Q4 2015 Outlook & Review

A QUARTERLY MARKET PERSPECTIVE FROM QMA'S ASSET ALLOCATION GROUP

KEY POINTS

Economic Outlook

The global economy continues to grow very slowly compared to its pre-crisis trend, and conditions have clearly weakened since the start of the year, with investor anxiety focused on sustainability of the global economic expansion and a structural slowdown in emerging market economies.

The United States economy is still doing reasonably well and appears relatively insulated from the turmoil in emerging markets. Consumer spending and housing data over the quarter suggests a healthy economy. September's weak employment report, however, may be enough to convince the Federal Reserve to postpone a rate hike to 2016.

As disappointing economic data has continued to flow out of China, investors began to contemplate the possibility of a Chinese hard landing sparking a global economic downturn. More likely, the emerging world weakness may continue (perhaps even intensify), but the developed world should be able to achieve at least some degree of decoupling.

The European economic recovery appears on track and should continue to benefit from hyper-accommodative monetary policy, a weak currency, low oil prices, less fiscal drag, and a better capitalized banking sector. Japan's recovery, in contrast, has been sputtering but further stimulus is expected from the Bank of Japan.

The recently announced Trans-Pacific Partnership (TPP), should have a large positive impact on global GDP over the much longer term when it is eventually implemented, but is unlikely to impact growth over the next couple of years. Countries like Japan, where protectionism is the greatest, should see the biggest benefit.

Investment Outlook

We believe that the global expansion, despite its sluggish nature, will continue and the equity bull market should remain intact. Though we expect equity returns to be less robust going forward, the bar to outperform bonds is low given the level of current yields. We are sticking with a more cautious investment strategy for now.

Issues that are dampening market sentiment include global growth concerns emanating from China, plunging commodity prices, as well as the guessing game about when the US Fed will raise rates. We also view earnings as a key obstacle.

On a longer term horizon, we continue to prefer European and Japanese stocks relative to US equities, however, on a tactical basis we are neutral across the developed regions for defensive purposes. Emerging markets continues to be an area where we feel caution is warranted and remain underweight.

Commodity prices have fallen sharply over the past year as China's economy has slowed, directly impacting many emerging market countries such as Brazil and Russia. This impact can also be seen with the sharp drop in the forward earnings estimates for emerging market companies.

While we believe overall defaults will remain low as the economic recovery continues, a surge in bond issuance, with proceeds being used for equity buy backs and M&A activity, has impacted corporate health. While we still see little value in US Treasury bonds, they continue to be an excellent diversifier in a risk-off environment.

Though we have reigned in risk on a tactical basis, we believe opportunities will arise as some of the recent headwinds begin to dissipate. We look for developed market equity returns to be subdued, but outpace bonds and cash over the next few years. We continue to favor real estate and preferred stock.

QMα

Economic Outlook

The global economy continues to grow very slowly compared to its pre-crisis trend, and conditions have clearly weakened since the start of the year, with no sign of a reversal as of yet. Investor anxiety has been focused on doubts about the sustainability of the global economic expansion, due mainly to a structural slowdown in emerging market economies.

As Greece moved out of the headlines, investors returned their focus to two key issues: China and the Fed. As disappointing economic data has continued to flow out of China, investors began to contemplate the possibility of a Chinese hard landing sparking a global economic downturn. A surprise currency devaluation (Chart 1) followed by muddled communications surrounding future policy steps led investors to believe that Chinese policymakers might be panicking. The Fed's decision not to hike rates in September, citing concerns about the global outlook, further unnerved investors.

Could a hard landing in China spark a global recession? While it's not a scenario to dismiss, it is still not the most likely one in our view. More likely, the emerging world weakness may continue (perhaps even intensify), but the developed world should be able to achieve at least some degree of decoupling (Chart 2).

The United States economy is still doing reasonably well and appears relatively insulated from the turmoil in emerging markets as the US exports less than 5% of its GDP to these economies. Furthermore, recent data show that consumer spending growth has been strong and has recently moved above its 30 year average (Chart 3). Coupled with consistent job growth and a resilient housing market, we see a healthy economy that has enough internal momentum to buffet the global headwinds. The recent weak employment report for September is one negative data point but does not yet make a trend, but it may be enough to convince the Federal Reserve to delay ending its zero interest rate policy until 2016.

Nancy Lazar at Cornerstone Macro has even argued that weakness in China is a net positive for the US economy. Why? In the previous decade, China boomed while US manufacturing jobs were decimated by offshoring. China's slower growing economy (that has also become less competitive globally due to relative labor cost inflation) has led to much lower commodity prices. The US has seen a modest rebound in manufacturing jobs since 2011 as its competitiveness vis-à-vis China has improved. Such weakness in commodity prices—in particular lower oil prices—should be welcomed by the vast majority of advanced economies.

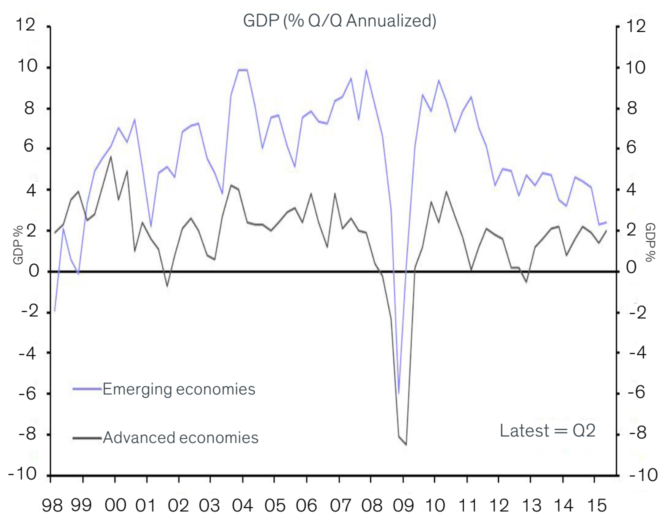
Looking toward the other developed economies, the European economic recovery appears on track and should continue to benefit from hyper-accommodative monetary policy, a weak currency, low oil prices, less fiscal drag, and a better capitalized banking sector. Japan's recovery, in contrast, has been sputtering probably due to its relatively greater exposure to a China slowdown. Further stimulus is expected from the Bank of Japan as Prime Minister Abe, armed with a new reelection mandate, has announced aggressive goals on expanding nominal GDP. A program of structural economic reform, long advocated by Abe but not yet meaningful delivered, remains a wild card in the outlook.

The recently announced Trans-Pacific Partnership (TPP), should have a large positive impact on global GDP over the longer term when it is eventually implemented, but is unlikely to impact growth over the next few years. Countries like Japan, where protectionism is the greatest, should see the biggest benefit.

1 / CHINESE CURRENCY DEVALUATION TRIGGERS EQUITY SELL OFF

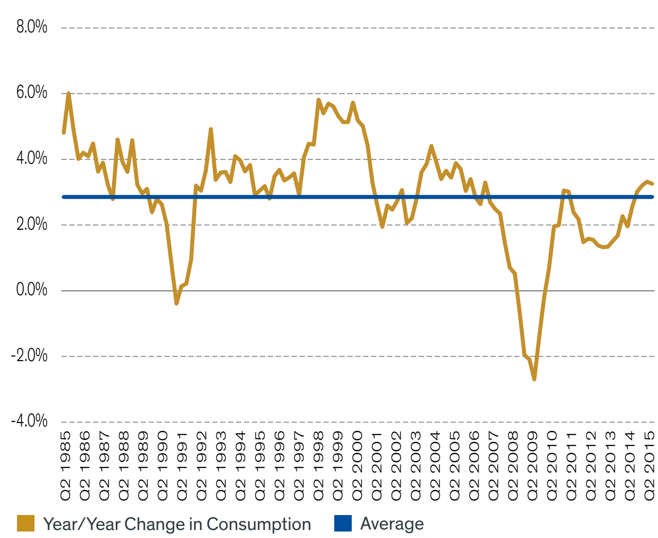
As of 9/30/2015.
Source: QMA, Thomson Reuters Datastream.

2 / DEVELOPED ECONOMIES ARE STILL RESILIENT



As of 6/30/2015.
Source: Capital Economics (Global Economics Chart Book, 9/4/2015).

3 / US CONSUMPTION GROWTH BREAKS ABOVE 30 YEAR AVERAGE*



*Q2 1985 — Q2 2015.
Source: QMA, Thomson Reuters Datastream and US Bureau of Economic Analysis (BEA).

Investment Outlook

In our third quarter outlook, we advised investors to reduce portfolio risk as we felt there was a reasonable likelihood of a pull back or consolidation in stocks. At the time, we cited concerns about Greece, flat profit growth for S&P 500 companies, a continued slowdown in China, and anxiety about the Fed ending its zero interest rate policy as the main reasons for our more cautious stance. Over the third quarter, Greece receded from the headlines and China sparked a global sell off in equities in August as volatility spiked to levels not seen in years (Chart 4). The Fed in September decided to postpone their expected rate hike and downgraded future rate level expectations further. Markets reacted negatively as investors worried that this decision implied a negative view by the Fed as to the state of global growth prospects.

As discussed in the previous section, we believe that the global expansion, despite its sluggish nature, will continue. If we are correct, the equity bull market should remain intact. Though we expect equity returns to be less robust going forward, the bar to outperform bonds is low given the level of current yields. Still, on a tactical basis we are sticking with a neutral position in stocks versus bonds across our portfolios as we still see several headwinds.

Issues that are dampening market sentiment include global growth concerns emanating from China, plunging commodity prices, as well as the guessing game about when the US Fed will raise rates. We also view earnings as a key obstacle. Global profit growth is expected to be flat this year, before rebounding in 2016. However, the 3-month change in forward estimates has rolled over, with non-US equities in negative territory, led by emerging markets plunging 10% on this metric (Chart 5). We would like to see a rebound here before becoming more constructive on equities in the near term.

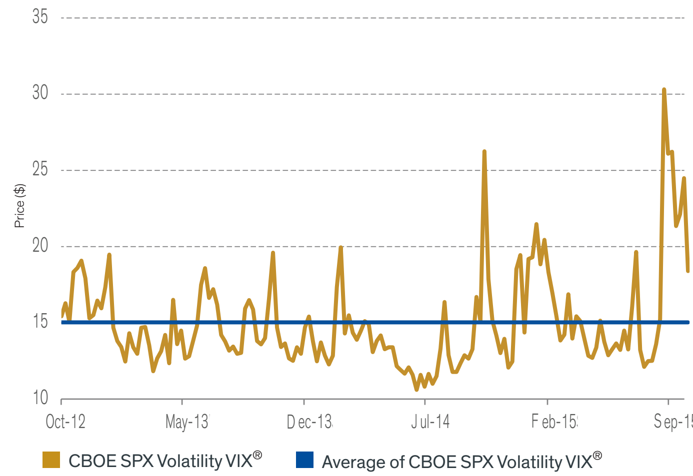
On a longer term horizon, we continue to prefer European and Japanese stocks relative to US equities; however, on a tactical basis we are neutral across the developed regions for defensive purposes. Emerging markets continues to be an area where we feel caution is warranted and remain underweight.

The Chinese slowdown continues and since official Chinese government data lacks transparency, it is difficult to assess the true extent of the slowdown. What we do know is that commodity prices have fallen sharply over the past year as China has slowed, directly impacting many emerging market countries such as Brazil and Russia. This impact can also be seen with the sharp drop in the forward earnings estimates for emerging market companies as we previously highlighted.

Another indicator signaling caution is the rise in corporate bond spreads. While we believe overall defaults will remain low as the economic recovery continues, a surge in bond issuance, with proceeds being used for equity buy backs and M&A activity, has impacted corporate health as measured by BCA Research (Chart 6). Historically, a move into "deteriorating health" has corresponded with weakness in corporate bond prices. While we still see little value in US Treasury bonds, they continue to be an excellent diversifier in a risk-off environment.

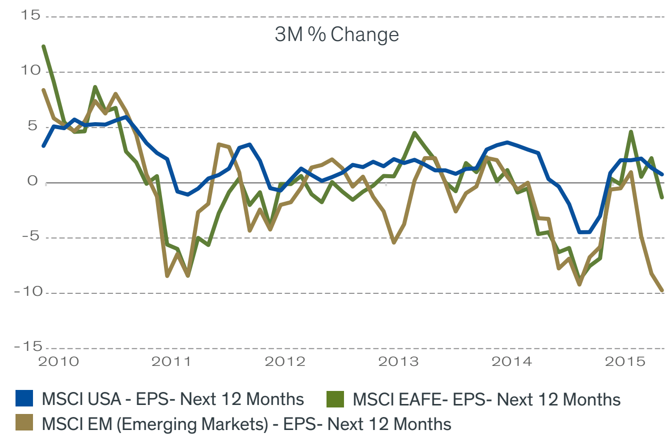
Though we have reigned in risk on a tactical basis, we have not thrown in the towel yet and believe opportunities will arise as some of the recent headwinds begin to dissipate. We look for developed market equity returns to be subdued, but outpace bonds and cash over the next few years. In addition, real estate remains a favored asset class due to solid fundamentals and attractive income. We continue to like preferred stocks on attractive yields and sturdy balance sheets.

4 / CBOE VOLATILITY INDEX (VIX®)



As of 9/30/2015.
Source: QMA and Thomson Reuters Datastream.

5 / MSCI USA VS. MSCI EAFE AND EM FORWARD EARNINGS PER SHARE



As of 9/30/2015.
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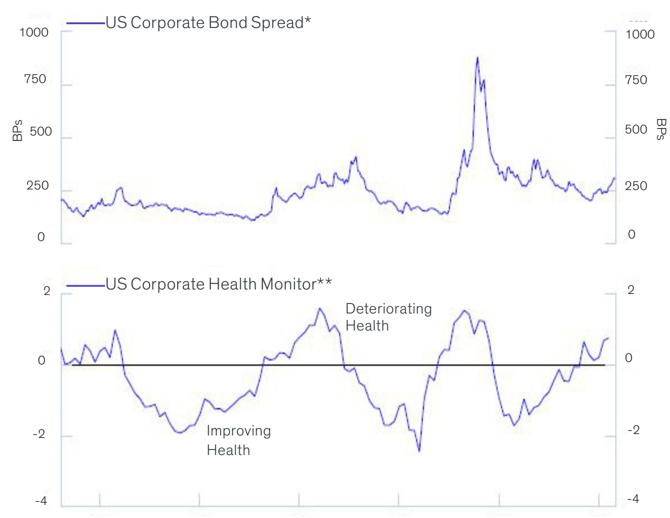
6 / US CORPORATE BONDS AND HEALTH MONITOR^



As of 9/30/2015.
^Below 0 = Improving Health; Above 0 = Deteriorating Health.
*Weighted Average of investment-grade and high-yield over Treasury master.
**Composite of 6 key financial ratios for the non-financial corporate sector.
Source: BCA Research, Barclays.

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 volatilityand 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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*As of 6/30/2015.