2015 Outlook:
We’re Just Getting Started

As we embark on 2015, I have three messages for investors:

1. The current cycle will ultimately be the longest on record.
2. Interest rates will remain low for the long term.
3. The case for stocks to outperform bonds and credit to outperform treasuries is as compelling today as it has been in each of the past six years.

The End Is Not Nigh

It’s said that business cycles always end the same way: The Fed “murders” them with rate hikes. By the time that happens, equity valuations are typically elevated, complacency has set in, credit growth has been robust and less discriminate, and pundits are ignoring clear warning signs (e.g., a flattening yield curve) from the bond market. Today, equity valuations are generally fair in absolute terms and cheap relative to bonds. Inflation is not a concern, the yield curve is relatively steep, and macro models of the credit cycle are assigning a near-zero probability of the credit turmoil that precedes a poorer risk/return profile for risk assets.

Investors, mistaking this environment for a normal cycle, have focused on rate hikes, when instead the real story has always been continued global economic weakness and an ongoing global deleveraging cycle. As we embark on 2015, the U.S. economy has mended and is growing modestly, and larger emerging market countries like India and China are recovering, although conditions in Europe and Japan have deteriorated significantly. Paradoxically, the unsynchronized and relatively weak nature of the global expansion—with disinflation still front and center—foretells the tightening cycle and in turn extends the cycle rather than curtails it. The old adage of not fighting the Fed (and the European Central Bank and the Bank of Japan) applies.

Investors waiting for a robust synchronized expansion (or less political dysfunction or world peace or the end of infectious diseases) are missing the point and making it too complicated. Here’s what they need to know:

- Nearly half of all issued government bonds yield less than 1%.
- 1.5 billion people around the world are experiencing negative real yields on shorter maturity bonds.
- Nearly 80% of the global equity market capitalization is supported by zero interest rate policies.

Being bearish in this environment will not be a fruitful exercise. Returns for risk assets over the next six years will be more volatile and less robust than in the past six. Valuations have moved higher—rightfully, but none of the usual end-of-cycle trappings are evident. The current cycle will ultimately prove to be the longest on record, and I believe investors will be well served for a long time to come by favoring growth over defensive assets.

Within these pages you’ll find our views for 2015 and a breakdown of our outlook, not by traditional asset class categories but by investment objectives—growth, income, real returns and diversification—an acknowledgment that people invest not simply to beat benchmarks but to achieve specific investment goals.
Income
Asset Allocation Views for Investors with an Income Objective (October 31, 2014)

<table>
<thead>
<tr>
<th>Least Favorable</th>
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<th>Neutral</th>
<th>Favorable</th>
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<tr>
<td>Government-Related Bonds</td>
<td>TIPS</td>
<td>Developed Government</td>
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Credit

<table>
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<tr>
<th>Global Investment Grade</th>
<th>Global High Yield</th>
<th>EM USD Credit</th>
<th>Senior Loans</th>
<th>Municipal Bonds</th>
</tr>
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Other Sources of Income

| Global REITs | Cat Bonds | MLPs | High Dividend Equity |

The scarcity of income in a “low-for-long” world will have investors paying up for income wherever they can find it. That is, at least until the seeds of the next major credit event have been sowed (i.e., tight monetary policy, flattening yield curve, excessive valuations, and deteriorating macro and corporate fundamentals). Until then, the environment favors dollar-denominated high yield credit and senior loans over government bonds. I believe high dividend-yielding equities and equity-like assets will also continue to provide more attractive income opportunities than government bonds, albeit with different risk profiles.

Government-Related Bonds

- Developed-world nominal yields on traditional and inflation-protected securities are unenticing; real yields are even more so.\(^1\)
- As the chart shows, the spread on the Barclays U.S. Aggregate Bond Index to the 10-year U.S. Treasury is tight from a historical perspective.
- Emerging market sovereign balance sheets remain largely solid, but many emerging market local government bonds also offer minimal real yields.\(^1\) The prospect of tighter monetary policy in the U.S. relative to the rest of the world favors the U.S. dollar.
- Opportunity costs in government bonds are high, but investors are unlikely to suffer substantial real losses. Barring anything unforeseen (such as the ECB spectacularly reversing deflation or China reviving growth through an unexpected policy stimulus), global rates will be low across the board. The U.S. will not be immune.

Credit

High Yield and Senior Loans

Highly favorable liquidity conditions and generally sound corporate fundamentals remain supportive of high yield credit. As shown in the chart, senior loans are trading at a historically wide 500 basis points above the London InterBank Offered Rate (LIBOR),\(^2\) the average estimated interest rate that banks would be charged if borrowing from other banks. High yield bond spreads are tight to historical averages but I believe rightfully so given current credit conditions.

- Deal leverage is rising modestly, but low borrowing costs give issuers more cushion to service debt.\(^6\)
- Senior loan and high yield bond issuers have been able to extend their maturities to well into the late 2010s and early 2020s.

Only 4.1% of all senior loans matures by the end of 2016, with only 0.5% coming due in 2015.\(^7\)

Municipal Bonds

Investment-grade muni bond yields are still attractive to treasuries, particularly on a tax-equivalent basis, while higher yielding municipal bonds are still trading at historically wide spreads, as depicted in the chart.\(^1\) Fundamentals have strengthened significantly, with state budget gaps decreasing by 70% from 2010 to 2013. Issuance is poised to climb in 2015, albeit from very low levels.

Spreads Over Benchmark Rates of Various Income-Producing Assets

<table>
<thead>
<tr>
<th>8%</th>
<th>Spreads Tight vs. Long-Term Average</th>
<th>6.3</th>
<th>Spread In-Line vs. Long-Term Average</th>
<th>3.2</th>
<th>Spreads Wide vs. Long-Term Average</th>
<th>2.2</th>
</tr>
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<tbody>
<tr>
<td>6</td>
<td>Barclays U.S. Aggregate Bond Index</td>
<td>4.9</td>
<td>JPMorgan Domestic High Yield Index</td>
<td>3.1</td>
<td>Lehman Municipal Bond Index</td>
<td>1.4</td>
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<tr>
<td>4</td>
<td></td>
<td>0.4</td>
<td></td>
<td>0.1</td>
<td>Merrill Lynch High Yield Index</td>
<td>0.4</td>
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<tr>
<td>2</td>
<td></td>
<td>-0.1</td>
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<td>0.1</td>
<td>JPMorgan High Yield Index</td>
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<td>0</td>
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<td>0.1</td>
<td>Citigroup High Yield Index</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Sources: Barclays Live, Credit Suisse, Alerian, FactSet and Bloomberg, 10/31/14. See index definitions on back page. * Credit Suisse Leveraged Loan Index spread is over LIBOR.

Other Sources of Income

Master Limited Partnerships

From an income perspective we are neutral on MLPs as the income is still very attractive but MLPs will add more equity market beta to portfolios than bonds. The sharp decline in oil prices has raised alarms but MLPs tend to have low long-term trading correlation with crude oil.\(^8\) Production in the major formations shale is likely to be little changed but drilling in more marginal wells may ebb.\(^8\)
The Right Way to Invest

Growth
Asset Allocation Views for Investors with a Growth Objective (October 31, 2014)

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<tr>
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<td></td>
<td></td>
<td>Developed Markets Equity</td>
<td>U.S. Equities</td>
</tr>
<tr>
<td>Market Capitalization</td>
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<td>Emerging Market Equities</td>
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<tr>
<td>Style</td>
<td></td>
<td></td>
<td>U.S. Small Cap</td>
<td>U.S. Large Cap</td>
</tr>
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<td>Other Sources of Growth</td>
<td>MLPs</td>
<td>Commodities</td>
<td>Global REITs</td>
<td>Global High Yield Credit</td>
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Clever strategists have referred to the current environment as T.I.N.A., meaning, “there is no alternative,” to equities. I agree, although I would revise the statement to say that for growth-oriented investors there is no alternative to common stock and global high yield credit, the latter of which has many of equities’ growth properties and is well positioned, given the current state of the credit cycle.

From a growth perspective we are less favorable on high dividend equities and master limited partnerships, not because the cases for the asset classes have changed, but rather because many of the alternative income strategies have been bid up relative to growth stocks. In a world where growth is scarce, investors will pay up for it.

Regional
The global economy may be expanding modestly in aggregate, but most of the developed world (Europe, Japan, United Kingdom) is slowing and decoupling from emerging markets, which are generally heading toward a more positive cyclical outlook.³

Risk assets tend to map into the business cycle stages (expansion, slowdown, contraction, recovery) in fairly intuitive ways, with risk asset outperformance in the recovery and expansion quadrants, underperformance in the contraction quadrant, and neutral performance in the slowdown quadrant.

Unsynchronized, and Muted, Global Expansion

U.S. Equities
The U.S. is on the cusp between expansion and slowdown, posting very close to trend growth. Valuations, while slightly higher than historical averages,¹ reflect sustained growth, healthy corporate balance sheets, and less uncertainty about fiscal and monetary policy.

Emerging Market Equities
Emerging market equities have become increasingly attractive. A pattern has evolved wherein the markets decline as investors focus on macroeconomic and geopolitical concerns, only to rebound when valuations are perceived as attractive and economies recover. We have reached the latter point. Valuations are below average,¹ and leading indicators for the bulk of emerging market countries are pointing at recovery, including most of the so-called Fragile 5: Brazil, Indonesia, India, Turkey and South Africa. The same goes for China—a notable change from its recent decline in GDP.³

European Equities
Valuations are relatively cheap, but earnings profiles are the same as they were in 2008, and the Eurozone economy is going nowhere in a hurry.¹ Investors need to be selective. We are encouraged that many European companies have used the ongoing malaise as an opportunity to streamline businesses and reduce operating costs, and we believe that many multinationals will benefit from the emerging market recoveries and modest U.S. expansion. The outlook will also brighten with further ECB policy accommodations.

Japanese Equities
The Japanese leadership is committed to doing what they can to beat deflation (or at least the easy things that they control). We have seen this movie before, so a great deal of skepticism is warranted. In the meantime, I believe the yen will continue to decline, and Japanese equities should perform well.

Market Capitalization
Small-cap stocks are experiencing the worst prolonged period relative to large-cap stocks since 1998,⁷ even though macro trends like a strong dollar, and a prolonged bull market should work in smaller companies’ favor. Small caps are trading richly to large caps,² leading us to prefer the latter, but a protracted low rate environment may ultimately reward small-cap investors.

Source: Organisation for Economic Co-operation and Development (OECD), 9/30/14. Based on OECD leading indicators. Size of flag represents country’s percentage of world GDP. Past performance does not guarantee future results.
**Real Return**

Asset Allocation Views for Investors with a Real Return Objective (October 31, 2014)

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<tr>
<td>TIPS</td>
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Inflation-protecting assets are generally less attractive in a world where the velocity of money is declining and spare capacity remains as a result of underemployed global workers. For investors seeking real returns, we favor commodities over both gold and Treasury Inflation Protected Securities (TIPS).

**Gold**

Gold is trading as rich to inflation as it has since 1981. A laundry list of problems led to gold’s demise in the early 1980s, with a rising U.S. dollar at the top of that list. A prolonged period of modest growth and modest inflation is not favorable for the yellow metal, but gold does provide a nice option should inflation rear its head.

**TIPS**

Investors are willing to accept virtually no yield in TIPS in the belief that the expected protection against inflation is worth the tradeoff. We believe it isn’t. Like gold, TIPS provide a nice option on inflation.

**Commodities**

Commodity prices now represent value. While reasons remain to be mindful of risks, there are a number of potential positives, including expanding U.S. growth, a strengthening China, and several commodity markets appearing fairly well balanced from a supply/demand perspective. The market is likely too bearish on the energy sector and not properly discounting the geopolitical and other risks to global crude production.

**Ratio of Commodities to Consumer Price Index**


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**Diversification**

Asset Allocation Views for Investors with a Diversification Objective (October 31, 2014)

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<td>Cat Bonds</td>
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<td></td>
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<td>Loans</td>
<td>REITs</td>
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</table>

Investors, despite the strong returns of both stocks and bonds over the past six years, have sought out strategies that historically deliver low beta to the equity and treasury markets, along with positive total returns. For diversification we favor alpha strategies over gold, which tends to contribute volatility that trumps its diversification benefits and MLPs, which tend to be highly correlated to equities in downturns.

**Alpha Strategies**

Alpha strategies are less reliant on economic growth or market direction to generate return and are driven more by manager skill and active management. These include alternative strategies like Equity Market Neutral, Global Macro, Equity Long/Short, Currency, and Relative Value. For alpha strategies to be attractive, market returns across and within asset classes must be differentiated. Correlations have been falling, causing alpha strategies featuring long/short characteristics to become more effective diversifiers. Favorable liquidity conditions are likely to prevent the liquidity crunches that cause spikes in correlations and a reversal in normal trends that momentum-based strategies rely on.

**Catastrophe Bonds**

Cat bonds are typically among the best diversifying asset classes because they are linked to physical systems (the weather and geology) rather than economic and behavioral systems. Cat bonds are currently trading at tight spreads, primarily as the result of crossover buying from income-seeking investors and the lack of large catastrophic events in recent years.

**Real Estate Investment Trusts**

REITs generally offer sound diversification benefits because they trade primarily based on local real estate fundamentals, rather than on broad macro conditions, and because they tend to move in line with inflation. We currently classify REITs as neutral because they embed tail risk that may make them sensitive to interest rates.
Where Do We Go from Here?

The global economy has reached a fork in the road, with three potential paths forward in 2015—each with real implications for financial markets.

**Path 1 Stagnation**
Growth comes in below trend and disinflationary forces prevail.

**How Do We Get There?**
- Lack of policy success from Europe, Japan and China leads to a collapse in U.S. inflationary expectations
- Policy mistake in the U.S.
- Flattening yield curve pressures financials; nascent credit expansion reverses course

**Outcome**
- Broadly positive for bonds and negative for stocks
- Extended period of low equity returns
- Interest rates trend lower

**Probability**
Low (but non-zero)

**Path 2 Great Moderation 2.0**
Growth is strong enough to support corporate earnings, but not strong enough to raise inflation concerns.

**How Do We Get There?**
- Policy mistakes avoided in Europe, Japan, China and U.S.
- Modest U.S. expansion fueled by increased credit creation and improved business investment
- Early-stage reforms in India and China unleash economic activity and provide a floor to the global economy

**Outcome**
- Stocks outperform bonds
- Interest rates remain in the same low range they have been in since 2009
- Investors pay up for growth and income in a world where each is scarce

**Probability**
High

**Path 3 Secular Expansion**
Secular growth forces prevail.

**How Do We Get There?**
- Outsized Chinese consumption growth
- Prolonged boom from the U.S. energy renaissance
- Major structural reforms in emerging markets and Europe
- Transformational technology and productivity advancements

**Outcome**
- Stocks outperform bonds
- Cyclical sectors outperform
- Interest rates trend higher

**Probability**
Low

The Middle Way

The paths will differ by region, and some of the catalysts in Secular Expansion are likely to create very attractive investment opportunities under almost any circumstance. In aggregate, I believe the Great Moderation 2.0 will be the ultimate outcome for the world economy in 2015 and beyond.

I have little doubt that the U.S. will continue to expand. Employment, incomes and credit creation are improving modestly, and companies are investing again. With inflation at bay and deflationary forces evident overseas, the Fed won’t stray from its long, deliberate policy normalization path. Regardless of the timing of the first rate hike (likely mid- to late-2015), a flattening yield curve is still years away.

In the post-taper world, other major central banks will carry the Fed’s mantle and continue to provide liquidity to the global economy. Still, European macro weakness will persist. Recoveries in larger emerging market economies like China, India and Mexico—all of which benefit from the stronger dollar, lower commodity prices and improving U.S. demand—help to provide a floor for the global economy.

For illustrative purposes only and not meant to predict the performance of any particular investment.
Source: Bloomberg, 11/30/14.
Source: OppenheimerFunds Proprietary Research, 11/30/14.
Source: Organisation for Economic Co-operation and Development, 10/31/14. Based on leading economic indicators.
Sources: Tudor Pickering & Holt, Baker Hughes, and OppenheimerFunds SteelPath, 10/31/14.
Source: Bank of America/Merrill Lynch, 10/31/14.
Source: JPMorgan, 10/31/14.
Source: Bloomberg, 10/31/14.
Source: Bloomberg, 11/30/14.

Index definitions
The Barclays U.S. Aggregate Bond Index is an investment-grade domestic bond index. The JP Morgan Domestic High Yield Index is an index composed of non-investment-grade corporate bonds. The Alerian MLP Index is the leading gauge of large- and mid-cap energy Master Limited Partnerships. The Merrill Lynch BBB Municipal Bond Index measures the performance of U.S. tax-exempt BBB municipal bonds. The Credit Suisse Leveraged Loan Index tracks senior loans.
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