

Investment Perspectives

MARKET PREVIEW
JANUARY 2015

INTRODUCTION

GREGORY J. LEONBERGER, FSA, EA, MAAA, MANAGING PARTNER, DIRECTOR OF RESEARCH

Similar to previous years, we offer our annual market preview newsletter. Each year presents new challenges to our clients, and 2015 is no different: U.S. equities are at all-time highs, uncertainty reigns for international equities, and to everyone's surprise, interest rates fell dramatically in 2014...but are poised to rise from historic lows over the next year. In the alternative space, real estate remains a solid contributor to portfolio returns, and private equity delivered on return expectations, though dry powder is on the rise. Hedge fund results were mixed, but have shown to add value in past rising interest rate environments. Further macroeconomic items that bear watching for their potential impact on capital markets include the precipitous fall in oil prices, the strengthening U.S. dollar, job growth, and international conflicts.

Each of the following articles contains insightful analysis and key themes to monitor over the coming year, themes which will underlie the actual performance of the asset classes covered. Recognizing that many of our clients may not have time to cover the following 25 pages of material, we offer the primary conclusions for each asset class heading into 2015:

- U.S. economy: Expected to grow between 2.5 – 3% in 2015. Overall sentiment is positive and inflation should remain low.
- U.S. equity: Given the massive run of the last three years expectations should moderate, though overall outlook is still positive. Investors may want to consider rebalancing if their allocations exceed targets.
- Fixed income: Though rates are expected to rise, better to remain in core mandate versus trying to time the rate hike by shortening duration. High yield and bank loan rallies are not yet over and emerging market debt offers diversification and yield opportunities. For those who can handle lower liquidity and additional credit risk, direct lending and distressed debt could be meaningful portfolio additions. **CONT...**

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"...the following articles contain insightful analysis and key themes to monitor over the coming year, themes which will underlie the actual performance of the asset classes..."

- International stocks: Developed equities likely to be assisted by easy monetary policy on behalf of the Bank of Japan and the ECB; emerging market equity returns will diverge based on exposures to commodity prices and the U.S. dollar.
- Hedge funds: Prior tightening cycles have created attractive alpha opportunities for hedge funds and the upcoming interest rate rise may lay the groundwork for strong returns.
- Private equity: Exit activity was very strong in 2014 which benefitted investors. Going forward, returns are expected to be solid, though perhaps a bit muted relative to the last few years of booming returns.
- Real estate: 2014 returns expected to be north of 10%, with 2015 return expectations around 8%. Income to represent a larger portion of the return as cap rate compression expected to slow and occupancy continues to rise.
- Infrastructure: Institutional interest continues to grow and more assets expected to come on the market.
- Commodities: The price of oil combined with the strength of the U.S. dollar will have the most influence on returns in 2015.

We hope that this set of articles can assist you and your committees as you plan for 2015. Should you have any questions about any of the content, please feel free to contact myself or any of the authors or consultants here at Marquette. We also have a webinar available on demand via our website if you would like to hear a high level presentation of the topics presented in these articles. Happy New Year! ▀

U.S. ECONOMY: Continued Modest Growth

JEFFREY HOFFMEYER, ANALYST

“Ultimately, when the Fed raises interest rates will have the biggest impact on the economy...”

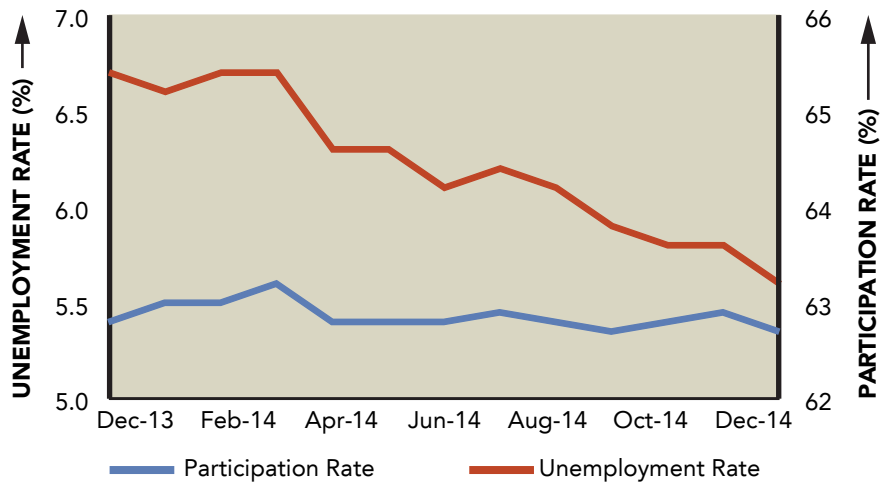
Going into 2015 the U.S. Economy appears poised for another year of moderate growth. Not counting the poor first quarter of 2014 due to the unusually harsh winter, GDP growth has been modestly strong, exceeding 2.5% in 5 of the last 7 quarters. Though there are always reasons to be pessimistic, most indicators suggest GDP growth will continue at a similar pace through 2015.

Domestically, the biggest uncertainty for the coming year is Fed policy and its impact on interest rates. In October, the Fed formally wrapped up its quantitative easing program, which saw the size of the central bank’s balance sheet grow from a pre-crisis level of \$800 billion to almost \$4.5 trillion. Given the progress of the economy’s recovery, the Fed can now once again focus on its more traditional policy tool of manipulating short-term interest rates. Janet Yellen and the Fed have pledged to keep the Fed Funds rates low for a “considerable” period of time. Investors have loosely interpreted such Fed-speak to mean that the first rate hike is likely to occur sometime in the second half of 2015.

The two biggest factors the Fed considers for its rate increase decision are unemployment and inflation. Initially, the Fed stated that it would raise rates once unemployment fell below 6.5% or when inflation reached 2.5%. However, when unemployment dropped more rapidly than expected the Fed abandoned this approach as many felt the economy was far from fully recovered. This past year the number of total people employed surpassed its previous high set in November of 2007, adding back the 8.5 million jobs lost due to the recession. However, this is somewhat misleading as there are two additional factors that should be taken into account when discussing the improvement in employment. The first is population growth. To achieve the same unemployment rate as November 2007, which was 4.9%, total employment would need to increase by about 1.3 million to around 149 million. The second, and much larger factor, is the difference in participation rate, which measures CONT...

labor force as a percentage of the total population over 16. Prior to the recession the participation rate was 66%, and it has steadily declined since then to 62.7%. To look at it another way, the civilian population has grown by about 16.1 million people but the labor force has only grown by about 2.3 million. All else being equal, if the participation rate today was 66% unemployment would be at 10.3%. At this level roughly 9.2 million additional jobs would be needed to reach the pre-recession unemployment rate.

Exhibit 1: Improving Labor Market

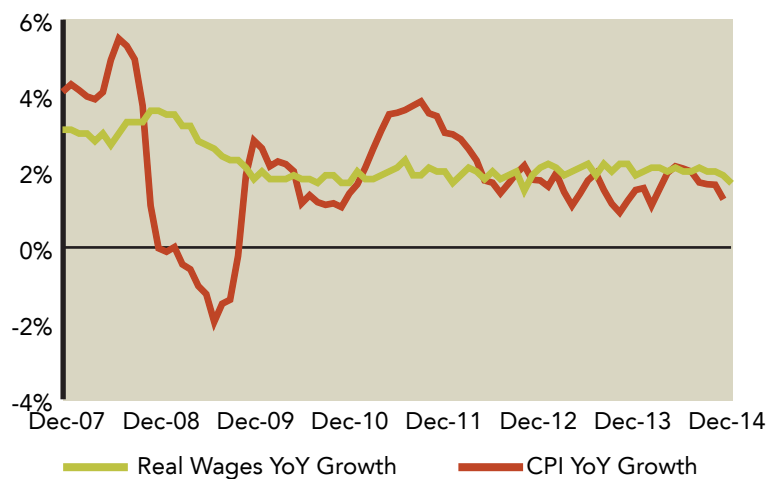


Source: Bureau of Labor Statistics

The good news is the participation rate appears to have stabilized while unemployment continues to decline. Between the end of the recession through late 2013, much of the decrease in unemployment was caused by a corresponding drop in the participation rate. But as exhibit 1 shows, during 2014 the participation rate did not materially change while the unemployment rate dropped nearly 1%. Due to changing demographics, such as baby boomers retiring and students remaining in school for a longer period of time, it is unlikely that the participation rate will return to pre-recession levels anytime soon. However, it is possible that participation will increase as unemployment continues to drop and more discouraged workers attempt to rejoin the workforce. Going forward we expect the participation rate to be roughly the same with a chance for a modest increase in 2015. Any increase will cause the drop in unemployment to slow, which we expect to end the year between 5% and 5.5%.

The Federal Reserve's other major indicator, inflation, has been relatively flat since the Great Recession. Over the past three years annual inflation has averaged 1.6%, well below the Fed's tolerance level of 2.5%. This low rate of inflation has been largely due to real wage growth hovering around 2% during this timeframe, as shown in exhibit 2. It should be noted that the current streak of 50 consecutive months of wage growth is the longest of the post World War II era. However, the roughly 2% year over year growth is approximately

Exhibit 2: Wage Growth Flat and Inflation Still Low

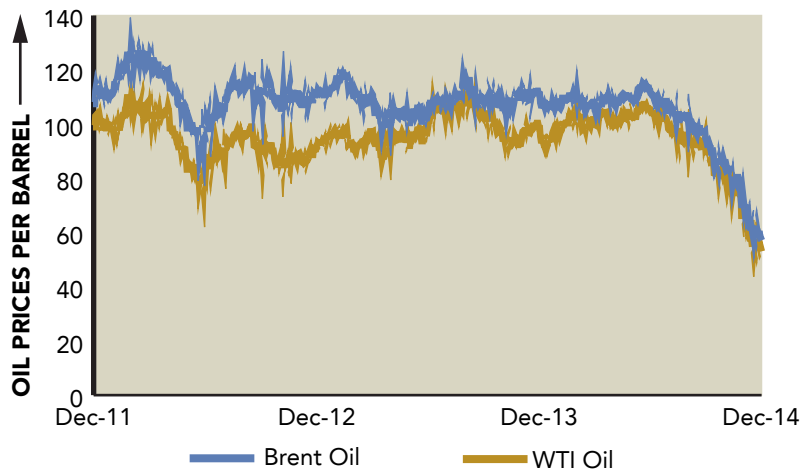


Source: Bloomberg

half of the typical extended wage growth over such a time period. Though there are always concerns that inflation will fall too low, most economists and the Fed seem to be comfortable with these levels. Given that wages have remained flat and show few signs of changing, it is unlikely that inflation will pick up in 2015. Since inflation is not likely to be an issue in the near term, this may lead the Fed to maintain low rates longer than expected. CONT...

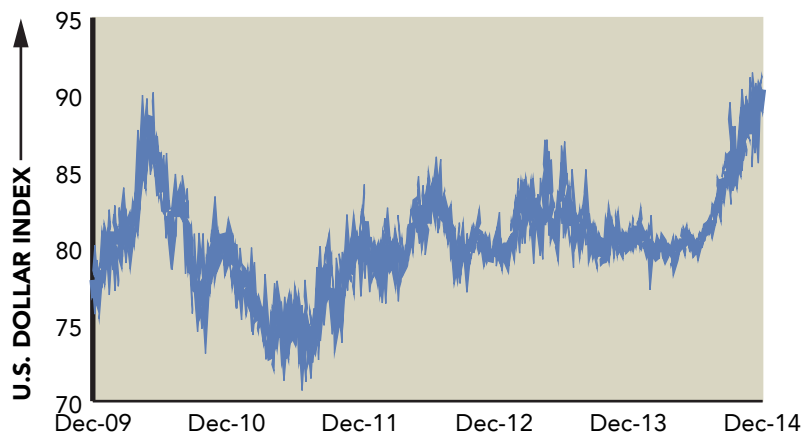
A further source of downward pressure on inflation has been the dramatic drop in the price of oil, which is one of the major components of CPI. Since June, the price of oil has declined over 50% to below \$50 per barrel. This drastic drop is the result of increased U.S. oil production and OPEC's refusal to cut its oil production. Countries such as Iran and Russia have suffered the most from the depressed oil prices and thus wanted to decrease the supply of oil, while Saudi Arabia wants to maintain its market share and reduce competition by keeping prices low. Where oil prices will go from here and how it will affect the U.S. economy is hard to predict. The U.S. oil industry adds \$1.2 trillion to U.S. GDP and supports 9.3 million jobs, but any business that relies on gasoline will see its costs decrease. Even if the oil industry in the U.S. takes a hit, the overall economy is likely better off with lower prices. Unless OPEC is able to come to an agreement to cut oil production we are unlikely to see \$100 per barrel again anytime soon, with most analysts predicting it will stabilize between \$45 and \$60.

Exhibit 3: Falling Oil Prices



Source: Bloomberg

Exhibit 4: U.S. Dollar Appreciating



Source: Bloomberg

Among developed economies the U.S. appears better positioned to grow while Europe and Japan both continue to face sluggish growth. The most recent IMF forecast gives the Euro Area a 38% chance of recession in the first half of 2015, compared to just a 14% chance for the U.S. However, if Europe does go into a recession, this will likely slow any domestic expansion in the U.S., given the integration of economies across the globe.

With U.S. growth expectations much more positive than the rest of the developed world, it should come as little surprise that the U.S. dollar has appreciated significantly over the last six months. Exhibit 4 is an index that tracks the relative strength of the dollar to other currencies, and we see a spike in the dollar's value, particularly over the last year. The reason for this dramatic increase is primarily due to investors' beliefs that the U.S. has better growth potential compared to the rest of the world. Additionally, the Fed is expected to raise rates more than other countries' central banks, which should cause the U.S. financial markets to outperform. cont...

Given all of these factors, we believe the economy is positioned for another year of moderate growth. Ultimately, when the Fed raises interest rates will have the biggest impact on the economy, and while there is a good chance it will occur next year, such a rate rise is far from guaranteed. All things considered we believe that GDP will grow between 2.5% – 3% for 2015, therefore continuing the stream of relatively consistent growth since the recession. ▀

FIXED INCOME: **Planning for the Rate Hike**

BEN MOHR, CFA, SENIOR RESEARCH ANALYST

“While we cannot know for sure if the rate hike will occur in 2015, we can position our portfolios as optimally as possible in the event that it does occur.”

Introduction

2014 was a year of many surprises for fixed income investors. The 10-year Treasury yield started the year at 3% with a projected rise to 3.5%, but instead declined to 2.2% by year-end. Reasons for the drop include the taper and eventual conclusion of quantitative easing (QE), geopolitical events like Russia’s annexation of Ukraine, Argentina’s bond default, Bill Gross’s departure from PIMCO and most recently, the drop in oil prices. Collectively, these events triggered a flight to quality and thus positive returns for U.S. Treasuries in 2014, most notably long Treasuries, which returned an unprecedented 25% for the year. As the yield curve continues to flatten, spreads head in the direction of all-time tights, and inflation and unemployment approach their desired levels, the following article offers our guidance for the fixed income market in 2015.

Core/Investment Grade

For investment grade allocations, we recommend that our clients maintain a core mandate as the fixed income portfolio’s anchor to diversify across maturities. As the U.S. economy continues to improve and unemployment drops while inflation rises, the Fed will be expected to hike rates, which will lead to the long-awaited selloff in U.S. Treasuries. Given this expected rate movement, it is tempting to shorten duration to minimize the subsequent price losses from higher interest rates. However, timing a rate rise from an investment perspective is notoriously difficult and as we have [documented](#) before, investors are better off maintaining a core strategy instead of trying to tactically time the rise in rates and overweighting positions on the short end of the curve with intermediate or short duration strategies. Looking beyond the Treasury component of core strategies, we are monitoring the following items:

- The securitized sector continues to face low mortgage rates. As rates rise, prepayments will decline and mortgage rates will start to rise, depressing existing MBS prices, but providing higher yielding new MBS issues.
- Corporate investment grade bonds have seen record issuance as issuers lock in low rates. Spreads are tighter than historical averages but have widened recently, providing opportunities for gains through spread compression.

While it would be imprudent to expect outsized returns from core bonds in 2015, we believe a consistent approach with a core strategy instead of tactically shortening duration in anticipation of the rate hike is a superior strategy.

Risk Credit

Risk credit asset classes such as bank loans and high yield continue to benefit from their spread cushions. While 2014 saw spread compression in the first half, the spread widening of the second half due to geopolitical events and the fall in oil prices provides new opportunities going into 2015. [CONT...](#)

Bank Loans

Bank loans returned 3% through November, but then retreated 1% in December due to concerns over oil prices for a total return of 2% during 2014. Following record inflows in previous years, bank loans have experienced outflows recently due to investors' concerns about an imminent rate hike. Spreads tightened for the first half of the year, but widened in the second half due to disappointing economic numbers - both in the U.S. and the rest of the world - as well as geopolitical events and the drop in oil prices. The year saw continued credit deterioration in the form of greater cov-lite issuance and 2nd lien issuance. As rates rise, we can expect more inflow leading to further spread tightening and credit deterioration, ultimately leading us closer to a bubble. But for the time being, our recommendation is to neutral-weight bank loans given that their yields are still greater than those of core bonds and key indicators suggest the asset class is not yet overheated.

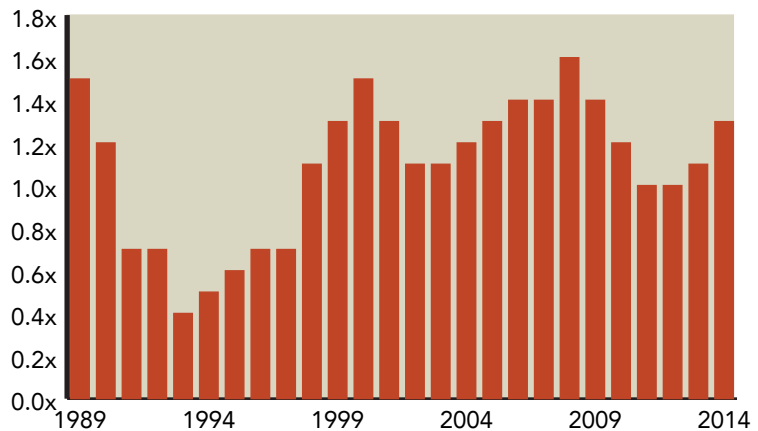
Moreover, while much has been discussed about the record amount of bank loans outstanding - which has exceeded well beyond pre-crisis levels in nominal terms - lenders have improved their ability to handle such leverage. With the rise in mandatory Tier 1 Capital levels for all U.S. banks, the ratio of bank loans outstanding to Tier 1 Capital is still relatively low compared with pre-crisis levels as shown in Exhibit 1.

Finally, during the previous rate hike in 2004 - 2006, bank loan inflows rose as investors gradually realized the benefit of their floating rates as shown in Exhibit 2. We can expect to see that happen again if the rate hike occurs in 2015. Both institutional as well as retail investors, realizing that the rate hike is really happening—when it does happen—are expected to reverse the outflow trend from the second half of 2014 and increase inflows into bank loans again throughout the rate hike. Such action should be accretive to bank loan prices, and by extension, returns. Our recommendation is neutral-weight for bank loans as we head into 2015.

High Yield

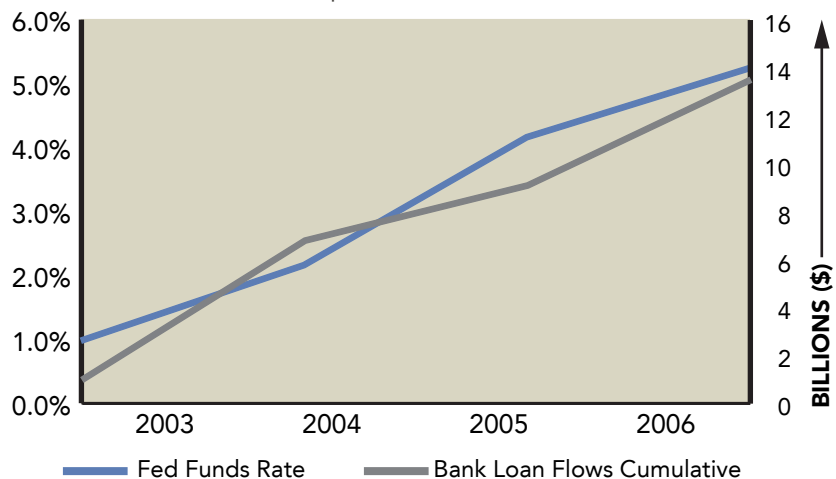
For high yield, our recommendation is neutral-weight as well. The "Goldilocks economy" continues, wherein growth that is not too fast or too slow creates a perfect environment for high yield. Like those for bank loans, high yield spreads tightened in the first half of 2014 but widened in the second half for the same reasons. High yield returned 4% through November and 2.5% for all of 2014, and yields are now at 6.7%. CONT...

Exhibit 1: Bank Loans Outstanding Over Tier 1 Capital



Source: Bloomberg. Note: Based on 1000x bank loans outstanding over combined U.S. banks' Tier 1 Capital

Exhibit 2: Bank Loan Inflows Expected to Rise in Rate Hike



Source: Pacific Asset Management, J.P. Morgan

While record high yield issuance has continued, other key indicators of the market's frothiness still point to a relatively benign environment. Exhibit 3 shows some of these key metrics at some key dates over the last five years: the peak of the financial crisis in June 2008 (between Bear Stearns' collapse in March 2008 and Lehman Brothers' collapse in September 2008), the trough of the recession in June 2009, and the latest data.

The color coding is relatively straightforward in the chart: green is indicative of attractive market data, yellow is moderate, and red is a sign of risk. In general, we see more green and yellow than red so, generally speaking, bank loans and high yield continue to offer opportunities to investors.

If we dig a bit deeper into the data, we can see that high yield bond issuance used towards leveraged buyouts and dividend payouts was at a high of 47% during the crisis, dropped to 4% in 2009, and has continued to drop to 2%. The issuance of high yield pay-in-kind bonds¹ was at a high of 16% in June 2008, dropped to 2% in 2009, and is still low at 3%. A similar trend can be seen for the issuance of CCC (the most risky) high yield bonds. Furthermore, while high yield issuers' average leverage ratio - issuers' debt divided by cash flow - has climbed to a relative high of 4.0x, coverage, which is the issuers' multiple of its cash flow over interest expenses, has risen to a solid high of 4.4x, due to issuers locking in low interest rates over the last five years. Finally, while the recent drop in oil prices is a significant headwind for energy companies that comprise 15% of the high yield index, the remainder of high yield issuers who have oil in their cost structure should benefit. In 2015, we expect further spread tightening, which will benefit high yield investors.

The Rate Hike and Fixed Income: Where to Hide?

Given the impending rate hike, where can we hide within fixed income? The answer is to diversify out of U.S. fixed income into the rest of the world, namely, emerging markets debt (EMD). For those with higher risk tolerance and lower liquidity needs, private credit - both direct lending and distressed debt - may offer some additional benefits.

Global Fixed Income

We recommend underweighting global fixed income mandates and related strategies such as international fixed income and Global Agg Ex-U.S. because most of the real yields for developed non-U.S. countries are negative, as shown in Exhibit 4. In 2015, the carry trade is expected to continue especially as rates rise cont...

¹ Payment-in-kind bonds - "PIKs" - do not pay cash interest but instead pay interest in the form of additional principal added to the original principal.

Exhibit 3: Environment Still Attractive for Bank Loans and High Yield

	6/2008	6/2009	Latest
High Yield % of Use of Proceeds for LBO/Dividend (TTM)	47%	4%	2%
High Yield % of Pay-in-Kind Issuance (TTM)	16%	2%	3%
High Yield % of CCC Issuance (TTM)	33%	7%	10%
High Yield Leverage Ratio	3.4x	3.8x	4.0x
High Yield Coverage Ratio	3.6x	3.2x	4.4x
Bank Loan % of Use of Proceeds for LBO/Dividend (TTM)	56%	16%	31%
Bank Loan % of Cov-Lite Loans (TTM)	4%	8%	64%
Bank Loan % of 2nd Lien Loans (TTM)	5%	3%	9%

Note: Latest high yield %'s as of 12/2014, high yield ratios as of 9/2014, bank loan %'s as of 11/2014.

Source: Fort Washington, Bank of America Merrill Lynch, Deutsche Bank.

Exhibit 4: Negative Real Yields in Developed Non-U.S. Countries

	5-Year Real Yield	10-Year Real Yield
Europe	-0.9%	-0.4%
Japan	-0.8%	-0.4%
UK	-0.4%	-0.1%
Developed World (Aggregate)	0.3%	0.0%
United States	0.2%	0.5%

Source: Bridgewater Associates

in the U.S. and possible deflation in Europe causes defaults. We expect further European Central Bank (ECB) stimulus through covered bond and ABS purchases to potentially compress spreads. However, developed Europe spreads are already at historic tights, and it is uncertain what the magnitude of major stimulus there might be, or if such stimulus will even happen.

Emerging Markets Debt

For emerging markets debt, which returned 7.4% for 2014, our recommendation is to overweight and take advantage of this asset class with a blended mandate that invests in hard and local currency EMD as well as sovereign and corporate EMD. Investors should expect the rate hike to strengthen the dollar, hard currency EMD spreads to tighten, and local currency EMD spreads to widen. Investors should also monitor the ongoing increase in local currency EMD issuance as well as corporate EMD issuance. Hard currency EMD is currently yielding 5.6% and local currency EMD is at 6.4%, both well above the U.S. 10-year at 2.2% and European and Japanese negative real yields.

Private Credit – Direct Lending and Distressed Debt: Additional Opportunities

For investors who have less liquidity needs and can bear additional credit risk, private credit allocations to direct lending and/or distressed debt could provide some significant benefits. To begin with, private credit allocations offer protection from rising rates due in part to their non-correlation with U.S. Treasuries. For direct lending, we believe European direct lending offers the most compelling opportunity. Under Basel III, European banks continue their deleveraging and selling of loans, providing immense opportunities for specialty direct lenders, and continued ECB stimulus will support this space.

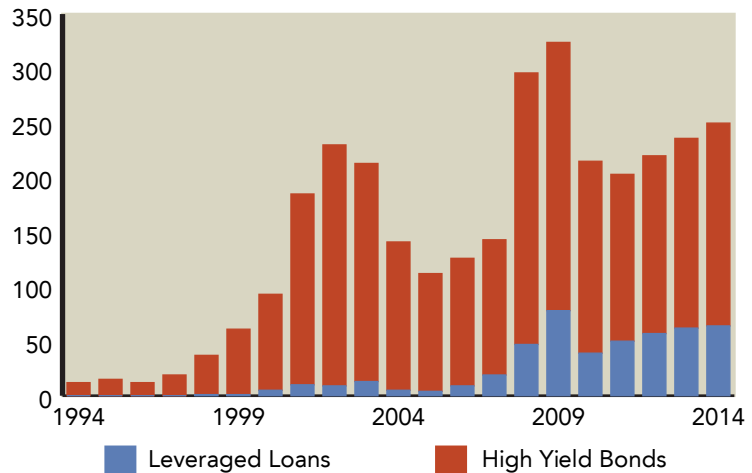
Finally, we recommend distressed debt for its ability to diversify sources of alpha. As we reach the end of the credit cycle, distressed debt managers will emerge to buy up troubled companies. The drop in oil prices has pushed one third of high yield energy issuers into distressed levels, resulting in more opportunities for distressed debt managers. Exhibit 5 shows the recent growth in outstanding debt rated CCC or below, which remains higher than pre-crisis levels. Ultimately, this should provide further return opportunity for distressed managers and investors.

Conclusion: Fixed Income Key Takeaways for 2015

While we cannot know for sure if the rate hike will occur in 2015, we can position our portfolios as optimally as possible in the event that it does occur. As such, we offer the following key takeaways for a fixed income portfolio in anticipation of a 2015 rate hike:

- Investment Grade: Neutral-weight, use Core versus Intermediate/Short Duration, diversify across maturities as the rate hike will have the most adverse effect on short-dated bonds.
- Bank Loan/High Yield: Neutral-weight, spreads are tight but have widened recently to provide opportunities, key indicators still show CONT...

Exhibit 5: Outstanding Debt Rated CCC or Below (\$ Billions)



Source: Credit Suisse

the market as not yet overheated.

- Global Fixed Income: Underweight, negative real yields.
- Emerging Markets Debt: Overweight, spreads are still wide, recent decline in oil and other commodity prices may provide tailwind.
- Private Credit (Direct Lending, Distressed Debt), if appropriate: Diversify out of public credit into private credit to reduce rate risk exposure, ECB stimulus to support European direct lending, recent decline in oil prices to provide distressed opportunities. ■

U.S. EQUITY: Changing Leadership

KELLI SCHRADER, CAIA, MANAGING PARTNER

"...the overall backdrop of steady corporate earnings, continued low inflation, and historically low interest rates generally bodes well for U.S. equity investments."

2014: Large Caps Lead the Way

The U.S. equity market ended 2014 with another year of positive gains, though there were some noticeable differences among styles and sizes. Large cap stocks, after more than five years of generally underperforming small caps, were the best performers. The Russell 1000 Value index turned in one of the best returns in 2014, up 13%. Small cap value, on the other hand, with steep declines in the third quarter, mustered just a 4% gain for the year.

While there were blips of market volatility in 2014 - mostly in the third quarter and early October - those down periods were short lived and followed by rapid rebounds. Among the S&P 500 sectors, defensive sectors like utilities and health care performed the best throughout the past year, while energy and materials, amid falling commodity prices and concerns over global growth, faltered. Energy, in particular, was the only S&P 500 sector to post a negative return, down 7% for 2014 after horrendous second-half performance.

In all, the S&P 500 reached record highs 53 times in 2014. When the closing bell rang on December 31, 2014, the S&P posted its third straight year of double-digit gains, a consecutive winning streak not seen since the late 1990s. That index has returned as astonishing 240% since the market low in March 2009.

Opportunities: Is There Anything Left in the Tank?

With yet another year of double-digit gains, the question going forward for the U.S. equity market is obvious: can this continue? Using traditional valuation metrics, areas of the U.S. market appear overvalued, while others still have room for appreciation. Exhibit 2 indicates each broad asset classes' current price-to-earnings ratio as a percentage of its 20-year average price-to-earnings ratio.

CONT...

Exhibit 1: 2014 Performance²

	Value	Core	Growth
Large	13.45%	13.69%	13.05%
Mid	14.75%	13.22%	11.90%
Small	4.22%	4.89%	5.60%

Source: Bloomberg

Exhibit 2: Current P/E Ratios as Percentage of the 20-Year Average

	Value	Core	Growth
Large	105.9%	94.4%	86.1%
Mid	116.2%	111.0%	91.5%
Small	111.9%	102.9%	91.4%

Source: JP Morgan

² Russell-style indexes with the exception of large core, which is reflected by the S&P 500 index

Analyzing this data, the most notable opportunities lie in large caps and growth stocks, which are trading at levels below their historical averages. By contrast, despite a lower absolute return this year, the Russell 2000 Value's current P/E is well above historical norms. We reiterate an important statement from last year's market preview concerning U.S. Equity: "We would encourage clients who have experienced large gains in their domestic equity portfolios to consider rebalancing per their investment policies." Given another year of positive performance from the U.S. equity market after last year's message, this message is all the more applicable for client portfolios entering 2015.

Concerns: What Could Derail the U.S. Market?

As we enter 2015, there are several potential roadblocks facing the U.S. stock market. While there are many positives about the current state of the domestic economy, we have outlined in the table below several positives and potential negatives we foresee in the year ahead.

Over the past year, there has been much speculation if, and when, the Federal Reserve would begin to raise interest rates. As the Fed's quantitative easing (QE) program came to an end in October, the Fed clearly sees positive signs of economic momentum in the U.S. Even if the Fed were to raise short-term rates in 2015, the immediate effect on the U.S. stock market is not likely to be a precipitous fall. Using history as a guide, Exhibit 4 shows the S&P 500's return for the six months following the start of a Fed rate-hiking cycle.

On average, the market, as measured by the S&P 500, returns nearly 4% in the short term following a rate hike. The notable exception on this table is September 1987, when the market fell 17% in the subsequent six-month period. As many might recall, that period includes the infamous "Black Monday" on October 19, 1987, when the Dow Jones Industrial Average dropped 508 points (22%) in one trading session. That aside, in general, the beginning of a rising-rate cycle does not spell doom and gloom for U.S. equities.

Moving on to analyze other potential roadblocks, the divergence of the U.S. economy from the rest of the world will likely be on the minds of many investors in 2015. Of particular interest is what effect, if any, negative news from abroad will have on U.S. companies. We saw this come to fruition, albeit briefly, in early October 2014. The IMF increased its probability estimate for a German recession, which sent U.S. large cap stocks tumbling. Normally, during a market downturn, large caps are seen as a flight to safety and protect capital more than their small cap counterparts. That was not the case during the October dip: With a large cont...

Exhibit 3: What Lies Ahead

Positives	Potential Negatives
Low historical interest rates	Europe falls into recession
Stable corporate earnings	Minimal U.S. GDP growth
Consumer confidence	Interest rate spikes
Low inflation	Political tensions in Russia/Middle East

Source: JP Morgan

Exhibit 4: Fed Rate Hike Table

Start of Fed Rate-Hiking Cycle	S&P 500 Return Over Next 6 Months
July 16, 1971	4.0%
August 31, 1977	-7.6%
September 26, 1980	11.0%
April 9, 1984	6.9%
September 4, 1987	-17.4%
February 4, 1994	-3.5%
March 25, 1997	26.3%
June 30, 1999	7.7%
June 30, 2004	7.2%
Average	3.8%

Source: S&P Capital IQ

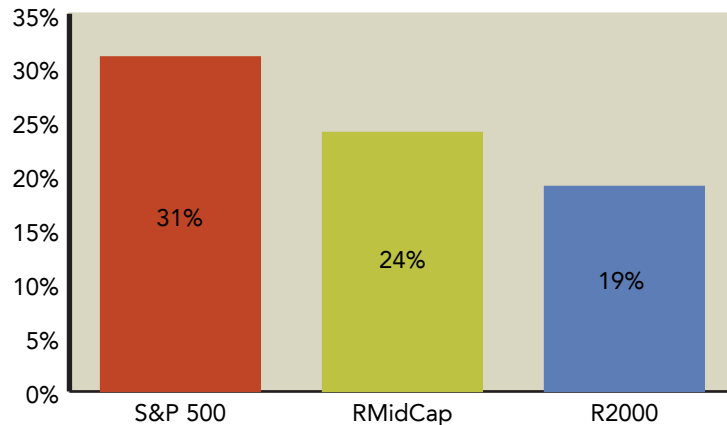
portion of corporate revenue derived from abroad, the S&P 500 fell nearly 3.5% during the first two weeks in October, while the Russell 2000 was down only 1%. Exhibit 5 shows the average percentage of non-U.S. revenue for several indexes. Companies within the S&P 500, for example, draw nearly a third of their revenue from abroad, while that number is just 19% for the Russell 2000's constituents.

As we enter 2015, a tepid European economy and slower growth in China could negatively impact U.S. large cap companies who rely on significant revenue from these areas. A continued strong dollar could also negatively impact revenue and earnings for these companies, particularly against the Euro.

What's Ahead: Corporate Earnings Estimates

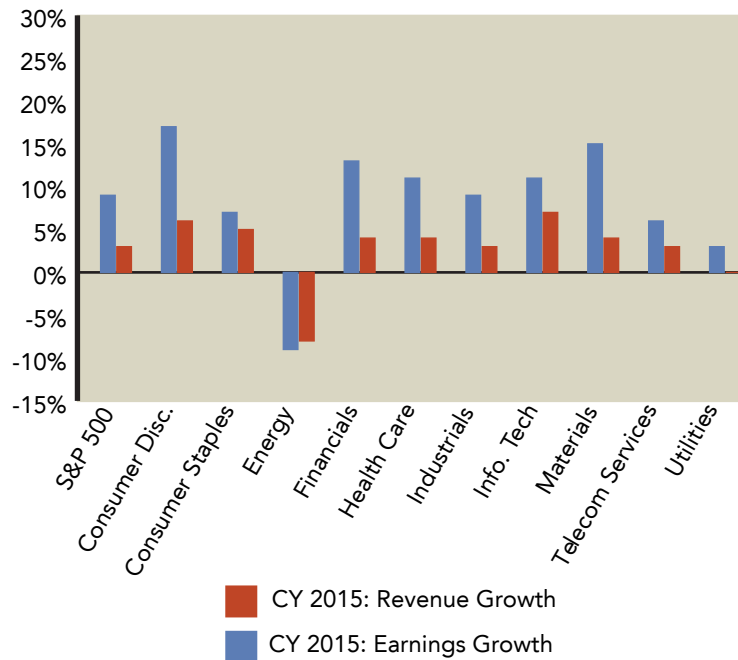
2015 calendar year earnings expectations for the S&P 500 sectors reflect several fourth quarter downward revisions, particularly in the energy sector. The estimate earnings and revenue growth for the S&P 500 is 8.8% and 3.0%, respectively, for 2015, as shown in Exhibit 6.

Exhibit 5: % of Non-U.S. Revenue



Source: Bloomberg, based on index constituents that break out revenue by geography.

Exhibit 6: S&P 500/Sector 2015 Revenue and Earnings Growth Estimates



Source: JP Morgan, Bloomberg

The energy sector, with a -9.2% estimated earnings growth, reflects a rapid negative downturn in expectations. In September, the overall predictions for the energy sector were a robust +7.7% for 2015. With the price of crude oil declining 50% since mid-June, analysts were quick to adjust their assumptions downward.

The counter effect to lower oil prices is the potential for increased consumer discretionary spending, as the average U.S. consumer will, in theory, have more dollars in his or her pocket for non-essential items. The consumer discretionary sector has the highest prediction with a 17% estimated earnings growth. That is an optimistic assumption, particularly because the sector delivered 2.5% in earnings growth during 2014. We caution investors to pay close attention to U.S. wage growth, which has remained stagnant at an average of 2% post-2008 recession. Other broad metrics such as retail sales and consumer confidence could indicate the strength of U.S. consumer spending in the year ahead. CONT...

Given the meteoric rise of U.S. stocks in the past five years and elevated valuation levels in some asset classes, we urge investors to moderate expectations going forward. While the U.S. economy appears stable in comparison to Europe and others, it may be difficult for U.S. stocks to decouple from negative foreign news in the year ahead. That said, the overall backdrop of steady corporate earnings, continued low inflation, and historically low interest rates generally bodes well for U.S. equity investments. Another year of positive high single-digit returns is certainly possible in 2015. ■

NON-U.S. EQUITY: 2015: A Year of Divergence

DAVID HERNANDEZ, SENIOR RESEARCH ANALYST

“...while much of the economic data in developed markets look bleak, the 2015 themes can support equity investors in this asset class.”

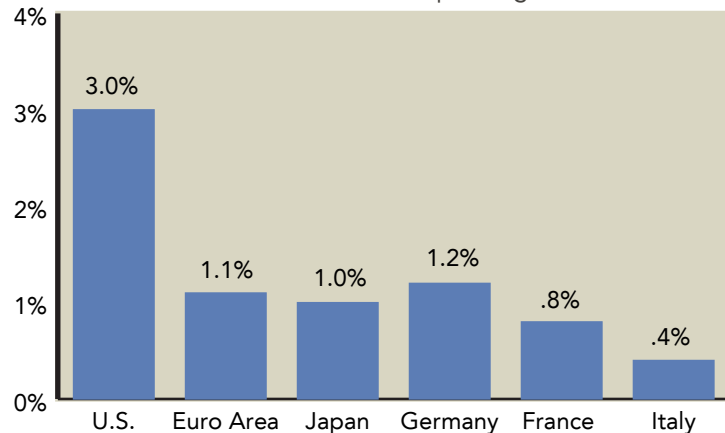
2014 was a challenging year for non-U.S. equity investors with developed stocks down 4.5% and emerging markets (EM) down 1.8%. In contrast, the S&P 500 generated a double digit return (13.7%) with several new index highs along the way. A strong U.S. Dollar in the second half of the year led to currency losses that significantly contributed to the underperformance. In fact, the EAFE local (6.4%) and EM local (5.6%) indices actually generated positive returns for the year. With the U.S. economy picking up steam and its international counterparts continuing to lag, we expect three key themes to influence international equity markets in 2015:

- Divergence: central bank policy and emerging markets
- Strong U.S. Dollar
- Weak commodity prices

As the last several years have proven, central banks can heavily influence equity markets; one does not need to look further than the U.S. for proof of this phenomena, as quantitative easing has most certainly contributed to the outsized returns from the U.S. equity market the last three years. Given the differences in projected economic growth, we expect the Fed to begin tightening this year while the European Central Bank (ECB) and Bank of Japan (BOJ) continue with their accommodative monetary policies. So while much of the economic data in developed markets look bleak, the 2015 themes can support equity investors in this asset class.

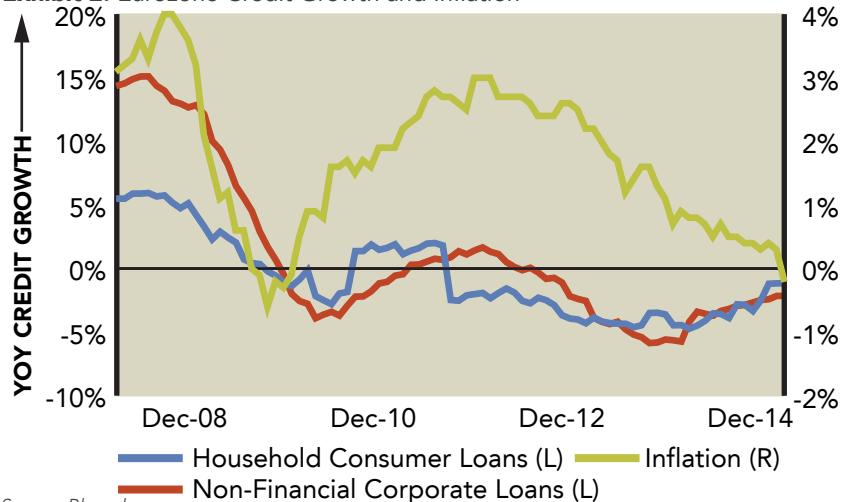
CONT...

Exhibit 1: 2015 GDP Forecast Select Developed Regions



Source: Bloomberg

Exhibit 2: Eurozone Credit Growth and Inflation³



Source: Bloomberg

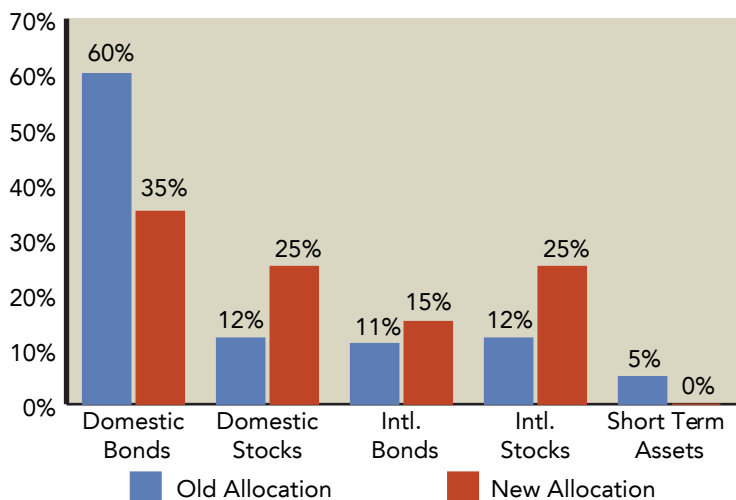
³ Inflation data through 12/31/14, credit data through 11/30/14

The Eurozone continues to face contracting credit markets and a build-up of deflationary pressures. Annual growth in corporate loans has been negative since 2012, while inflation has remained below the 2% target since the first quarter of 2013. Over the last couple of years the ECB delivered much lip service to these two issues but underwhelmed investors with the actual actions taken through the early portion of 2014. However, in the second half of the year the ECB aggressively introduced several stimulus measures including the TLTRO⁴, asset backed securities purchases, and a commitment to increase its balance sheet by 1 trillion Euros. While inflation has not improved, credit growth has begun to stabilize. Markets expect policy aggressiveness to continue into 2015 with the possibility of a quantitative easing program commencing as early as January 22nd.

While ECB action has at times underwhelmed, the same cannot be said for the BOJ, which under the influence of Shinzo Abe has bloated its balance sheet. The BOJ also became more aggressive in the second half of the year raising its government bond purchases by 30% after a first quarter increase to the country's consumption tax stymied economic growth. In addition, the Government Pension Investment Fund (GPIF), the world's largest pension fund with roughly \$1.2T in assets, announced its plan to increase holdings of domestic (Japanese) equities with an offsetting decrease to domestic bonds. The two actions meld nicely as the BOJ will purchase the government bonds that the GPIF needs to sell. Roughly \$187B of the plan's assets will be moved into global equity markets as part of the planned increase to equity allocations. In general, such a shift should help boost returns for international equities.

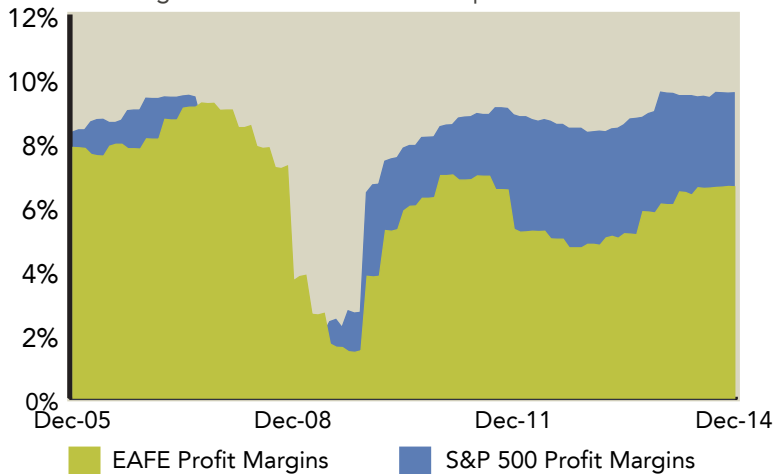
The widening differences in monetary policies and economic growth support a strong U.S. dollar in 2015. While a headwind for U.S. based investors, a weaker local currency can increase the profitability of companies, particularly heavy exporters who become more competitive in the global market. Profit margins have been much stronger in the U.S. and are at an all time high (9.6%). Conversely, non-U.S. developed market profit margins are 6.6%, below their long term average. Not surprisingly, this difference is one reason U.S. equities have outperformed the last cont...

Exhibit 3: Changing Portfolio Allocations for the GPIF



Source: GPIF, Japan

Exhibit 4: Profit Margins U.S. vs. Non-U.S. Developed



Source: Bloomberg

⁴ Targeted Long-Term Refinancing Operation – a program in which the ECB provides loans to Eurozone banks with a maturity date of September 2018. The goal of the program is to improve bank lending in the non-financial private sector of the Euro area.

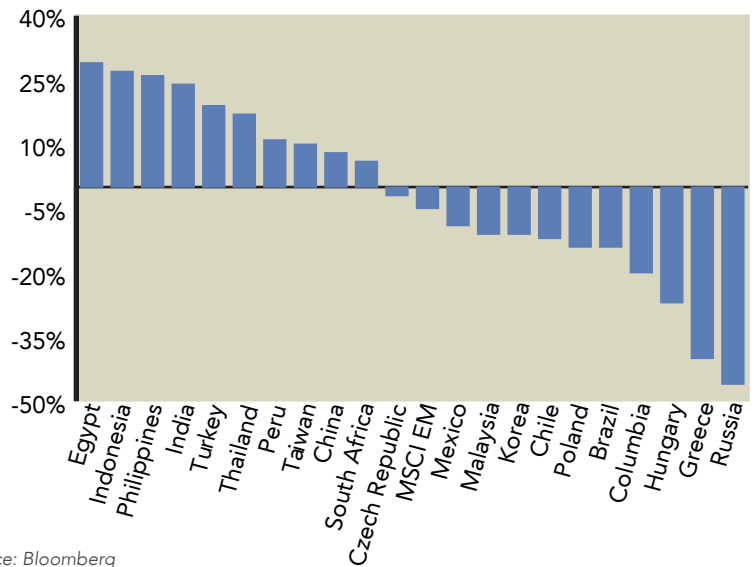
several years. An improvement in overseas profit margins should lead to stronger earnings which are supportive of higher international equity prices.

Emerging Markets

In 2014, emerging markets continued to produce wide ranging results in terms of political elections, structural reforms, economic growth, and equity returns. As an example, India returned 23.4% for U.S. investors after a favorable election, positive reform, and solid growth. In contrast, Brazil lost 13.7% in 2014 after the incumbent won the presidential race and GDP grew at a tepid 0.3%.

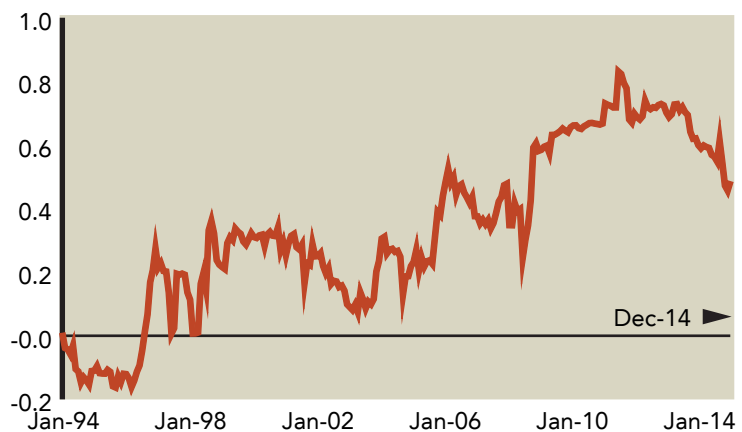
In 2015 we expect the variation in country performance to continue, the macro environment creating winners and losers across emerging countries. The recent fall in commodities' prices (including oil) is a phenomenon that is expected to continue into 2015 given the strength of the U.S. dollar. Historically emerging market equities have been highly correlated with commodity prices; however that correlation has begun to fall given the decline of the MSCI EM index's commodity exposure over the last seven years. In fact several countries stand to benefit from a drop in commodity prices, thus creating further differentiation within the asset class. CONT...

Exhibit 5: Country Returns for Emerging Markets⁵



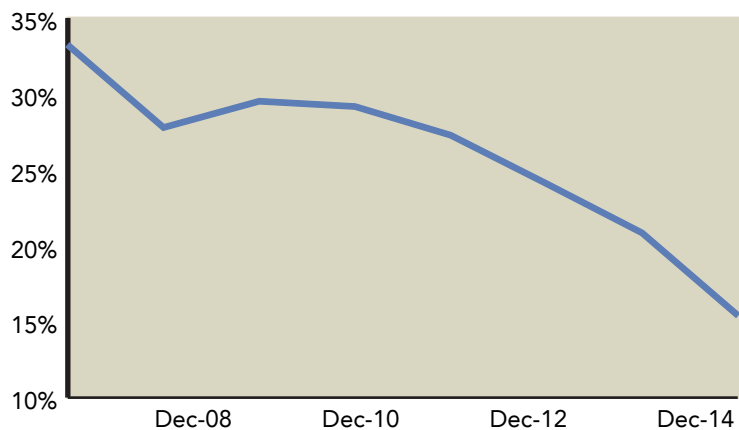
Source: Bloomberg

Exhibit 6: Rolling 3-Year Correlations Between EM Equity and Commodity Prices



Source: Bloomberg

Exhibit 7: Commodity Exposure for MSCI EM Index



Source: Bloomberg

⁵ Total returns in U.S. Dollars

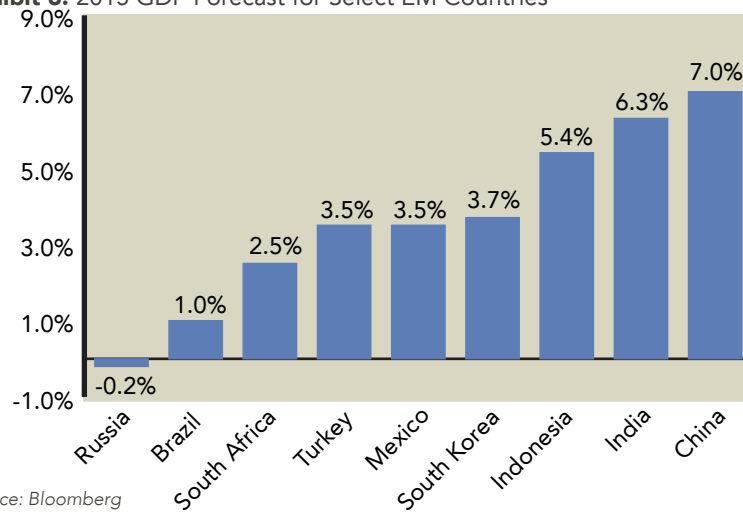
Significant variation also exists when examining projected 2015 GDP growth rates and current account balances. Given its heavy reliance on oil prices it is no surprise to see Russia projected to contract this coming year, however there are also several countries that are projected to grow by more than 3.5%. Current account balances vary from -6% of GDP in South Africa to 12.4% of GDP in Taiwan. From exhibit 9, it should be clear that major differences exist between emerging market countries and investors should expect significant variance in performance.

Valuation

On a trailing price to earnings basis non-U.S. equities offer better valuations compared to U.S. stocks. The S&P 500 and Russell 2000 trade at roughly 18% to 20% above their ten year averages. In contrast, the MSCI EAFE and MSCI EAFE small-cap indices trade between 2% and 6% above their ten year averages and the MSCI EM index trades 8% below its average. This is not surprising given the relative strength of the U.S. economy. Investors should note that lower valuations do not guarantee outperformance, especially in the short term, but they do provide better upside potential should economic conditions improve.

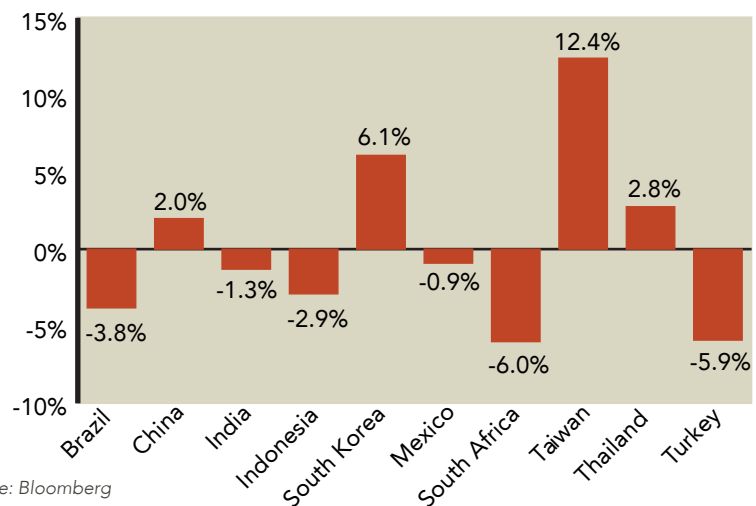
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Exhibit 8: 2015 GDP Forecast for Select EM Countries



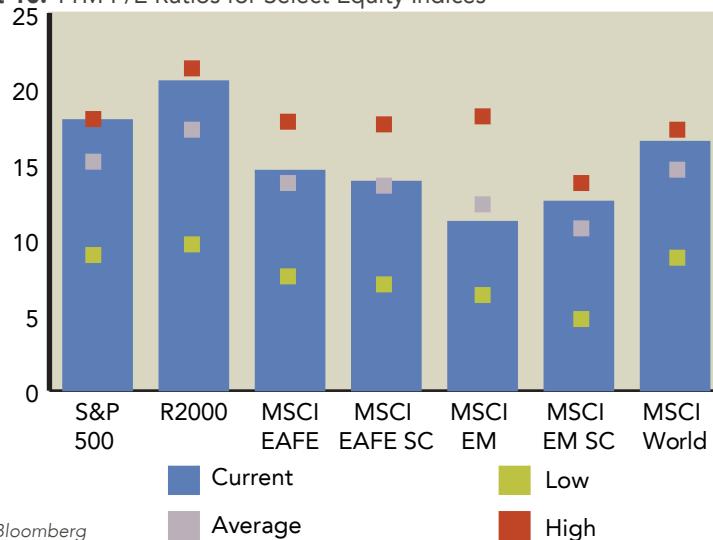
Source: Bloomberg

Exhibit 9: Current Account Balance – Measured as a Percent of GDP⁶



Source: Bloomberg

Exhibit 10: TTM P/E Ratios for Select Equity Indices⁷



Source: Bloomberg

⁶ Data as of 9/30/2014

⁷ Ten Years of monthly data from 1/31/2005 to 12/31/2014

Conclusion

Looking ahead, we anticipate divergence to prevail in 2015. The Fed remains on course to raise rates in the second half of the year while central banks in both Japan and the Eurozone are expected to continue their aggressive monetary policies. Differentiation amongst emerging markets will continue as countries cope with falling commodity prices and a strong U.S. dollar. While economic and earnings growth remain an issue for developed countries, there seems to be significant commitment to, and supply of, stimulus to facilitate positive equity returns. For emerging markets, the long-term investment thesis remains intact and current valuation levels are attractive. The asset class is prone to volatility; however this can provide compelling entry points and/or opportunities to rebalance. ■

HEDGE FUNDS: Return to the Good Old Days?

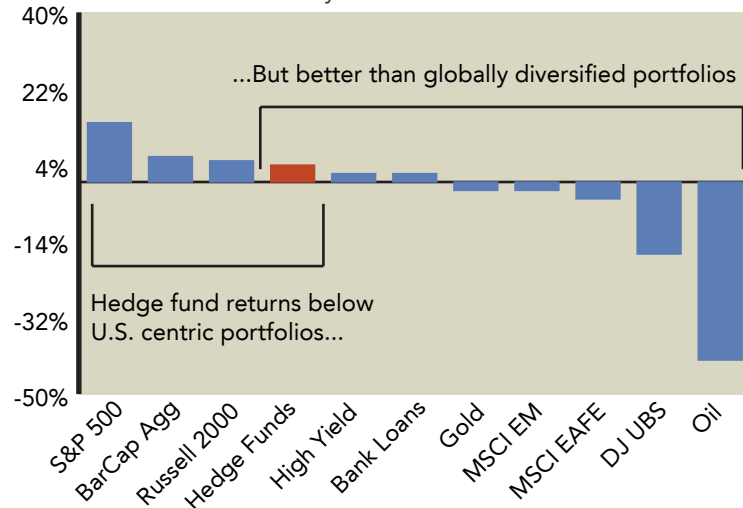
NAT KELLOGG, CFA,
ASSOCIATE DIRECTOR OF RESEARCH

All of the major hedge fund strategies generated a positive return over the course of 2014, but returns were muted with the best performing strategy (global macro) up just 6.38%. Compared to a traditional U.S.-centric 60/40 portfolio, hedge fund returns were fairly disappointing. However, when compared to a global mix of asset classes, hedge funds actually provided solid returns and good diversification (see exhibit 1). Global macro funds did well betting on a strong dollar; one of the most widely held trades during the year.

In our 2014 Market Preview we suggested that after a few lean years, managed futures could be due for a rebound in 2014. It took a few quarters to play out, (as shown in exhibit 2) but managed futures funds captured the bull market in bonds and the bear market in oil, thus generating strong returns, particularly during the second half of the year. CONT...

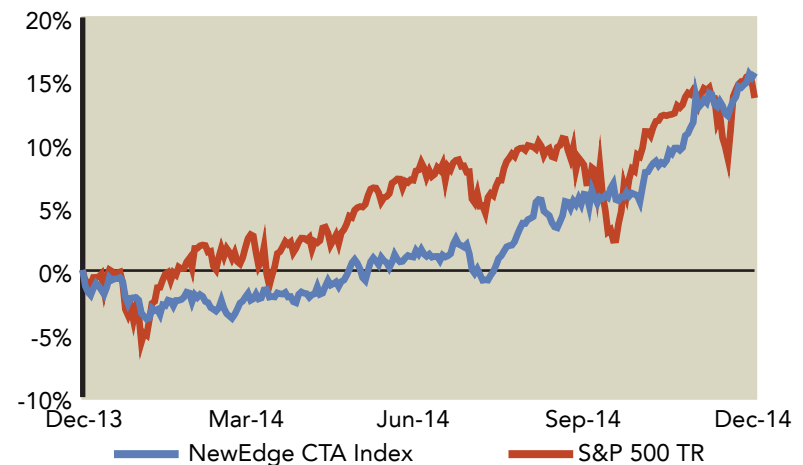
"The prospect of higher short term interest rates and widening credit spreads is likely to make for a bumpy ride ..."

Exhibit 1: Performance is in the Eye of the Beholder



Source: Bloomberg

Exhibit 2: Strong Performance from Trend Following Strategies

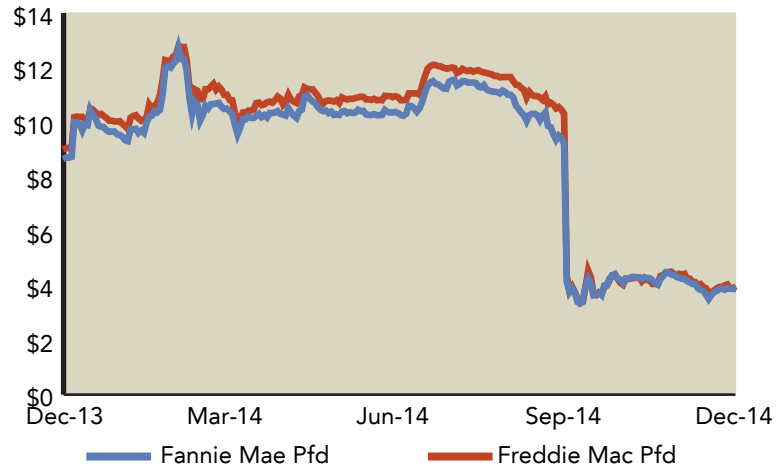


Source: Bloomberg

The most significant headlines from 2014 occurred in October when two very popular hedge fund trades collapsed. First, Fannie Mae and Freddie Mac preferred securities have been a prominent - and very profitable - holding for many hedge funds. The investment case was driven by a shareholder lawsuit claiming the U.S. government has unfairly received all profits from Fannie and Freddie since the financial crisis, at the expense of shareholders. An unfavorable court ruling for shareholders sent the preferred securities for both companies into a tailspin (see exhibit 3). October also saw the collapse of the AbbVie-Shire deal (exhibit 4) which was a widely held merger arbitrage position. Despite these disappointments, the merger and acquisition environment remains robust and continues to create opportunities for event driven managers.

Looking ahead to 2015 distressed debt focused funds may provide some compelling opportunities. After the crisis distressed debt was one the top performing strategies for a number of years. However, as economies have normalized and markets have risen, the number of defaults is at cyclical lows leaving distressed focused funds with little to do. However, widening high yield spreads, particularly for energy and low quality (CCC) issuers as shown in exhibit 5, indicate there may be trouble on the horizon, which typically translates into opportunities for distressed debt managers. CONT...

Exhibit 3: Unfortunate Events: Fannie/Freddie Preferreds



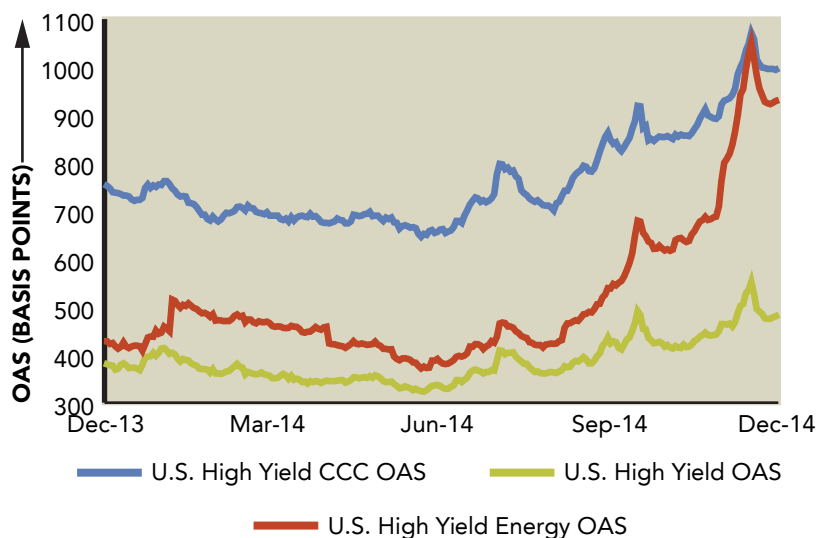
Source: Bloomberg

Exhibit 4: Unfortunate Events: AbbVie Shire Transactions



Source: Bloomberg

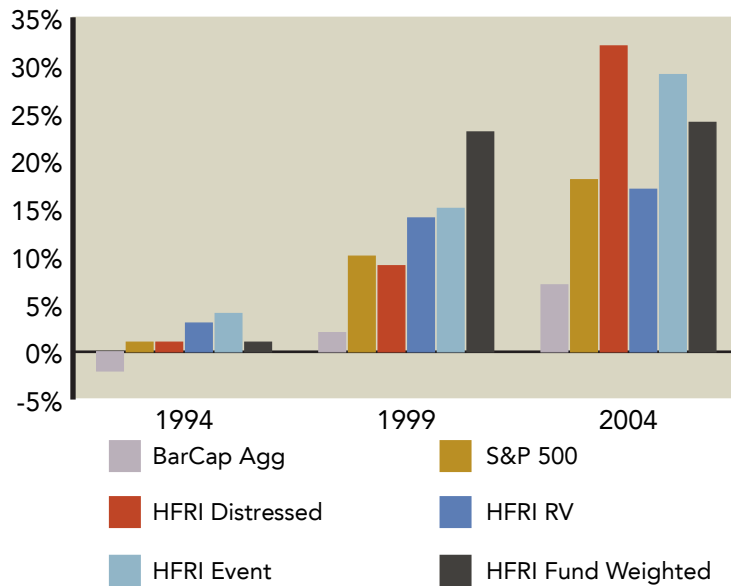
Exhibit 5: Distressing Situation Presents Opportunity



Source: Bloomberg

Lastly, it has been six years since the onset of the Fed's zero interest rate policy (ZIRP). However, it appears increasingly likely that the Fed will begin to raise short term interest rates at some point during 2015. As shown in exhibit 6, investors should note that hedge funds have done quite well, both on an absolute basis and compared to other asset classes, during the prior three Fed tightening cycles. Higher interest rates help hedge funds in two ways. First, a higher Fed funds rate leads to a higher short interest rebate, and second, the increase in rates also tends to create more dispersion across securities (some companies are better prepared for higher rates than others) and across asset classes.

Exhibit 6: Will Next Tightening Cycle Lead to Outperformance?



Source: Bloomberg, Marquette Associates

The prospect of higher short term interest rates and widening credit spreads is likely to make for a bumpy ride in 2015 for many asset classes. While there is no guarantee history will repeat itself, prior tightening cycles have created some attractive alpha opportunities for hedge fund managers, which could lay the groundwork for some of the best returns from hedge funds relative to traditional asset classes since the credit crisis. ▀

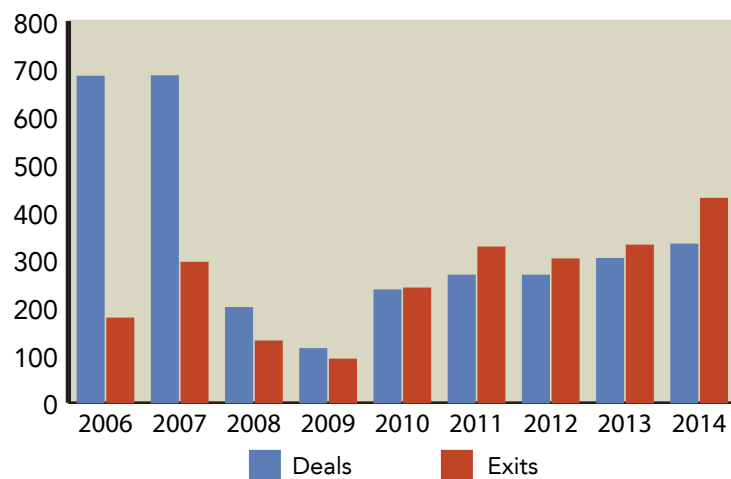
Private Equity:
I've got a fever and the only cure is more realizations

NAT KELLOGG, CFA, ASSOCIATE DIRECTOR OF RESEARCH

"...private equity still looks intriguing, even if future returns are likely to be a bit lower than previous years."

In last year's market preview we predicted that 2014 would be the "Year of the Exit". This turned out to be spot on as accommodative equity and credit markets led to a yearlong wave of selling activity from private equity firms. Exit activity was clearly strongest in the U.S. where the IPO market was wide open for both early stage venture backed firms and more mature buyout backed companies. Consequently, 2014 set a new all time record for exit activity with \$428 billion of exits during the year, up 29.7% from 2013. CONT...

Exhibit 1: 2014 the Year of the Exit



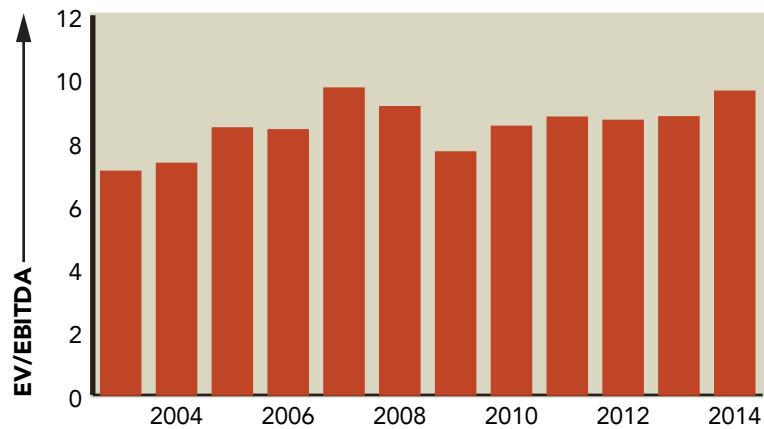
Source: Preqin

The private equity funds raised during the boom years, 2005-2008, have all completed their investment periods and are in the process of selling portfolio companies and returning capital to investors. So while exit activity in 2014 was partly due to timing, valuation multiples also played an important role. Strong public equity markets and accommodative credit markets have pushed purchase price multiples back to the lofty levels experienced at the prior peak in 2007, as shown in exhibit 2. As long as the public markets remain open we expect exit activity to be strong, but valuation multiples are clearly a concern for investors and managers putting fresh capital to work.

Exit activity was so strong in 2014 that it actually exceeded the amount of capital that was committed to new deals. As a result the private equity industry as a whole was actually a source of liquidity in 2014. This, in turn, has created a fairly robust fundraising environment as LPs are forced to make new commitments to maintain their overall allocation to the asset class. While fundraising remained strong in 2014, with total capital raised of \$322 billion, fundraising was actually down 7.4% from 2013. Despite a modest slowdown in fundraising global private equity dry powder hit a new all time high of \$987 billion, up 11.1% from a year ago.

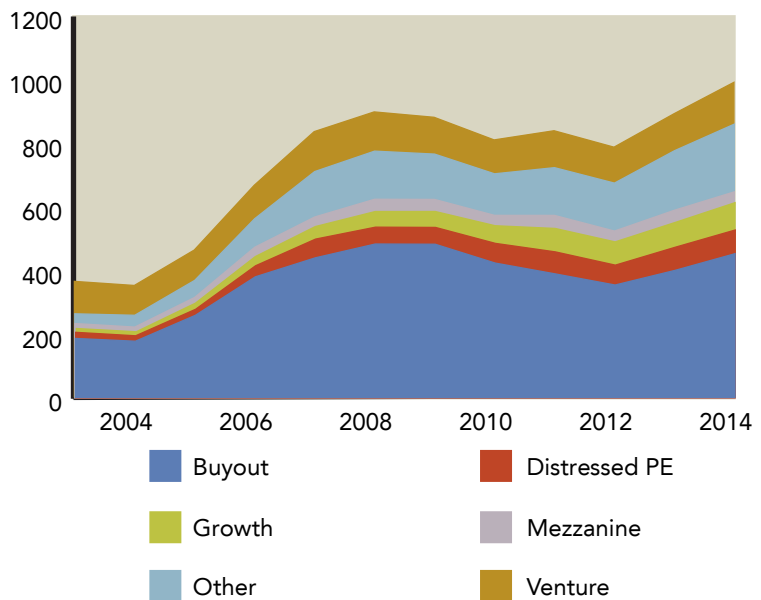
All of this exit activity is fabulous news for existing investors but does give us some caution as we look to the year ahead. Timing the private equity markets is just as difficult and foolhardy as timing the public markets, but high valuations and record amounts of dry powder are a concern. Two areas that still look interesting, however, are distressed funds and secondary funds. Distressed is clearly the more contrarian play since the U.S. economy seems to be strong and improving, but weakness in Europe, the energy sector, and widening credit spreads indicate that opportunities may materialize faster than people think. Secondaries are not the steal they were in the immediate aftermath of the crisis when existing interests could be picked up for as little as 50% of net asset value. While the discounts to fair value today are admittedly modest, the secondary sector appears to be one of the few areas of the PE market where there is better balance between the amount of capital being cont...

Exhibit 2: Rich Valuations: Purchase Price Multiples



Source: S&P Capital IQ

Exhibit 3: Global Private Equity Dry Powder (\$ Billions)



Source: Preqin

raised and the size of the overall market opportunity.

Lastly, we would note that on an absolute basis the last few years have been excellent for private equity, though relative to public markets the returns look less impressive. But it is important to remember that while 2006 and 2007 vintage funds did not produce great returns, relative to public markets they did much better than 2009 and 2010 vintage funds. While it is impossible to know what lies ahead, from an allocator's perspective, private equity still looks intriguing, even if future returns are likely to be a bit lower than previous years. ■

REAL ESTATE: Another Solid Year

OLU ROSANWO, CAIA, SENIOR RESEARCH ANALYST

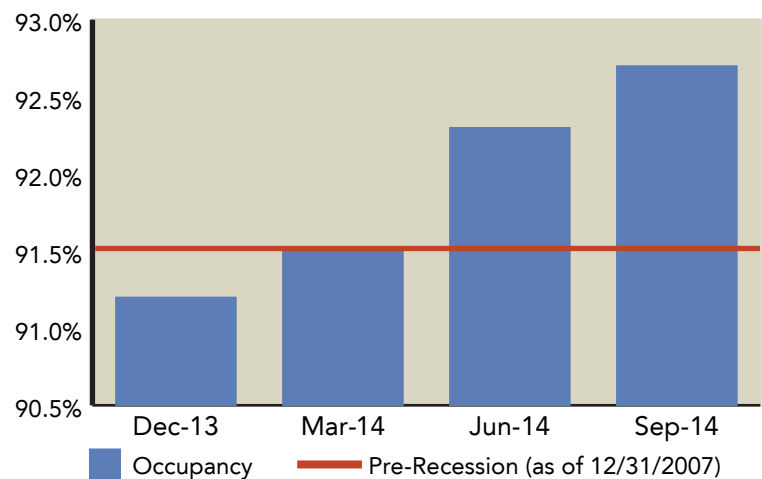
"...further economic growth should help fuel additional positive real estate returns."

The commercial real estate market had another good year in 2014. Real estate, as measured by the NFI-ODCE Index, advanced by 8.9% through the end of the third quarter.⁸ The advance was comprised of a 5.0% appreciation return and a 3.8% income return. The appreciation component of return continued to benefit from a compression in cap rates, and the income portion has been strengthened by an increase in occupancy levels. On a sector basis, hotels and retail properties drove returns while drivers of returns from a regional perspective were the southern and western areas of the U.S.

As we shift our focus to the coming year, our outlook for real estate is positive. Developments to look for over the coming year include:

- GDP is a fundamental driver across real estate sectors. The U.S. appears to be gaining some momentum in terms of GDP growth based on the last two years, and further economic growth should help fuel additional positive real estate returns.
- The labor market is important for real estate because it drives business expenditure in the office and industrial sectors and consumer expenditures in the multifamily and retail sectors. The improvement in the labor market since the recession should provide further tailwinds for returns in 2015.
- The energy sector is worth watching, as it may have ramifications for regional portions of the country due to the precipitous decline in oil prices that began in the fourth quarter of 2014 and extended into early 2015. CONT...

Exhibit 1: 2014 Occupancy Levels (Core Open-End Funds)

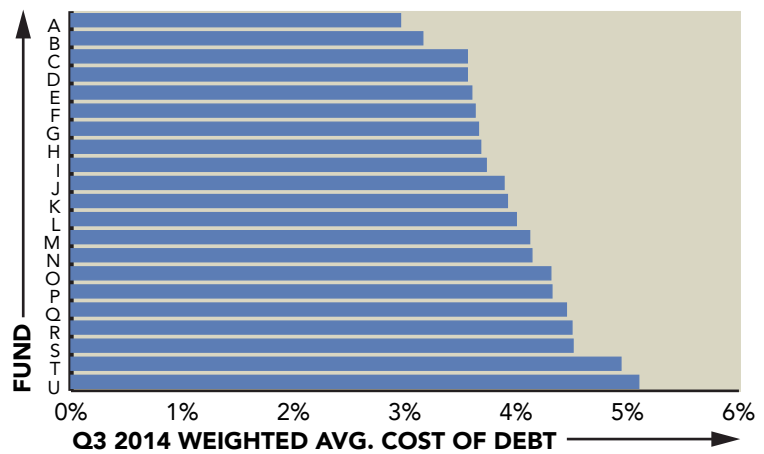


Source: NCREIF

⁸ At the time of writing, fourth quarter return data is not available but is expected to be around 3%.

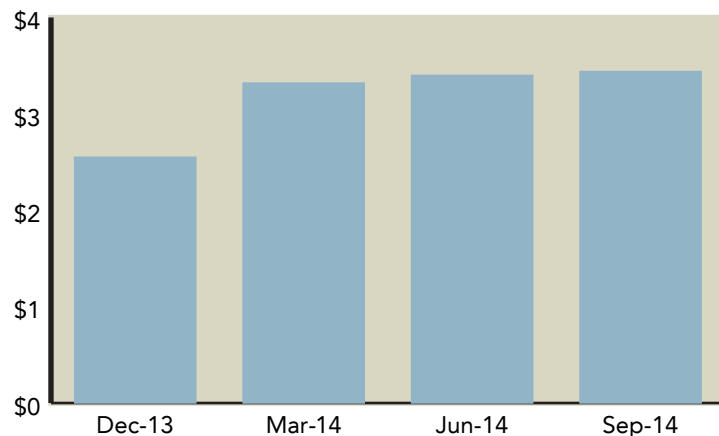
- Real estate yields have been favorable compared to other asset classes. This is likely to continue in the year ahead as the yield component of the asset class is the main attraction for investors who use it as a supplement to their fixed income portfolios.
- Occupancy levels saw a positive trend last year and have passed 2007 levels (see Exhibit 1). It is likely that we will see more demand for Class A space in secondary and tertiary markets due to record low cap rates in primary markets.
- Real estate investors have benefited from loan refinancing and broad access to debt, and that is expected to continue in 2015. Exhibit 2 charts the weighted-average cost of debt for several of the most commonly used core, open-end real estate funds. This metric is closely monitored by fund managers and investors, as it is one of the measures of a portfolio's health and "conservatism." Investors should expect activity in the debt markets to remain robust over the next year, as major lenders continue to compete for deals. This is important to those allocating to real estate because it supports transaction activity, which helps fund managers put capital to work.
- From a flows standpoint, investor interest continued to grow in 2014. Portfolio allocators added more than \$10 billion in net cash flows to core, open-end real estate (see Exhibit 3) in the first three quarters of 2014. Net cash flows rose slightly throughout the year, peaking at \$3.4 billion at the end of the third quarter.⁹
- We expect that real estate appreciation will moderate in 2015. Current income is important, but net operating income (NOI) growth is arguably more important. Income generation is one of the primary purposes of real estate in the portfolios of many institutions. Investors should expect income to represent a larger share of total returns in the coming year. *CONT...*

Exhibit 2: Weighted Average Cost of Debt (Core Open-End Funds)




Source: Real estate managers

Exhibit 3: Net Investor Cash Flows (Billions)



Source: NCREIF

⁹ Fourth quarter data is not yet available but is expected to be consistent with the first three quarters of 2014.



If we look at the four main real estate property types of the NFI-ODCE index, we can more accurately formulate expectations for 2015. In the following, we examine the office, industrial, retail, and multifamily sectors of the real estate market.

Office

Investor interest in office continues to expand because rent growth still has room to run in this sector. Furthermore, the growth in U.S. employment has been solid, suggesting additional strong performance from the office sector. It is still cheaper to buy than to build in the office sector, and rents have been climbing as leases signed during the recession continue to roll. Climbing rents have been the result of expansion in key areas of the economy, such as technology and energy, although the boost from energy may be dampened in the short term due to the decline in oil prices. In technology, tenant preferences for non-traditional office spaces continue to grow, and most markets should see gains in rent and occupancy levels. The office sector is expected to be among the stronger performers in the coming year.

Industrial

Strong performance is also expected from the industrial sector. Robust demand has been driven by growth in industrial production, retail sales, and e-commerce. E-commerce continues to represent a meaningful portion of consumer purchases, especially as retailers woo customers with fast shipping speeds that range from two-day delivery to as quick as same-day delivery. This trend is expected to generate solid interest in distribution centers and warehouse space for large retailers. Demand is likely to strengthen, as absorption of industrial space has been high. Sustained improvement in the U.S. economy will prove favorable for the industrial sector and continue to generate demand for these properties.

Retail

The outlook for retail in 2015 is mixed. Investors should expect to see continued strength from the high-end and discount segments of the sector. Retail in non-primary markets also has a positive outlook as a result of the broadening recovery in employment numbers. The outlook for mid-level retail remains cautious. Many middle-income consumers adjusted their consumption habits after the recession and have remained cost-conscious since then, while high-income consumers continue to spend. Absorption in the retail space has been high amid low supply growth, which has been positive for the sector. Furthermore, the recent decline in gasoline prices has provided an increase in discretionary income for consumers at all levels. One cannot ignore the effect of continued growth in e-commerce sales, but overall, the positive trend in employment growth and GDP will be beneficial to the retail sector.

Multifamily

Multifamily may face headwinds in 2015. There has been rapid expansion in the multifamily sector, from both a rent and occupancy standpoint. This is one sector where it has been cheaper to build than to buy in many markets across the country. As such, supply levels have been increasing, and pricing is notably above 2007 levels. It is likely to think that apartments will underperform on a relative basis in the short-term, as supply growth has been strong and NOI growth is expected to decelerate. Over the long-term, however, apartments will remain a solid sector due to lower maintenance costs and continued growth in household formation. CONT...

Conclusion

In summary, 2015 is shaping up to be a good year for commercial real estate. The growth in GDP and the labor market that came with 2014 should provide a good base for the asset class in the coming year. Concerns could arise from properties in energy-driven areas of the country as a result of the rapid decline in oil prices. While the performance for office and industrial is expected to be stronger than that of retail and multifamily, the aggregate performance of the four main property types should secure another additive year for real estate investors. ▀

INFRASTRUCTURE: Growing Asset Class

“...more than half of institutional investors plan to maintain or increase their allocation to infrastructure...”

OLU ROSANWO, CAIA, SENIOR RESEARCH ANALYST

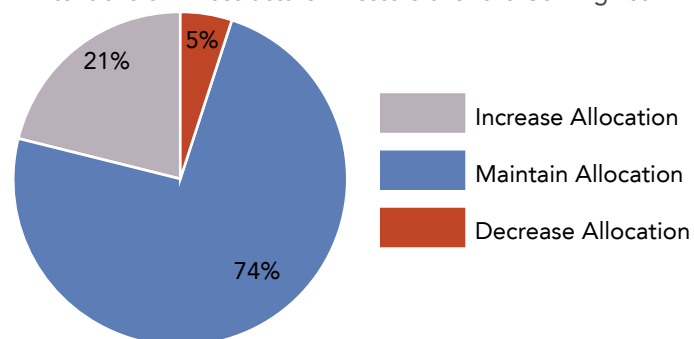
We expect to see ongoing institutional investor interest for global infrastructure opportunities, and will watch the following items carefully in 2015:

- Access to debt capital – this helps managers put capital to work and enhance the value of portfolio assets.
- Dry powder levels and fundraising – dry powder has grown, while fundraising ticked down slightly.
- The energy market – the price declines in oil are likely to result in asset sales by energy companies.
- More investment activity in North America and Asia – the majority of activity has historically occurred in Europe.

In the fourth quarter of 2014, the World Bank announced its launch of a new global infrastructure facility in conjunction with sovereign wealth funds and asset management firms that aspires to meet the need for infrastructure investments in emerging markets. Certainly, such a facility would not have been developed without sufficient confidence that infrastructure investing will be a profitable and attractive endeavor in the coming years. Additionally, more than half of institutional investors plan to maintain or increase their allocation to infrastructure, according to a Preqin survey of long-term allocations for institutional investors (see Exhibit 1).

Beyond the growing interest conveyed by the information above, favorable access to debt is another item that should support the asset class in 2015. Infrastructure investors have used the current low interest rate environment to refinance the outstanding debt on their assets, which is accretive to investors because it enhances the capital structure of the assets by reducing interest costs. As investors continue to search for yield, we should see infrastructure managers benefit from favorable access to debt capital markets, especially as the relative stability of infrastructure assets makes them appealing to institutional lenders. This is important because the bond-like series of cash flows that contain regulatory or contractual provisions are attractive qualities to capital providers. The financial improvements that come from taking advantage of the debt capital markets, coupled

Exhibit 1: Intentions of Infrastructure Investors over the Coming Year



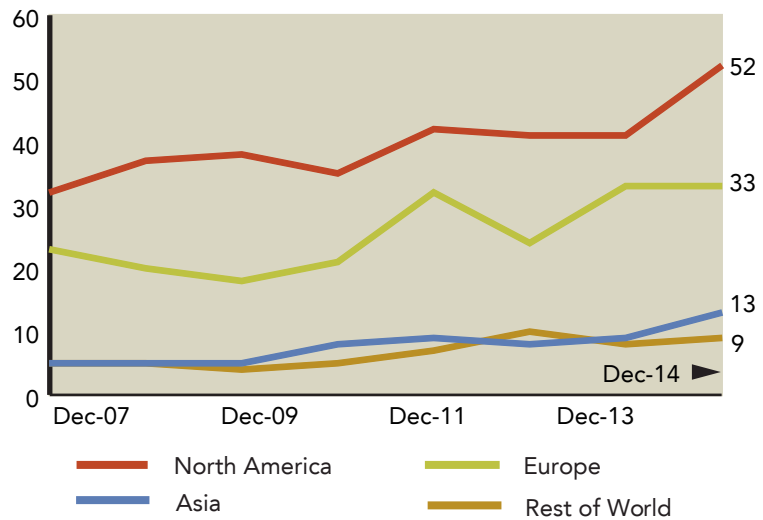
Source: Preqin

with the operational improvements delivered by management, result in added value for the infrastructure investor.

A potential risk on the horizon is the level of dry powder (see Exhibit 2). Given the growth in dry powder that we saw in 2014, it is natural to be concerned that too much capital is sitting in the coffers of infrastructure managers. The market broadly agrees that access to easy capital may tempt managers to overpay for assets. As investors know from previous market cycles, price is the most important factor, and overpaying leads to fund underperformance. However, despite its existence for some time, the infrastructure market is a relatively young asset class, so the growth in dry powder is not a significant concern as many assets continue to enter the market. This is particularly the case in the energy sector as a result of increased activity and the desire for firms to restructure their balance sheets. In Europe, utility companies are expected to continue the delevering process, and governments are expected to allow for more privatization to shore up public finances.

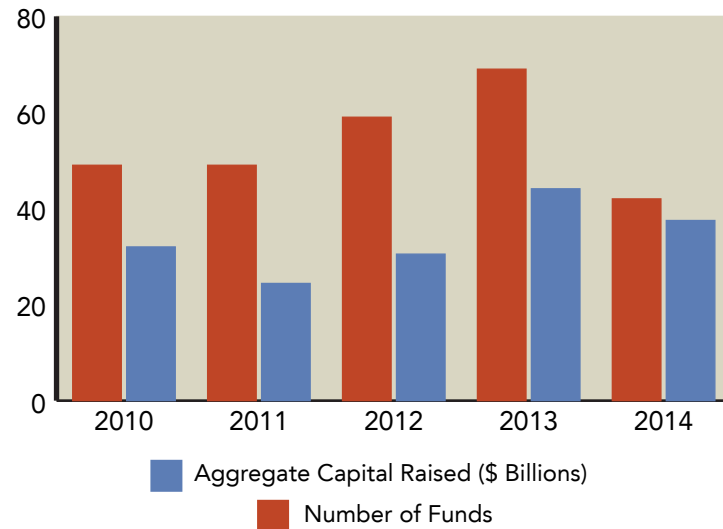
Exhibit 3 charts the trend in fundraising. Unsurprisingly, the growth in infrastructure dry powder coincided with a downturn in fundraising in 2014. Forty-two funds were raised in 2014, nearly 40% less than the number of funds raised in 2013. Despite being 15% lower than 2013's capital

Exhibit 2: Infrastructure Dry Powder (\$ Billions)



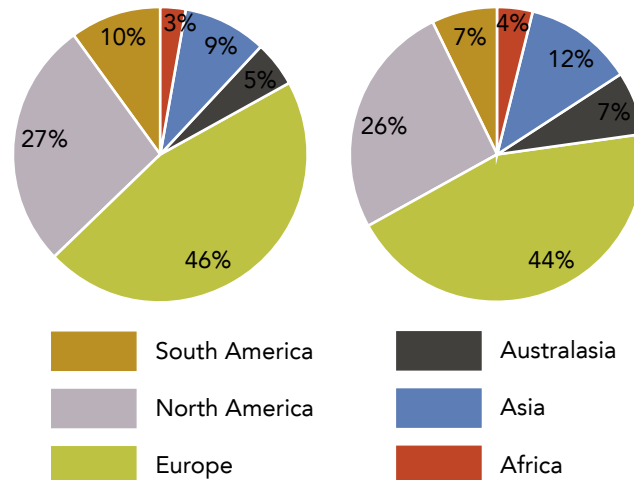
Source: Preqin

Exhibit 3: Infrastructure Fundraising



Source: Preqin

Exhibit 4: Infrastructure Deals by Region – 2014 (L) and All Time (R)



Source: Preqin

raise, the amount of capital raised in 2014 was robust and approached \$40 billion.

Europe has historically represented the lion's share of infrastructure activity and exposure (see Exhibit 4). In the year ahead, we expect more activity in North America due to the notable growth in commitments from North American investors and the increased activity in the midstream energy and transportation industries. As investors look to enhance their geographic diversification, we also anticipate more activity in regions such as Asia, Africa, and the Middle East, as capital commitments from investors in these regions have been increasing.

Overall, our outlook suggests a favorable year for infrastructure in 2015. Investor interest remains strong, and plenty of assets are entering the market to help absorb the dry powder that has grown in recent years. An increase in transactions outside of Europe is likely to occur in the coming year. Finally, a healthy amount of activity in the energy sector would not be surprising, as oil and gas companies reassess their balance sheets on the back of price declines in crude oil. ■

Commodities: The Impact of Oil and the U.S. Dollar

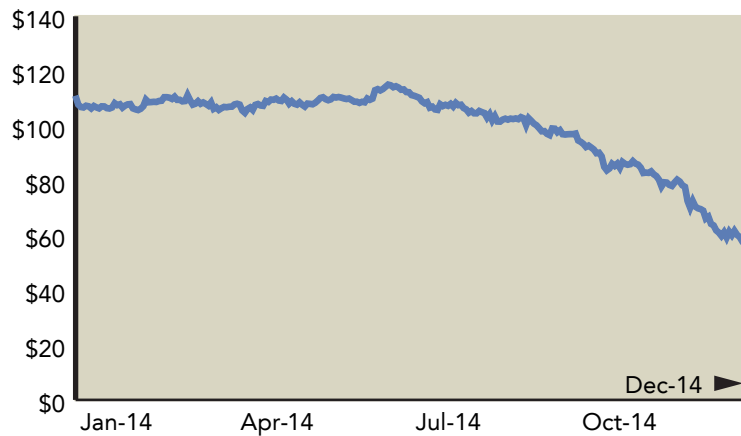
OLU ROSANWO, CAIA, SENIOR RESEARCH ANALYST

Commodities notched a fourth consecutive year of losses in 2014, with the fall in oil playing a meaningful role. Our December 2014 newsletter, [Real Assets: The State of Commodities](#), provides a broad overview of how the asset class fared in 2014. In 2015, the main events to watch will be oil, due to the energy sector's significance to the commodities markets, and the U.S. dollar, due to its impact on purchase activity.

Oil prices fell by more than 40% in 2014 as a result of strong production and OPEC's decision to refrain from supporting prices (see Exhibit 1). The price of oil has fallen well below the \$75 - \$80 range, which is the least viable price for most producers in the U.S. Now, slowing production and how energy firms navigate low oil prices will be closely watched by the market. It is likely that energy companies cont...

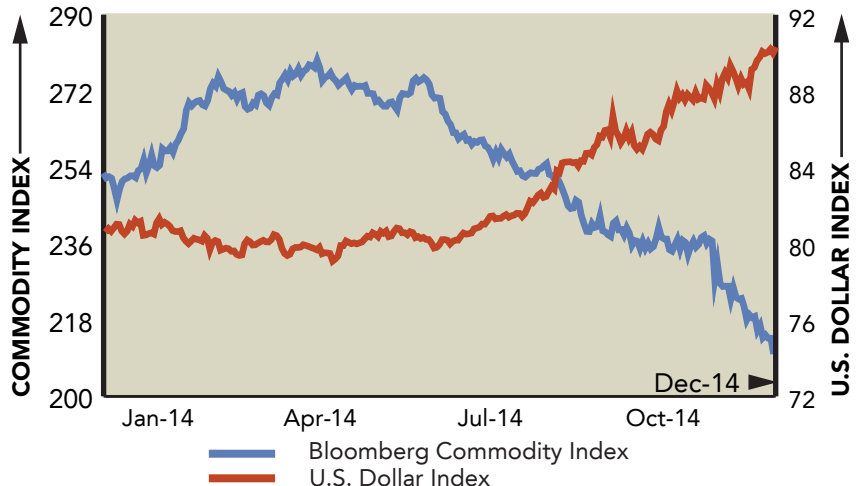
"It is likely that energy companies will reduce production and/or sell assets to de-lever their balance sheets."

Exhibit 1: Oil Prices per Barrel



Source: Bloomberg

Exhibit 2: Commodities and the U.S. Dollar



Source: Bloomberg

will reduce production and/or sell assets to de-lever their balance sheets. Furthermore, investors will monitor the debt of these companies for any signs of stress from declining cash flows arising from lower oil revenues. Consumers may see a growth in disposable income as a result of lower gasoline prices at the pump. Depending on the savings patterns of consumers, this unexpected surplus in income may benefit other sectors of the economy, such as retail sales.

In addition to oil, the U.S. dollar will be another item to monitor for commodities markets in 2015. The U.S. dollar is an important factor for commodities since many commodities are traded in the currency. When it is strong relative to foreign currencies, holders of foreign currencies purchase less of commodities and other dollar-denominated products because they have to pay more of their home currency to acquire dollars. Likewise, when it is weak relative to foreign currencies, purchases of commodities and other dollar-denominated products tend to increase because more dollars can be purchased with a unit of the stronger foreign currency. Last year, the U.S. dollar index saw a 12.8% rise, most of which took place in the third quarter after the Federal Reserve officially ended its Quantitative Easing Program (see Exhibit 2). The reason behind the movements in the U.S. dollar will be an important factor in 2015. If the scenario is one in which the dollar continues to strengthen because of a healthy U.S. economy, then that will eventually bode well for commodities due to a sign of healthy demand. If the strength in the dollar is a result of pessimistic views on the rest of the global economy, then the result will be a dampened outlook for commodities. ■

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