April 2014

TIAA-CREF Asset Management

# Market outlook: Delayed gratification

## Introduction

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Global Investment Strategist

Was investor optimism at the beginning of the year misplaced, or simply premature? January began with 10-year U.S. Treasury yields at 3% as the economy looked to accelerate in the year ahead; expected corporate earnings growth of over 10% for U.S. companies suggested that equity prices could continue to rise even after the 30% gain for the S&P 500 Index in 2013. Three months later, bond yields have fallen sharply and U.S. equities are not far from where they began the year *(see Exhibit 1)*.

We believe some of the forces that drove this performance — namely, doubts about the strength of the U.S. recovery following an unusually severe winter and political events such as the turmoil in the Ukraine — will not last. But others will remain for some time: emerging market weakness due to Federal Reserve tapering and a rising dollar, and lingering doubts about China's economic model. Markets may consequently struggle to achieve much momentum, but the initial optimism of early 2014 should return once the impact of tapering has worked its way through the global financial system.

## Executive summary

- Outside of an unexpectedly deeper slowdown in China, there are few evident risks to the economic recovery in the U.S.
- The environment for equities is largely benign, with fair valuations, improving GDP growth, and low inflation supporting modest gains, though not without volatility.
- Bond yields will resume their slow climb, so investors should continue to seek shelter in the higher-yielding parts of the fixed-income market.

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## Exhibit 1: Global asset returns

| | Market Value ($tr) | Relative P/E (%)* | Dividend Yield (%) | Total Return (%) 1Q 2014 | Total Return (%) Last 12 months | Total Return (%) Last 12 months (USD) |
|---|---|---|---|---|---|---|
| **Equities** | | | | | | |
| Global (ACWI) | 35.9 | -8 | 2.5 | 1.0 | 17 | 17 |
| Small/Mid Cap | 12.0 | -1 | 1.9 | 2.5 | 20 | 20 |
| Growth | 18.0 | 3 | 1.7 | 0.3 | 17 | 17 |
| Value | 17.9 | 7 | 3.2 | 1.7 | 18 | 18 |
| High Dividend | 9.9 | -2 | 4.0 | 2.0 | 14 | 14 |
| Developed Markets | 32.2 | -5 | 2.4 | 1.2 | 19 | 20 |
| United States | 17.6 | 6 | 2.0 | 1.8 | 22 | 22 |
| Europe | 8.9 | 6 | 3.2 | 1.9 | 16 | 25 |
| Japan* | 2.6 | -21 | 1.9 | -7.4 | 18 | 8 |
| Asia ex-Japan | 1.6 | 0 | 3.9 | 0.6 | 10 | 2 |
| Emerging Markets | 3.8 | -19 | 2.7 | -0.5 | 4 | -1 |
| Asia | 2.4 | -23 | 2.4 | -0.3 | 6 | 4 |
| Latin America | 0.7 | 4 | 3.2 | -1.7 | -5 | -14 |
| Europe, Middle East, and Africa | 0.7 | -13 | 3.2 | 0.3 | 10 | -1 |

| | Market Value ($tr) | Duration | Yield (%) | Total Return (%) 1Q 2014 | Total Return (%) Last 12 months | Total Return (%) Last 12 months (USD) |
|---|---|---|---|---|---|---|
| **Bonds** | | | | | | |
| Multiverse | 46.7 | 6.1 | 2.2 | 2.1 | 1.6 | 2.2 |
| Treasury | 23.7 | 6.8 | 1.5 | 2.0 | 1.2 | 1.2 |
| United States | 6.0 | 5.1 | 1.4 | 1.3 | -1.3 | -1.3 |
| Eurozone | 7.0 | 6.6 | 1.6 | 3.8 | 5.8 | 13.5 |
| Core | 4.3 | 4.8 | 1.2 | 2.8 | 1.5 | 9.0 |
| Periphery | 2.7 | 5.1 | 2.3 | 5.4 | 13.3 | 21.6 |
| Japan | 6.5 | 8.2 | 0.6 | 0.8 | 0.4 | -8.3 |
| Agency | 3.1 | 4.9 | 2.0 | 1.6 | 1.0 | 1.6 |
| Inflation-Linked | 2.2 | 12.4 | 0.2 | 2.5 | -4.8 | -4.9 |
| Securitized | 6.7 | 5.2 | 2.7 | 1.7 | 1.0 | 2.4 |
| Corporate (IG) | 7.4 | 6.0 | 2.8 | 2.6 | 2.3 | 4.1 |
| Industrial | 3.6 | 6.6 | 2.9 | 2.9 | 1.5 | 3.4 |
| Financial | 3.1 | 5.0 | 2.5 | 2.1 | 3.2 | 4.9 |
| High Yield | 2.1 | 3.8 | 5.4 | 2.9 | 7.4 | 9.0 |
| EM Sovereign (USD) | 0.5 | 6.8 | 5.3 | 3.6 | 1.0 | 1.8 |
| EM Corporate (USD) | 1.1 | 4.9 | 4.9 | 2.3 | 1.0 | 1.6 |
| EM Sovereign (local currency) | 1.4 | 5.0 | 6.2 | 1.5 | 1.3 | -5.4 |
| EM Corporate (local currency) | 0.2 | 4.1 | 5.2 | 0.9 | N/A | N/A |

Last data: 3/31/2014. IG = Investment grade. EM = Emerging markets. All returns are in local currency unless otherwise indicated. Bond yields are for relevant index, not benchmark. *Relative P/E compares current next 12-month P/E versus average since 1987 or earliest data available, except Japan, which is from December 2000. Sources: MSCI, Barclays, Bank of America Merrill Lynch, and TIAA-CREF Asset Management.

## United States

**Economy**

The harsh weather across much of the United States certainly chilled some activity, but we believe the recovery is still heating up. (See the recent analysis by TIAA-CREF Chief Economist Tim Hopper, "Why the economy's winter blues won't last.") Many of the weaker economic reports that caused markets to tumble in January (e.g., payrolls and construction spending) were most likely due to the cold temperatures. More recent data has shown rising consumer spending and an improving labor market. With the Fed committed to not raising short-term interest rates this year, and a more cooperative Congress, we see few evident risks to the economy. There is still uncertainty, however, about the impact of tapering on longer-term interest rates. Fortunately, communication from the Fed about its plan to taper has improved and there should be no more surprises such as last summer's "taper tantrum." The United States, nonetheless, remains in uncharted monetary policy waters, and no one is certain how far interest rates will rise without the Fed snapping up much of the issuance at each Treasury auction. Our belief is that the Treasury market overall is so large (nearly $12 trillion), and there are enough willing buyers of U.S. government debt, that a retiring Fed will not lead to a significant increase in rates.

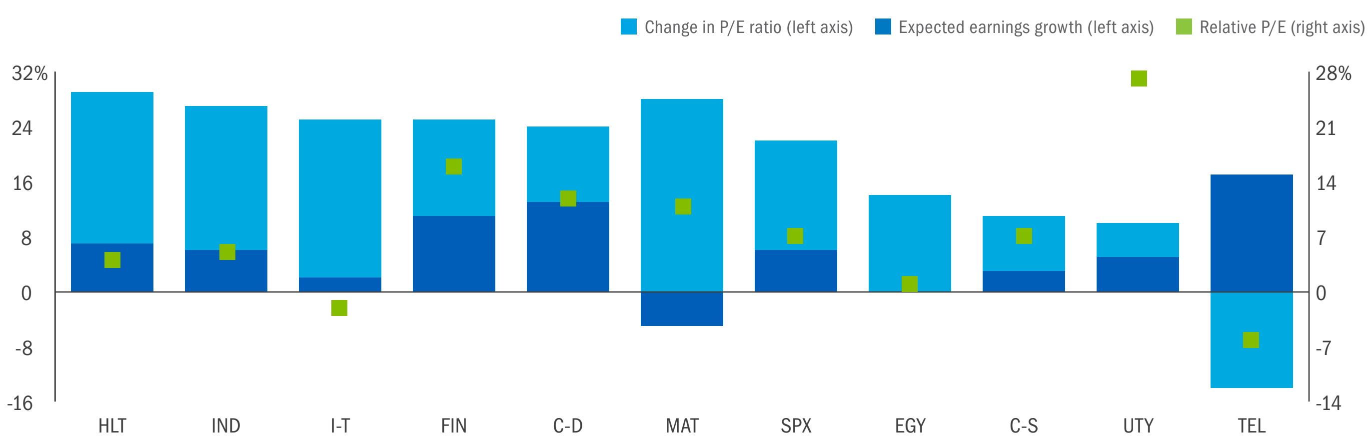
U.S. equities showed their resilience again in the first quarter, outperforming all major markets just as they did in 2013.

**Equities**

U.S. equities showed their resilience again in the first quarter, outperforming all major markets just as they did in 2013 *(see Exhibit 1)*. The key driver of returns has been earnings growth, with companies in the S&P 500 generating 8% year-on-year gains in earnings per share (EPS) in the fourth quarter of 2013. Over the last 12 months, profits improved across most sectors, though higher price-to-earnings (P/E) ratios accounted for the majority of the gains for the S&P 500 *(see Exhibit 2)*. These gains have pushed the P/E ratios for some sectors, namely Utilities, Materials, and Financials, above their long-run averages. With markets likely to be less defensive through the rest of the year, Utilities in particular may lag, and earnings growth expectations are negative for Materials. Better opportunities may be found in the Consumer Discretionary sector, as falling unemployment and improving wages should support rising corporate profits. Industrials may also prove to be an attractive sector if stronger GDP growth finally leads companies to start spending cash on fixed capital, as a recent Business Roundtable survey suggested may happen.

Negative earnings revisions have offset earnings growth, as analysts realized their earlier forecasts were too aggressive. While the most recent earnings season was encouraging, companies were less optimistic in their guidance. We believe the uncertainty about tapering played a role in this, as CEOs, too, were unsure about how demand will develop over the course of the year. Analysts have been lowering their forecasts and will probably continue to do so, as current estimates for 12% earnings growth in 2014 are unlikely to hold up.

### Exhibit 2: Composition of S&P 500 sector returns over the last year




Last data: 3/31/2014. HLT = Health Care, IND = Industrials, I-T = Technology, FIN = Financials, C-D = Consumer Discretionary, MAT = Materials, SPX = S&P 500, EGY = Energy, C-S = Consumer Staples, UTY = Utilities, TEL = Telecommunication Services. Relative P/E is current next-twelve-month multiple relative to the median value since 1994, except for technology which is since 2002. Sources: IBES and TIAA-CREF Asset Management.

**Fixed income**

The march toward higher interest rates predicted at the beginning of the year has stalled, in part because of concerns over growth in the United States and China and heightened market sensitivity to geopolitical risk. Rates should trend higher, however, as tapering continues and the U.S. economy gathers steam. To protect against rising rates, investors should consider not only the potential increase in yields, but also the amount of income they receive, which can help offset falling bond prices. Yields on most types of fixed-income assets are well below historical averages, but some more than others. Municipal bonds and non-agency residential mortgage-backed securities (RMBS) are currently yielding just 140 basis points (bps) less than they have since 1994 and 1999, respectively, suggesting there is less scope for rates on these instruments to rise further *(see Exhibit 3)*. RMBS have the advantage of providing a yield-to-maturity over 5%, while munis are yielding under 3%. (Tax considerations account for part of the lower muni yield.)

Another sector that may offer a cushion against rising rates is high-yield debt, although at current levels these higher rates are nearly 400 bps below their historical average. Retail fund flows to the high-yield sector have slowed over the past year, from nearly $10 billion per month to a still substantial $5 billion. With default rates expected to remain low, the risk of a dramatic increase in yields is unlikely, but investors owning high-yield debt should be thinking now of how they plan to adjust their exposure once the credit cycle looks ready to turn.

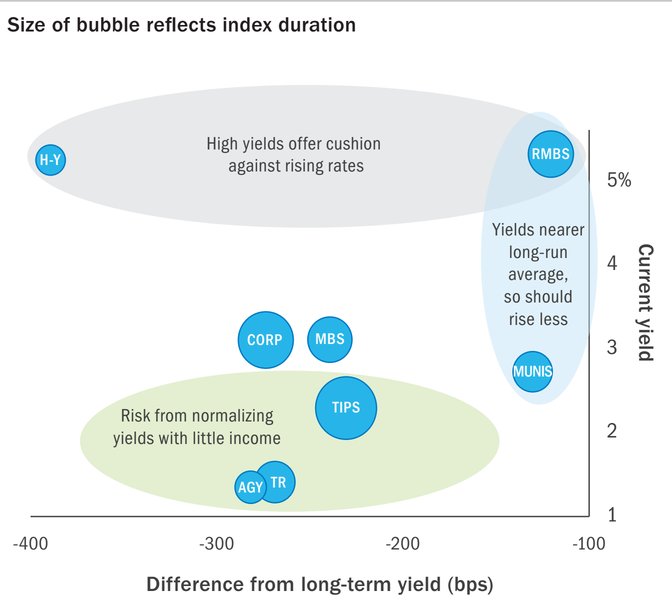
# Europe

**Economy**

One of the key barriers to a more robust recovery in Europe is the lack of credit growth. While in the United States lending to households and corporations is rising over 8% a year, in the eurozone credit is still contracting, though not as rapidly as it has in recent years *(see Exhibit 4)*.

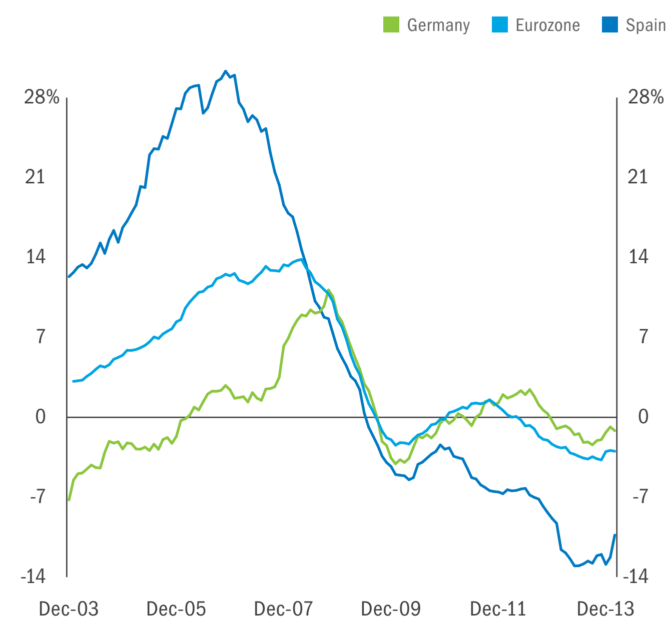
There are many reasons for this. Lack of demand certainly plays a role. Given how fast credit expanded through 2007, it is not surprising that less lending would be needed today. Regulation and corporate timidity also play a role. In addition, banks in Europe have been slower to recognize likely losses on outstanding loans. It is only happening now that the European Central Bank (ECB) is undertaking another Asset Quality Review (AQR), forcing banks to write down assets to market value. A slower approach was preferred in Europe in order to avoid damaging the economy, but the actual result has been simply to weaken the recovery.

## Exhibit 3: Duration, current yield, and difference from average for fixed-income indices




Last data: 3/31/2014. Sources: Barclays, BofA Merrill Lynch, and TIAA-CREF Asset Management. H-Y = High Yield, RMBS = Residential Mortgage-Backed Securities, CORP = Corporate, MBS = Mortgage-Backed Securities, MUNIS = Municipal Bonds, TIPS = Treasury Inflation Protected Securities, AGY = Agencies, TR = Treasuries.

## Exhibit 4: Credit growth (year-on-year)




Last data: 2/2014. Sources: ECB and TIAA-CREF Asset Management.

**Equities**

The range of returns among the major European equity markets has narrowed as peripheral markets continue to recoup the worst of losses from the eurozone crisis. Spain and Italy, for example, have outpaced Germany since December 2012, but their equity markets have returned just 45%–60% since March 2009, while core markets are up 80%–120% for the same period. Valuations throughout the region have recovered as well, with only two countries, Germany and Italy, trading at below-average P/E multiples.

Besides attractive valuations, Italy has the advantage of a new government, led by Matteo Renzi, who may be able to address some of the country's chronic political and economic weaknesses. The main political weakness in Italy is frequent changes of government. (The current one is the 62nd since World War II.) The electoral system allows numerous small parties into parliament, which makes ruling coalitions difficult to maintain. By allying himself with former Prime Minister Silvio Berlusconi, Renzi may be able to push through reform limiting the number of parties. On the economic front, he has promised help for low-income families to stimulate demand (without clarifying how it will be paid for), and he recognizes the need for greater labor market flexibility to create opportunities for the country's numerous unemployed youth. In France, reforms may appear less dramatic, but they have the potential to significantly boost corporate profitability. Return on equity has fallen below the average for European companies, suggesting above-average returns if French companies are able to take advantage of the new initiatives.

Greater exposure to emerging markets has hurt, not helped, European companies relative to their U.S. counterparts.

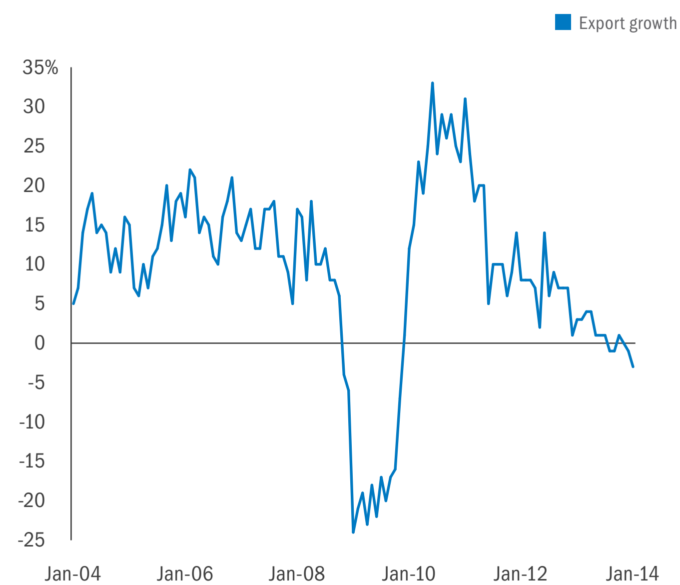
One of the supposed virtues of European companies relative to their U.S. counterparts has been their greater exposure to emerging markets. The argument was that buoyant emerging markets would allow earnings to grow even as demand in their home countries stagnated. This advantage has turned out to be a weakness, as emerging markets, too, have seen slowing GDP and have imported fewer goods from Europe *(see Exhibit 5)*. With interest rates rising in many emerging markets as their central banks move to defend local currencies and control inflation, growth is unlikely to recover soon. European corporations will need to find ways to cut costs if they hope to significantly increase earnings—a challenge as labor markets are more heavily regulated than in the United States.

**Fixed income**

The rally in peripheral government bonds (such as those from Portugal, Ireland, Italy, Greece, and Spain) would seem to leave little room for further gains. With the exception of Greece, 10-year yields are currently below 2007 precrisis levels. This may reflect investors' search for income above inflation more than a renewed confidence in the fiscal integrity of these countries. Yields on U.S. and U.K. debt have risen much more than they have in Germany, as German yields reflect both lower inflation expectations and lower growth. With German government bonds trading just above 1.5% and eurozone inflation forecasted to be only 1% this year, the prospect of getting twice the German yield from Spanish or Italian debt is enticing.

The ECB appears unlikely to pursue a more aggressive monetary policy, at least partly because it can't (quantitative easing would not be allowed under current EU law) and partly because there is little more that it can do. (Interest rates are already near zero.) The review of bank balance sheets may ultimately prove to be the most beneficial measure for the region's economies as it should ultimately enable banks to begin lending again, but the AQR won't even be finished until October. In the meantime, investors can continue to enjoy whatever income they get from higher-yielding bonds in the region.

Exhibit 5: Eurozone exports to emerging markets (year-on-year change)




Last data: 1/2014. Sources: Eurostat and TIAA-CREF Asset Management.

## Japan

The Japanese equity market has gone from the best performing major equity market in 2013 to the worst so far in 2014. The disappointing returns are the result of four factors:

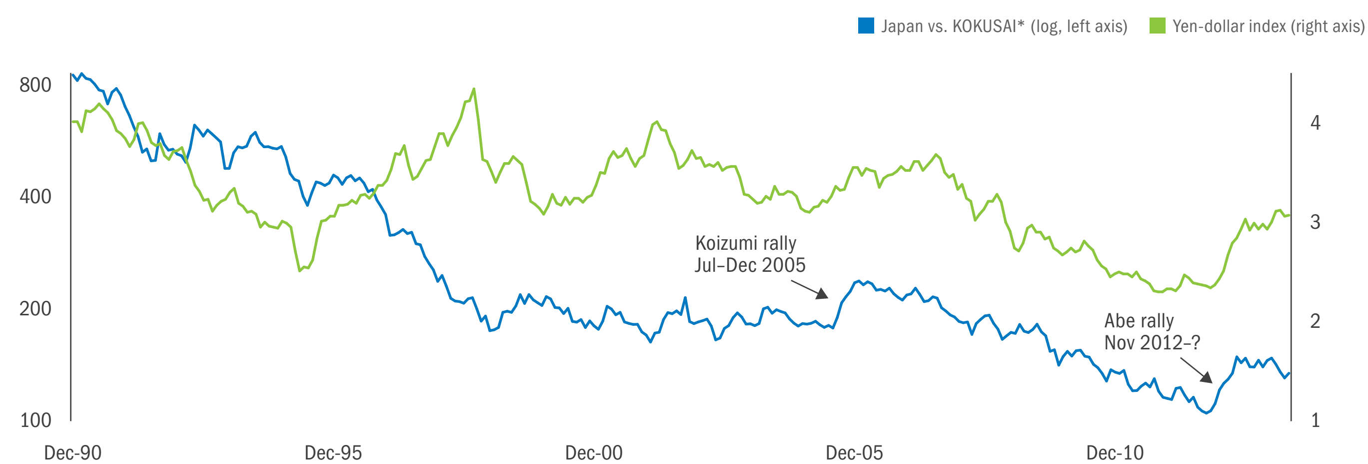
1. A stronger yen, as a volatile first quarter in global markets led to gains in safe-haven assets like the Japanese currency. Japanese equity market returns have been highly correlated with the value of the yen versus the dollar, because a weaker yen translates into higher earnings for the country's exporters;
2. Disappointment in the pace of reform from Prime Minister Shinzo Abe's government. A year-end breakthrough in negotiations for the Trans-Pacific Partnership (TPP), the free trade agreement between the United States and countries in the Pacific Rim, did not take place. Additionally, progress on tax and labor market reforms has been slow;
3. The anticipated impact of the consumption tax hike that took effect on April 1;
4. A more cautious-than-expected central bank that has so far not indicated a willingness to further expand the money supply through additional quantitative easing.

The underperformance this year unnervingly mirrors what occurred after the last wave of Japan euphoria following Prime Minister Junichiro Koizumi's promise of radical reforms in 2005. After a strong rally, the equity market reverted to its typical pattern of underperformance once reform expectations weren't met *(see Exhibit 6)*.

Is the game up then for Japan? We believe it is too soon to throw in the towel. A key difference between December 2005 and the present is that today's valuations are much more attractive. When the Japanese stock market began underperforming in 2005, its forward P/E ratio was 19.1x, compared to 13.2x currently. Today's P/E is 20% below its average since 2000, making Japan one of the few large developed equity markets trading at a discount. Earnings expectations are still rising. It is also possible the yen will resume its decline if market anxiety falls. The Fed continues to taper, reducing the oversupply of dollars, while the Bank of Japan is still printing yen. If the Japanese economy is not able to withstand the consumption tax hike — which is necessary in the long run to address the country's enormous debt burden — the Bank of Japan can increase the money supply further.

In the long run, difficult reforms will need to be implemented to revive the Japanese economy and propel sustained equity market outperformance, but we believe that investor pessimism about the country has gone too far.

### Exhibit 6: Relative performance of Japanese assets




Last data: 3/31/2014. * The MSCI KOKUSAI Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding Japan. Source: Japanese Statistics Bureau & Statistics Centre, Bank of Japan, FactSet, and TIAA-CREF Asset Management.

## Emerging markets

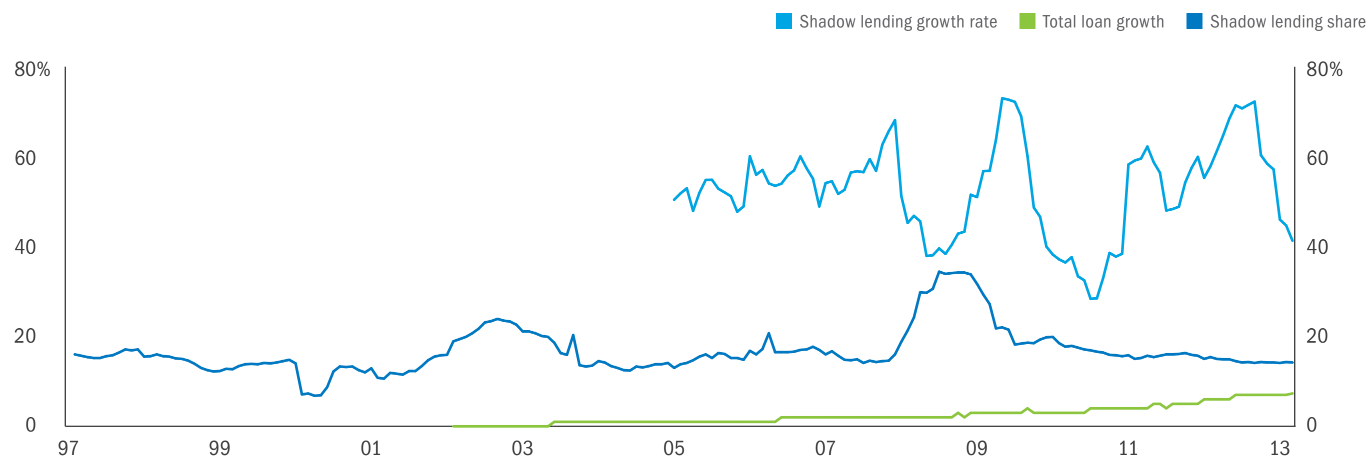
**Economy**

The question of whether China's economy is heading for a "hard" or "soft" landing has reappeared. Given the size of China's equity market and GDP relative to other emerging markets, it is difficult for emerging financial markets as a whole to advance if China does not. If you believe the Chinese government is adroitly managing the country's economic slowdown by restraining credit growth, deflating a property bubble, and reducing excess capacity, then you believe the landing will be soft. On the other hand, if you believe the government, faced with feeble demand for the country's exports, is desperately trying to weaken the currency and will eventually be forced to pump up investment spending again, then the landing could be very hard. The opaqueness of China's economy and lack of data make it difficult to know for sure, suggesting caution is in order.

The recent corporate bond default, China's first for a locally issued security, has been called "the canary in the coal mine," presaging more turmoil to come. Weaker-than-expected economic growth could prompt more defaults, which could ripple through the economy because the loans are often backed by third parties, who could subsequently default themselves. The prospect of more bond defaults is a positive development to the extent that it will enforce market discipline, but no one knows how far defaults might spread. Official data indicates that nonperforming loans account for just 1% of total lending, compared to 1.7% in the United States, but estimates are that it could be as high as 5%–6%. At the same time, China is not a true market economy, and the government will ultimately determine how far it wishes the ripples to spread.

Commentators worry that the slew of potential defaults will come from loans made in the "shadow" banking sector (lending made outside of traditional banks). Shadow lending has indeed grown at an dramatic pace over the past several years, although the rate of growth has fallen to merely 40% *(see Exhibit 7)* thanks to the government's crackdown. Defaults will continue, and until it is clearer how far they will spread, sentiment about China will remain negative. We do not believe, however, that defaults pose a systemic risk to the country (or the world). Shadow banks account for a small part of lending activity across the entire economy (just 7%). If any part of the banking sector needs to be recapitalized, the government certainly has the cash to do so. (China's foreign exchange reserves are $3.8 trillion, compared to total bank assets of $25 billion.) But even if default rates are reasonable, equity market returns are likely to be poor until the magnitude of investors' losses is known.

### Exhibit 7: China loan growth




Last data: 2/2014. Sources: People's Bank of China and TIAA-CREF Asset Management.

**Equities**

The MSCI China equity index makes up 18% of the MSCI Emerging Markets index, and the Chinese financial sector makes up one-third of the MSCI China index. Chinese companies with potentially problematic bonds are well represented in the Industrial and Materials sectors. But this is not the only challenge facing emerging-market equities. The Fed looks certain to maintain its policy of regular reductions in the amount of government and mortgage debt it purchases, with quantitative easing (QE) expected to wind down by the fall. The resulting decrease in the supply of dollars, improving economic growth, and rising interest rates all argue for a stronger dollar — which has traditionally corresponded with the underperformance of emerging-market equities relative to U.S. stocks *(see Exhibit 8)*. Retail fund flows reflect this negative outlook as investors have withdrawn $15 billion from emerging-market equity funds since June 2013, after pouring in nearly $30 billion during the first half of 2012.

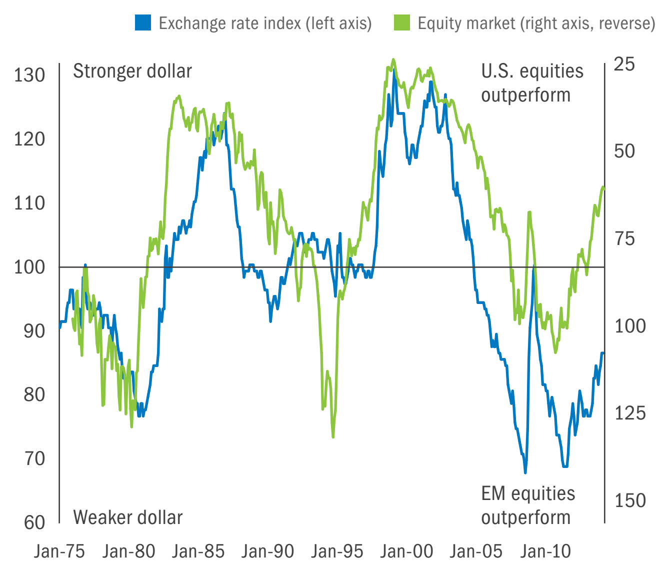
The appeal for investors is that many emerging markets are now trading at very attractive valuations, particularly relative to most developed markets. The forward P/E ratio of the MSCI Emerging Markets Index is about 20% below its long-run average, while for United States and Europe, the P/E ratio is about 8% above. That does not mean, however, that the time is right to overweight emerging markets. Valuations may become yet more attractive as tapering runs its course. Profitability of emerging-market corporations is still lagging that of companies in the developed markets. Until the dollar stabilizes, and return-on-equity rises faster in emerging markets than in developed markets, investors should remain cautious about the region.

**Fixed income**

The inevitable end of QE, brought to the forefront of investors' minds during the taper scare last summer, led to a sharp increase in emerging-market debt yields. The difference in yields between equivalently rated U.S.-dollar emerging-market and developed-market debt has jumped to the highest levels since 2009 *(see Exhibit 9)*.

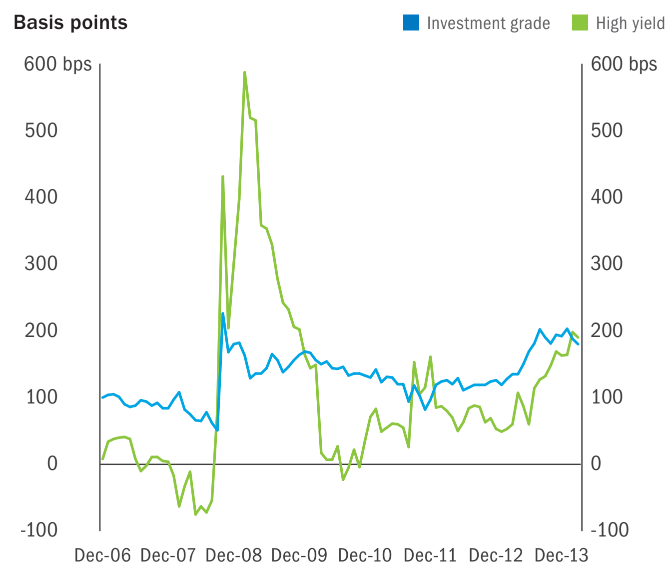
The gap between yields on emerging-market and developed-market high-yield debt has increased since June, not because emerging-market debt yields have climbed further, but because developed-market debt yields have fallen back toward historic lows. For investment-grade debt, spreads for emerging-market debt have not been 200 bps greater than developed-market debt since 2004 (other than during the beginning of the global financial crisis when Lehman Brothers declared bankruptcy). The pattern is similar for investment-grade sovereign debt. The current gaps suggest that on a relative basis, hard currency emerging-market debt should outperform its developed-market equivalent.

## Exhibit 8: Relative performance of emerging equity markets and currencies vs. the United States




Last data: 3/31/2014. Note: Exchange rate index is the real effective exchange rate of the U.S. dollar vs. a basket of its main emerging market trading partners. Equity market is relative performance of emerging markets vs. U.S. total return indices in USD. Sources: S&P/IFC, MSCI, IMF, and TIAA-CREF Asset Management.

## Exhibit 9: Yield difference between USD emerging-market and developed-market corporate debt




Last data: 3/31/2014. Sources: J.P. Morgan, Barclays, and TIAA-CREF Asset Management.

## Timberland

**Sandra LaBaugh, CFA**
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Timberland Investments Portfolio Manager

Over the last 25 years, timberland has grown in popularity as an asset class for institutional investors. This growth can be attributed to timberland's attractive investment characteristics, including the potential for solid cash flows, long-term capital appreciation, and protection against inflation. In addition, well-managed forests can maximize profits by harvesting when prices are high and deferring when prices are low. As global interest in the asset class increases across both structural and non-structural forest product categories, timberland investors should benefit from the steady demand and improving competitive tension for products including logs, lumber, pulp, and woody biomass.

Traditionally, timberland's "core" institutional investment regions have included the United States, Canada, New Zealand, and Australia, where softwood forests (including pine, spruce and firs) represent the majority of property supply. Investors in timberland located in these countries should be able to capitalize on two key trends: the growth in demand from China and the recovery of the United States and global housing markets.

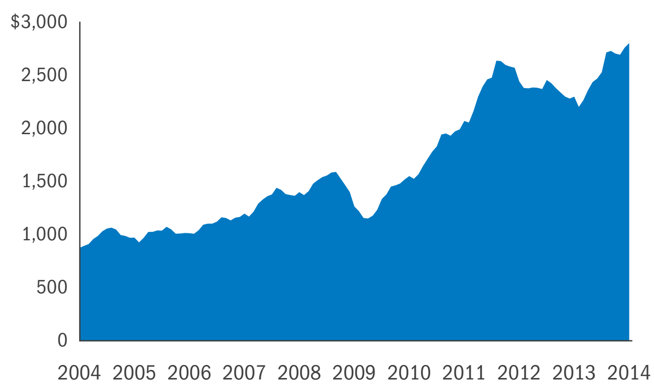
China's significant demand for forest products is a result of the country's long-term timber deficit. In other words, China is not able to produce enough forest products to meet its local demand. As shown in *Exhibit 10*, wood imports to China are up significantly over the last several years. In high-quality categories such as logs and lumber, these rising imports most significantly benefit the western United States and New Zealand. For housing markets, momentum since the recession continues to build due to improving U.S. conditions and an increase in pent-up demand. As shown in *Exhibit 11*, housing starts in the United States have recently reached their highest level in nearly six years and capacity utilization is increasing alongside. Performance for timberland reflects these trends, as the NCREIF Timberland Index, a common benchmark for institutional-quality properties in the United States, returned 9.7% in 2013 and has produced an average annual return of 8.5% for the past 20 years, with relatively low volatility.

The number of ways to allocate assets to timberland is also increasing. Strategies including investing in fast-growing hardwood plantations and increasing allocations to international markets are becoming more popular. Fast-growing hardwoods (such as poplar and eucalyptus) offer shorter rotation periods and potentially more frequent cash flows than softwood forests. In addition to producing logs and pulp, fast-growing hardwoods are attractive to both governments and utilities looking for renewable energy sources to be processed into wood pellets and biomass. The demand generated by wood products for energy purposes is already meaningful and poised for future growth.

For the reasons presented, timberland remains a compelling addition to the portfolios of institutional investors.

### Exhibit 10: China — imports of select major forest products*

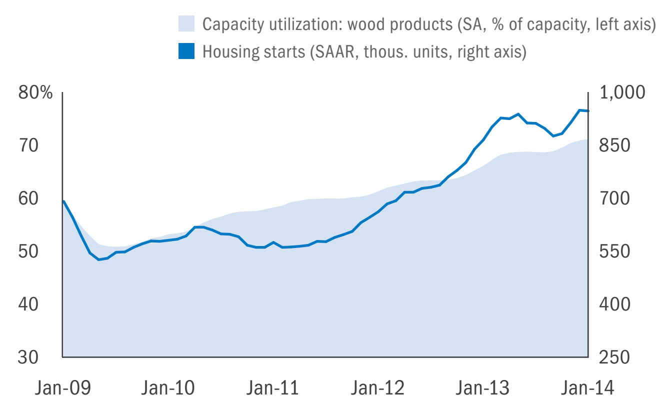
**Six month moving average, in USD$Millions**




*Paper & Paperboard, Wood in the Rough, Wood Sawn, Plywood and Pulp. Source: China General Administration of Customs, TIAA-CREF analysis.

### Exhibit 11: U.S. wood product capacity utilization and housing starts

**Six month moving average**




Source: U.S. Federal Reserve, U.S. Census Bureau, TIAA-CREF analysis.

# Conclusion

The environment for equities, with fair valuations, improving economic growth, and low inflation, remains largely benign — agreeable, but not terrific. Investors may need to wait until the second half of the year for much benefit, however, when tapering has tapered off and interest rates have adjusted. U.S. equities should continue to outpace most other markets thanks to ample liquidity and a better earnings growth outlook, which justify the current slight P/E premium. At some point, emerging-market equity valuations will become compelling, but macroeconomic factors warrant moving cautiously. The foundation for better returns is being laid today with current account deficits declining. Expected returns over a longer-term horizon for emerging markets (and Europe as well) are quite attractive.

The prospects for developed-market investment-grade debt are still poor, with occasional periods of positive returns likely to occur only during times of heightened investor anxiety. Developed-market high-yield debt should be able to sustain current heady valuations as long as default rates remain low, but yields do not seem to offer adequate compensation for the risk of the asset class. Emerging-market fixed income may have already undergone much of its adjustment to the Fed's tapering, meaning that investments there look more promising. The key risk to this scenario is a harder landing in China than we expect. The next several months are likely to be turbulent, as the true level of sour lending in the Chinese economy becomes evident.

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Mr. Morris holds an MBA from the Wharton School and a Master's Degree in International Relations from Johns Hopkins' School of Advanced International Studies (SAIS). His undergraduate degree is in mathematics from Pomona College, and he is a CFA charterholder. Mr. Morris is a frequent conference speaker, guest on CNBC, Bloomberg, and other financial networks, and is widely quoted in the press.