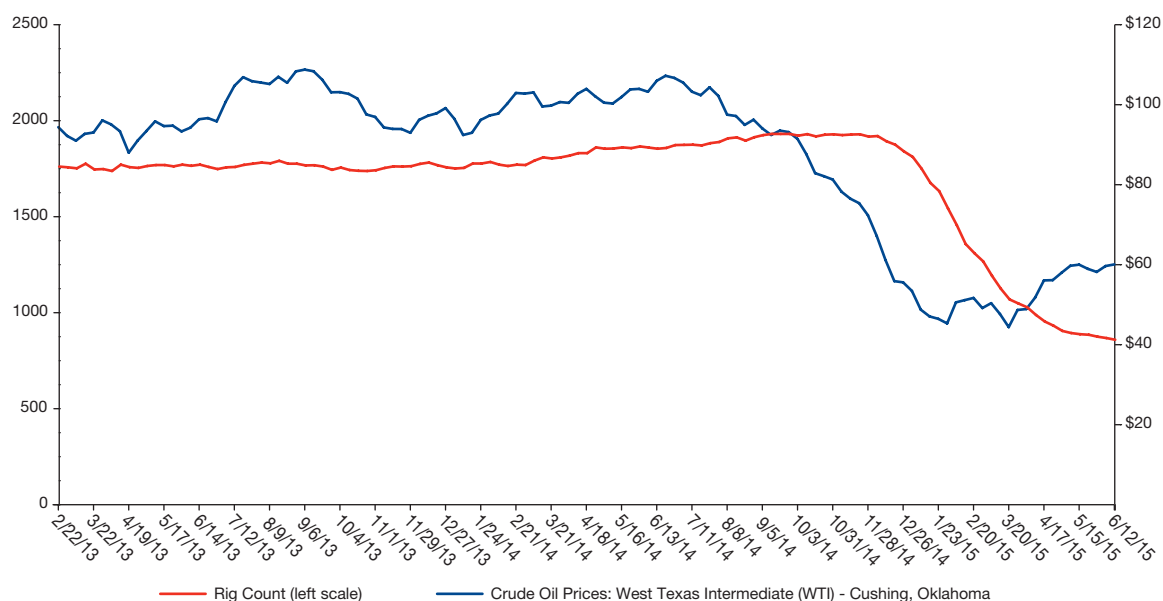
The third question as to whether last year's price decline will prove to be a net positive or negative to the global economy is the one with the least available evidence so far, for no other reason than timing. For the record, we stated back at the year's outset that we believed a stabilization of oil prices to the \$80 dollar level or below would ultimately prove additive to global economic growth and we still believe that to be the case.

However, there is no question that the favorable and unfavorable impacts of lower oil prices are not necessarily on the same schedule. Through the first half of 2015 the carnage within the energy sector has reared its head before the benefits of lower gasoline costs for consumers and cheaper fuel costs to energy consuming companies could fully channel through the system. This can be seen in the fact that the decline in corporate earnings growth within the energy sector far outweighed all other industries to the point that it moved overall S&P 500 earnings growth negative for 1Q15 and that business investment within the sector declined close to 25% which in turn was the principal contributor to the broader economy's shift from positive to negative Nonresidential Fixed Investment for the quarter. Yes, we have seen the bad before the good but this does not mean the good is not coming.

In summary we continue to believe that the net decline in oil prices since the summer of 2014 represents two opportunities: That of its continued recovery and of a newly sustained price level considerably lower than it was a year ago.

Figure 2: **The Current State of Oil Prices**

WTI Crude vs. Baker Hughes North America Rig Count (March 2013 – June 2015)



Source: NYMEX West Texas Intermediate Crude Oil

The risk of rising interest rates will persist through the rest of 2015 and beyond

First things first, we believe the market is overly concerned with Fed timing as to when precisely the first short-term rate hike since 2006 will occur. The more important point in our opinion is that the long-term trend in rates has likely already begun moving higher along with the risk of a steepening yield curve. Our question here is a basic one: five years, three years, or even one year from now will it really matter what month in 2015 the Fed finally decided to raise rates? We certainly don't think so.

While the weak 1Q15 economic data took a June rate hike off the table, leaving the Fed followers to quibble between football and basketball season as to when they will finally pull the trigger, we believe that even despite the lower oil prices and the higher dollar, time is running out on our economy and our culture to continue moving forward in a zero interest rate environment. Quite simply, we are reaching the point, if we have not already, that the net result of zero rates has shifted from incenting borrowers to penalizing savers. At some point the Fed will have to realize that the 70 million Americans turning 65 between now and 2035 probably shouldn't rely on a rising stock market every year to budget their retirement.

This also ties into another important reality often overlooked by those obsessed with Fed behavior, which is that when all is said and done in this post-QE world, the Fed only controls the short end of the curve and true market dynamics now ultimately affect longer-term yields. This could not have been more evident than during the interim of late March through the middle of June, when it became all but official the Fed would not be raising rates until at least the autumn time frame yet the 10- and 30-year bonds still experienced yield increases of more than 60 and 75 basis points respectively (from 1.88% to 2.50% on the 10-year and from 2.46% to 3.22% on the 30-year between March 24 and June 10). This of course was a direct reaction to the spike in rates seen in Europe during this time as the German 10-Year Bund yield exploded from its anemic .05% annualized rate to a whopping 1%.

One reason we believe that despite the challenges experienced in 1Q15 the underpinnings of the U.S. economy remain strong and therefore warrant higher rates in the future is the improving strength of the job market. For the rolling one year ended in May 2015, job gains exceeded 200,000 in 11 out of 12 months and averaging better than 250,000. This compares quite well to the one year ended May of 2014 when job gains exceeded the 200,000 bogey in only 5 of those months and averaged only 207,000. This in our opinion reflects a new plateau of employment growth. The next vital development necessary for these new jobs to better move the economy forward will be wage growth, which since the outset of our recovery 6 years ago has been stuck in the 2% range curtailing personal spending levels. However, as the labor market continues to tighten as it has during these past few years, it will become more likely overall compensation rates will rise, particularly in light of the fact that in many cases companies will be competing for more select groups within pools of available workers. When we see that wage growth, it is probable that not only the Fed will take more action but the long end of the curve might actually begin to discount inflation. All of this points in the direction of higher rates.

Key takeaway:

We continue to recommend bond investors stay short on the curve.

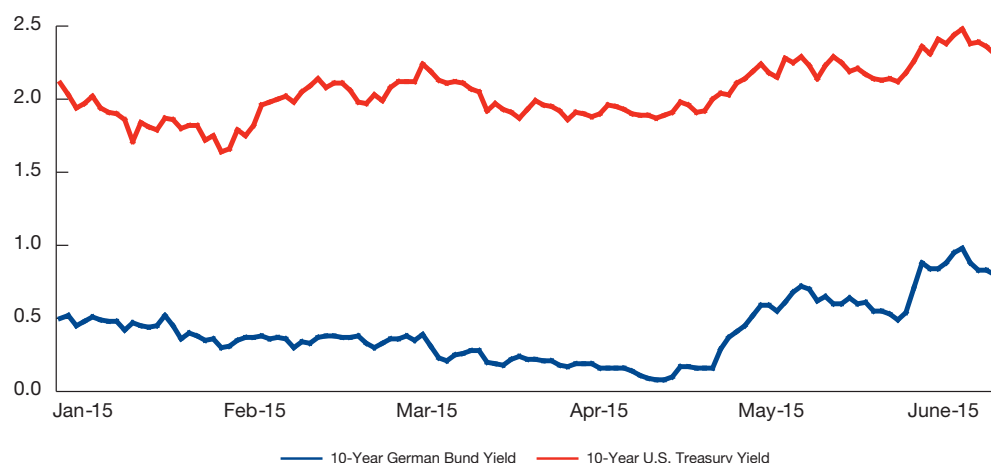
Secondly, the positive economic developments in Europe have so far exceeded expectations since the beginning of the year. When European Central Bank (ECB) President Mario Draghi announced the long awaited 1.1 trillion Euro (\$1.2 Trillion) QE program in January, the popular thinking was that it would have a similar fate to QE here in the U.S. —a potential boost to asset prices but a far more muted effect on generating inflation and growing the broader economy. There is now mounting evidence this may not prove to be the case as early signs in Europe are pointing toward rising inflation and economic growth.

Last year at this time, composite GDP growth for the European Union swayed dangerously close to negative territory. Fears of another recession were afoot and by year's end deflation was also a major concern as December's inflation report for the region turned negative. Fast forward to now, only 3 months after the ECB's early March implementation of QE and consensus forecasts for 2015 and 2016 GDP have now reached close to 2%. Perhaps more importantly, May inflation for the region came in at positive .3% versus a flat reading in April and above expectations. As a result the yield on the German Bund jumped more than 90 basis points, pushing U.S. yields higher as well. We see the impact of these European trends on U.S. rates as likely to continue into 2016.

All of this is occurring as the interest rate sensitivity of longer-term bonds here in the U.S. remains near historic highs. As of mid-June the duration on the U.S. 10-year treasury stood at close to 9 meaning that a 1% increase in its yield would result in about a 9% decline in its price. This of course is widely known and supposedly discounted by the market, meaning investors should not be surprised if it happens and have incorporated this level of bond price volatility into their market risk assessments. That having been said we believe that market risk assessments are akin to battle plans and as Ulysses S. Grant once said, "All battle plans are thrown out the window the minute the first shot is fired." More than a century later Mike Tyson stated this same theory a bit differently by saying "Everybody has a plan until they get hit in the face."

Suffice it to say we don't want investors to get hit in the face and therefore we continue to recommend bond investors stay short on the curve.

Figure 3: Interest Rates Increase in Q2 2015
January 2, 2015 – June 15, 2015



Source: Bloomberg

Default rates have ticked up slightly, however we believe current credit spreads continue to represent opportunities for high yield bonds.

In the second half of 2014, high yield bond spreads suffered an expansion of more than 200 basis points versus comparable Treasury maturities as uncertainties regarding the impact of energy issues, comprising 15% of sub-investment grade issuance, might adversely affect the overall asset class. It was our feeling at year's end that at a yield premium of approximately 500 basis points high yield would be a good space for 2015, assuming default rates did not increase materially outside of the energy sector.

Through the first half of the year we have seen defaults tick up modestly from slightly below to slightly above 2%, still representing levels very close to the thirty-year low points of 1995 and 2007. Most importantly, this slight uptick came almost exclusively from a series of somewhat expected defaults within the energy sector, supporting our belief that even after credit spreads modestly declined to the mid 400 basis point level, investors were being adequately compensated for risk in most non-energy related sectors.

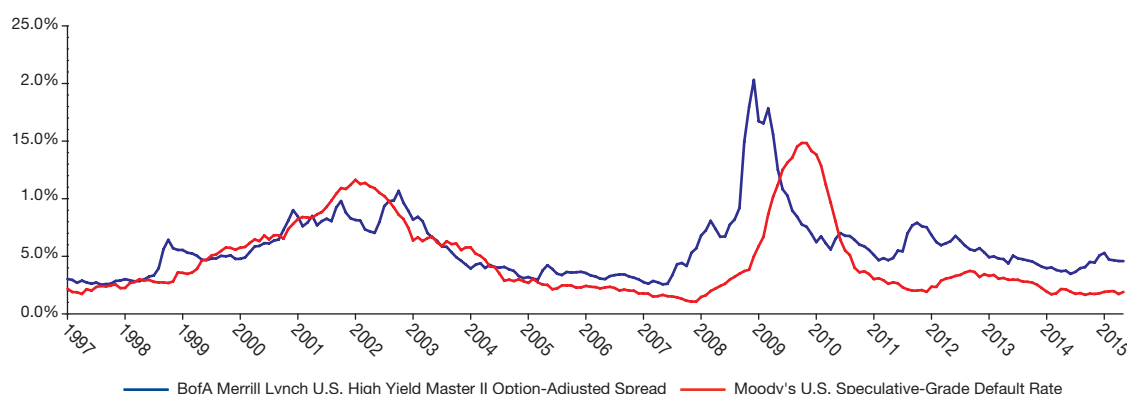
Since 2H14 the segmentation of the high yield market has been distinct and in sharp contrast to recent history. Over the past two decades, energy bonds had traded at lower spreads to the rest of the high yield market in large part because of their historically lower default rates which averaged only about half that of all other sectors combined. This has since been turned on its head as energy issues through 1H15 are now hovering at about 750 basis points above comparable Treasuries or some 50% higher than the spreads of the rest of the market. We are not yet ready to call a top on this relative spread differential and continue to recommend that high yield bond portfolios remain well diversified and underweight the energy sector.

It is also important to note that we believe high yield should be far better positioned to weather a rise in interest rates than its investment grade brethren assuming such higher rates would not coincide with a negative credit cycle which at the current time we do not anticipate. Reasons for this relative advantage during rising rates include higher coupons serving as a cushion against price declines, lower durations resulting in less overall volatility, and potentially tightening credit spreads in the event rates rise due to an improving economy.

Key takeaway:

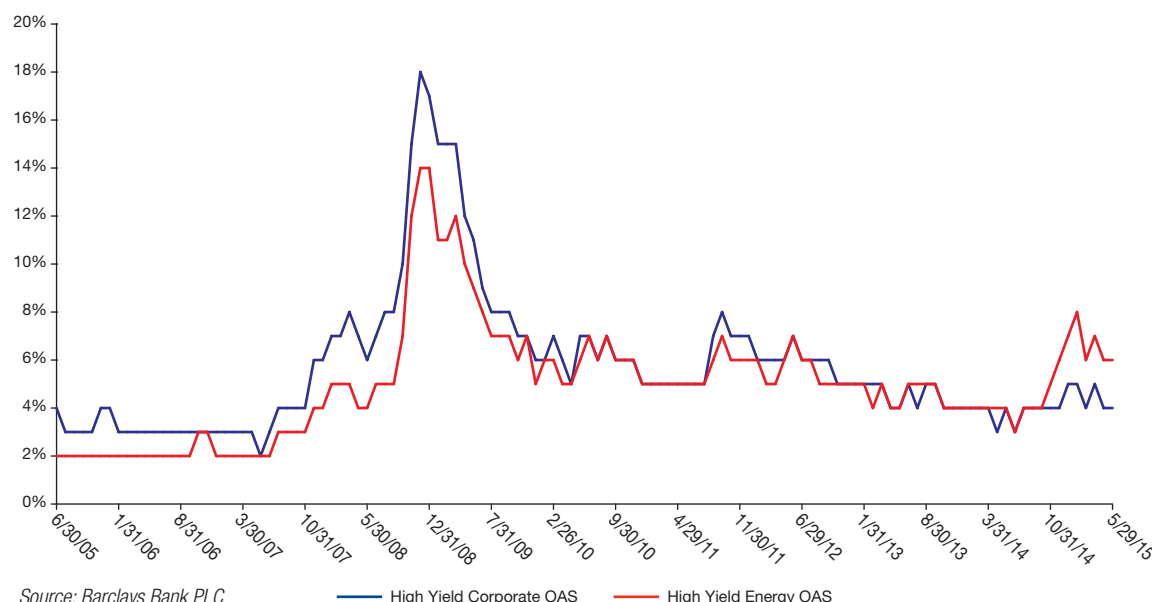
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Figure 4: High Yield Credit Spreads vs. Default Rates
January 31, 1997 – May 31, 2015



Adjusted Spread Source: Federal Reserve of St. Louis
Default Rate Source: Moody's

Figure 5: **High Yield Corporate Spread and High Yield Energy Spread**
June 30, 2005 – May 31, 2015; (OAS)



The prospect of a Greek default and Euro exit carry less systematic risk than most believe while Japan and Europe should continue to benefit from accommodative monetary policy and lower energy prices

As the tumultuous month of June concludes for Greece and its creditors, we now believe the investment thesis in Europe should be viewed from the perspective that a Greek default and exit from the Euro is a distinct possibility. There is great debate about how far reaching this event might ultimately prove to be. A recent New York Times headline summed up the question eloquently: “Is Greece Lehman Brothers, or is it Radio Shack?”

Ever since the Greek debt crises first reached levels of international awareness more than five years ago, the issue has never been about this country’s overall economic presence on the global stage, as statistics quickly cited stress that its GDP is less than 2% of Europe’s total or in U.S. terms about the size of the state of Oregon. More importantly, the central focus has always been about contagion, who owns Greek debt, how much and how that exposure might damage the global banking and credit system.

So while nobody can fully predict the precise chain of events likely to ensue immediately following a Greek default and exit from the Euro, we feel the best place to start would be an account of who constitutes the bulk of this country’s creditors and how has that composition changed versus where it was five years ago when the pending crises first began to evolve. When looking at this current profile, who stands to be hurt most is now considerably different and appears to hold far less systematic risk than was the case when this whole mess started.

Of the 313 billion Euros (\$350 billion) in Greek debt currently outstanding, only about 80 billion is now in the form of publicly issued bonds as the rest has been transformed to direct loans through the multiple bailout transgressions that have taken place since 2010. The bulk of these loans, more than 200 billion, reside in Financial Support Mechanism Loans, mostly from the International Monetary Fund (IMF) and European Financial Stability Facility (EFSF) which have established

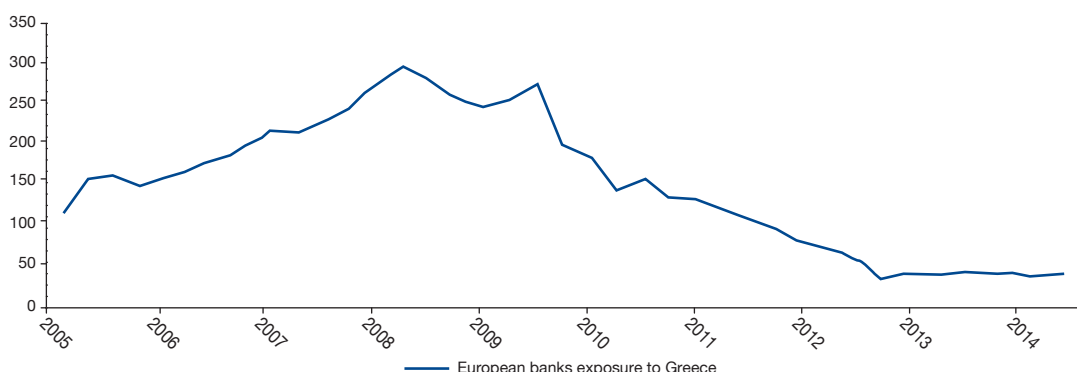
Key takeaway:

Systematically speaking, we see the risk of wider spread consequences [of a potential Greek Eurozone exit] to all of Europe and the global economy as being far less drastic than they were a few years ago and when all is said and done, potentially quite manageable.

funds solely to deal with distressed sovereign debt. As a result, since 2010 the total exposure of European banks to Greek debt has declined from about 270 billion to approximately 40 billion. In our opinion this mitigates the risk of contagion considerably.

Nobody likes to see a nation on the brink of default, nor institutions such as the IMF or EFSF imposing terms of austerity such as tax increases, reductions in pension benefits, or defense spending cuts in order to have a reasonable shot at getting their money back. A Greek default and exit from the Eurozone could certainly have some dire consequences for the citizens of that country and we don't want to downplay that in any way. However systematically speaking, we see the risk of wider spread consequences to all of Europe and the global economy as being far less drastic than they were a few years ago and when all is said and done, potentially quite manageable.

Figure 6: European banks' exposure to Greece is limited



Source: BIS Foreign claims by nationality of reporting banks, immediate borrower basis, Bloomberg, Danske Bank Markets

Following challenging economic conditions in 2014 we identified what we believed to be a rare double catalyst for the equity markets in Europe, China, and Japan: Central banks of these regions were implementing more accommodative monetary policies and as oil importing regions they stood to benefit from lower global energy costs.

Our thesis was not so much based on the premise that we would see a rapid recovery in Europe and Japan, and in China's case a reacceleration to higher GDP growth, but more along the lines that with these two tailwinds the markets in these regions would discount improving economic conditions at a faster rate. We believe this has for the most part played out through the first half of 2015 as the stocks of these three regions have posted strong returns and outperformed the U.S.

Now as we assess these three markets halfway through the year, we can add a third piece to the criteria, that of devalued home currencies versus the stronger U.S. dollar. This has provided a boost by helping to drive expectations that these overseas economies will benefit from rising exports, better positioning them for growth than they have been over the past few years.

Perhaps most encouraging is the early evidence that unlike here in the U.S. where QE was widely believed to have driven asset prices first and the overall economy a not so close second, these programs of large monetary stimulus in Japan and Europe over the past nine months appear to be making identifiable macro headway right out of the gates.

In Japan, where asset purchases were ratcheted up to \$80 trillion yen (\$700 billion) annually last October, the widespread effects seem to be tracking in the right direction. First and foremost, the nation officially emerged from recession in 4Q14 (albeit one many believed to be self-inflicted from a personal consumption tax hike in 2014) by posting 2.2% GDP growth to finish out the year, promptly followed by an impressive 3.9% annualized rate in the first quarter of 2015. Improving exports, housing, factory output, and capital spending led the charge and while most second quarter estimates are calling for growth of about half 1Q's cumulative GDP rate, directionally speaking there is little to argue about compared to this time a year ago.

Moreover, following their June meeting, Bank of Japan (BOJ) Governor Haruhiko Kuroda corrected market speculation that the bank might be curbing stimulus due to a declining yen by stating asset purchase levels would remain intact for the time being and that their current view is that the BOJ's target inflation rate of 2% can be achieved by the second half of 2016. So in our opinion, there remains a strong possibility Japan equity markets can continue to operate within the sweet spot of an improving economy and highly accommodative monetary policy.

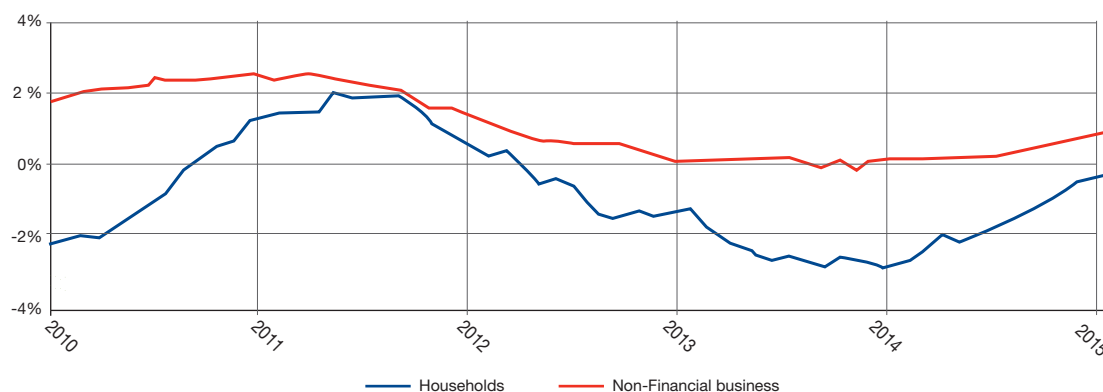
In Europe, where ECB President Mario Draghi announced its 1.1 trillion Euro QE program in January, there also seems to be real evidence this stimulus is creating positive economic momentum. After a double dip into recession during 2012 – 2013 followed by near stagnant growth in 2014, GDP is now expected to rise in the 2% range for 2015 and 2016. While this may appear as somewhat less than exciting in absolute terms, such levels if achieved could certainly prove to be champagne-popping in nature given where the Eurozone has been over the past five years.

When looking at the immediate effects of the few months since its early March implementation, one cannot help but be encouraged that the ECB's version of asset purchasing appears to be accomplishing what QE should: A transformation from deflation to inflation along with greater access to credit for both consumers and businesses.

Eurozone headline inflation during May officially reversed the negative trend incurred during 2014 by cracking into positive territory at .3% and the .9% core result approached its highest levels in more than a year. This has also been accompanied by a sharp rise in the availability of household credit, which spiked in April to 1% growth (its highest point since 2012) and business lending, which may be on the verge of ending three years of contraction.

In isolation, these numbers may not seem like the makings of dramatic economic expansion, but given their favorable trends and the fact that Mr. Draghi and the ECB remain committed to existing levels of QE, we believe they set the stage for continued outperformance in the European equity markets.

Figure 7: Euro zone bank loans and credit, annual growth



However, in China where the Shanghai Composite Index has more than doubled over the past year, driven by four rate cuts in six months as well as mounting margin debt, we feel it might be time to take some money off the table and perhaps redirect it toward Europe and Japan. There is no question that aggressive monetary policy, as seen in the decline of the Peoples Bank of China (PBOC) one-year loan rate from 6.0% to 4.85% and one-year deposit rate from 3.0% to 2.0%, has played a major role in this meteoric rise in stocks. Combined with greater access to retail investor margin borrowing, these rate cuts propelled the Shanghai Composite to a rise of more than 50% on a year-to-date measure and more than 100% on a one-year basis as of early June. Even with a 20% correction through the end of June, this bellweather index was still up more than 30% since the year's beginning.

We have turned cautious on China because this rise in stocks has occurred against what still appears to be decelerating rates of growth in the Chinese economy. Following 7.4% GDP growth in 2014 it looks as though a seven handle going forward will be a continued challenge as the PBOC estimates a 7.1% rate in 2015 and the IMF believes the year will come in even lower at 6.8% followed by 6.3% in 2016. The PBOC also anticipates inflation is going in the wrong direction with an expected reduction to 1.4% for the year, down from its previous estimate of 2.2%. In summary, this is not the supporting backdrop for a double in stocks.

At the year's outset we believed Chinese equities were positioned to outperform other regions, but the magnitude by which they have done so warrants reallocation to other markets, where monetary policy is showing more provable results, namely Japan and Europe.

What a changing workforce and excess Fed reserves could mean for future inflation rates

For someone like me whose formative years spanned the late 1970's and early 1980's, I still feel a pang of irony whenever I hear about the efforts of central banks throughout the globe to create inflation. My first vision always seems to be that it's a bit like starting a fire in the living room to heat your house.

Admittedly, U.S. inflation reports through 1H15 remain extremely muted and continue to run below the Fed's 2% annualized target. While the rebound in gasoline prices pushed up headline CPI in May to .4% from .1% in April, core inflation (excluding food and energy) came in at only .1%. On an annualized basis this number tracked at 1.7%, still noticeably below the Fed's target. Moreover, the Fed's preferred metric to measure inflation, or the lack thereof, Core Personal Consumption Expenditures (PCE), as of the end of May was only annualizing at about a 1.25% rate.

While the price of crude oil has rebounded to date it is still more than 40% below its highs of last summer and the 10-year break-even rate on Government Treasury Inflation Protection Securities (TIPS) is hovering in the 1.9% range, indicating market expectations the Fed may not induce inflation to its target for another decade. So suffice it to say as we stand today, concerns of potential deflation outweigh those of inflation by a sizable degree.

So what's to worry about on the inflation front? Well, perhaps it is that 1970's teenager in me who remembers double-digit inflation all too well that ascribes to the premise that nobody worrying is a good reason why most should be. Is our newly found drive for inflation one in which we are currently spinning wheels in the mud, only to be spinning too fast once we get out?

Were it not for the unique characteristics created by six years of unprecedented Fed liquidity and a once in a generation bifurcated labor force, I would say this "wheels-out-of-the-mud" risk would be small. However, given the fact that these two elements will be with us for some time we believe there remains a structural risk of inflation not reflected within the current trends cited above.

Key takeaway:

We continue to believe that while current inflationary trends remain muted future inflationary risks remain.

As we mentioned in January, we are not disputing currently benign inflationary data, however we do believe that unique risks exist. As job growth continues to strengthen we believe that wage inflation probably is not far behind. Growth in average hourly earnings have been stuck in the 2% range since the end of 2009 and we have reason to believe that this 5 year plus logjam could break soon.

The segmented composition of today's labor market is one reason why wage growth may be set to finally take off. Approximately 29% of those unemployed are categorized as long-term unemployed, defined as having been out of the workforce but actively seeking employment for more than 27 weeks. While this is down a few percentage points from the depths of the Great Recession it is still materially above historical averages. This likely means that when companies increase hiring they will be looking at a far smaller pool of labor they deem appropriate. One theory as to why the level of long-term unemployed remains so high is the generational differences within America's labor force as older displaced workers have far more difficulty regaining employment due to their disparity in technological skills compared to their younger counterparts. The end result of this is that when companies decide to hire in larger numbers, the labor market may be much tighter than it now appears.

These unique labor dynamics are also taking place against a historically low Labor Participation Rate (LPR) of 62.9% as of the end of May. Defined as those people either working or actively seeking work, this level is only slightly above the multi-decade low established in March (62.7%) when this metric dropped to a point not seen since 1978. We believe this reflects the ongoing retirement of Baby Boomers, implying we are more likely to see these lower LPR levels as the norm going forward rather than the generational anomalies they might at first appear to be. If that is in fact the case, upward wage pressure should result over time.

Finally, as we have mentioned before, the aftermath of more than 6 years and \$4 trillion of Fed open market bond purchases have left about \$2.6 trillion sitting in excess bank reserves yet to be disseminated into the economy. (As a point of reference, this amount sat at only \$2 billion in September of 2008). The Fed is currently paying interest on these reserves, something it did not do prior to 2008 and this is believed to have played a role in the huge accumulation to date. The risk here, as we have stated, could be that this \$2.6 trillion is released into the economy too rapidly, creating a classic case of too much money chasing too few goods and services, which would result in higher rates of inflation.

In order to prevent this from occurring, the Fed must strike a balance between raising rates and letting this capital flow into the economy to incent growth. They may even be caught in the difficult position of increasing the Fed Funds Rate and decreasing the rate they pay on these excess reserves. To their credit, the Fed has so far appeared effective at mitigating a disorderly distribution of these excess reserves and we have seen a decline of approximately \$150 billion from the year-end 2014 level without apparent adverse impact. We are not saying the Fed cannot manage through this inflationary risk, but until they do so it will remain just that—an inflationary risk.

In summary we continue to believe that while current inflationary trends remain muted, future inflationary risks remain.

Figure 8: Labor Force Participation Rate
June 30, 1995 – May 31, 2015

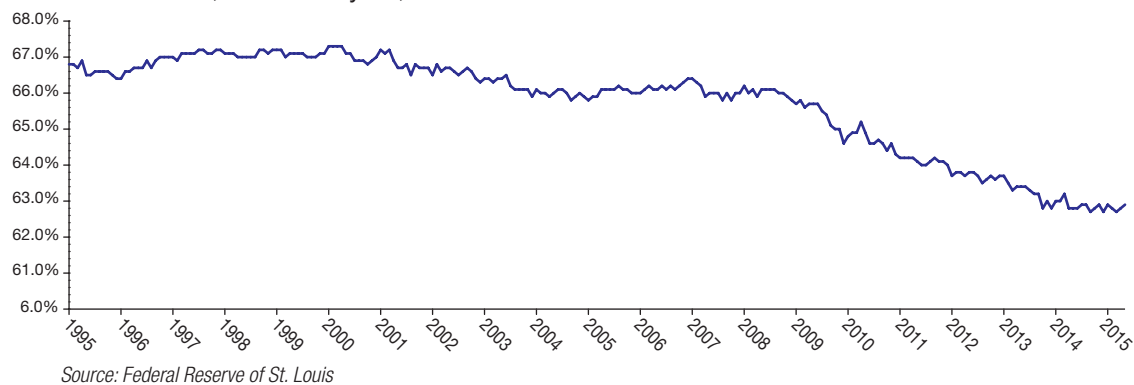
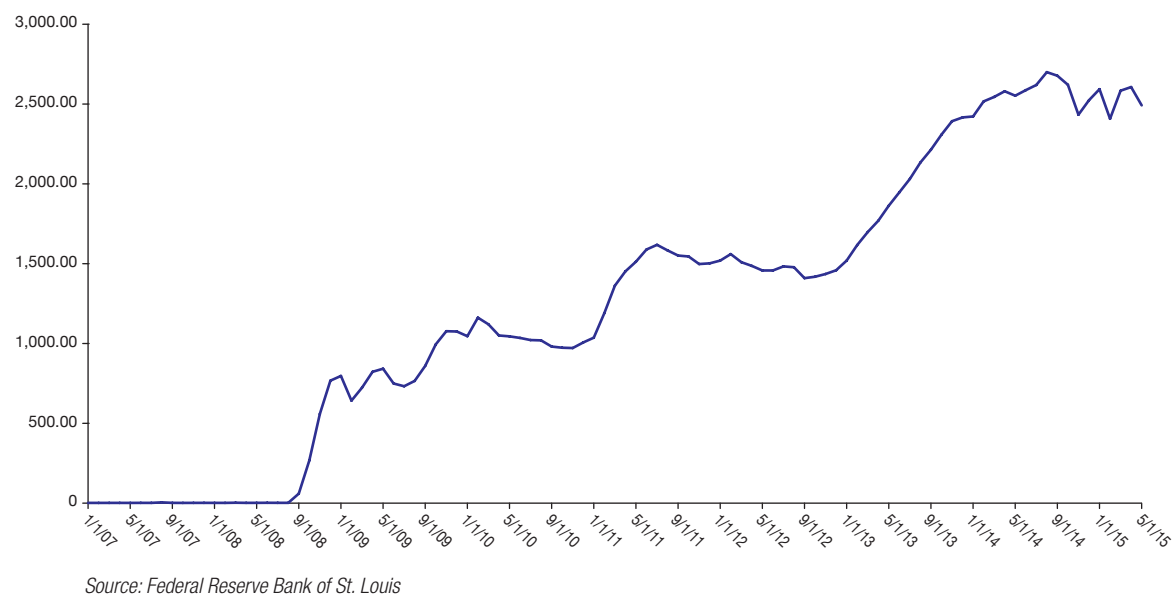


Figure 9: Excess Reserves of Depository Institutions
(\$Billions)



How to Position for the Second Half of 2015

Based on our outlook, we recommend that investors focus on the following themes:

- U.S. stock appreciation will be driven far less by price-earnings multiple expansion than it has been over the past several years. We continue to like small- and mid-cap stocks with exposure to consumer discretionary spending segments of the economy as well as high-dividend-paying stocks capable of increasing payouts.
- In the international markets we continue to favor European and Japanese equities but would take profits in China where we believe stocks have become overheated. We would recommend a reallocation within these regions from China to Europe and Japan.
- Regardless of the precise date the Fed decides to hike short-term rates, the upward movement in longer-term interest rates has begun. We recommend investment-grade bond investors stay short on the curve.
- High yield bonds outside of the energy sector can deliver above-average returns and could also be adequately positioned in a rising rate environment.
- Despite current data, we believe structural inflationary risks remain. We recommend TIPS and other inflation protection strategies for a portion of most portfolios.

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Fixed income investing is subject to credit rate risk, interest rate risk, and inflation risk. Credit risk is the risk that the issuer of a bond won't meet their payments. Inflation risk is the risk that inflation could outpace a bond's interest income. Interest rate risk is the risk that fluctuations in interest rates will affect the price of a bond. Investing in floating rate loans may be subject to greater volatility and increased risks.

Equities are subject to market risk meaning that stock prices in general may decline over short or extended periods of time.

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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