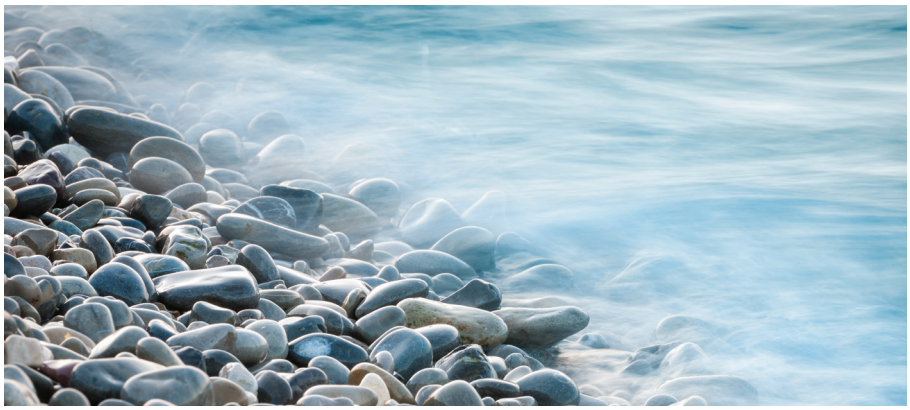
Perspectives

Keeping you informed and engaged about macroeconomic trends and market events



The Sound, the Fury, and the Stock Market

"The daily machinations of the stock market are like a tale told by an idiot, full of sound and fury, signifying nothing. Don't let all the noise drown out your common sense and your wisdom. Just try not to pay that much attention, because it will have no effect whatsoever, categorically, on your lifetime investment returns."

— Jack C. Bogle, founder of the Vanguard Group

MARKETS OPENED UP 2015 WITH SOUND AND FURY, but in the end this volatility signified nothing as global stocks rose and bond yields fell in another solid quarter of returns for investors. The European Central Bank finally launched quantitative easing, the Federal Reserve danced around the question of when it will begin hiking rates, the Russia and Ukraine crisis continued, and, as always, there was turmoil in the Middle East, this time due to the frightening advance of the militant group ISIS (Islamic State in Iraq and Syria).

Kicking off the quarter, the fate of Greece captured a multitude of headlines after the election of Prime Minister Alexis Tsipras and his anti-austerity, radical leftist Syriza party. After a series of tense, post-election negotiations, Eurozone finance ministers finally approved a four-month extension of Greece's bailout in late February, with concessions made on both sides. Approval of the extension means that Greece's €240 billion bailout will run until the end of June, which allowed the markets to enjoy some respite from the brinksmanship that was responsible for quite a bit of volatility in the first six weeks of the year. That said, a follow-up deal must be negotiated in time for nearly €7 billion in bond repayments that come due in July and August, so the respite is only temporary.

Beyond Greece and other geopolitical concerns, the dollar set the tone across markets in the first three months of the year. Currency market movements continue to be extraordinary, with the euro down another 12% against the dollar thanks to ECB's finally pulling the trigger on QE. Emerging-market currencies declined 7% in the first quarter on expectation of rising U.S. rates as well as ongoing developing

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Markets were volatile in the first quarter thanks to central banks and geopolitics, but ultimately delivered solid returns with few exceptions. Investors are queasy about macro overhangs and valuations, but we believe any future corrections are likely to reflect a pause but not a peak in market advances.

2

The U.S. economy lost some momentum in the first quarter thanks to a combination of bad weather in many parts of the country that disrupted consumer spending and construction, labor unrest at West Coast ports, the strong dollar, and a contraction in energy jobs and production.

3

Developed international markets were jolted to life by the fulfillment of ECB President Mario Draghi's promise to do 'whatever it takes' to protect the eurozone from collapse with his announcement of QE. Meanwhile, Japan is making progress on recovering from a VAT tax-induced slide.

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Emerging markets remain a varied picture as Brazil and Turkey struggle with high inflation and weak growth, Russia faces a commodity and geopolitically-induced recession, China's growth is recalibrated to the consumer, and India is now the fast-growing of any major economy in the world.

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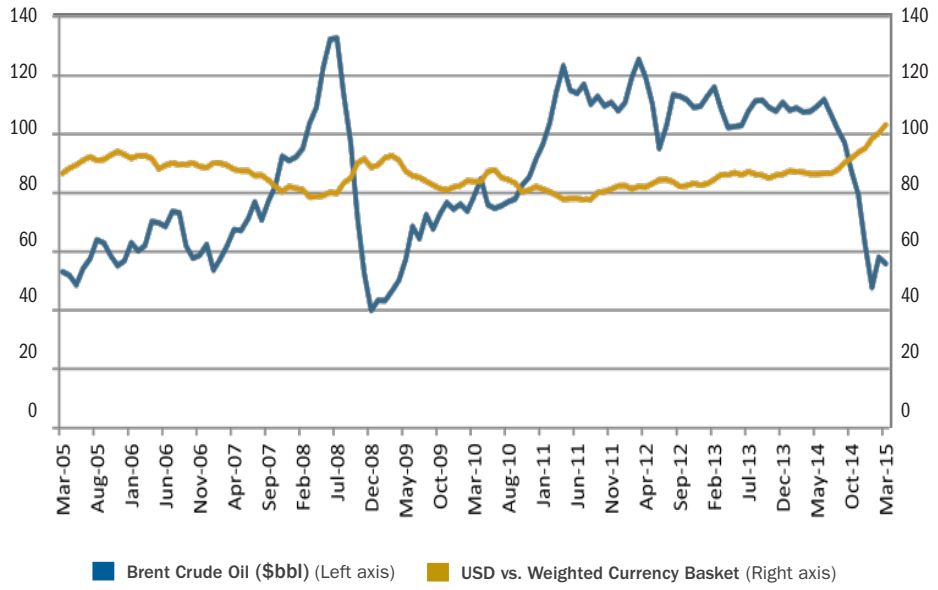
world growth and demand concerns. The strong dollar, or at least the pace of its rise, is now unsettling U.S. equity investors concerned about earnings of large multi-nationals that rely heavily on foreign sales.

Meanwhile, crude oil fell more than 10% in the first quarter, extending a rout that saw the commodity post a 46% plunge in 2014. Record supplies and tightening storage capacity in the U.S. combined with a stronger dollar sent prices for crude-oil futures lower for a third straight quarter. The potential that an Iranian nuclear deal will result in the easing of sanctions on the crude exporter and contribute to global oil supplies also pressured prices. Only concerns over turmoil in Yemen and the possibility of disruption to oil transport in the region helped offset some of that weakness, pulling oil from six-year lows to end the month at $47.60 a barrel.

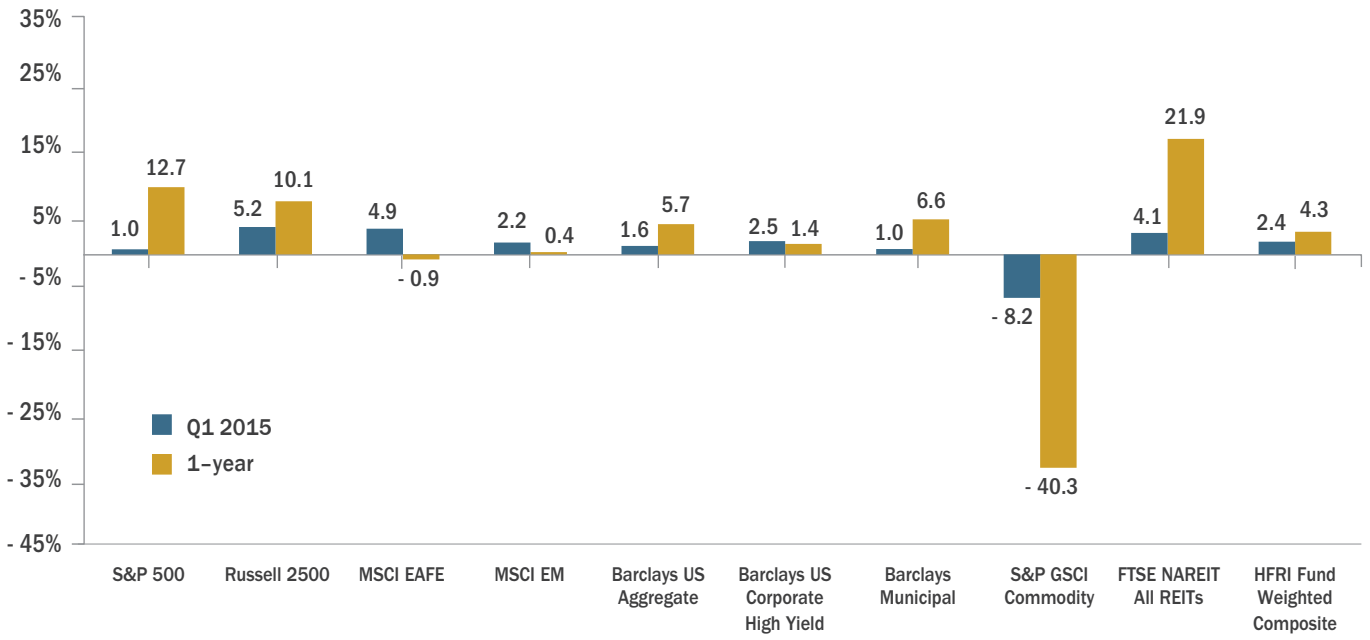
More broadly, investor sentiment continues to be dominated by a relative unease over a market cycle that seems too long to be true and fears over asset bubbles created by central banks being too accommodative for too long. From our vantage point, there is very little irrational exuberance in the system, with economic data globally reflected a prolonged and muted recovery that still has ground to cover and consumers and corporations still conservative with their cash. While it is true global equity market valuations are broadly in line with or slightly above long-term averages, they are still reasonable in consideration of low interest rates and inflation. Furthermore, a closer examination of individual markets, sectors, and stocks reveals opportunities for astute investors who can navigate the full terrain.

Without a doubt, at current levels, markets are likely to be more vulnerable to moments of sound and fury. We believe these moments will be no more than a pause, and not yet a peak in market returns, and emphasize the opportunities these conditions may create and the importance of disciplined long-term investment planning.

USD vs. Crude Oil: Sharp Moves Have Unsettling Implications



Major Market Index Performance: A Quarter of Solid Returns



Global Economic Overview: Fragile But Improving

The global economy remains fragile but is expected to gradually gain traction through next year. Global trade is slowly recovering after bottoming out in the first half of 2013, but the pace of recovery continues to be anemic. Fiscal policy has been too contractionary to catalyze growth, with leaders in Europe, China, and Latin America focused on paring down debt and the excesses of the past. While monetary policy in most corners of the world has been extraordinarily accommodative, it is a blunt instrument at best, and has not had its desired efficacy given the dissonance with the fiscal restraint of economies across the world.

While time has worked to heal some of these wounds, in 2015 falling oil prices may provide a powerful stimulus to the global recovery by lowering energy costs, boosting real income and consumer spending, and improving the external accounts of oil importers. We are also seeing as demand recovers that global unemployment, while elevated, is on the decline, and a more rational approach to fiscal restraint is taking hold, particularly in the U.S., China, and in some of the European economies.

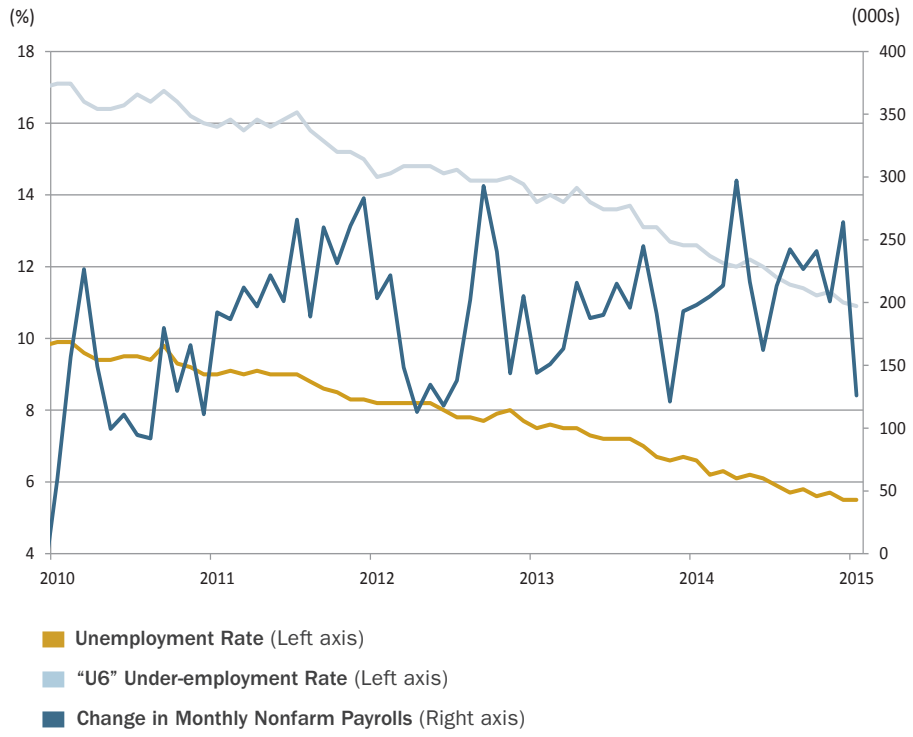
A key risk to our fragile but improving outlook beyond geopolitical risks is whether tighter U.S. monetary policy later this year could prompt large capital outflows from emerging markets, putting ever more pressure on the Fed to delicately extract without undermining confidence, financial stability and growth across these and all markets. It will be a delicate balance, to be sure.

U.S. Economy: Frozen the Sequel

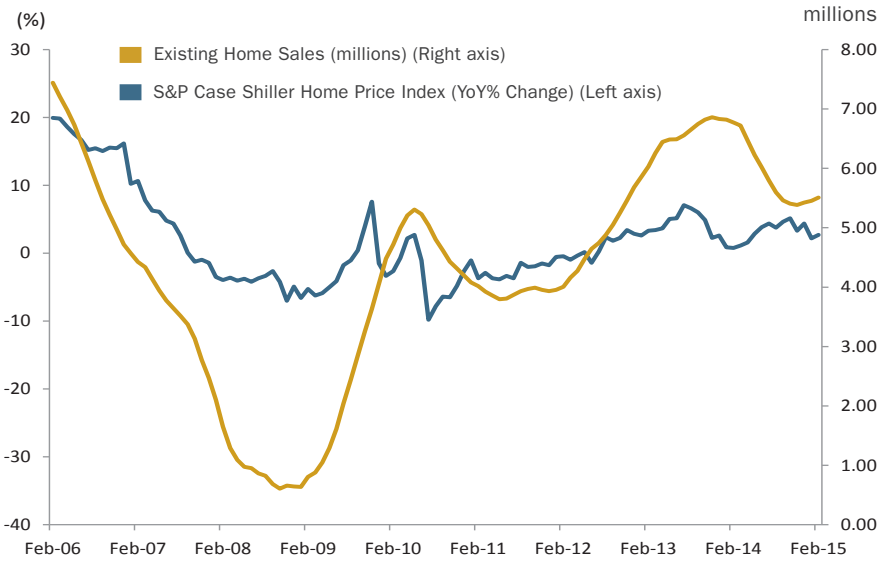
U.S. economic data lost momentum in the first quarter, led by declining job growth. Indeed, payrolls rose by just 126,000 in March. Bad weather accounted for some, but not all, of the softness in March. Job growth has shifted lower in recent months, to around 200,000 per month, down from above 300,000 in late 2014. The unemployment rate held steady at 5.5% in March, although the labor force contracted over the month. The average workweek fell by a tenth of an hour to 34.5 hours in March. The one bright spot was that average hourly earnings rose 0.3% in March and were up 2.1% from one year earlier.

The weaker job growth in early 2015 is consistent with a temporary softening in real GDP growth in the first quarter, to near 1% annualized rate. Despite rising wages and lower energy costs, consumer spending has so far remained at a stagnant 2% pace. In the first couple of months of the year, Americans spent more on services such as health care and utilities, but in a negative sign, purchases of big-ticket items such as new cars fell for the third straight month. Meanwhile, the Institute for Supply Management's purchasing managers index showed that manufacturing activity, while still in expansion mode, hit a 14-month low of 51.5 in March, with a labor slowdown at West Coast ports blamed in part for the drop. Housing was likewise constrained during the quarter, primarily based on lackluster demand. Existing home sales for February (the latest monthly data available) advanced at an annualized rate of 4.9 million units, modestly above the 4.8 million unit rate reached in January, but only up about +4.7% from February 2014. Prices are higher by nearly 8.2% from a year ago, thanks in part to how tight the inventory of existing homes remains, with only about 4.6 months of supply. For this reason, it was surprising that the NAHB (National Association of Home Builders) Housing Market Index, a measure of homebuilding activity, ended the quarter at a level of 53, down from the previous quarter's reading of 58, and the lowest level since July 2014. The outlook for housing is less certain than in the past few quarters, as countervailing forces impact the market. On one hand, employment is improving and mortgage rates remain low. However, waning consumer confidence and anticipation of a looming increase in interest rates are potential hindrances to significant housing gains.

First Quarter Economic Data Shows Loss of Momentum, Especially in Job Gains



Housing Market Gains Slowing Down on Low Supply & Uncertain Rate Outlook



The combination of bad weather in many parts of the country that disrupted consumer spending and construction, labor unrest at West Coast ports, the strong dollar, and a contraction in energy jobs and production have all weighed on economic growth in early 2015. The good news is that most of these drags will be temporary, and we expect growth will reaccelerate over the rest of this year as consumers spend more and construction projects are restarted. Energy-related activity will remain a drag in the near term, but less spending on gasoline and other energy items will boost consumer spending on other goods and services, supporting faster economic growth. We expect a strong rebound in real GDP growth in the middle two quarters of this year, along with jobs accelerating back to a running rate of 250,000 per month, which should push the unemployment rate even lower. In other words, we expect déjà vu all over again in 2015 as we experienced in 2014!

A lynchpin to this outlook is the smooth transition to a more normal monetary policy environment after the extraordinary measures put in place during the financial crisis. In her semiannual testimony before the Senate Banking Committee in February, Fed Chair Janet Yellen said a rise in interest rates would be considered on a "meeting-by-meeting" basis, citing sluggish wage growth and low inflation as concerns. At the most recent Federal Open Market Committee (FOMC) meeting, the Fed dropped references to it being "patient" in waiting to raise rates, opening the door to an increase as early as its June meeting. But other language in the statement referred to moderating growth, a desire to see a rise in core inflation, and mixed economic data. Public comments from the Fed have most believing that the increase may be put off until later in the year, and Yellen reiterated in March that the central bank would proceed slowly in hiking rates. Even then, all guidance appears to be for a very slow path to normalization, reflecting the fragility of economic and market conditions in these modern times.

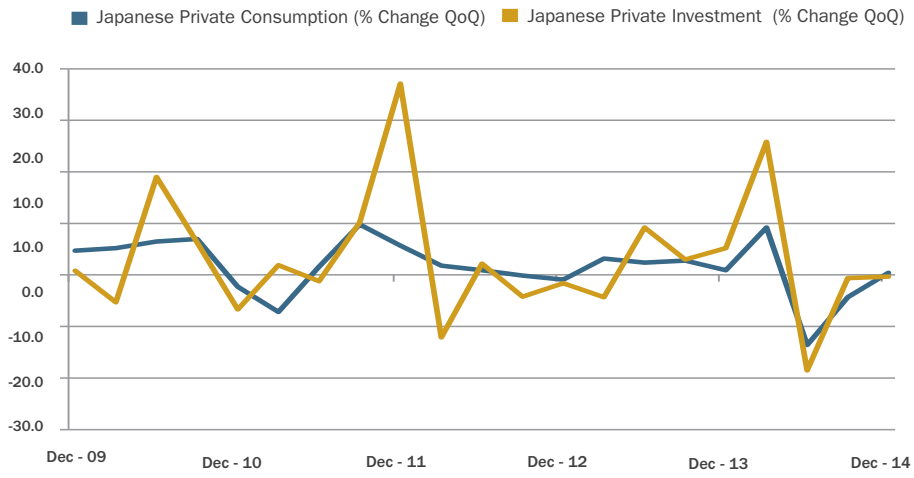
Developed International Economies: QE Alchemy

The first quarter started out with a bang in 2015 when, in a surprise move, the Swiss National Bank (SNB) surprised markets by unexpectedly scrapping its three-year policy of capping the Swiss franc to the euro. Following the announcement, the franc rose nearly 30% in intraday trading and closed as much as 22% higher against the euro; it has since settled up around 15%. Although the SNB caught investors flat-footed, there were several reasons behind the decision, including political pressure and the devaluation seen in the franc during 2014. Nevertheless, the reason that garnered the most investor attention was the central bank's anticipation that the European Central Bank (ECB) would, just one week later, announce the rollout of QE.

Indeed, the SNB was correct and investors finally got what they were looking for out of ECB President Mario Draghi when he followed up on his commitment to expand the central bank's balance sheet by €1 trillion. On January 22, Mr. Draghi unveiled a QE program under which total monthly asset purchases will amount to €60 billion. The program commenced in March and will run through September 2016 or until inflation objectives are met.

Even before the official announcement of ECB QE, modest economic growth had already emerged in the form of accelerating European retail sales, rising export activity, and improved credit availability

Japan Private Consumption and Business Investment Recover after VAT Tax Increase Absorbed



for businesses and households. A sharply weaker euro, lower oil prices, and modestly improving credit conditions should continue to support moderate expansion.

To be sure, though, QE does not negate the need to implement deeper and more significant structural reforms across the Eurozone, and Mr. Draghi echoed this sentiment when he called for governments to "…swiftly, credibly, and effectively…" implement economic restructuring during a March 11 speech in Frankfurt.

Meanwhile, Japan has recovered from last year's technical recession, induced by a hike in the sales tax, and its economy is poised to grow at a faster pace in 2015. A weak yen—the result of the Bank of Japan's monetary-stimulus program—should make the country's exports more competitive, and we expect modestly stronger global growth to further boost demand for those exports. Additionally, domestic consumption in Japan will likely benefit from the government's decision to postpone the second tranche of the sales-tax increase to 2016. Of course, the longer term concerns for Japan's economy—including minimal real wage growth, an aging population and the shrinking ratio between prime-age workers and retirees—have not gone away.

China & Emerging Economies: A Varied Picture

The economic picture continues to be varied in the emerging market economies, as Brazil and Turkey struggle with high inflation and weak growth, Russia faces a commodity and geopolitically-induced recession, China continues to forge its path toward growth driven by domestic consumption, and India claims its spot as the fast-growing of any major economy in the world.

Beginning with Brazil, economic statistics demonstrate a somber picture of stagflation. Economic growth is weak, with real GDP growing at a paltry 0.1% rate in 2014. Unemployment is high and inflation continues to increase. Additionally, a lack of significant structural reforms continues to act as a strong headwind to economic growth.

Exacerbating these conditions, Brazil is embroiled in a multi-billion dollar political corruption scandal involving state-run oil company Petrobras. Further, Brazilian authorities announced on March 26 that they uncovered a tax fraud scheme at the Finance Ministry's tax appeals board involving 70 companies spanning a range of industries that may have cost tax payers up to 19 billion reais ($5.96 billion).

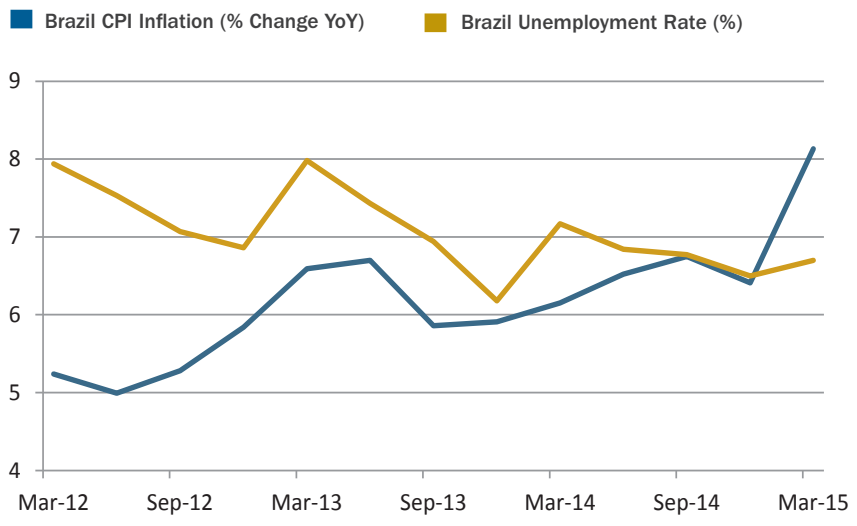
While not quite as dire, the Turkish economy slowed notably in the third quarter of last year, dragged down by weakening domestic and external demand. More recent data for 2015 paint a mixed picture of the economy going forward. The manufacturing PMI signaled contraction for the second month in a row in February, but both consumer and business confidence improved. Of grave concern, the Turkish lira fell to a new record low in March amid political uncertainties related to monetary and fiscal policy. The government has stepped up criticism of the Central Bank's and is perceiving to be strong arming interest rate cuts, raising fears that the Bank's independence could be in jeopardy.

Even less hopeful is the outlook for Russia. Sanctions imposed by the U.S. and the European Union over the conflict in Ukraine cut off access to international markets and stoked capital outflows. This, coupled with an almost 50% crash in oil prices and the ruble's worst crisis since 1998, has caused the economy of the world's largest energy exporter to grind to a halt.

Turning to China, preliminary first-quarter data showed that the Chinese economy continued to slow after its weakest expansion (7.4%) in more than a decade last year. While the quality of growth is improving as its economy evolves toward domestic consumption, the decline from 10-12% growth levels continues to be difficult to calibrate. In recognition of the need for targeted stimulus measures to prevent a hard landing, the central bank lowered the minimum down payment requirement for second-home buyers to lift the property market. The People's Bank of China also reduced lending and deposit interest rates in March, due to concerns about the country's slumping property market, slowing economic growth, and deflationary pressures.

While most emerging nations have struggled mightily against the strong U.S. dollar and falling commodity prices, India remains a standout example of what is going right in the developing world. As India is a big importer of oil, falling prices are a big win for both businesses and consumers there. A relatively new government, led by Prime Minister Narendra Modi, has also ushered in a wave of reforms to bolster businesses and jobs. Likewise, India's central bank leader, Raghuram Rajan, has been focused on reducing India's foreign debt. Their leadership, plus the country's young worker population, are building investors' confidence and will keep India as a poster child for emerging market success in 2015.

Brazil Inflation & Unemployment Show Dire Straits



Global Market Outlook: Diversification Delivers

While the first quarter opened with sharp market movements, as the period progressed, volatility subsided. Risk assets were buoyed by a cease fire between Russia and Ukraine, a negotiated deal between Greece and its international creditors to extend the country's bailout program, improving economic data out of the Eurozone, as well as the ECB's unveiling of a quantitative easing (QE) program.

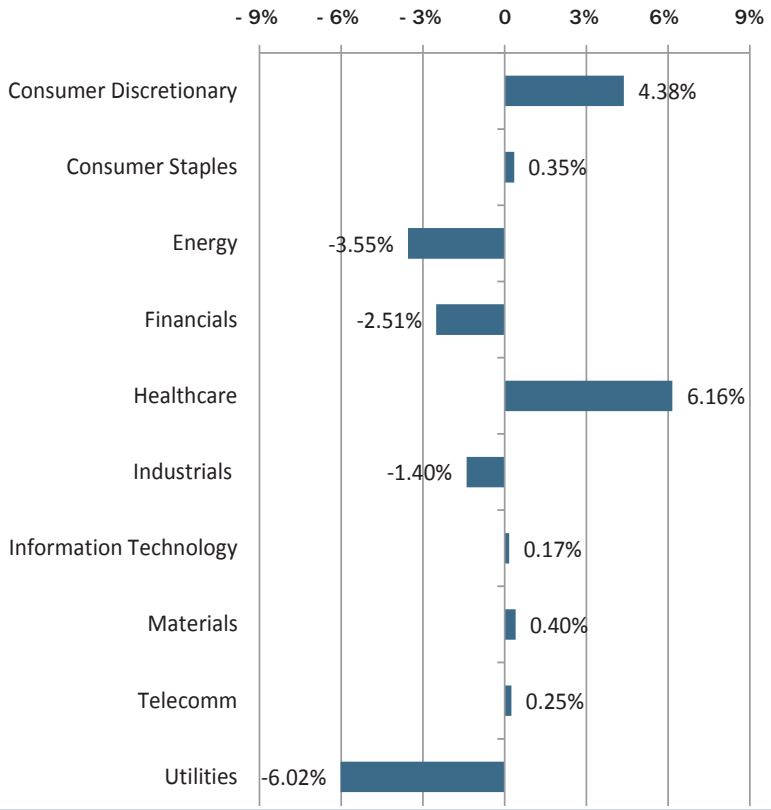
Against this backdrop, global equities generated strong absolute returns during the first three months of the year. For the first time in many quarters, U.S. stock returns lagged the rest of the world as investors contended with the impacts of a rising dollar, oil price volatility, and the timing of the Federal Reserve's impending interest rate hike. The Standard & Poor's 500 Composite Index was up just under 1%, though it did hit a new record high in March. Growth stocks outpaced value-oriented stocks, and mergers-and acquisitions activity (Pfizer-Hospira, Charter-Bright House Networks, UnitedHealth and Catamaran, and Kraft and Heinz) particularly buoyed the health care and consumer discretionary sectors, which rose 6% and 4% respectively. In contrast, the utilities sector lagged, falling 6% as a rise in interest rates loomed. The energy sector remained under pressure given the inability of oil prices to find support. Notably, by the end of the quarter, large multinationals were demonstrating that currency headwinds are taking a toll on sales and revenues, with weaker earnings and warnings issued by the likes of construction equipment maker Caterpillar and biopharmaceutical leader Bristol-Myers Squibb.

After a significant performance gap in 2014, and without the headwind of a strong dollar dragging export growth, small cap U.S. equities surged in the quarter, gaining over 4%.

Turning to the rest of the world, European stocks powered ahead, supported by improving economic data, falling oil prices and an aggressive new stimulus program launched by the ECB. Despite renewed concerns that Greece might exit the eurozone, most national stock markets enjoyed double-digit gains, notching some of the best quarterly returns in years. The euro, meanwhile, tumbled to multiyear lows against the U.S. dollar. Overall, the MSCI Europe Index rose nearly 12% in local currency but only 3% in dollar terms.

When returns between local currency and U.S. dollar-denominated show this kind of dispersion, it is natural to ask the question whether it makes sense to hedge international equity exposure for currency risk. While we acknowledge the drag the dollar's strength has had on a short-term basis, there are many drawbacks to consider when hedging foreign exposure to the dollar. For example, there is a built-in hedge to buying international equities given that as a country's currency declines, the cost of its goods declines as well on a relative basis, which translates to higher sales and better margins for exporters. Investors who hedge may not take a hit when the foreign currency declines, but they are likely to miss out when their foreign stocks rebound. It is also important to recognize that foreign multinational companies typically use their own elaborate hedging strategies to protect their assets, revenue, and expenses in the major currencies. Furthermore, at the implemen-

S&P 500 Struggles to Gain Momentum; Sector Returns Vary Wildly



Sharp Differentials in Local and USD European Market Returns: Hedge From Here?

ANNUAL PERFORMANCE (%)		
YEAR	MSCI Europe Local	MSCI Europe (USD)
2015	11.60	3.45
2014	4.66	-6.18
2013	21.55	25.23
2012	15.61	19.12
2011	-9.34	-11.06
2010	6.83	3.88
2009	27.70	35.83
2008	-38.91	-46.42
2007	6.04	13.86
2006	19.05	33.72
2005	24.93	9.42
2004	12.24	20.88
2003	19.78	38.54
2002	-29.36	-18.38

tation level, major drawbacks to hedging include transaction costs which can drag returns, not to mention timing issues. The recent collapse in the euro may have gone a long way toward pricing in much of the future policy differential between Europe and the U.S. Looking ahead, there may be a reversal in some of the euro's weakness, as European data releases have been surprisingly strong, albeit above very low expectations, while U.S. data releases have disappointed. For all of these reasons, we see little value from here to hedging, and suspect the tide may be turning.

Outside of Europe, Japanese equities rose amid strong corporate earnings and optimism that companies would begin raising dividends. Further boosted by data showing that the nation's economy had exited recession, the MSCI Japan Index gained a very robust 10%.

Turning to the emerging markets, the MSCI Emerging Markets Index rose just 2% given so many geopolitical uncertainties and fears over the impact of looser monetary policies around the world on emerging market currencies. Indeed, most EM currencies continued to slide against the U.S. dollar, though a few regained some ground late in the period as the U.S. Federal Reserve indicated it was likely to be cautious about raising interest rates. Asian equities posted solid gains as several countries adopted looser monetary policies. Chinese equities climbed 8% as continued monetary easing seemed to temper worries about slowing economic growth. Indian equities rose 6% after the central bank twice lowered interest rates. The government also released a relatively modest budget emphasizing infrastructure spending and social welfare programs in late February. Elsewhere, technology stocks helped lift equity markets in Taiwan and South Korea, which rose 4% and 6%, respectively. South Korea's central bank surprised markets by cutting interest rates to a record low of 1.75%.

Russian stocks soared more than 18% as the Ukraine crisis receded from the front burner for most investors and crude oil prices stabilized. Hopes of a lasting truce in Ukraine-which would reduce the risk of more sanctions on Russia's already weak economy—drove a rally in the ruble, which gained more than 3% against the dollar and was the quarter's best-performing currency.

In contrast, Brazilian stocks fell 15%, hurt by concerns about deteriorating economic and political conditions and the sharp depreciation of the real. Ordinary shares of oil producer Petrobras lost 17% as a corruption scandal rocked the state-owned firm. Also pressuring markets was Brazil's central bank ongoing moves to hike interest rates: they lifted the benchmark Selic twice in the quarter, to a six-year high of 12.75%, to help rein in inflation.

Turkish stocks sank nearly 16% as a feud between the country's central bankers and politicians over monetary policy shook investor confidence. Turkey's central bank twice reduced its various policy rates early this year. However, the rate cuts failed to appease government officials who had called for steeper reductions to stimulate the economy and raised doubts about the central bank's independence from political pressure. The lira fell to a record low versus the dollar during the quarter, which exacerbated Turkey's losses.

In the fixed income markets, U.S. Treasuries were volatile but finished with gains, marking the fifth consecutive quarter of positive returns for U.S. government debt. In January, the benchmark 10-year Treasury note's yield decreased by 49 basis points to 1.68%, its lowest level since May 2013. However, in February, Treasuries experienced their sharpest sell-off since the "taper tantrum" in 2013, as the yield on the 10-year note increased by about 40 basis points in approximately three weeks. Treasuries reversed course and rallied again in March, and the 10-year note's yield ended the quarter at 1.94%.

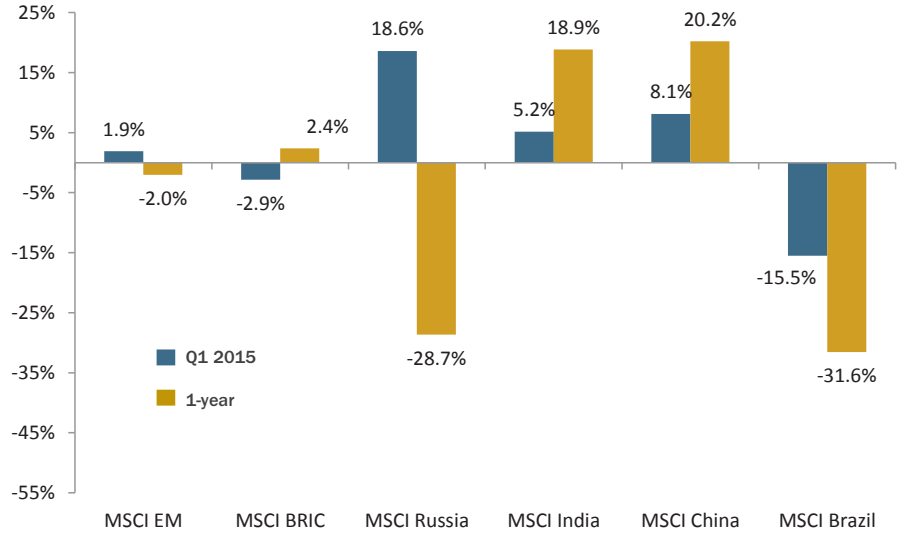
Investment-grade corporate bonds generated broadly solid returns, although they lagged high yield bonds. Issuance was heavy as companies brought bonds to market to take advantage of the low interest rate environment. Pharmaceutical company Actavis sold $21 billion of debt, the second-largest corporate bond offering ever, to fund its acquisition of Allergan, maker of Botox. U.S. firms have also been rushing to sell new bonds in Europe, where rates are even lower.

High yield debt was particularly strong in the first quarter, recuperating from last year's energy-driven rout. We continue to expect high yield bond returns to be supported by solid credit fundamentals and the continuing strong appetite for yield.

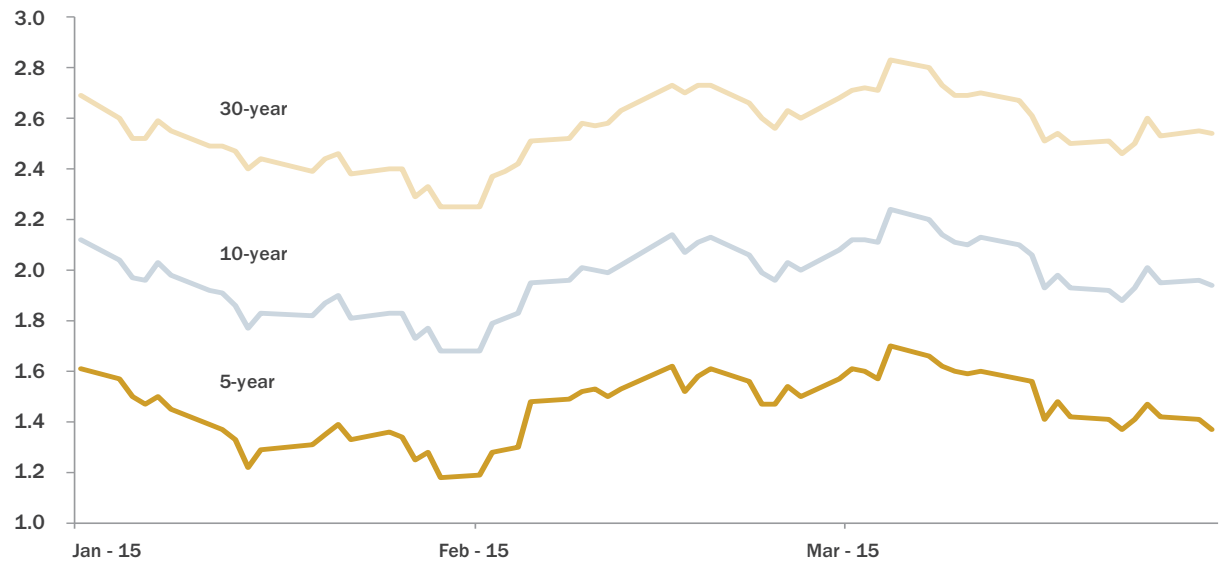
Mortgage-backed securities and municipal bonds gained 1.1% and 1.0%, respectively, restrained by low interest rate levels. U.S. dollar–denominated emerging markets debt advanced as investors appeared to search for yield against the backdrop of lower global interest rates. In contrast, currency losses held back local bond returns for U.S. dollar–based investors.

In the alternatives category, REITs continued on a torrid pace, jumping sharply in the first quarter. The FTSE NAREIT All REIT Index gained +4.7% during the quarter, with the index now up 21% over the past 12 months. Commodities once again could

Emerging Markets Varied Returns Reflect Country Specific Risks & Opportunities



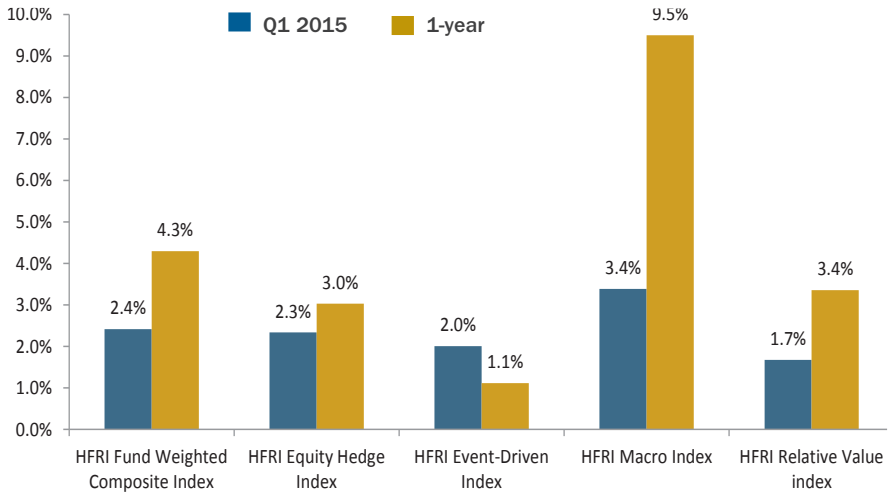
Treasury Bond Yields
Were Volatile in the Quarter But Ended Lower Than They Started



not find any footing during the first quarter, as energy prices continued to hover near multi-year lows. They sank for the fourth consecutive quarter, with the Goldman Sachs GSCI Index down over 8% through March and off more than 40% over the last twelve months.

The stars aligned for managed futures and global macro hedged strategies in the first quarter. These strategies benefitted from the return of volatility to global financial markets against the backdrop of quantitative easing in Europe, the Swiss National Bank's decision to unpeg its currency, and elections in Greece. One of the key trades that has benefitted hedge funds has been the correct call that the US dollar would rise sharply against other major currencies. Also finding some traction in the quarter were equity long-short strategies that were able to successfully navigate the volatility in U.S. stock markets effectively as fundamental stock selection and the ability to short worked to their advantage. As the macroeconomic divergence between the US, Europe, and Asia continues to expand into 2015, flexible, tactical strategies which are able to adapt to fluid developments in markets and position investors to benefit from these powerful dynamics are likely to attract investor capital.

Hedge Funds Rise Again:
First Quarter Performance Restores Their Reputation



Even as market volatility increased in the first quarter, market returns rewarded investors for taking risk. To be sure, we are entering a period of greater uncertainty, as markets contend with the prospect of reduced Fed largesse at a time when global growth is fragile and geopolitical risks abound. We do not believe that this year has the markings of a finale of the secular bull market that began nearly six years ago; but it could be a year marked by a greater frequency of corrective phases. It is also likely to be a year when global diversification is appreciated more than in the past.. Indeed, the current configuration of global conditions makes the Eurozone's equity markets well placed to enjoy a period of outperformance, as one example. Likewise, there are many benefits to smaller capitalization stocks right now that provide greater exposure to domestic revenues than other market segments. Our diversified approach should help weather the risks and challenges in the global economy, as well as our flexibility to thoughtfully review our allocation of capital, in order to remain open to opportunities as they are presented.