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Global Perspectives 2014 Midyear Update

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"I am waiting for the next pullback to get invested." Most investors caught uttering this sentence over the past few years ended up learning an expensive lesson, as so often the "next pullback" became the "next pullback" became the "next pullback" and so on. This year has been no different, as there were a number of developments — including periods of market weakness in both January and June inspired by flaring geopolitical concerns — to give skittish investors reasons to delay a full allocation to equities. Markets haven't had time for such excuses, however; not only has the bull run continued, it has broadened across global markets as the early-year cold spell was trumped by a resurgence of global economic activity in the second quarter.

Broadening Equity Markets Mark Second Quarter

The second quarter saw global equity markets broaden considerably, including a rebound from first-quarter laggards emerging market stocks and domestic small caps, as well as continued strong performance by global REITs. Not only did equities outperform fixed income during the second quarter, the asset class took over the year-to-date lead. High yield, global bonds and U.S. corporates were among the fixed income categories that saw success in the quarter, as the hunt for yield overwhelmed risk concerns; for the year, however, long treasuries remain the runaway leader, confounding investors who expected interest rates to rise as tapering commenced. An increased appetite for risk was bolstered by the European Central Bank's June 5 announcement of aggressive deflation-fighting monetary stimulus — including the first-ever negative deposit rate by a major central bank — and a promise of more to come as necessary.

The second quarter comeback of the emerging markets — a key to a broadening global economy — was driven by a number of positive events, including India's pivotal parliamentary election of a pro-growth, business-friendly leader; cross-border M&A activity surpassing that of developed markets; and an increasing attention to free trade, exemplified by the Pacific Alliance of Mexico, Chile, Peru and Colombia.

Despite a roster of geopolitical risks to which the prospect of an Iraqi civil war was added, this equity bull market continued to be resilient, sending the S&P 500 to new record highs more than 20 times this year. However, the best performing equity asset class continues to be global REITs, with its high cash flow and diversifying characteristics. Moreover, all asset classes — within both equity and fixed income — were positive through the first half of the year.

2014 Forecasts Affirmed at Midyear

We are affirming our forecasts issued at the start of the year. This includes our targets for S&P 500 earnings per share ($121) and price level (2020). The positive trend in corporate earnings has continued unabated — second quarter 2014 should represent the eighth straight period of year-over-year profit growth — to push the S&P 500 ever

Executive Summary

- Markets have looked past the early-2014 economic cold spell as fundamentals heat up and systemic risks wane.
- European Central Bank bolsters monetary stimulus as the Fed and Bank of England continue tightening.
- Cold War redux in Ukraine and Middle East instability inspire yawns.
- Given seven consecutive quarters of S&P 500 earnings growth, we affirm our 2014 forecasts for EPS and price level.

All Asset Classes Positive for 2Q14 and 1H14

Index	June 2014	2Q14	1H14
Equity			
S&P 500	2.1	5.2	7.1
S&P MidCap 400	4.1	4.3	7.5
S&P SmallCap 600	4.7	2.1	3.2
Global REITs	1.4	7.9	12.2
EAFE	1.0	4.3	5.1
Emerging Mkts	2.7	6.7	6.3
Fixed Income			
Corporate	0.1	2.7	5.7
U.S. Treasury 20+	-0.2	5.1	13.2
Global Aggregate	0.7	2.5	4.9
High Yield	0.8	2.4	5.5
Senior Loans	0.5	1.0	2.2

Source: FactSet, FTSE NAREIT, Voya Investment Management

higher. We also stand by our predictions that the yield on ten-year U.S. Treasuries will end the year at 3.25% and that the euro zone will generate GDP growth of 0.5% for 2014. In addition, we affirm our U.S. GDP growth forecast at 3% despite the disastrous 2.9% contraction in the first quarter; positive domestic trends and the broadening global economic expansion should more than compensate for the worse-than-expected first quarter print, which is also highly prone to revision.

A few of the insights from our 2014 forecast, we shamelessly note, have already come to pass. For example, the Fed taper and Washington brinkmanship were nonevents. The pace of improvement in the U.S. job market exceeded even our optimistic expectations, as the unemployment rate dipped to 6.1% — below both our year-end projection of 6.25% and the Fed's 6.5% threshold for reconsideration of zero interest rate policy — with June's payroll data. "Europe will be compelled to institute or reinstate monetary stimulus" was fulfilled at the June 5 ECB meeting. Germany and the U.K. have been bright spots in an otherwise shaky Europe. Top picks global REITs and emerging market equities delivered first- and fourth-place returns, respectively, in the first half of 2014. And our "tectonic shifts" continue to shape the global economy, as we discuss in more detail below.

Tectonic Shifts Have Major Impact on First Half

Our tectonic shifts (energy, technology, frontier markets, global trade) have been catalysts for economic growth in the first half of 2014, even more than the market is currently discounting.

- In **energy**, the U.S. is increasing exports of oil and gas and decreasing its imports at a faster rate than the market expected. A recent decision by the Obama administration has cleared the way for exports of unrefined American oil; though the U.S. placed a ban on selling crude oil overseas after the Arab oil embargo four decades ago, limited export shipments could begin as early as August under the new rules. Because of the momentum in the energy renaissance, we expect the trade deficit that has persistently detracted from the country's growth since 1975 will turn into a surplus within two years.
- In **technology**, meanwhile, big data, the cloud, robotics and smart factories are but a few examples of the tech developments impacting every economic sector and creating top-line, bottom-line and quality-of-life opportunities considered far off even a short time ago. The drive for transformative products and ideas has also been instrumental in the wave of global M&A deals — volume in the first half of 2014 hit $1.7 trillion, a 75% rise over last year and the highest since before the recession.
- **Frontier markets** continue to gain traction and attention, though they remain somewhat under the radar when it comes to the global search for yield and growth opportunities. But investors are increasingly taking note, as the MSCI Frontier Market Index was up 26% last year and is up more than 20% year-to-date 2014. Meanwhile, astute U.S. companies are increasing their reach into these markets and their ever-increasing consumer bases.
- With developed economies mired in slow growth coming out of the recession, **global trade** has been under pressure, though the so-called "south-south"

After a Surprising First Quarter, Corporate America Is Poised to Deliver Eighth Consecutive Quarter of Year-Over-Year Earnings Growth

Sector	Reported		Earnings Growth			Earnings Surprise		
	Actual	Total	Percent	Positive	Negative	Percent	Positive	Negative
Telecommunication Services	5	5	31%	3	2	3%	3	2
Utilities	30	30	23%	24	5	9%	24	6
Health Care	54	54	8%	31	22	8%	36	15
Consumer Discretionary	84	84	4%	52	29	5%	58	22
Information Technology	65	65	2%	39	25	7%	51	9
Industrials	64	64	1%	42	22	4%	49	13
Consumer Staples	41	41	1%	26	14	0%	21	14
Materials	31	31	-2%	15	14	4%	20	6
Energy	44	44	-3%	25	18	8%	36	8
Financials	82	82	-4%	47	31	3%	50	27
S&P 500	**500**	**500**	**2.1%**	**304**	**182**	**5%**	**348**	**122**

Note: Earnings Growth is the percentage change in the cumulative share-weighted EPS earnings from that of a year ago. Earnings Surprise Percent is the share-weighted average of the ratio of actual company earnings vs. the consensus estimates.

Source: Bloomberg, Standard & Poor's, FactSet

trade — i.e., trade between emerging markets — is booming. According to a recent McKinsey study ("Global Flows in a Digital Age" April 2014), south-south trade in 2012 stood at $4.2 trillion, or 24% of the $17 trillion global trade market; in 1990, this figure was roughly $200 billion, or 6% of total flows.

Midyear Portfolio Recommendation

The biggest surprise at the midyear is the pervasive fear that continues to dominate investor behavior. A defensive portfolio consisting of U.S.-only equities and near-cash fixed income investments has been anything but effective; as we've said any number of times, building wealth while mitigating adverse outcomes requires an effective diversification plan that features meaningful and broad exposures to a full spectrum of markets. Fixed income was the best performing asset for most of the first half, offsetting the volatility we saw in equity markets to open the year; in fact, this is the long bond's primary role in a portfolio. Meanwhile, riskier equity classes like global REITs outpaced more commonly held assets like domestic large caps.

We expect the broadening global economic expansion we saw at the beginning of the year will continue throughout the second half, and we advocate an equity exposure to match. Risks abound, of course, highlighting the importance of fixed income as attractive downside protection; for example, we remain concerned about the "shadow banking" system — nonbank financial intermediaries that provide bank-like services but lack explicit access to central bank liquidity or other federal backstops — which is particularly pervasive in China. That said, with valuations compelling and tectonic shifts providing catalysts for growth, markets should continue to march forward in the second half despite certain investors' insistence on waiting for the "next pullback" to return to a normal allocation.

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