Second Quarter 2014 Investment Perspectives

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Executive Summary

In the first quarter of 2014, investors encountered an uncertain economy, a surprisingly restrained interest rate environment, concerns over valuation levels in certain market segments and renewed volatility surrounding geopolitical events. Harsh winter weather conditions no doubt added to the economic uncertainty as weaker than expected data early in the year appears to be giving way to better trends now that spring has arrived. Interestingly, bond investors have reacted very differently than stock market investors to guidance provided by new Fed Chair Janet Yellin. The bond market focused on the still lengthy period before short-term interest rates are likely to rise, while stocks reacted more to the winding down of Fed stimulus via quantitative easing (QE). Recently, over-leveraged hedge fund managers have been dumping last year's big biotech and social media winners and refocusing on 2013's laggards. Russia's provocations in Ukraine and possibly in other former Soviet Union members triggered intermittent volatility in financial markets, but, at this point, market response has been generally dispassionate. We are still on guard for our early year forecast for a market correction in the first half, but our expectations for a stronger economy and positive second half investment results remain intact.

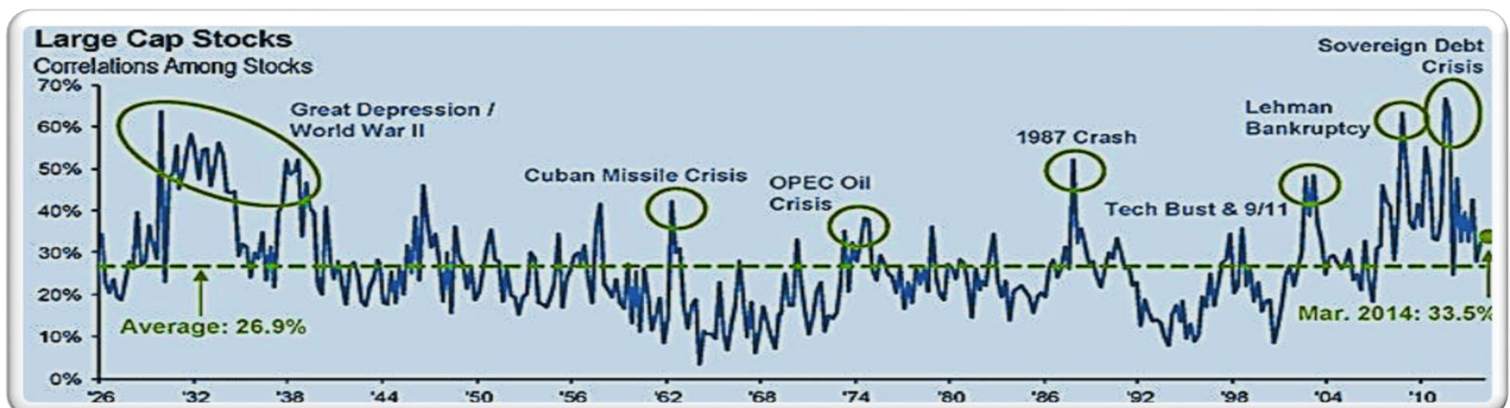
Key Considerations

- It appears that the soft-patch of economic data earlier this year was likely weather related, but this bears watching as second quarter reports are released.

- Interest rates have moved in a narrow range so far this year as uncertainty over the strength of the economy prevailed. If stronger data is reported, it will be important to watch the bond market's reaction as investors will be attempting to gauge the pace and timing of the Fed's QE tapering and eventual increases in short-term interest rates.

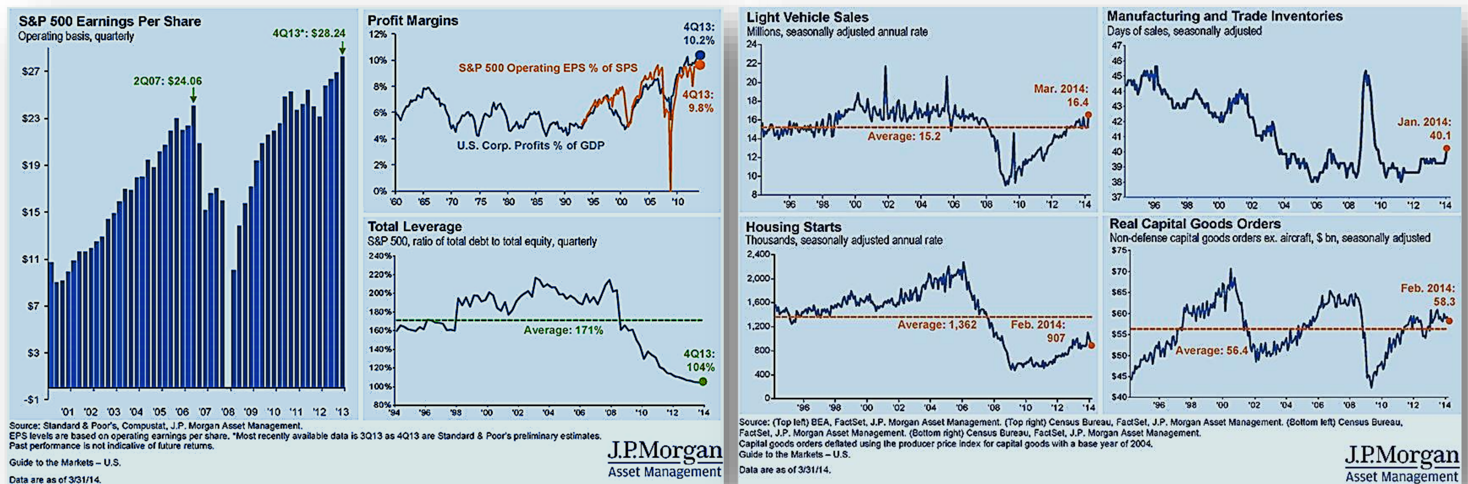
- First quarter corporate earnings releases will be monitored closely for an indication of trends during the last quarter, but, even more importantly, for guidance into the present and future quarters of this year.

- When and at what level will the so-called momentum stocks bottom? Is the shift away from biotech, social media and other high-flying stocks the start of a new trend, or is it merely hedge funds selling over-weighted positions and rotating to previously unloved sectors?

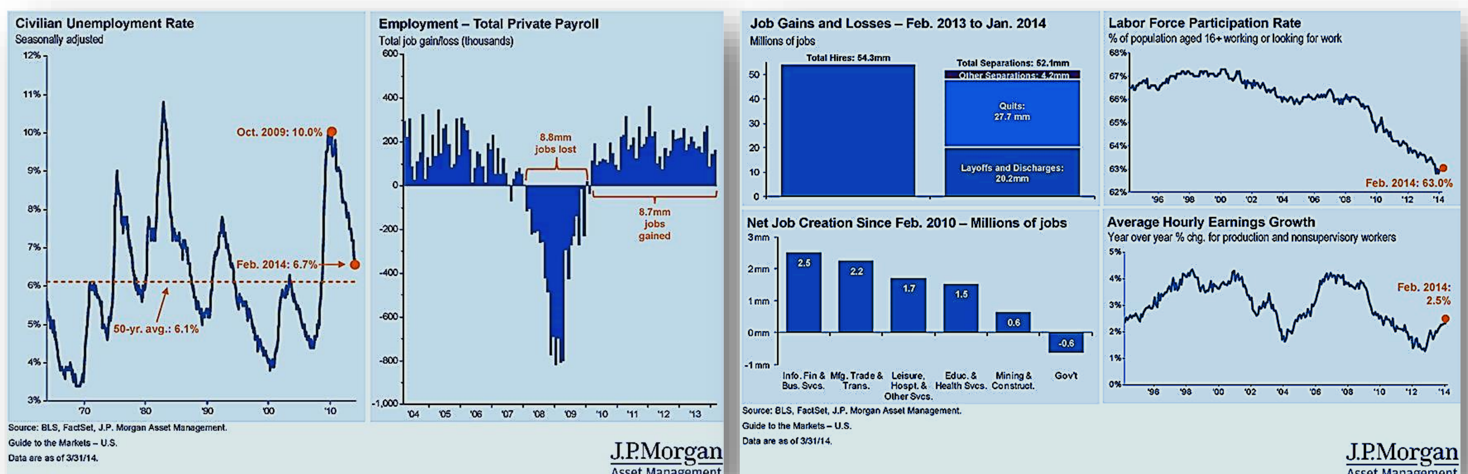


Source: (Top) Empirical Research Partners LLC, Standard & Poor's, J.P. Morgan Asset Management. Capitalization weighted correlation of top 750 stocks by market capitalization, daily returns, 1926 – Mar. 31, 2014. (Bottom) CBOE, Dow Jones, J.P. Morgan Asset Management. DJIA

Expectations are relatively low for both the economy and corporate earnings in the fourth quarter, in large part due to the severe winter. With weather conditions finally beginning to thaw, so too does it appear that economic growth is starting to turn more positive. As corporations release first quarter earnings, investors will be very focused on post-earnings commentary and guidance. With confidence levels improving and fiscal concerns beginning to abate, we are most likely to hear cautious optimism from corporate executives. Recent surveys have shown both manufacturing and service sector demand to be improving. Additionally, retail sales in March rose by 1.1%, the biggest gain since September 2012, with auto and furniture sales leading the way. Housing hasn't yet bounced back as quickly as some economists had expected, but, with mortgage rates still low and employment numbers improving, it is still reasonable to assume this sector will spring back soon.

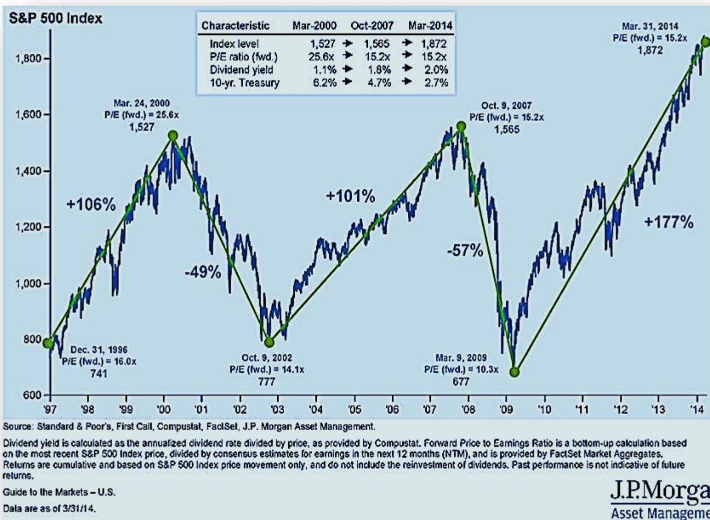


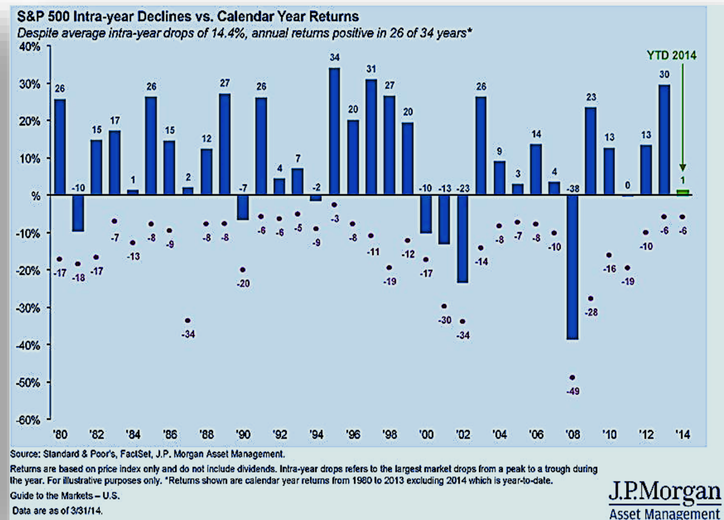
Even with the unemployment rate dropping below 7%, jobs continue to be the main focus under new Federal Reserve Bank Chairman Janet Yellin. In the Fed's attempt to move to a more normal monetary policy, its cautious and methodical tapering of the quantitative easing program, coupled with assurances from Fed officials that interest rates are likely to remain low for an extended period of time, exposes just how concerned they are about still high long-term unemployment levels. On fiscal policy, federal tax receipts are rising and government spending has grown slower in the past couple of years under a divided government. This combination has allowed the federal budget deficit to shrink to its lowest level since 2007. With midterm elections in November, it is unlikely that any important legislation will be passed as both parties posture for advantage.



U.S. Equities

In the past month the DJIA and S&P 500 reached all-time highs before profit taking and sector rotation produced another mini-correction. Much of the selling occurred in a few narrow market segments referred to in the media as "momentum" stocks. These include many of last year's big winners such as biotechs, social and new media stocks, and recent IPOs where profits are thin and valuation levels stretched. The pattern of this selling suggests that certain large hedge funds may have had over-sized positions in some of these stocks and groups via ETFs. And, what may have started as normal profit taking and rotation, may have triggered margin calls leading to indiscriminate selling of all stocks within the segment without differentiation between those with strong fundamentals and growth and those that were over-valued and over-hyped. None of this is action is especially unique as market corrections, group rotation and forced selling events happen rather frequently within market cycles. We still believe that, if we are presently in the midst of a market correction, it will not be terribly severe or long lasting. With the economy and corporate profits growing, no meaningful excesses visible, reasonable valuations, and alternatives to stocks so unappealing, investors are unlikely to stay away for long.





International Equities

It appears that some of the assets that flowed out of U.S. stocks in the past several weeks flowed into international equity markets. Fundamentals in many of these markets have not changed meaningfully, but, after tax-loss selling ran its course late last year, valuation levels in some of these markets became overly depressed. Coupled with a pause in the ascent of U.S. interest rates, we have witnessed steady gains in many non-U.S. developed markets and a modest upturn in certain emerging markets. We continue to believe that, as U.S. interest rates begin to rise again, developed markets are likely to outperform emerging markets. Events in Ukraine and other Baltic countries are unlikely to rattle investors for long, unless there is a significant escalation in violence or evidence linking the actions to the global economy, such as disruptions in oil or natural gas markets. In Europe, investors are watchful of low inflation and concerned about the possibility of deflation. This has many economists anticipating some form of Euro-based quantitative easing which has buoyed stocks recently. In Japan, after a strong start, Prime Minister Abe's economic revival plan appears to have stalled. Fiscal stimulus has waned and the sales tax was raised to 8% from 5% effective April 1. An increase in the size of the Bank of Japan's QE program in July is expected, but many believe structural reforms are necessary before any long lasting economic turnaround can occur. With China now the world's second largest economy, its fortunes have a meaningful effect on global economic growth and capital

flows. There have been well-publicized fears about China's growth rate slowing too rapidly and triggering imbalances of supplies and capital. Thus far, these concerns have been over-blown, as reported GDP growth has remained steady at around 7.5%. China's government has been walking a fine line by implementing reforms intended to promote consumption, while simultaneously reducing credit growth.

Fixed Income

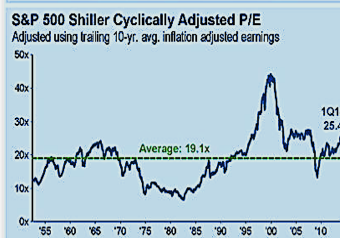
The rise in interest rates that started almost a year ago stalled in the first quarter, as investors became confused about the pace of U.S. economic growth. We believe much of the concerns had to do with harsh weather conditions that slowed normal commerce and injected uncertainty about the sustainability of the current expansion as monetary stimulus is removed. With less fiscal drag as tax rate increases lapse, stronger housing and auto markets, and improving employment trends, we continue to believe GDP growth will accelerate this year and interest rates will resume their rise.

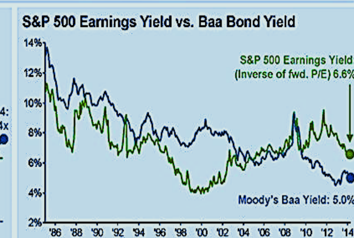
Conclusion

After significant gains in 2013, financial markets have begun 2014 more hesitantly and with more volatility. As last year's gains are further digested and the economic and interest rate picture becomes clearer, we expect additional equity market gains to ensue. In our U.S. equity strategy, we've begun to transition to companies that embrace and benefit from clear new trends. As society conducts more of its commerce and communication online, there are and will inevitably be winners and losers. In addition, trends within medical research clearly favor biologics, as opposed to traditional chemical-based drug development. We remain disciplined in our equity selection process and seek only to invest in companies with leading positions in rapidly growing markets. We favor companies that have predictable earnings growth and quality management teams and that maintain solid profit margins and low debt levels. Internationally, we have changed our equity focus toward more active management in developed markets vs. our former more passive approach in emerging markets over the past decade. Within fixed income, we continue to recommend shorter maturities and the use of alternatives to generate current income. High yield bonds, high yield common stocks, energy MLPs and REITs often provide better total returns than bonds during periods of rising interest rates. We have a list of securities within each category that we currently find attractive as fixed-income alternatives. In a rising interest environment we have also broadly de-emphasized any commodity investments.

S&P 500 Index: Valuation Measures

Valuation Measure	Description	Latest*	1-year ago	Historical Averages: 3-year avg.	5-year avg.	10-year avg.	15-year avg.
P/E	Price to Earnings	15.2x	13.7x	13.1x	13.2x	13.8x	16.0x
P/B	Price to Book	2.8	2.3	2.3	2.2	2.4	2.9
P/CF	Price to Cash Flow	10.6	9.4	9.0	8.8	9.5	10.7
P/S	Price to Sales	1.6	1.4	1.3	1.2	1.3	1.5
PEG	Price/Earnings to Growth	1.7	1.5	1.3	1.3	1.7	1.6
Div. Yield	Dividend Yield	2.1%	2.2%	2.2%	2.2%	2.1%	1.9%





Source: (Top) Standard & Poor's, FactSet, Robert Shiller Data, J.P. Morgan Asset Management.
Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Price to Book is price divided by book value per share. Data post-1992 include intangibles and are provided by Standard & Poor's. Price to Cash Flow is price divided by consensus analyst estimates of cash flow per share for the next 12 months. Price to Sales is calculated as price divided by consensus analyst estimates of sales per share for the next 12 months. PEG Ratio is calculated as NTM P/E divided by NTM earnings growth. Dividend Yield is calculated as consensus analyst estimates of dividends for the next 12 months divided by price. All consensus analyst estimates are provided by FactSet. (Bottom left) Cyclically adjusted P/E uses as reported earnings throughout. *Latest reflects data as of 3/31/2014.
(Bottom right) Standard & Poor's, IBES, Moody's, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S.
Data are as of 3/31/14.

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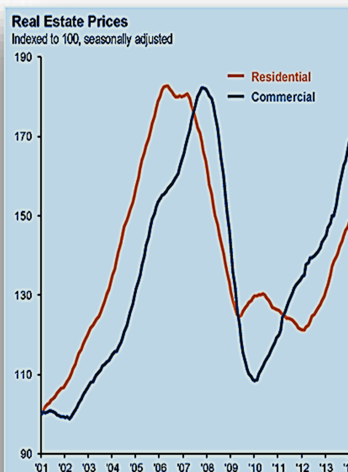

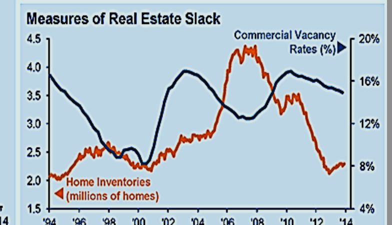

Sources: (Left) Standard & Poor's, Moody's, J.P. Morgan Asset Management. Residential prices shown as Case-Shiller 20-city home price index. Commercial prices shown as Moody's/RCA National All-Property commercial property price index. (Top right) Census Bureau, J.P. Morgan Asset Management. Monthly mortgage payment assumes the prevailing 30-year fixed-rate mortgage rates and average new home prices excluding a 20% downpayment.
(Bottom right) CBRE Econometric Advisors, Census Bureau, National Association of Realtors, J.P. Morgan Asset Management.
Commercial vacancy rates shown for nationwide total office market as calculated by CBRE Econometric Advisors. Guide to the Markets – U.S.
Data are as of 3/31/14.

J.P.Morgan Asset Management

As we have frequently stressed, we believe the key to effective investing is to align investment objectives with the proper mix of domestic and international stocks, fixed-income instruments and other asset classes. We look forward to reviewing your individual needs and objectives in conjunction with our view of economic and market trends to affirm or modify your investment strategy.