Introduction

We host a rather sanguine view of economic conditions for 2014. The economies of the U.S. and Euro area are growing, and the pace is poised to accelerate. Japan appears to have cleared its perennial bouts of recession/deflation, and policy reforms give reason to believe it’s sustainable. While China’s economy has downshifted, its growth rate remains enviable and policymakers seem committed to real, and healthy, adjustments to open its marketplace in myriad ways. Taken together, 85% of the world’s economy is expanding in a synchronized fashion.

While this is certainly welcome, it is also necessary to bring the process of large-scale central bank intervention to an end. The Federal Reserve, and its counterparts in the UK, Europe, and Japan, have adopted exceedingly lenient interest rate policies and implemented other non-conventional monetary tools in an effort to amplify economic activity. While it has helped to stoke growth and stabilize financial conditions, it remains somewhat unsettling that roughly five years removed from the financial crisis and recession, central banks still occupy such a large presence in the market.

Fortunately, the signs of a self-sustaining expansion are beginning to materialize. In the U.S., the world’s largest economy, labor markets are strengthening, bank lending is increasing, consumers and businesses are spending—collectively at a pace that portrays enough inertia to encourage policymakers. The Fed’s gigantic bond-buying regime is being wound down, and other central banks have halted or eased back on similarly designed programs. While it will be quite some time before the uber-easy policies of global central banks are reversed, their expanse is clearly waning. The story for the New Year and beyond will be the shift from hyper-accommodation to normalization and what, if any, the consequences of policies employed to save the financial system and resuscitate economies have left behind in their wake.

While 2013 was a terrific year in the equity markets, the same cannot be said for the bond market. Improving economic conditions, growth in corporate earnings, and the lack of choices for risk-based capital combined to drive investors to the equity markets—pushing prices higher. While returns in the U.S. increased most, bourses from Japan to Germany also had stellar years. Given the continued favorable backdrop for risk assets, equities should produce attractive returns once again. Arguably, higher beta non-U.S. equity markets offer greater potential for appreciation, given the growing acceptance that global growth is gathering momentum. That background typically does not serve interest-rate-sensitive investments very well. While inflation is benign at the moment, the anticipation of higher rates as a consequence of a better economy is enough to alter the landscape for bond prices. Most categories of bonds, with the exception of high yield, fell in value and are likely to be under pressure again in 2014. Adopting a framework of capital preservation by shortening duration and increasing liquidity may prove to be the best defense, if interest rates grind higher again this year as last.

The New Year brings optimism that growth expectations, which proved disappointing in previous years, match the positive sentiment of forecasts. If so, it may mean, that like 2013, the choices made in allocating assets will be an important driver to surprisingly disparate results.

Mark Luschini
Chief Investment Strategist
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Performance data quoted represents past performance and is no guarantee of future results. Current returns may be either higher or lower than those shown.
### Talking Points

<table>
<thead>
<tr>
<th>Developed economies are growing in a synchronized fashion.</th>
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<tbody>
<tr>
<td>Recessions have ended, but conditions in some economies remain fragile.</td>
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<td>Monetary policies around the globe remain highly accommodative.</td>
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<td>Forward guidance is replacing balance sheet expansion at central banks.</td>
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<td>Risk assets should reward investors, albeit not in a replay of 2013.</td>
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<td>Pivot globally diversified equity portfolios to international markets.</td>
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<tr>
<td>Bonds will suffer under the weight of improving economic growth.</td>
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<tr>
<td>Select commodities should fare well, due to increased global activity.</td>
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<tr>
<td>Cash equivalent yields will remain repressed by lingering Fed intervention.</td>
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Developed market economies are growing in a synchronized fashion.

For the first time in three years, forecasts of global growth are being marked up.

<table>
<thead>
<tr>
<th>U.S. economic activity is poised to accelerate.</th>
<th>Europe has ended its 18-month recession—producing modest, if anemic, growth.</th>
<th>Japan has responded positively to the “three arrows” of Prime Minister Shinzo Abe’s policies.</th>
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<tbody>
<tr>
<td>A fiscal tailwind comes as spending cuts, estimated to have cost a 1.5% drag on growth in 2013, are reduced.</td>
<td>Germany, Europe’s largest economy, is expanding as exports increase and domestic consumption improves.</td>
<td>Aggressive monetary action has devalued the yen, stoking export activity.</td>
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<tr>
<td>The apprehensive pace of business spending picks up due to receding fiscal and monetary uncertainty.</td>
<td>Peripheral economies have turned the corner, and are slowly transitioning from crisis mode to stability.</td>
<td>Endemic deflation has given way to inflation that is edging toward the Bank of Japan’s target of 2%.</td>
</tr>
<tr>
<td>Aged consumer deleveraging and better job growth promote steadily increasing consumption.</td>
<td>The European Central Bank is attentive, but may do more to ensure the path to rehabilitation is firming.</td>
<td>Fiscal reform, dedicated to encouraging a more dynamic economy and reducing debt, is being embraced.</td>
</tr>
</tbody>
</table>
Turning towards growth in major global economies.

### OECD Composite Leading Indicators

![OECD Composite Leading Indicators](source: OECD)

### Baltic Dry Index

![Baltic Dry Index](source: Bloomberg)

### JP Morgan Global Manufacturing Composite PMI

![JP Morgan Global Manufacturing Composite PMI](source: JP Morgan)

### IMF World Economic Projections 2013 - 2014

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
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<tbody>
<tr>
<td>World Output</td>
<td>2.9</td>
<td>3.6</td>
</tr>
<tr>
<td>Advanced Economies</td>
<td>1.2</td>
<td>2.0</td>
</tr>
<tr>
<td>United States</td>
<td>1.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Euro Area</td>
<td>-0.4</td>
<td>1.0</td>
</tr>
<tr>
<td>Japan</td>
<td>2.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Developing Economies</td>
<td>4.5</td>
<td>5.1</td>
</tr>
<tr>
<td>Russia</td>
<td>1.5</td>
<td>3.0</td>
</tr>
<tr>
<td>China</td>
<td>7.6</td>
<td>7.3</td>
</tr>
<tr>
<td>Mexico</td>
<td>1.2</td>
<td>3.0</td>
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</tbody>
</table>

![IMF World Economic Projections](source: IMF)
The pace of growth in the U.S. could tease escape velocity.

U.S. GDP

Source: BEA

U.S. Household Net Worth

Source: Federal Reserve

U.S. Durable Goods Orders ex Transportation

Source: U.S. Census Bureau

U.S. Unemployment Rate

Source: Bloomberg
Modest but uneven growth is in store for the Euro area.

Eurozone GDP

Source: Eurostat

Spanish Bond Yields

Source: Bloomberg

OECD Euro Area Composite Leading Indicators

Source: OECD

European Central Bank Target Rate

Source: ECB
“Abenomics” has led Japan out of recession to a sustained growth path.

Japanese GDP

Japanese Bond Yields

OECD Japan Leading Indicators

Bank of Japan Balance Sheet

Source: Economic & Social Research Institute of Japan

Source: Bloomberg

Source: OECD

Source: Bank of Japan
The emerging market story is nuanced, with China as its centerpiece.

**Emerging economies are faced with shifting financial and economic realities.**

<table>
<thead>
<tr>
<th>Bank deleveraging, particularly in Europe, has exposed countries hosting fiscal imbalances.</th>
<th>Commodity consumption by China has slowed dramatically, just as supply has caught up.</th>
<th>Slowing demand for raw materials is creating blowback to commodity-driven economies.</th>
</tr>
</thead>
<tbody>
<tr>
<td>European banks, a primary source of wholesale funding to the emerging markets, are lending less.</td>
<td>China’s double-digit growth has slowed toward a target rate of 7–7.5%.</td>
<td>After a decade of China’s rapid growth, a falling U.S. dollar, and insufficient supply, the dynamics have changed.</td>
</tr>
<tr>
<td>Some emerging market countries were running fiscal deficits that were covered over by cheap and available funding.</td>
<td>The Third Plenum devotes significant resources to lift internally-generated consumption.</td>
<td>Economies that rely on a strong commodity impulse have been negatively impacted.</td>
</tr>
<tr>
<td>Countries that hold a current account surplus have greater flexibility to invest, and prosper in a slower growth environment.</td>
<td>Short-term pain for long-term gain, as adjustments from an investment-led economic model occur.</td>
<td>Those countries where commodities are a feedstock for economic activity will benefit from lower input costs.</td>
</tr>
<tr>
<td>The shifting drivers of growth will bring attention to social factors, such as wages, benefits, health care, and retirement.</td>
<td></td>
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</tbody>
</table>
China is shifting to a more stable economic model.
The commodity super cycle is over.

**Australian Dollar**

![Graph of Australian Dollar rate over years](source: Bloomberg)

**Commodities (CRB Index)**

![Graph of CRB index value over years](source: Bloomberg)

**Brazil GDP**

![Bar chart of Brazil GDP year over year change](source: Worldbank)

**Copper Prices**

![Graph of Copper Prices in U.S. Dollars per pound](source: Bloomberg)
Incoming Chair Janet Yellen will continue down the Fed’s highly accommodative path.

Tapering is not Tightening.

- Unwinding the $85 billion per month asset purchase program will occur over the balance of 2014.
- ZIRP will likely last well into 2015, to ensure economic lift-off is self-sustaining.
- A Yellen Fed will be laser-focused on employment growth.
  - Fear of hysteresis among the underemployed will drive decision-making.
  - Inflation may be tolerated above target of 2% as the sacrifice to faster job growth.
U.S. equity markets are fully valued, but that does not impart a negative bias.

Priced off of forward consensus earnings estimates, the S&P 500 trades at a price-to-earnings ratio of 15.

- A historic forward and trailing P/E of 14 and 16 suggests that U.S. stock values are neither cheap nor dear.
- Sectors that have attractive valuation support include energy and technology.
  - The energy patch should do well, as oil prices levitate at economically profitable levels.
  - Business-facing tech companies should be beneficiaries of a capital spending push to upgrade aging systems and boost productivity.
- Sectors that are appealing for their sensitivity to the quickening pace of global activity are financials and industrials.
- Financials, particularly regional banks, insurers, and asset managers, stand to gain from increased commercial activity
- Industrials, like tech, are positioned to grow with the business spending revival.

Elevated multiples increase the potential volatility of a corrective phase.

- Price fluctuation is natural, but a more significant decline should be expected at any time.
- Equities are likely in a secular expansion—therefore, any sizeable pullback should be viewed opportunistically.
- Holding defensive sectors, or using bonds as a governor on equity market uncertainty, are a means of tempering risk.

U.S. companies have high levels of cash and healthy balance sheets, and are recording record profits.
<table>
<thead>
<tr>
<th>Sector</th>
<th>Strategy Allocation</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Materials</td>
<td>Neutral</td>
<td>We continue to hold a favorable view on undervalued cyclical sectors. Europe is recovering, Chinese data suggest re-acceleration, and leading indicators point to an uptick in global growth. Favor select agribusiness and diversified chemicals.</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>Neutral</td>
<td>The recovering housing market and advanced consumer deleveraging should continue to support this sector. Poor confidence and a weak labor market remain headwinds. Favor media for business spending and auto parts for pent-up auto demand.</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>Underweight</td>
<td>Pricing power for premium brands is being challenged, but steady growth and high dividends make this sector an appealing anchor. Favor select drug retailers, household product, and beverage companies. Staples remains an underweight due to better value in globally exposed cycicals. We are also concerned about exposure to weak emerging markets.</td>
</tr>
<tr>
<td>Energy</td>
<td>Overweight</td>
<td>Oil companies are trading at very attractive valuations, often with significant dividend yields. Near-inelastic demand from emerging markets and improving global growth should keep oil prices elevated. Favor major integrated, exploration and production, and service companies.</td>
</tr>
<tr>
<td>Financials</td>
<td>Overweight</td>
<td>Financial regulation makes forecasting the capital needs for universal banks difficult. Valuations, a steady domestic environment, improving housing, and pent-up durables demand are compelling for regional banks. Favor select insurers, regional banks, consumer finance, REITs, and asset managers.</td>
</tr>
<tr>
<td>Health Care</td>
<td>Neutral</td>
<td>Sector reduced to neutral on improved valuation, reflecting lifting of uncertainty following passage of new health care bill. Outlays for health care should remain strong. Opportunities can still be found in this defensive sector. Favor medical device companies and select insurers. Pharmaceuticals are a core holding, but they are exposed to the end of easy Fed policy.</td>
</tr>
<tr>
<td>Industrials</td>
<td>Overweight</td>
<td>Sales and earnings forecasts have been reduced, and valuations have been marked down. Europe and China are recovering, while the Fed is seeing improvements in the U.S. economy. Favor globally exposed, cyclical companies with above-market dividends.</td>
</tr>
<tr>
<td>Information Technology</td>
<td>Overweight</td>
<td>Information technology spending can grow, as business confidence lifts and pent-up demand is released. Most large-cap technology companies are cash rich and look attractive on a dividend yield basis. Favor software, semiconductors, storage, and technology enablers.</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>Underweight</td>
<td>Defensive characteristics and attractive dividends are being offset by competitive pressures. We see more value in other sectors, although traditional carries are attractive for their yields. Favor those with wireless exposure.</td>
</tr>
<tr>
<td>Utilities</td>
<td>Underweight</td>
<td>Industry fundamentals are a concern for this defensive sector that had been bid up in the search for yield. Some companies are favored by the emergence of natural gas abundance and coal displacement. Favor regulated electric utilities.</td>
</tr>
</tbody>
</table>
International equities sport unusually attractive valuations.

Valuations and a brightening economic picture prompt allocations to international markets.

The Shiller P/E—a smoothed view of equity valuations in a long term context—shapes allocations.

Over the last 40 years, an equity market with a Shiller P/E of 15 produced an 8% annualized return in the subsequent decade.

- Developed countries that currently possess Shiller P/Es of 15 or less and are fundamentally appealing are:
  - UK, Germany, and France.
- Emerging market countries that currently hold the same characteristics are:
  - China, South Korea, and Vietnam.
  - Mexico has a slightly higher P/E, but reforms under President Nieto and the country’s link to U.S. growth make it appealing.

When a Shiller P/E of 10 or less exists (a rarer circumstance), the following decade of equity performance produced 16%/yr.

- Countries hosting a P/E of 10 or less, and are fundamentally but speculatively attractive are:
  - Spain, Italy, Poland, Russia, and Greece.

By way of comparison, the U.S. stock market trades at a Shiller P/E of 24—above its historical mean of 16.5.
Bonds offer a refuge, but total returns will be negligible.

**Bond yields should grind higher as the economy strengthens.**

The backdrop of better economic growth and the vanishing bond-buying regime by the Fed pressures bond prices.

- The 10-year Treasury bond may yield 3.5–3.7% in 2014.
- The yield curve will flatten as the belly of the curve bulges out, while the long end remains fairly stable.
- Short-term rates remain zero-bound.

Spread product—corporate and municipal bonds—are relatively attractive.

- High-yield, senior floating rate bonds and TIPS offer a buffer to rising yields.
- State and municipal finances are improving, making Detroit the exception not the rule.

![U.S. Treasury Yields](chart)

Source: Bloomberg
Interest rate sensitivity can be mitigated by managing duration.

**Bond prices have fallen on higher interest rates.**

The most interest-rate-sensitive and longest maturities are most vulnerable.

- Non-government bonds may defend value if credit upgrades result from improving business conditions.
- High-yield and municipal bonds offer decent yield for investors seeking income within the fixed arena.

If yields push higher as forecast, 2014 may reproduce a scenario of negative returns.

Bonds are strategically important, and may best serve as a cushion to equity volatility.
Success in the commodity complex—energy, precious and base metals, and softs—is varied.

Energy prices are profitably high, and demand remains strong.
- 50% of global crude demand comes from non-OECD usage, and that percentage is rising.
- Saudi Arabia is motivated to keep the tipping point in pricing around $100/barrel.
- New supply sources, especially in the U.S., should keep pricing tame absent a flair-up in the Middle East.

Precious metal returns are bifurcated.
- Platinum and palladium prices should harden as car sales increase.
- Gold and silver have lost luster as a better economy and receding macroeconomic risks usurp their safe haven status.

Base metals may offer improving fundamentals.
- Increasing industrial activity and capital spending could ignite nickel, zinc, and copper prices.
- Mining company retrenchment is helping to remove excess supply and improve pricing performance.

Softs fulfill the secular need for more food, to satisfy growing populations and rising per capita incomes.
Cash equivalent yields remain zero-bound.

An excerpt from the December Federal Open Market Committee meeting reads:

“The Committee also reaffirmed its expectation that the current exceptionally low target range for the federal funds rate of 0 to ¼ percent will be appropriate at least as long as the unemployment rate remains above 6 ½ percent…”

Interpretation: The current pace of job growth (200,000 per month over the last four months) suggests this target could be achieved at the end of 2014. If the Fed holds through that threshold, it means ZIRP well into 2015.

“…inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and longer-term inflation expectations continue to be well-anchored.”

Interpretation: While this implies that the Fed is willing to accept a reading of 2.5% on inflation, their litmus test is the core PCE (personal consumption expenditure) index. Since this measure does not include food and energy prices, headline readings of inflation could be above their stated tolerance.
Inflation is likely to remain benign.

Headline inflation is well below historic levels.

- The Consumer Price Index (CPI) has averaged just over 3% since the early 20th century.
- Still-weak demand and excess labor provide little impetus for price increases.
- Inflation expectations remain subdued, taken out over extended periods.
- CPI is a lagging indicator, so advanced signals need to be monitored.

While reported cash balances of financial corporations near $2 trillion, it’s not moving.

- The cash mountain held by the Federal Reserve on behalf of U.S. financials earns just 0.25%.
- Banks are increasingly willing lenders, but the sentiment is not matched by equivalently eager borrowers.
- A signpost for “too much money chasing too few goods” is the increase in the velocity of money.
  - This represents increased credit activity—the transmission mechanism for economic activity.
  - At just 1.62 today, it plumbs lows of the last 50 years.
### Optimistic case: 25% probability

<table>
<thead>
<tr>
<th>Economy and markets</th>
<th>Increasing confidence in the economy’s strength and the job market induces a marked increase in activity, spurring the economy to a surprisingly healthy rate of growth. While bond yields creep higher, the climate for profit gains overwhelms the fear of rising rates, driving equity markets much higher. Employment trends toward 6.5%, and yet the Fed holds short-term rates near zero well beyond the end of quantitative easing. Sidelined investors and underinvested institutions reallocate to risk assets, providing a funding source for equity purchases. A tolerant inflation score provides no challenge to multiple expansion. The avoidance of any major geopolitical setback limits any significant drawdown for equity markets to overcome. Double-digit earnings growth and a further reduction in the equity risk premium produce a target of 2,040 on the S&amp;P 500 index. A mid-teens return from U.S. equities is trumped by international markets. Bonds fail to post positive total returns for the second consecutive year—clearly defining the yield of 1.4% on the 10-year Treasury note reached in 2012 as the inflection point for a secular shift in the bond market.</th>
</tr>
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<tbody>
<tr>
<td>Investment strategy</td>
<td>A pro-cyclical posture via exposure to business-facing technology sectors, industrials, financials, and energy companies is warranted. Better valuations and retreating risks invite market participants to make more daring equity placements, including peripheral Europe and emerging market equity bourses. Bond investors seek shelter.</td>
</tr>
</tbody>
</table>

### Base case: 65% probability

<table>
<thead>
<tr>
<th>Economy and markets</th>
<th>The U.S. economy strengthens as business and consumer spending combine with a reduced fiscal drag to lift growth toward 3%. In concert, the Euro area, Japan, and China grow, touching 85% of the world’s GDP. Risks of an unintended encounter in the East China Sea between Japan and China, and an as-yet unsettled Iranian nuclear armament negotiation, loom as threats to our sanguine view. The stock market rally has pushed multiples in the U.S. to fair value—making further advances incumbent upon earnings growth. The shift in monetary policy by the Federal Reserve to pare its asset purchase program leaves intermediate interest rates vulnerable to an upward, but unalarming, bias. Inflation remains benign—allowing monetary conditions to remain accommodative, and insulating profit growth and margins. Corporate profits rise to $120 for S&amp;P 500 companies, and valuations remain near long-term trend. Stocks succumb to a healthy pullback as investors react to a changing monetary landscape. Stocks recover to achieve a price target of 1,920 for the S&amp;P 500 Index, delivering an upper single-digit return year-over-year before dividends.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment strategy</td>
<td>U.S. stocks produce attractive returns, outperforming bonds and cash. As a defensive equity bourse, U.S. returns lose the performance derby to international equity markets, particularly those in Europe, Japan, and China, as investors’ risk appetites grow. The most interest-rate-sensitive securities, both equity and fixed income, should be underweight.</td>
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## Pessimistic Case I: 7% probability

<table>
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<th>Scenario Analysis</th>
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<tr>
<td><strong>Economy and markets</strong></td>
<td>The Fed’s liquidity withdrawal induces a growth scare, and worries spike that sputtering economic activity will lead to faltering profits. Additionally, the belief that the Fed’s policies may be pushing on a string even if renewed, and there being little appetite for new fiscal stimulus, opens a gap of uncertainty. Markets correct, and Treasury bond yields drop below 2.5%. Non-U.S. equities shutter over the U.S.’s relapse, and the correction lowers stocks by some 20%. As market participants realize the economy holds enough momentum to sturdy in the absence of the Fed's largesse, a recovery gets underway. However, profit growth expectations are marked down and valuations are de-rated. The market prices off lower expectations, and a target for the S&amp;P 500 Index becomes 1700, or a P/E of 14.5 priced against earnings of $117. If the market declines severely, cash or a rebalancing program should be utilized advantageously to buy at lower levels. An accompanying bond rally that should occur in a flight-to-quality stage should be sold, as yields will drift higher when the economy reestablishes traction. Investors should not abandon long-term investment policies in the midst of the correction, because it is likely only in the context of a long, secular expansion in equity prices.</td>
</tr>
<tr>
<td><strong>Investment strategy</strong></td>
<td>U.S. stocks do relatively better than non-U.S. equities. Favor high-quality, large-cap dividend payers, especially the defensive areas of staples, telecommunications, and utilities. Bonds produce better returns than stocks, with Treasuries gaining the most in the de-risking process. Cash equivalents and low-correlated investments serve to buffer portfolio volatility. Gold benefits spark a tradable rally toward 1,500.</td>
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## Pessimistic Case II: 3% probability

<table>
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<tr>
<th>Scenario Analysis</th>
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<tr>
<td><strong>Economy and markets</strong></td>
<td>The Fed’s model for the output gap—a key statistic guiding its monetary policy—may overstate the participation rate’s importance. A recent research report by the Philadelphia Fed found that almost two-thirds of the decline in recent years can be attributed to issues unrelated to potential but discouraged labor participants. If job growth continues at its most recent pace, it may ignite inflation from wage growth via a tightening of employment slack sooner than currently anticipated. That may enlist market participants to expect the Fed’s rate policy of “lower-for-longer” to be pulled forward. A likely selloff in the bond market would be shared by a decline in equity markets as an immediate reaction. Equities should not experience a permanent impairment in valuations until inflation rose above 4%. Therefore, subsequent to a near-term disruption, equities move toward 1,840 on the S&amp;P 500. Bond prices, on the other hand, hold declines through year-end.</td>
</tr>
<tr>
<td><strong>Investment strategy</strong></td>
<td>U.S. stocks finish at levels modestly above where they began the year. Economically sensitive sectors gain on the prospects for faster growth, while interest-rate-sensitive securities and defensive areas underperform. Commodities break their slumber with growth specialties, such as oil and select industrial metals performing well. Bonds lose more value than their coupon, igniting a wave of defections from bond funds to equities. Cash yields remain near 0, but the window to a change in Fed policy—lifting the Fed fund rate—closes to within 12 months.</td>
</tr>
</tbody>
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**A weighted blend of these scenarios establishes a year-end price target for the S&P 500 of 1931.**