EDGE

Q4 2014 Outlook

Winter 2014

CONFIDENTIAL

TRICK OR TREAT?

Has the world fundamentally changed during these past four weeks? As of the time of writing this Quarterly Outlook, asset markets are in the process of testing each investor's conviction in the fundamental strength and valuation of the investments they have made. Did the world awake from a low-volatility slumber to see a world completely different from what they believed it to be just a short time ago?

That is what has been suggested by the asset markets these past four weeks. After years of strong, relatively uninterrupted trends higher in risk assets, what has taken hold these past few weeks is fear. Fear from traders that they would be the last one in the market if the global progress made these past five years has been a trick.

When we evaluate the businesses in our core themes, we continue to see real strength. On the following pages, you will see the work we have done to assess our conviction. More than that, we are using this time as an opportunity to assess whether valuations are opening up new ideas through which we can turn this near-term trick into a long-term treat.

THE LEGEND OF "STINGY JACK"

People have been making jack-o'-lanterns at Halloween for centuries. The practice originated from an Irish myth about a man nicknamed "Stingy Jack." According to the story, Stingy Jack invited the Devil to have a drink with him. True to his name, Stingy Jack didn't want to pay for his drink so he convinced the Devil to turn himself into a coin that Jack could use to buy their drinks. Once the Devil did so, Jack decided to keep the money and placed it in his pocket next to a silver cross, which prevented the Devil from changing back into his original form. Jack eventually freed the Devil, under the condition that he would not bother Jack for one year and that, should Jack die, he would not claim his soul. The next year, Jack again tricked the Devil into climbing a tree to pick a piece of fruit. While he was in the tree, Jack carved a sign of the cross into the tree's bark so that the Devil could not come down until he promised Jack not to bother him for ten more years.

Soon after, Jack died. As the legend goes, God would not allow such an unsavory figure into heaven. The Devil, upset by the trick Jack had played on him and keeping his word not to claim his soul, would not allow Jack into hell. He sent Jack off into the dark night with only a burning coal to light his way. Jack put the coal into a carved-out turnip and has been roaming the Earth with it ever since. The Irish began to refer to this ghostly figure as "Jack of the Lantern," and then, simply "Jack o'Lantern."

In Ireland and Scotland, people began to make their own versions of Jack's lanterns by carving scary faces into turnips or potatoes and placing them near windows and doors to frighten away Stingy Jack and other wandering evil spirits. In England, large beets are used. Immigrants from these countries brought the jack o'lantern tradition with them when they came to the United States. They soon found that pumpkins, a fruit native to America, make perfect jack-o'-lanterns.

Source: History.com

RECOMMENDATIONS

Fixed Income

If we didn't like the 10-Year US Treasury at 3% (exiting 2013), we certainly do not like it at 2.2% (October 2014). Consistently throughout 2014 we have advocated that investors avoid duration exposure within core fixed income and this is not the time to reverse course. The forward outlook for rates may be lower today than where it was earlier in the year, but in any case, the outlook is still higher.

We advocate floating rate strategies, mortgage bonds (specifically non-agency), and short-duration securities that are positioned to generate return in a variety of rate environments.

Equities

Stay the course in equities and take advantage of market pullbacks by adding to high-conviction positions

US fundamentals remain strong and should be buoyed by even lower energy prices. Housing and auto data will ebb and flow, but we believe both are supported by healthy fundamentals. US manufacturing (aided by lower energy prices) continues to gain traction.

Within the US, quality large capitalization companies offer an even wider valuation discount versus the broader market. Yields are even higher today, and for the first time in a long time, the yield of the S&P 500 is above the 10-Year US Treasury.

European conviction is being tested; avoid / minimize FX exposure

In prior outlooks we emphasized that the European profit and economic cycle would fluctuate between optimism and pessimism, and we are experiencing the latter. For several reasons we believe sentiment and fundamentals will shift back again, due to weaker euro, additional ECB activity, lower energy prices, labor reform and valuations near multiyear lows.

China is executing on its plan; equities remain favorable

Reform is slow; change is slow. We urge investors to be patient and remain invested in China (and broader Asia, ex-Japan). Valuations are among the lowest in the world, growth is the strongest, and lower fuel prices are tremendous for emerging economies where goods fight for every consumption dollar.

Real Assets

Selectively invest in volume opportunities within energy; avoid price exposure for now

Energy prices have entered a new paradigm (at least in the short-run), and current price levels remain supportive of investments in pipelines (toll-roads) and fee-based opportunities, within both energy equities (Energy Renaissance theme) and MLPs.

Expect minor production curtailments in the short run as producers react to a new environment. Lower prices are supportive of gasoline demand (driving miles) and US manufacturing. Supply disruptions will create a price floor, but expect volatility to continue through year-end.

OUTLOOK

Realize MORE

ANTICIPATING THE FED'S FIRST MOVE

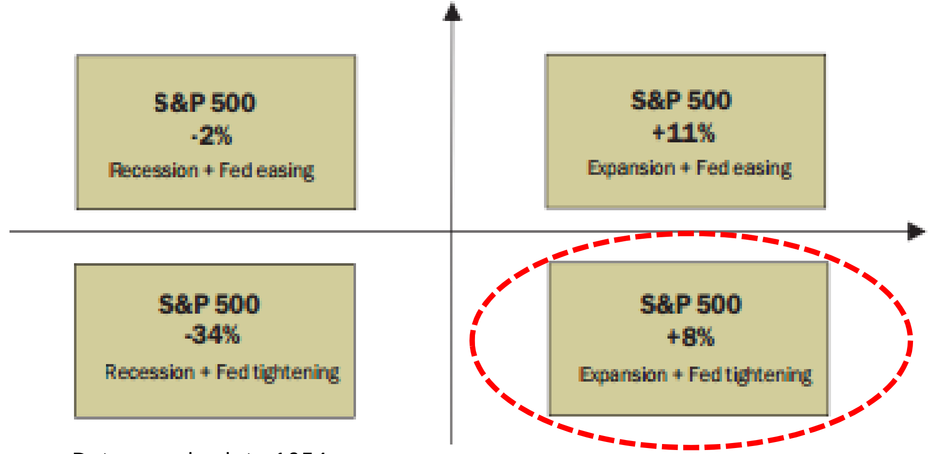
According to Fed funds futures, the estimated probability of a 25 basis point rate hike by the Fed in 2015 is approximately 40%. This number has fluctuated in recent weeks, and the most recent Fed meeting notes point to a lively debate among Fed officials about how long to keep rates unchanged. **We believe that a Yellen-led Federal Reserve will keep rates lower for longer in the effort to improve the sustainability of the recovery. The Fed will increase rates slowly in an effort to achieve full employment.**

One concern increasingly weighing on investors' minds today is how the equity markets will react in anticipation of the next Fed rate hike. Market participants are fearful that monetary tightening will choke off the economic recovery, as evidenced by the recent volatility in US equity markets. We believe this fear is overblown. History shows that market volatility can occur at the beginning of the rate-tightening cycle, although bull markets did not end after the first rate hike. The peak in the market usually occurs between one and a half and three years after the initial Fed rate increase.[1] Looking at two periods when the Fed began tightening considerably - Feb. 1994 and June 2004 - valuations were at levels similar to today, with a forward P/E between 15 and 16 vs. 15.6 currently. Looking at data going back to 1954, stocks provide the highest returns while the economy is expanding and the Fed is easing (see top right graph). **We believe we are moving away from this environment and heading toward Fed tightening (slowly) and continued expansion (bottom right quadrant). In short, if the Fed is tightening during an expansion, stocks can still achieve positive returns.**

Equities tend to be most at risk when the economy is contracting while monetary policy tightens (likely in response to inflation accelerating). We do not believe this is the case today. Absent a meaningful acceleration in wage growth or inflation, an aggressive increase in rates is an unlikely event in 2015. **We would not reduce equity exposure in anticipation of an increase in the Fed funds rate and continue to believe that equities will be a positive source of long-term return going forward.**

Equities Rise While Business Grows

Average Annual Return by Period



Data goes back to 1954

(1) Source: Gluskin Sheff, Haver Analytics, Bloomberg

1994 Fed Tightening Cycle (First Rate Rise 2/4/1994)

Time Horizon	S&P 500 - % Change	Unemp. Rate (Jan - 6.6%)	CPI Core Change (Avg Y/Y % Chg)
9 Mos Before	6.7%	7.1%	3.4%
3 Mos Before	2.7%	6.6%	3.1%
12 Mos After	3.5%	5.4%	3.0%
24 Mos After (Annualized)	19.5%	5.5%	2.9%
36 Mos After (Annualized)	21.9%	5.2%	2.5%

2004 Fed Tightening Cycle (First Rate Rise 6/30/2004)

Time Horizon	S&P 500 - % Change	Unemp. Rate (Jun - 5.6%)	CPI Core Change (Avg Y/Y % Chg)
9 Mos Before	14.5%	6.0%	1.2%
3 Mos Before	1.3%	5.6%	1.6%
12 Mos After	6.3%	5.0%	2.0%
24 Mos After (Annualized)	7.5%	4.6%	2.6%
36 Mos After (Annualized)	11.7%	4.6%	2.2%

* The unemployment rate for Sept 2014 was 5.9%, and the Aug 2014 Y/Y change in CPI Core Inflation was 1.7%.

(2) Source: Bloomberg, Strategas

MACRO

"CARS AND REFRIGERATORS" POINT TO EXPANSION

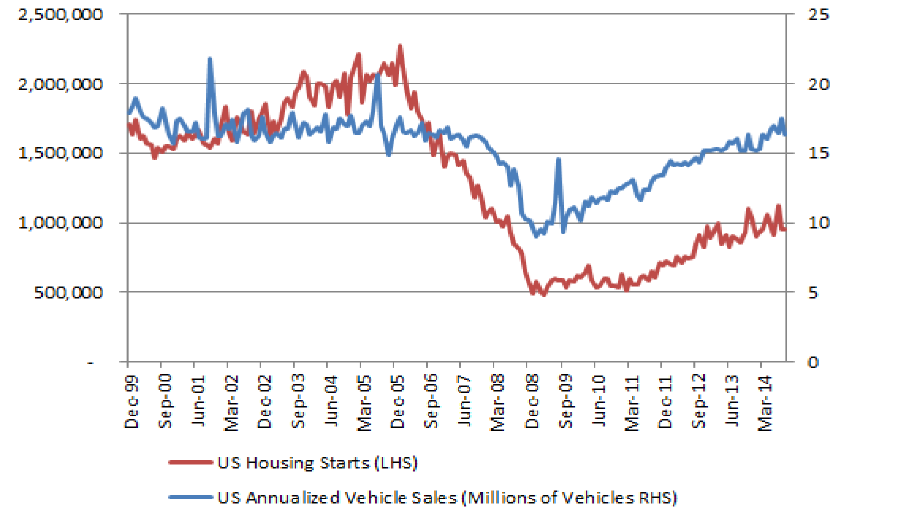
A business school professor once told his Applied Investment Management class that the only two data points that mattered to the US economy were sales of cars and refrigerators (his proxy for strength in housing). This statement is only a slight exaggeration - when consumers have both the income and the confidence for such major purchases, the broader outlook is generally good.

The Federal Reserve is nearing the end of its bond purchase program (QE), and the debate now rages regarding the timing and impact of an eventual interest rate increase. Against this backdrop, it is important to remember that the US economy continues to expand. **After a weak start to the year (-2.1% in Q1), US economic growth has reaccelerated. Q2 GDP was revised higher to 4.6%, and Q3 should show continued strength.**

Among the drivers of strength are consumer-related sectors such as housing and autos as well as industrial sectors such as oil and gas production. Given continued gains in employment and strong end-market demand, we expect all of these businesses to drive further job (and income) growth and contribute directly to US GDP.

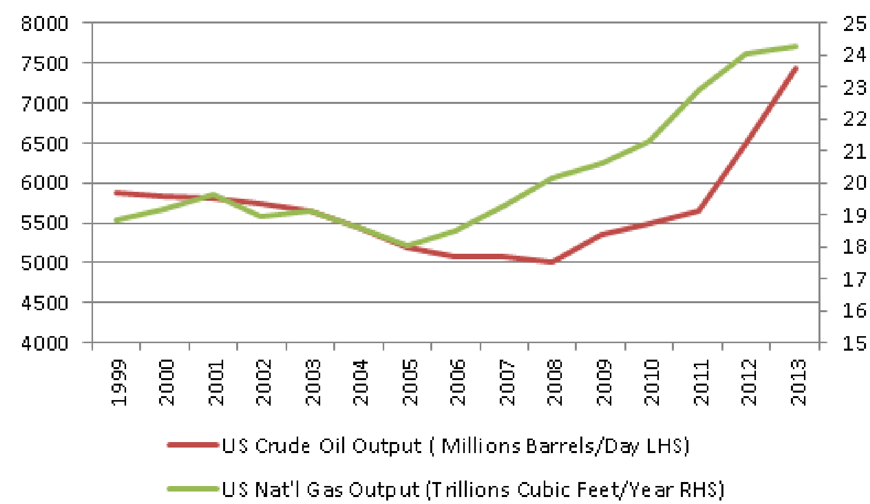
Given these tailwinds in the economy, we believe that investors should focus on the positive side of stronger growth in the context of reduced monetary stimulus. US companies are operating from a position of strength, and profit fundamentals remain positive.

Fundamental Strength in Housing & Autos



Source: Bloomberg

US Oil & Gas Production on the Rise



Source: Bloomberg

CONSUMERS GETTING SOME RELIEF

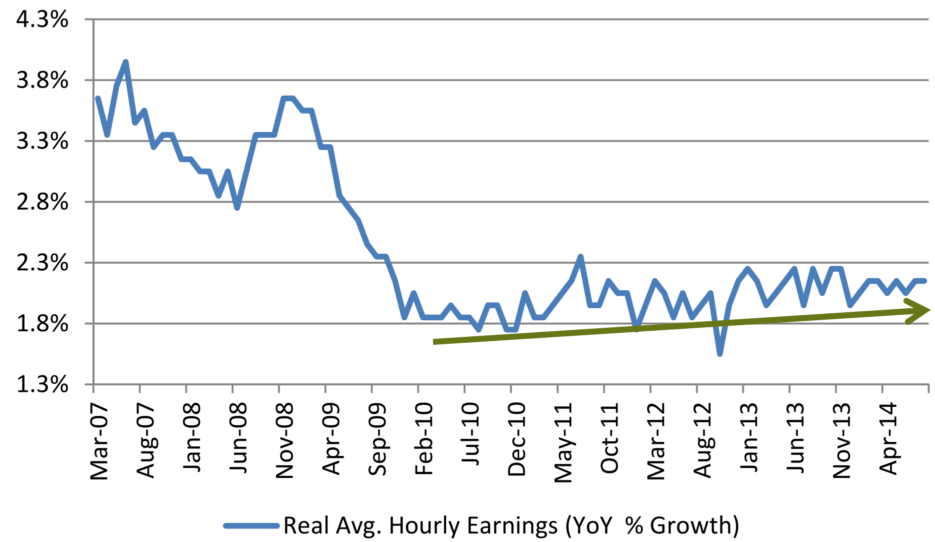
Stronger US economic data has been accompanied by good news for the US consumer. The health of the consumer is critical to an economy that depends on consumption for close to 70% of GDP.

Sluggish real wage growth has provided fodder for political debates and has exacerbated dissatisfaction with leadership in Washington, DC. Although progress in wage growth has been slow, the trend is positive. At 2.1% year-over-year growth (inflation adjusted), consumers are seeing increased income, but the rate of growth is not rapid enough for the Federal Reserve to be forced into raising rates quickly to head off inflation.

Combined with real wage growth, the consumer also benefits from a $0.40-per-gallon decline in US gasoline prices caused by the rise of hybrid and electric vehicles, stricter fuel standards, and flat miles driven together with falling WTI and Brent oil prices. Because consumers tend to drive the same amount regardless of gasoline price (at least in the short run), a decline in prices translates nearly one-for-one into greater disposable income (energy consists of approximately 15% of a US consumer's discretionary spending). In 2013, US drivers used 130 billion gallons of gasoline. On a full-year basis, the recent decline in prices translates to $54 billion in savings. Lower energy prices are another deflationary force, which gives the Fed more breathing room in rate policy - allowing more time before rate increases are required.

Given fundamental strength in the economy and more disposable income for consumers, we believe that US equity investments remain well-positioned for further upside.

Wage Growth Continues to Improve



Source: Bloomberg

… And is Aided by Falling Gasoline Prices

Change in Gasoline Price	Annual Consumer Savings (Billion USD)
$0.10	$13
$0.20	$27
$0.30	$40
$0.40	$54
$0.50	$67
$0.60	$80
$0.70	$94
$0.80	$107
$0.90	$121
$1.00	$134

Source: Bloomberg

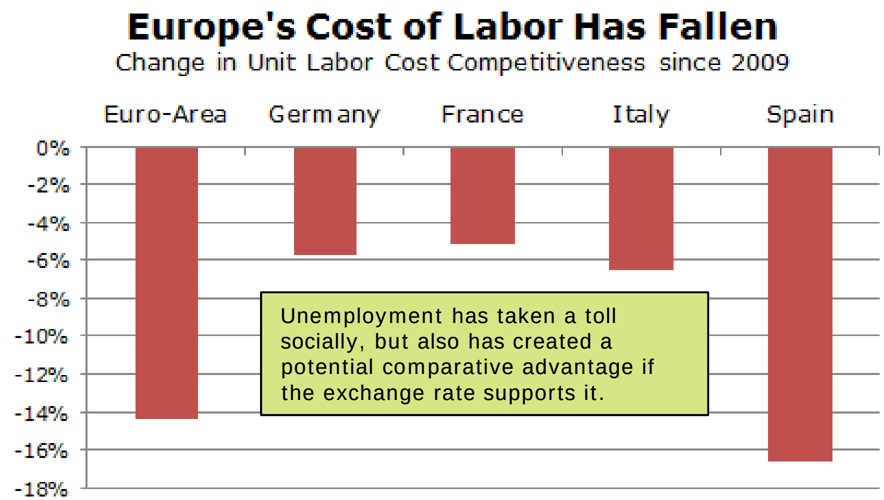
SUSTAINABILITY REQUIRES FOLLOW THROUGH

We have said in recent Outlooks that the road to recovery in Europe would be bumpy. We are hitting one of those patches in the road now. Inflation has remained weak (around 0.3% on last reading). Unemployment has remained high (the headline statistic has stayed above 11%, while the jobless rate among those under 25 is at an astounding 21%). Credit provided by banks to nonfinancial corporations continues to shrink. Recent economic data throughout the eurozone suggests that the green shoots of growth appear to be drying up. Even the recovery of the stalwart Germany is showing fatigue. Taking the market's standard form of forecasting (i.e. take recent experience, assume it continues), there has been a palpable change in sentiment as compared with the fourth quarter of 2013.

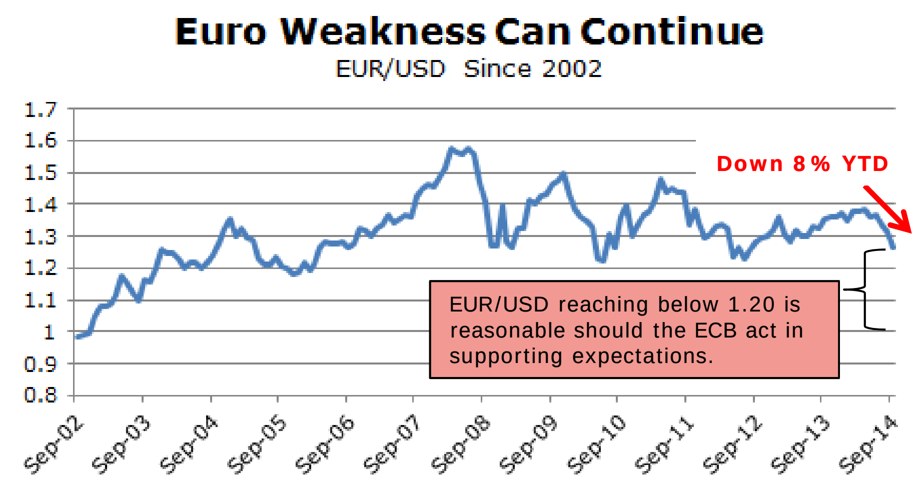
So what's it going to take? There is no mystery here. Looking to the US and the UK as examples, **there must be monetary and fiscal support, providing time for structural reform**. Europe must take advantage of the fall in relative labor costs by devaluing the euro to improve export competitiveness and put an upward pressure on inflation (exports comprised 27% of eurozone GDP in 2013). They must increase economic confidence by reducing unemployment and stimulating activity fiscally. In addition to confidence, Europe must facilitate credit creation by getting liquidity transmitted through banks into the real economy so that private activity can take over from these first steps by policy makers.

The challenge remains bureaucracy. In recent quarters, we have seen politics lean toward growth and away from austerity, but coordinating the 18-nation bloc remains a challenge. The recent vote in Scotland on whether to separate from the UK shows continuing fragmentation and a desire for self-determination that almost overwhelms economic rationality. Bold leadership that cuts through the noise and the red tape is required to develop Europe's own brand of common good and, thus, common action in support of this goal.

After strong words and many promises, European Central Bank (ECB) President Mario Draghi fell flat on October 2nd with a lack of details for the asset purchase plan intended to grow the ECB balance sheet and weaken the euro. Draghi opted for ambiguity instead of starting with a committed number that shows a good-faith step on the path of recovery. **The path remains in place, with only the need for a determined leader willing to revive the green shoots with liquidity.**



Source: European Central Bank, Bloomberg



Source: Bloomberg

EQUITIES

LOOKING THROUGH DISPERSION AND PRICE VOLATILITY

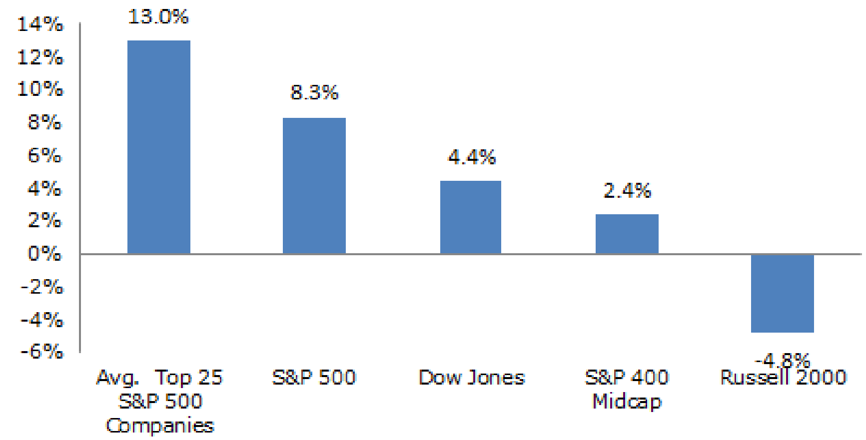
In most years, answering the question of "how are stocks performing" would be relatively straightforward. This year, however, the answer requires more nuance. Equity index returns are very different when comparing across sector, geography, and market capitalization. As shown in the table, investors who purchased only the largest stocks in the S&P 500 have done well, while Dow Jones investors (another large-cap index) have earned roughly one-third of the return of the former group. Small cap investors have lost money continuously this year. It is not uncommon for small caps to zig while large caps zag, but the discrepancy within market capitalizations is unusually sizable.

Explaining the discrepancy is even more difficult than answering the question posed above. Benjamin Graham once said, "In the short run, the market is a voting machine, but in the long run it is a weighing machine." In other words, market volatility in the short run does not always forecast or reflect changing corporate fundamentals that, over the long-term, ultimately drive stock performance. When volatility increases, we emphasize the importance of fundamental investing, or in other words, valuations and earnings growth. Based on our vantage today, corporate fundamentals remain strong and continue to represent an attractive investment opportunity.

If we focus on the broadest measure of corporate fundamentals (the S&P 500), index earnings increased roughly 9% year over year through the first half of 2014. Consensus estimates expect earnings to increase in the low-double-digit range for the second half of the year and again in 2015. We have been at this long enough to know that consensus earnings are historically overzealous, and our forward return models are forecasting more conservative estimates. We believe earnings growth in the high-single-digit range (2014) and mid-single-digit range (2015) are achievable over the next 18 months. Using our 2015 assumption suggests that the S&P 500 is valued at approximately 15.5x our estimates, slightly below the market's long-term average. We continue to reduce expectations for higher multiples and believe returns will be driven largely by earnings and dividends for this year and next.

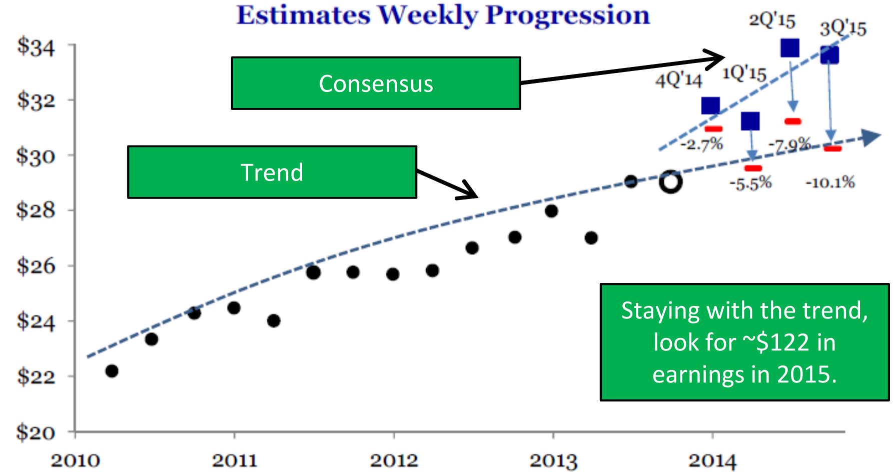
<u>In summary, our work continues to suggest that US large-cap fundamentals remain sound and offer an attractive balance of risk and reward. FX volatility is likely to reduce second half results (especially in Q4), but expect earnings growth. We continue to look for a more favorable entry opportunity for US small caps.</u>

Year to date returns through 10/8



Source: Bloomberg

S&P 500 Quarterly Earnings Estimates Weekly Progression



Source: Strategas

EQUITIES

RELATIVE VALUE AND GLOBAL GROWTH OF CASH FLOW

Our stance to avoid small caps and remain overweight US large-cap equities, particularly those with attractive dividend yields and growth, has rewarded investors YTD. Amazingly, 30% of companies in the S&P 500 Index yield more than the 2.5% yield offered by the 10-Year US Treasury note that is fixed. Meanwhile, the dividend payout ratio for the S&P 500 remains stubbornly low at 33%, which suggests a great margin for dividend growth given its 49% average payout ratio over the last 78 years. Relative value still resides in equities vs. investment-grade fixed income. Furthermore, dividend equities currently offer more income (that can grow) than fixed income as dividend yields are greater than or equal to government bond yields globally (except for in the US).

With further multiple expansion difficult to come by in the US, total returns are likely dependent on earnings growth and dividend income. Yet most equity markets outside the US – especially in Europe and the emerging markets – offer lower valuations and higher dividend yields than those in the US, indicating greater potential for multiple expansion. The risks to this thesis are slower earnings growth and currency exposure.

We illustrate the relative value and performance of global dividend payers vs. their US counterparts. S&P's Dividend Aristocrat constituents have increased their dividend for at least ten consecutive years. The Global Dividend Aristocrats offer a dividend yield twice that of the U.S. Dividend Aristocrats and trade at a 15% earnings multiple discount. The US Dividend Aristocrats have been the best place to be over the past five years, but their global peer group has underperformed by nearly 5% on an annualized basis.

We stress the importance of a long-term time horizon with our relative value stance – investors must be patient with the balance between higher valuations and growth expectation for US equities vs. lower valuations and growth expectations outside the US. Either way, dividend income and growth will be critical components of total equity returns in the future.

Dividend Yields & Valuation Outside The US

Index Name	Dividend Yield	2014 Earnings Yield	2014 P/E	2014 P/EBITDA
S&P 500 INDEX	2.0%	6.2%	16.2	8.2
S&P/TSX COMPOSITE INDEX	2.9%	6.3%	15.9	6.4
BRAZIL IBOVESPA INDEX	4.0%	7.9%	12.7	4.7
FTSE 100 INDEX	3.9%	7.4%	13.4	6.4
CAC 40 INDEX	3.3%	7.0%	14.3	6.0
DAX INDEX	3.1%	7.9%	12.7	5.4
NIKKEI 225	1.7%	5.7%	17.6	6.7
HANG SENG INDEX	3.7%	9.3%	10.8	7.6
S&P/ASX 200 INDEX	4.9%	6.9%	14.6	7.0

Source: Bloomberg and Edge Capital as of 10/7/14

Global Dividend Payers vs. US Dividend Payers

Fundamental Comparison	Div Yield	Trailing P/E	Projected P/E
S&P Global Dividend Aristocrats	4.9%	17.3	14.8
S&P US Dividend Aristocrats	2.4%	20.0	16.7
S&P 500	2.0%	19.0	15.0

Total Return Comparison	YTD	3YR Annualized	5YR Annualized
S&P Global Dividend Aristocrats	3.9%	14.7%	12.8%
S&P US Dividend Aristocrats	6.5%	23.0%	17.6%
S&P 500	8.3%	23.0%	15.7%

Source: Standard & Poors as of 9/30/14

A ROCKY ROAD TO RECOVERY

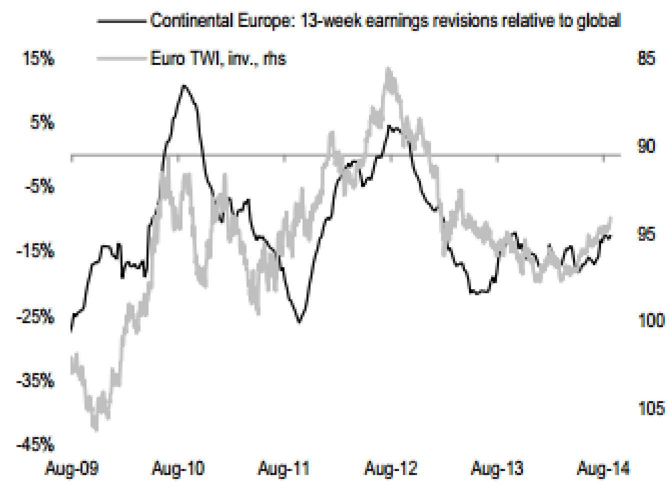
After years of avoiding the region, in late 2013, we initiated exposure to European equities. We recognized that we were early but the valuation opportunity and the building case for growth-supportive policy was enticing.

So far in 2014, Euro-area economies have not met recovery expectations and earnings have grown at a slower-than-expected pace. Some of the reason is that the euro remained elevated until very recently. Approximately 58% of European company sales originate outside the eurozone suggesting close ties between earnings and the exchange rate. The close relationship can be seen in the chart illustrating that upward revisions are to be expected when the exchange rate falls as it has recently. It can take time for the effects of a devalued currency to flow through fundamentals, so we temper our expectations for the pace of improvement. That said, any increase in top-line sales originating from an economic pickup or currency translation can have a sizable impact on earnings based on operating leverage.

From a valuation perspective, it can be helpful to evaluate the European equity opportunity using multiple measures. It is typical to observe a "discount" in Europe relative to the US across metrics including multiples on earnings, book value, EBITDA, and sales. Therefore, it is important to compare the current readings to the longer-term average of differences. Evaluating through these multiple lenses, we observe larger-than-normal discounts that are on average over 5% more than typical.

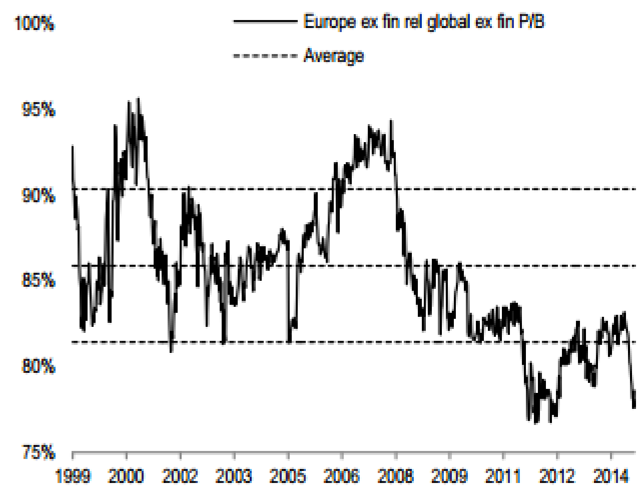
At this point, **we remain underweight to the region relative to global equity comparisons, which has benefited portfolios (due to underperformance relative to large-cap US equity). That said, we remain committed to our existing investments in the context of its higher risk and higher return potential.** There remain quality companies at attractive valuations domiciled in the region (active manager stats: 13.7x P/E, 1.5x P/B vs. S&P 500 15.3 P/E and 2.7 P/B). **Looking forward in a 3-5 year context, the divergence between US and European monetary policy will benefit European assets in local currency terms** – it will just take time. As always, we must remain thoughtful of the effect of currency as US dollar-denominated investors.

Weakening Euro Improves Earnings



Source: Credit Suisse

Relative Valuation is Near Previous Crisis Levels



Source: Credit Suisse

EQUITIES

NEW CHINA CONTINUES TO PROGRESS

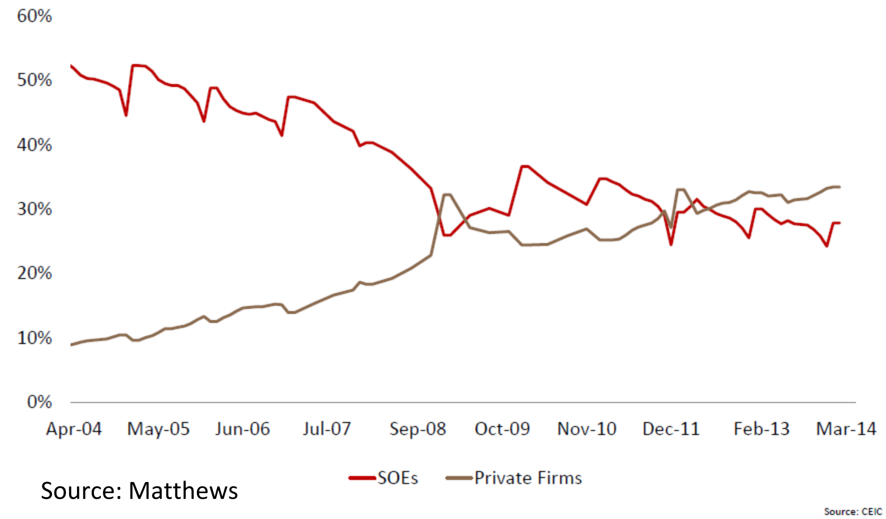
Almost one year ago, the leadership of China announced a significant platform of economic reforms from the Third Plenary session, intending to liberalize the economic policies of the country and cede more control over price and supply to market forces. The pace of progress on those goals has been measured but consistent in its follow-through. Corporate bankruptcy has been allowed demonstrating risk to investors. The exchange rate has fluctuated. Private banks are being chartered to bring private lending into a regulated environment and out of the shadows. Corruption, graft, and bribery have been prosecuted. Trade regulations are being loosened in certain special economic zones to test new policies. A limited trade connection between the Hong Kong and Shanghai stock markets is also being tested to broaden capital raising solutions (one of the reasons the A share equity market rallied 15% in Q3 2014 alone). The registration system for social services is being overhauled to enable the migration of 100mm people into cities in the next six years.

All together, the command economy is being transitioned toward a market-based, consumer-driven economic system that in the long term will have more stability and better resource allocation. In the short term, policy makers must maintain political stability (i.e. create jobs) while managing the legacy issues of their prior development. Specifically, they must continue to cool overheated areas of the economy created by a generally closed capital account (i.e. real estate) while fostering growth in other areas. Therefore, we should not be surprised that real estate prices are falling and that stimulus is smaller and more targeted than the broad brushstrokes seen in 2009. China must also deal with government financing. Concerns over the amount of government debt are cause for China bears to be squeamish. As progress is made, we expect policy makers to increase transparency on government debt (central and local) while broadening the sources of revenue available to local governments away from a dependence on real estate. The list of challenges goes on, not terribly dissimilar to issues in other regions of the world, but policy makers appear determined.

Meanwhile, the transformation of the economy continues to support opportunities for private enterprise to thrive. The total value of retail sales is approximately the same in China as it is in the US – but China's continues to grow at over double the US rate! We continue to have confidence in the consumer theme in China. Selectivity is important to emphasize consumer, healthcare, technology, and some industrial companies in the new vein of growth offering mid-teens growth rates at attractive valuations (12.4x P/E and 1.8x P/B), especially when compared with the rest of the world.

Private Firms Have Outgrown the State

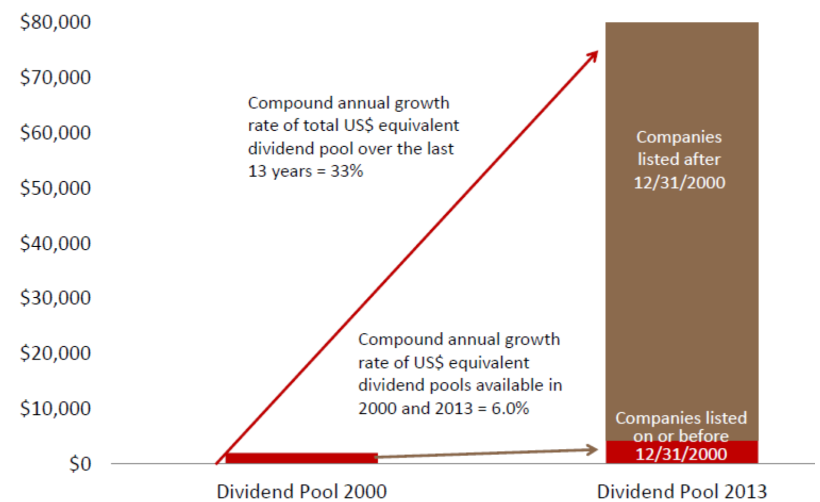
Share of Total, Larger Firm Industrial Profits By Ownership in China



Source: Matthews

Good Companies Pay Good Dividends

Dividend Growth in China, US$



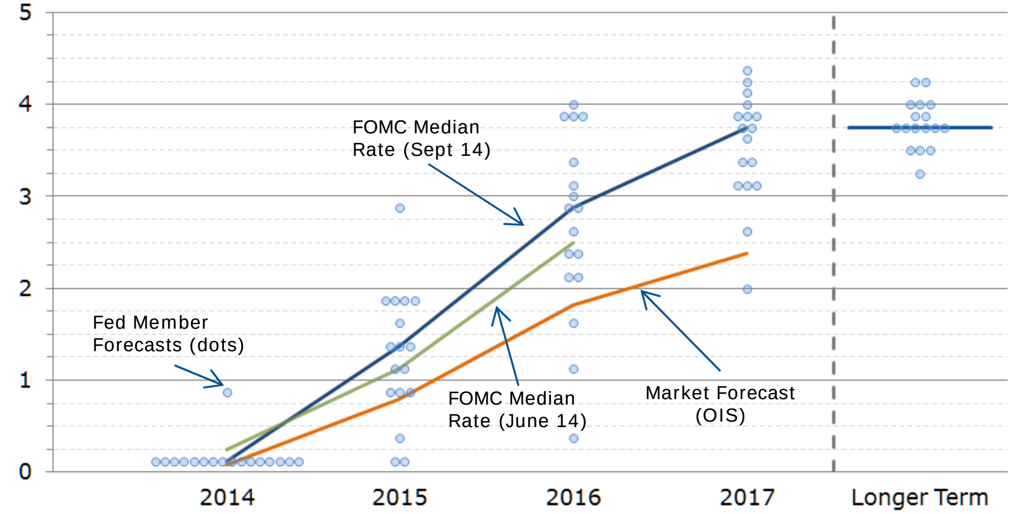
Source: Matthews

THE MORE THINGS CHANGE, THE MORE THEY STAY THE SAME

Both inflation and unemployment are starting to firm up, and absent a large surprise, quantitative easing will come to an end this quarter, but US interest rates continue to remain low. One could argue that this is the difference between the Bernanke and Yellen doctrines; the former seemed to extrapolate historical trends forward to forecast future trends, while the latter seems to be waiting for the data to prove action is necessary. This would tend to indicate that we could remain in a "lower for longer" rate environment, even as employment and inflation pick up. Historically, the Fed does not have a strong forecasting record, the chart on top shows that the market is expecting future Fed Funds rates to be lower than what the Fed estimates they will be. While we are not about to change our conviction on staying short duration, **there could be a period where longer duration assets continue to outperform their shorter brethren. Either the Fed or the market is going to be wrong on interest rates, and we do not want to be on the wrong end of that trade, however it turns out.**

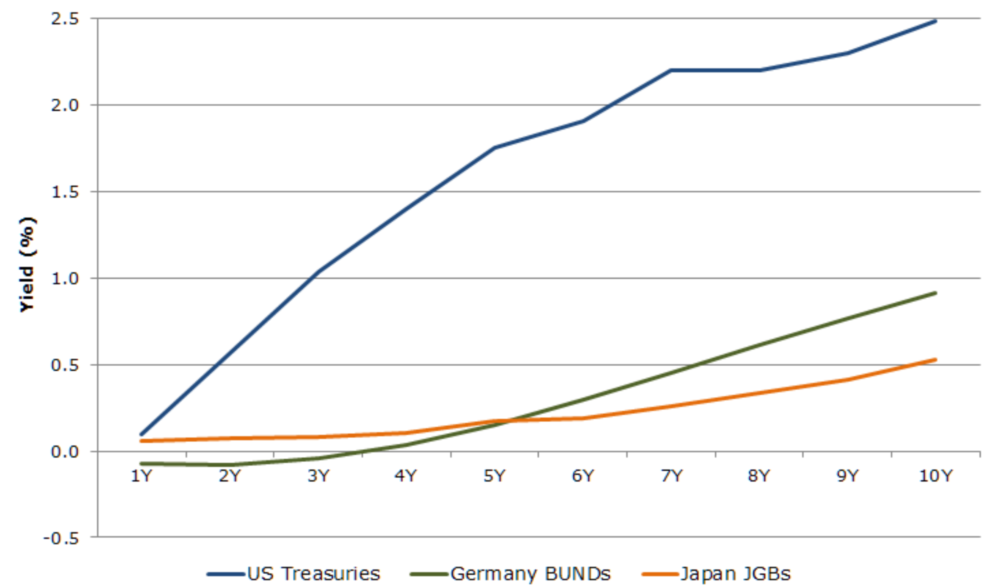
While it is of little solace, rates in the US are actually significantly higher than those of their developed market peers. As the chart at bottom right shows, Japanese bonds are at a noticeable low for 10+ years and German Bunds are actually negative out to three years. We use this illustration to convey the argument that the US is still the best house in a bad neighborhood. Do not misunderstand us; we are not yet spiking the football. There is still plenty of excess slack that needs to be removed from the economy. Crossover buyers from other countries may rotate into US Treasuries, further suppressing yields and inflation. But fixed income still has a place in portfolio allocations, whether it be to dampen equity risk, generate consistent income, or serve as a source of dry powder for future deployment. As such, **we continue to favor select parts of the fixed income markets, mortgage-backed securities, floating rate securities, and short-maturity fixed rate bonds that will roll off quickly and allow for reinvestment at higher rates** down the road. We believe that on an after-tax basis, municipal bonds make sense for investors seeking maximum cash flow returns. As of 9-30-14, Bloomberg estimates the average three-year single A revenue municipal bond yields 0.93%, while a corporate of the same maturity and credit quality yields 1.35%, so investors with a tax bracket above 30% will receive more after-tax income by being in a municipal bond.

Fed Funds – Market vs FOMC Estimates



Source: Bloomberg, Fed Minutes

Comparative Yield Curves



Source: Bloomberg

REAL ASSETS

FALLING OIL PRICES CHANGE THE ECONOMICS FOR SOME

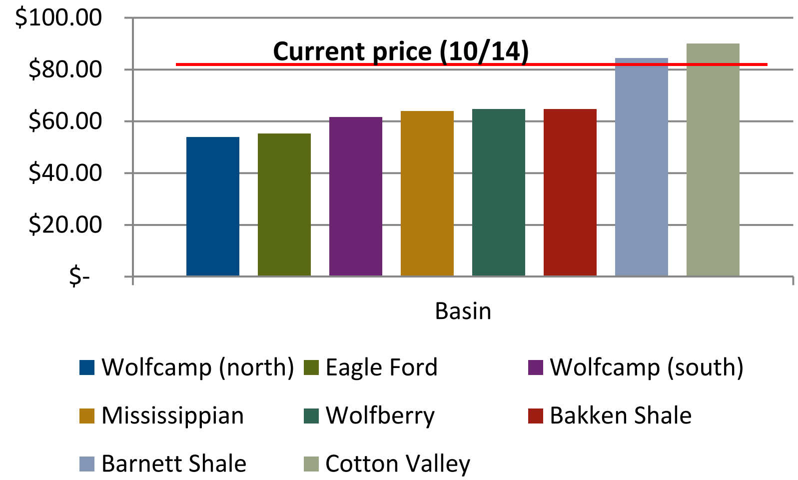
Dollar up, commodities down! Commodity price correlations fluctuate, but this historical relationship resurfaced in a big way in Q3. As the dollar touched a low of $1.39 (per euro) in May, a barrel of Brent could be purchased for $110. A lot has changed since then. In a short time span, the dollar has rallied to $1.26 per euro and Brent has plummeted 22% to $85. The severe decline has, simply put, crushed the energy markets in recent weeks. Investors, government officials, and corporate management teams are all asking the question, is $85 the new $110? It might be, at least for a while. With building US supplies, slowing European and China growth, and an overall increase in car efficiency, the supply/demand balance has reversed from what has been the norm in recent years.

So what to do now? Recalculate and replan. The decline (if persistent) will change the drilling economics not only between onshore and offshore, but also across various shale structures that offer differing economics for drillers. As indicated, not all shales are created equal. The change in price could not occur at a worse time. Capital markets have been wide open for the E&P complex, borrowings across the top 100 energy companies has increased from $700bn in 2010 to $1.1tr today. We don't know where oil finds a bottom; at this time the sell-off appears overdone, but as we witnessed in other times of stress, prices often overshoot their natural levels.

Outside of the US, the reduced price outlook carries consequences beyond the corporate level. Across the Middle East and into Russia, some fiscal budgets depend largely on the price of Brent and other commodity derivatives. Without the income of $100+ Brent, governments must pull other levers to make ends meet, typically through capital markets and debt issuance. Increasing volume is another option but at the potential expense of lower prices. At a time when economic growth is hard to find, the above dilemma will force many nations into a difficult corner.

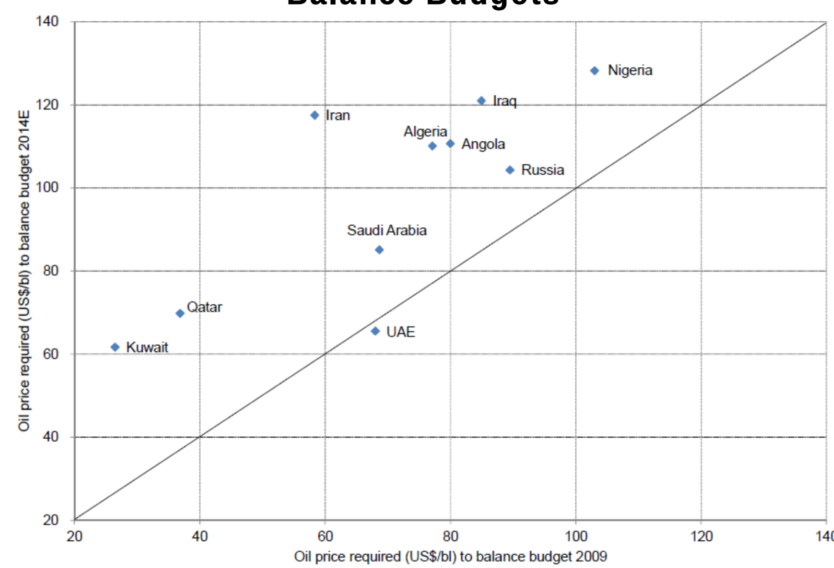
To both take advantage of the opportunity and protect capital, we recommend investors steer clear of direct commodity price exposure and instead focus on volume stories, exposure to favorable economics (onshore in the right shales), and strong balance sheets. For those with room, liquidity is valuable both to survive and to acquire other newly valued opportunities.

WTI Breakeven (15% IRR) Prices



Source: Swank Capital, Credit Suisse

Brent Oil Price Required by OPEC Countries to Balance Budgets



Source: Goldman Sachs

FOCUS ON VOLUME ABOVE PRICE WITH MLPS

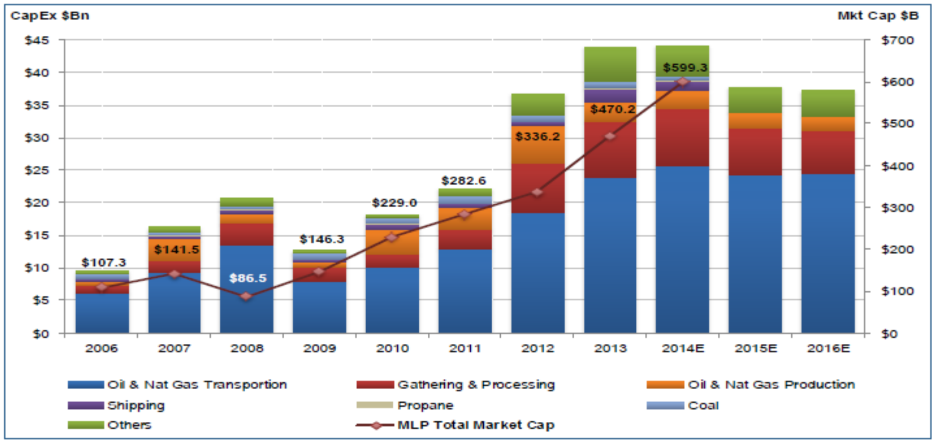
While standout performers through the third quarter of 2014, Master Limited Partnerships (MLPs) along with the US Energy Renaissance and Value Chain themes have experienced significant price weakness in recent weeks as investors react to falling energy prices and the changing energy landscape.

Edge MLP exposure continues to be concentrated in midstream energy MLPs, which should perform well when commodities remain in a range that is high enough to maintain drilling activity and low enough to protect demand. Most US basins are highly economical at WTI prices north of $85, so E&P production growth should continue. Should prices fall and stay below $80, we would expect discussions surrounding production curtailment to accelerate. It is important to highlight that long-term decisions are predicated on long-term forecasts and not front-month WTI pricing. We don't discount the impact of lower energy prices on fundamentals, but we would be remiss to not mention the benefits of gasoline sustainably below $3 per gallon, both for demand and consumer spending.

The outlook for MLPs remains strong with stable fundamentals, expected CAPEX in excess of $35bn through 2016, high-single-digit expected distribution growth in 2015, and current yield approaching three times that of the 10 Year US Treasury. Note that when the yield of the Alerian MLP Index was 300-350BPS higher than the 10 Yr US Treasury (currently at 350), the 12 month forward return for MLPs averaged over 15% in previous periods going back to 1996. The larger the spread, the better the index historically performed.

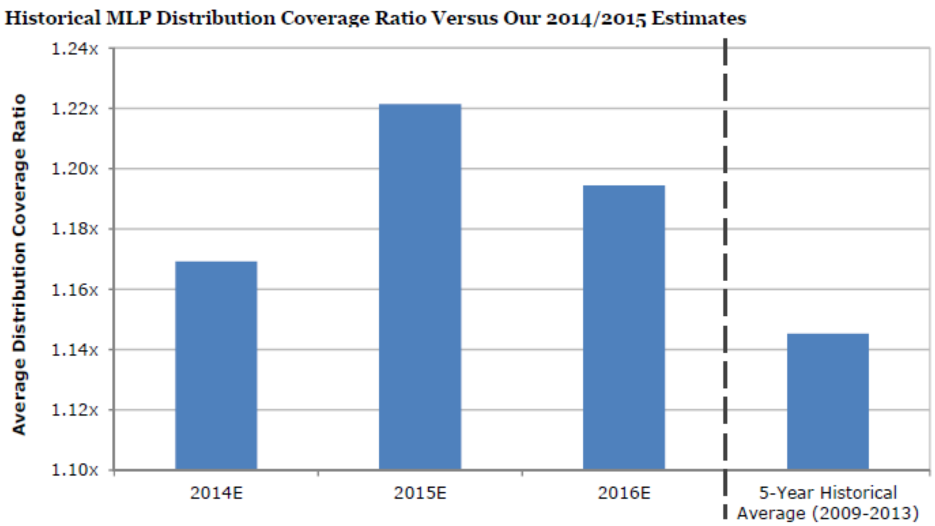
Over the long term, both midstream energy MLPs and Energy Renaissance have shown low correlations to oil and gas prices. Similarly, MLP prices and interest rate movements show low correlations. However, both strategies can show short-term sensitivity to commodity prices and interest rate changes. **We would use this short-term weakness to add selectively to positions, given the long-term infrastructure opportunity in the US coupled with favorable commodity prices to support continued growth.**

MLP CAPEX (Notably Transportation) Sets Record Highs:
Significant Infrastructure Opportunity



Source: Credit Suisse

MLPs Lower Debt Cost, Income Looks Stable:
Weighted Average Long Term Debt Rates Drop 2%+ since 2009



Source: Partnership reports and Wells Fargo Securities, LLC estimates

APPENDIX

Realize MORE

Realize MORE

Market Performance

Index	July	August	September	Q3-14	2014	2013	2012	2011	2010	3yr	5yr	10yr
	Total Return									Trailing (annualized)		
DOMESTIC EQUITY												
S&P 500	-1.4%	4.0%	-1.4%	1.1%	8.3%	32.4%	16.0%	2.1%	15.1%	15.6%	18.1%	7.7%
DOW JONES INDUSTRIAL	-1.4%	3.6%	-0.2%	1.9%	4.6%	29.7%	10.2%	8.4%	14.1%	13.1%	17.3%	7.6%
NASDAQ	-0.8%	5.0%	-1.8%	2.2%	8.6%	40.2%	17.7%	-0.8%	18.1%	17.6%	20.0%	9.2%
S&P 400 Midcap	-4.3%	5.1%	-4.5%	-4.0%	3.2%	33.5%	17.8%	-1.7%	26.6%	12.5%	19.6%	9.8%
RUSSELL 2000 INDEX	-6.1%	5.0%	-6.0%	-7.4%	-4.4%	38.8%	16.4%	-4.2%	26.8%	10.7%	17.4%	7.6%
RUSSELL 3000 INDEX	-2.0%	4.2%	-2.1%	0.0%	7.0%	33.6%	16.4%	1.0%	16.9%	15.1%	18.3%	8.0%
ALERIAN INDEX	-3.5%	8.2%	-1.6%	2.7%	19.5%	27.6%	4.8%	13.9%	35.6%	18.3%	25.3%	17.3%
INTERNATIONAL EQUITY												
MSCI AC World (ACWI)	-1.2%	2.3%	-3.2%	-2.2%	4.2%	23.5%	17.0%	-6.8%	13.4%	9.3%	13.7%	7.7%
MSCI EAFE	-1.9%	-0.1%	-3.8%	-5.8%	-0.8%	23.6%	18.1%	-11.6%	8.4%	6.2%	10.6%	6.9%
MSCI EM	2.0%	2.3%	-7.4%	-3.4%	2.6%	-2.3%	18.7%	-18.2%	19.4%	-1.1%	8.4%	11.7%
MSCI EMEA	-1.9%	0.4%	-6.4%	-7.8%	-5.2%	-4.7%	22.5%	-20.2%	23.9%	-4.4%	7.2%	8.9%
DJ Stoxx 50	-5.5%	0.0%	-2.1%	-7.5%	-2.0%	28.2%	21.8%	-15.7%	-8.4%	3.7%	8.0%	5.9%
FTSE 100 INDEX	-1.4%	0.3%	-4.9%	-5.9%	-0.9%	21.4%	15.6%	-2.3%	9.1%	7.9%	12.8%	7.0%
NIKKEI 225	1.5%	-2.3%	0.0%	-0.9%	-3.5%	30.6%	12.4%	-10.4%	11.5%	8.1%	9.0%	4.7%
HANG SENG INDEX	7.3%	0.2%	-7.1%	-0.1%	1.9%	6.5%	27.7%	-17.3%	8.3%	4.6%	7.9%	10.0%
SHANGHAI SE COMPOSITE	9.3%	1.3%	6.9%	18.4%	13.8%	-1.0%	6.9%	-16.5%	-9.7%	-0.4%	0.2%	10.6%
BRAZIL BOVESPA INDEX	2.2%	11.3%	-19.5%	-8.4%	1.1%	-26.8%	-2.0%	-27.1%	5.9%	-16.7%	-3.2%	12.1%
MSCI BRAZIL SMALLCAP	-5.6%	9.0%	-17.4%	-15.0%	-10.9%	-26.1%	29.5%	-24.0%	43.1%	-12.5%	10.9%	NA
S&P SECTOR BREAKDOWN												
S&P 500 ENERGY INDEX	-3.3%	2.2%	-7.6%	-8.6%	3.2%	25.0%	4.6%	4.7%	20.4%	7.6%	13.9%	12.1%
S&P 500 MATERIALS INDEX	-1.9%	3.8%	-1.5%	0.2%	8.9%	25.6%	15.0%	-9.8%	22.2%	10.1%	16.8%	8.8%
S&P 500 INDUSTRIALS IDX	-4.1%	4.2%	-1.1%	-1.1%	2.9%	40.6%	15.3%	-0.6%	26.7%	14.1%	20.8%	7.9%
S&P 500 CONS DISCRET IDX	-1.3%	4.5%	-2.8%	0.3%	0.9%	43.1%	23.9%	6.1%	27.7%	18.8%	24.4%	9.2%
S&P 500 CONS STAPLES IDX	-3.2%	4.7%	0.6%	2.0%	7.2%	26.1%	10.8%	14.0%	14.1%	15.1%	17.0%	9.8%
S&P 500 FINANCIALS INDEX	-1.4%	4.2%	-0.4%	2.3%	7.4%	35.6%	28.7%	-17.1%	12.1%	15.6%	15.3%	0.2%
S&P 500 HEALTH CARE IDX	0.1%	4.9%	0.4%	5.5%	16.6%	41.5%	17.9%	12.7%	2.9%	22.3%	20.8%	9.5%
S&P 500 INFO TECH INDEX	1.5%	4.0%	-0.7%	4.8%	14.1%	28.4%	14.8%	2.4%	10.2%	17.5%	18.7%	8.3%
S&P 500 TELECOMM SVCS IX	3.7%	-1.0%	0.4%	3.1%	7.5%	11.5%	18.3%	6.3%	19.0%	11.1%	14.4%	8.3%
S&P 500 UTILITIES INDEX	-6.8%	5.0%	-1.9%	-4.0%	13.9%	13.2%	1.3%	19.9%	5.5%	11.8%	12.8%	10.0%
FIXED INCOME												
US TREASURY BILLS	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.2%			
US TREASURY MASTER	0.6%	1.1%	-0.2%	1.6%	3.2%	-3.4%	2.2%	9.8%	5.9%			
US MUNICIPAL 3-5 YEAR	0.4%	0.5%	0.0%	0.9%	1.5%	1.4%	2.4%	5.4%	2.5%			
US BROAD CORPORATE	1.2%	1.5%	0.2%	2.9%	5.9%	-1.5%	10.4%	7.5%	9.5%			
GLOBAL BROAD MKT CORP	1.0%	1.3%	0.3%	2.6%	5.3%	0.1%	10.8%	5.2%	7.4%			
US HIGH YIELD	0.7%	1.0%	0.8%	2.6%	5.6%	7.4%	15.6%	4.4%	15.2%			

All performance data quoted in USD and includes dividends

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