Drexel Morgan Capital Advisers

Global Economic and Market Commentary

First Quarter 2016

"Risks to the global outlook remain tilted to the downside and relate to ongoing adjustment in the global economy: A generalized slowdown in emerging market economies, China's rebalancing, lower commodity prices and the gradual exit from extraordinarily accommodative monetary conditions in the United States. If these key challenges are not successfully managed, global growth could be derailed."

- *Lecture by Christine Lagarde, Managing Director, IMF, Hosted by the Bundesbank and Goethe University, Frankfurt, Germany, April 5, 2016*

The first quarter may be an accurate forecast of the performance of risk assets for the entire year, which is likely to be one of a flat average and a wide range of individual monthly returns. After the initial five-week decline in risk asset prices, global stocks reversed their initial losses, high yield bonds spreads tightened, and the CRB Commodities Index finished higher by the end of the quarter than at the beginning of the quarter. In short, risky assets experienced a volatile round trip in the first quarter.

We think that the latest pattern in risk assets is unstable, similar to previous market tumbles and rebounds, most recently August to November 2015. There is a continued struggle for supremacy between still lofty valuations for equities, given high multiples and a mediocre growth outlook and central banks' aggressive attempts to prop up the prices of risky assets.

Summary

- *Global equities and bonds are likely to be range-bound through the remainder of 2016.*
- *Changes in global risk appetite are occurring more frequently and rallies can rapidly become downturns.*
- *The risk focus of markets is shifting.*
- *Sustained market improvement requires a recovery in Developed Market (DM) corporate earnings, a better political environment, and more clarity from central banks.*

In such a market, investors sell rapidly when a rebound appears to be faltering since they doubt that valuation is justified by fundamentals. Market declines are ephemeral provided the downside risks do not materialize. In the event that markets break through theoretical support levels, interest rates are pushed into negative territory or rate hikes are delayed, asset purchases are stepped up by central banks, and safe assets become less attractive.

We expect that this struggle between countervailing forces will continue beyond Q1 and well into Q2, if not for the rest of the year. While we expect risky assets to be volatile, there should be no significant upward trend in prices, and for this reason, we are reducing our overall equity exposure to a modest degree. Valuations are stretched and earnings growth is expected to be weak although the bar for upside earnings surprises has been set lower.

Since bond yields are likely to be range-bound and the risk-adjusted return is likely to be higher than that of equities, the case for investment grade credits has been made stronger. The following spells out our forecast for global equity and bond returns and accompanying portfolios strategy in greater detail.

THE OUTLOOK FOR GLOBAL EQUITIES

The MSCI Global World Index ended the quarter slightly ahead of where it was in the beginning of the year. This recovery was mainly the result of a sharp turnaround in emerging market equities since advanced country stocks -on average- were slightly down in the first three months of the year. The main unanswered question is whether the global rally of the second half of the first quarter has legs. Equity market movements in the first quarter seem to have been driven by factors that had little to do with company operations. The dominant influences, in addition to further central bank accommodation, seem to be a recovery and stabilization in crude oil prices, a weaker dollar and a rally in commodity prices, all of which were initiated by a reversal of Chinese policy.

US Stocks and the US Economy

The US economy had disappointed in the first two months of the quarter when growth in activity was in the 1.1 to 1.5% range but the rate of expansion jumped to an estimated 2.2% in the last month according to the nowcast estimates cited by Gavyn Davies.[1] There were several upside surprises in activity data published in March, notably in the extremely strong survey data from the regional Feds and stronger than expected ISM Purchasing Managers' Index (PMI) data.[2]

The US Institute of Supply Manufacturing (ISM) PMI rose above 50 in March indicating expansion for the first time in several months. Inventories have stabilized, the effects of a strong dollar have abated, and the cutbacks in energy investment have ceased. The March US ISM Non-Manufacturing Index also came in stronger than in the first two months of the quarter.

The slight uptick in the University of Michigan's consumer confidence indicator (Consumer Sentiment Index), which is still well below the level of last year, is consistent with the latest employment numbers. These demonstrate a pattern that remains unchanged. Employment is improving at around a 2% per annum pace, as it has been for several years, although not yet fast enough to either make US citizens much happier or give them negotiating power for substantial wage gains (see Exhibit 1). The fact that the labor force participation rate has risen for six months after imploding could be seen as a sign that inflationary pressures could emerge, but the jury is still out.

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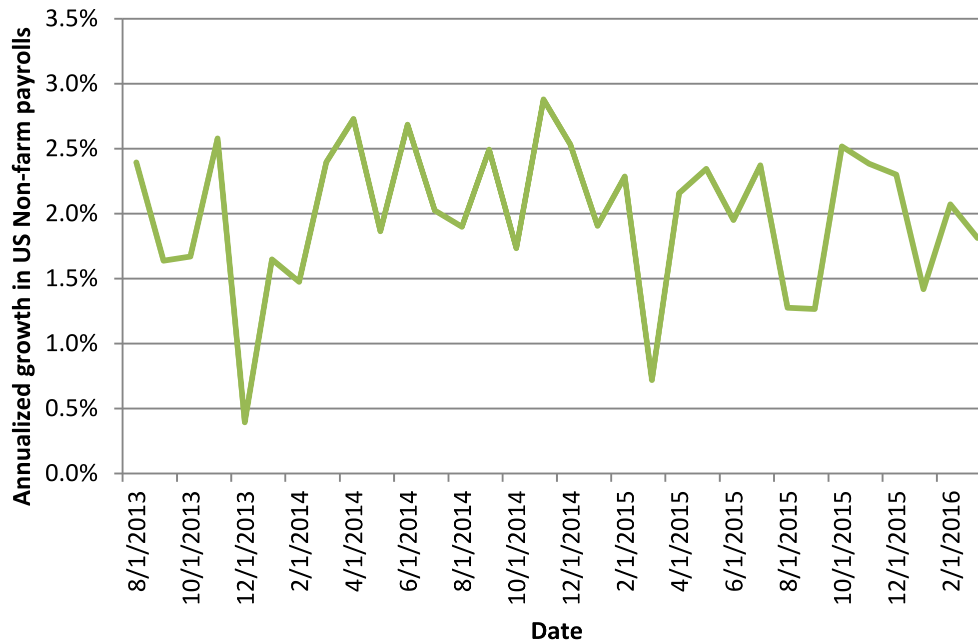
[1] Gavyn Davies, "Is the Global Economy Snapping Back into Gear?" Financial Times, March 27, 2016.
[2] Op. cit.

Exhibit 1: US Non-farm Payroll Growth, Annualized: August 2013-February 2016



Source: Bloomberg, DMCA

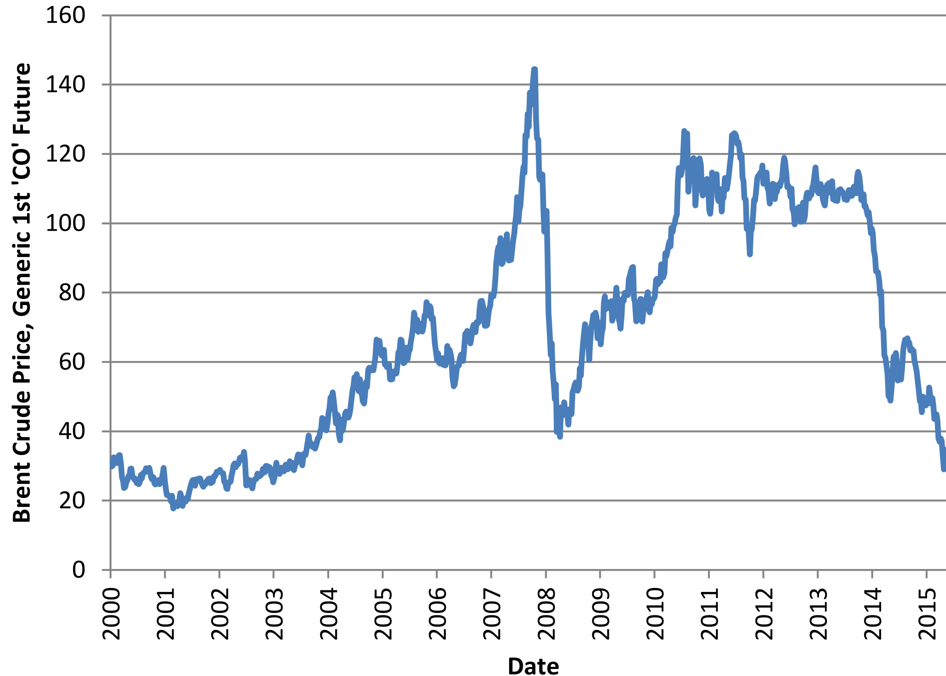
In contrast with the slight increase in the Consumer Confidence Index (CCI) two other factors involving sentiment have been negative:

- First, expectations for profit growth have collapsed. According to Thomson Reuters, the forecast for US profit growth in the first quarter has moved from 2.3% to -6.9%, while the forecast for the full year has dropped from 7.6% to 2%.[3]

- Second, the price of gold has risen more than 16% in dollar terms. Some of this is a reaction to a weaker dollar, but it also suggests a crisis in confidence in the central banks' ability to move markets and the economy. The Fed, in particular, has been sending mixed signals about its commitment to normalize rates and has registered second thoughts about its decision to hike interest rates by 25 basis points in December.

[3] "Momentum Matters as Earnings Estimates Go from Bad to Worse," John Authers, Financial Times, February 26, 2016.

Exhibit 2: Brent Oil September 2000 – April 2016



Source: Bloomberg

The US economy has been held back by a large decline in oil prices over the last year and the recent downturn in the early part of 2016 indicates that this trend is unlikely to reverse soon (see Exhibit 2). The price of oil affects real economic activity through three channels:

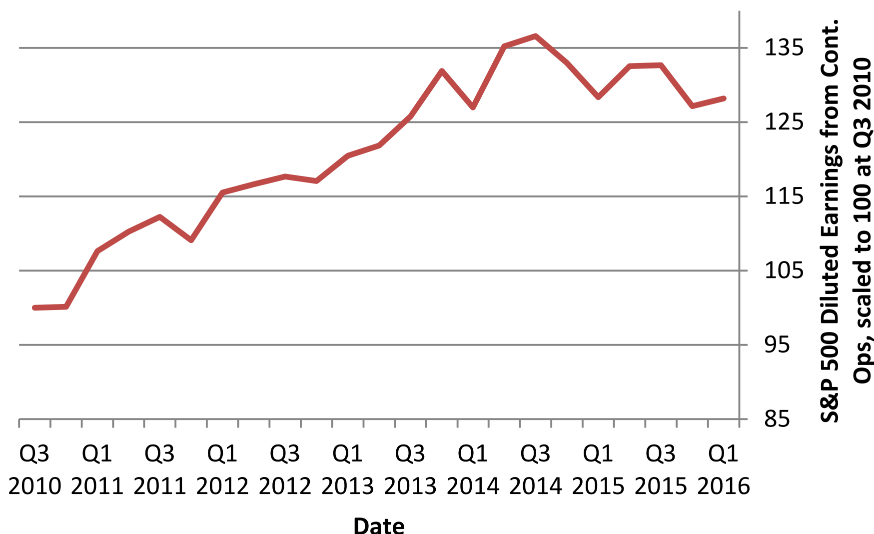
- Capital expenditure
- Consumption
- Trade

The negative investment effect and the positive consumption effect of the oil price decline from $70 to about $30 a barrel starting in the first half of 2015 have been offsetting with respect to their influence on GDP. This leaves the trade effect. Because US production is more price elastic than US demand, the petroleum trade deficit is wider in the $30 scenario than it is in the $70 scenario. This has resulted in a net 0.25 percentage point decline in GDP. If oil prices remain in the $30-$50 range, we do not expect an oil price change to have any effect on GDP, although it will have a substantial influence on oil company profits and on credit spreads in the high yield bond market. There will be no investment effect with oil prices below the breakeven $50 level. At the same time, the trade and consumption effects will tend to cancel each other out.[4]

[4] Goldman Sachs, US Economic Analyst, April 2, 2016.

We expect the US equity market to remain range-bound during the remainder of the year and are giving it a neutral weight. The combination of continued low oil prices, monetary tightening, albeit muted, a stronger dollar, weak earnings and high equity valuation is likely to limit the upside for US stocks (see Exhibit 3). Even after adjusting for its upward biases, the revised cyclically-adjusted price to earnings ratio, CAPE, which has better forecasting ability than the original CAPE, is still 19% above its historic average on a price basis. However, even this difference may overstate the attractiveness of US equities if we adjust profit margins downward to their historic range.[5] On an estimated 12-month forward earnings basis, US price to earnings ratios, at slightly over 18, are well above their ten-year and 35-year averages.[6] Thus it is unlikely that further multiple expansion will propel the US market substantially higher.

Exhibit 3: S&P Earnings per Share: Third Quarter 2010- First Quarter 2016



Source: Bloomberg

At the same time, we see only limited downside to US stocks. There is little evidence of a major imbalance in the real economy, such as a housing bubble, accelerating inflation, a capital expenditure boom, or an S&L crisis, which have resulted in sustained bear markets and recessions in the past. Much of the recent growth disappointment has come from external forces, particularly weak foreign demand, declining capital expenditure in the mining sector and the impact of a strong dollar. Competing “nowcast” estimates of GDP from the Atlanta Fed and the New York Fed have predicted first quarter GDP growth at 0.1% and 1.1%, respectively.[7] Both models are new, but both demonstrate a slow first quarter. In our view, the aforementioned drags should cease in the second half of the year and US growth should rebound moderately. We expect the Fed to raise rates only

[5] Jeremy Siegel, “The Shiller CAPE Ratio: A New Look?" Financial Analysts Journal, Forthcoming.
[6] Goldman Sachs, Us Economic Analyst, March 14, 2016.
[7] Federal Reserve Bank of Atlanta; Federal Reserve Bank of New York.

gradually and the divergence in policy between the Fed and other major central banks to be less pronounced than originally thought.

The first quarter was unusually difficult for active stock managers. Indeed, it was the worst since 1998. Overall, just 19% of US equity funds and 6% of large-cap funds have positive alphas. Four factors account for this:[8]

1. Most managers were wrong about the direction of the economy. At the beginning of the year, active managers were overly exposed to cyclical stocks and stocks, such as financials, that benefited from higher rates which did not materialize. However, an unexpected Chinese devaluation, subsequently reversed, was enough to start a growth scare including fears of a US recession which were reinforced by poor macro data. Managers had substantial exposure to healthcare and pharmaceuticals, which have traditionally been insensitive to the real economy, but concerns about major restrictions on drug pricing in the future resurfaced and a general loss of confidence in these sectors caught managers unaware. The best performing sectors were other defensive sectors in the consumer staples, utility and telecom areas, which managers generally missed.
2. There was a reversal in momentum. FANG stocks (Facebook, Amazon, Netflix and Google), to which managers were overexposed, faltered after leading the market in 2015.
3. The return on stocks was more narrowly dispersed than usual, which made it difficult for active managers to benefit from their stock picking abilities.
4. Managers overweighted high beta stocks as a result of the market run-up in the second half of 2015, which proved unrewarding and a source of major underperformance.[9]

We have been placing more emphasis in our portfolios on smart beta strategies, such as those based on fundamentally weighted benchmarks and minimum volatility indices, to avoid the tendency for active managers to get whipsawed in the present environment.

European Equities

While the ECB growth rate has declined slightly, it is still positive and consumer demand has improved significantly. This improvement has been the result of higher real incomes associated with lower oil prices. However, there is little indication that the rate of expansion will return to last year's level during the rest of the year. Capital expenditures have not recovered to the levels we anticipated and lack the vitality of previous upturns, although business confidence may improve if there is a negative vote on the Brexit (Britain departing from the European Union) in June. This has left the currency union vulnerable to the recent setbacks in the emerging economies, especially

[8] John Authers, "Investors Rake Over Ashes of a Dismal Quarter," Financial Times, April 7, 2016.
[9] Ibid.

China, which are limiting exports. Industrial output growth has been weak in Germany, France and Italy, the three biggest economies.

Whereas European stock markets were buoyant in early 2015, they plunged in the first six weeks of 2016, with particularly sharp falls in bank shares. Though they have recovered somewhat in the last six weeks of the quarter, the stocks in the Europe 600 Index remain 7.15% down through the end of the quarter, unlike the S&P 500, which increased during this period. Part of this weakness is because the composition of the STOXX 600 Index is not equivalent to the euro area economy. The STOXX 600 has a much higher exposure to banks, materials companies and multinational corporations with large international exposure, particularly in China and other EMs.[10]

Against this backdrop, the ECB eased forcefully in March, cutting the deposit rate further into negative territory and the main refinancing rate to zero. The central bank introduced new targeted long-term refinancing operations with four-year maturities and expanded QE purchases. These purchases will now include investment grade nonfinancial corporate bonds. With these moves, the ECB demonstrated that it continues to have resources at its disposal which may lend support to European equities overall. For this reason, combined with compelling valuations and reduced fiscal austerity, we are still slightly overweight European stocks in relation to a reduced overall equity exposure.

We expect 4% earnings growth for companies in the STOXX 600 Index in 2016 against a -2% growth rate last year. This growth rate should be substantially higher if we exclude banking stocks which have been undergoing a mini crisis partly due to negative interest rates. Higher earnings growth, consistent with a higher than mid-single digit return, requires a more durable improvement in the Chinese and EM outlook, which we expect next year.

Japan

The TOPIX Index declined by 12.1% in Q1. We expect the Japanese market to rebound over the next 12 months although we are neutral in the short term. During the next year, we expect the market to be supported by three factors:

1. Sustained profit growth.
2. A more stimulative policy environment.
3. Inflows from domestic buyers.

[10] Goldman Sachs, Portfolio Strategy Research, “Strategy Matters,” April 1, 2016.

We expect looser monetary and additional expansionary fiscal policies. The Bank of Japan should expand its negative interest rate and asset purchase programs through June and the Abe government will likely announce a fiscal spending package for fiscal year 2016.

We also expect a suspension of the April 2017 consumption tax hike. We anticipate ongoing equity purchases from corporations, public pension funds and the Bank of Japan (BOJ), although the participation of retail investors remains uncertain. In addition, foreign selling could start to diminish based on our assumption about continued profit growth, greater macro stability and more stimulative fiscal and monetary policies. We expect earnings per share for the TOPIX to rise by around 11% between FY15 and FY 16. We also expect Japanese real GDP growth to accelerate to 1.3% in fiscal year 2016 from 0.8% in fiscal year 2015 and project TOPIX sales growth of 2.5% in fiscal year 2016.

The 12-month forward P/E stands at 13.3 X and the price-to-book multiple stands at 1.1 X. While valuations are tracking slightly above trough levels, assuming the earnings expansion cycle continues, they are still low enough to underpin the market. Because multiples are unlikely to contract and because we expect significant per share earnings growth, the TOPIX should appreciate 10% in the next 12 months.[11] The main risks are weaker than expected global growth, a Chinese hard landing, and additional appreciation of the yen against the dollar that further weakens Japan's competitive position.

EMERGING MARKET EQUITIES

By the middle of Q1, emerging market (EM) valuations had fallen to very low levels. At that time EM equities were trading at a 30% discount to developed market (DM) equities on a forward P/E basis and a remarkable 60% discount on a cyclically-adjusted basis. The ongoing decline in EM currencies, down almost 19% since the end of 2014, had left real effective exchange rates well below their 2005-2015 averages in many countries, China being the notable exception.[12] Such a weak exchange rate and extremely low relative P/E ratios, along with a sharp rally in commodity prices, produced a major rebound in EM equities starting in early February.

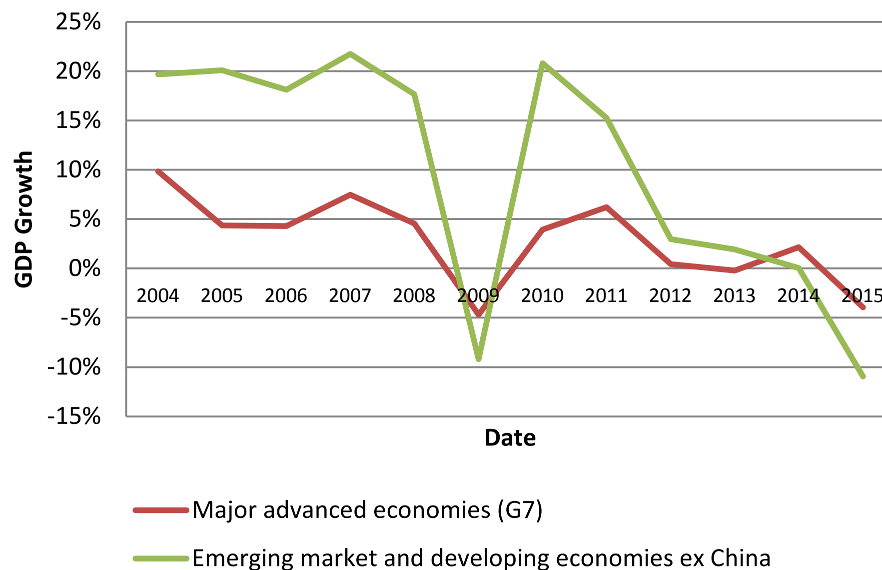
The Chinese outlook seems to have improved. China continues its pattern of many cycles which last less than a year from peak to peak, superimposed on a gradually declining trend rate of growth. The latest mini cycle has taken the activity growth rate down to about 5% in early Q1, according to the Fulcrum Nowcast estimate, the lowest rate recorded since the Great Recession. It is clear that fiscal and monetary policies are now in an expansionary mode and this should lead to recovery soon. We predict that after the recovery in the PMI in March to a level above 50, industrial production will stage a further rebound and sequential activity will accelerate in the second half of

[11] Bloomberg
[12] Institute of International Finance, "Capital Flows to Emerging Markets: Dirt Cheap or New Normal?" January 19, 2016.

2016. Chinese GDP growth should bottom at 5.5% in Q2 2016 and modestly recover thereafter. A rebound in industrial production (IP) growth, a recovery in the housing property market, stabilization of exports, further policy easing, tax cuts and lower interest rates, should provide cyclical support.[13]

We are retaining a slight underweight to EMs, because of foreign debt service problems in the EM corporate sector and because the outlook for commodity prices is hardly stellar. In addition, EMs will have difficulty attracting significant capital inflow unless and until oil prices recover and EM GDP growth starts to exceed DM GDP growth once again (see Exhibit 4). In the past, there has been a high correlation between petroleum market strength and the ability of EMs to finance external deficits. However, a strong case can be made for selective investment in certain EM sectors. For example, the return on equity of non-commodity EM stocks is higher than that on non-commodity DM stocks, an advantage that is not thoroughly reflected in equity prices.

Exhibit 4: Advanced Economy (G7) vs Emerging Market Growth 2004-2015



Source: IMF

Good country selection in the EM space should also provide additional return. Especially attractive are EMs with reform-minded governments, limited dependence for growth on China's gradually slowing economy and commodity exports. We also prefer EMs that have low debt levels, especially in US dollars, and are in a position to generate significant domestic growth.[14]

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[13] Gavyn Davies, Op. cit.
[14] Lombard Street Research, "EM Screening Back in Vogue as Rally Evolves," April 8, 2016.

FIXED INCOME

Chairwoman Yellen has now made it clear that global market volatility will influence Federal Reserve monetary policy. While not formally documented, a temporary third input to the Fed's "Dual Mandate" of full employment and low inflation has emerged. The volatility experienced in the first quarter was likely a key factor in the dovish revisions in the median dot plots released in March. The dot plots are now in line with our estimates of two 25 basis point hikes in 2016, down from four from the December release. As seen in Exhibit 5, our estimate of the present real equilibrium ten-year yield has decreased and now stands at 2.42%, down from our year end 2015 estimate of 2.58%. Based on the model which uses the geometric mean forward Fed Funds rates, we expect the ten-year zero coupon yield to rise to 2.66% at year end.

Exhibit 5: Estimated Equilibrium Yield for Five- and Ten-Year Treasuries Given Likely Hikes in the Policy Rate

	3/31/2016	**End of 2016**	**End of 2017 Assuming 75 bp in 2017**	**End of 2018 Assuming 75 bp in 2018**	**End of 2019 Assuming 25 bp in 2019**	**End of 2020 Assuming 0 bp in 2020**	**End of 2021 Assuming 0 bp in 2021**	**End of 2026 Assuming 0 bp in 2026**
Nominal Fed Funds rate (based on increases from previous year indicated in header, based on DMCA assumptions)*	0.50%	0.75%	1.50%	2.25%	3.00%	3.00%	3.00%	3.00%
Subtract projected inflation	1.55%	1.70%	1.70%	1.90%	1.95%	1.95%	1.95%	1.95%
Real Fed Funds Rate	-1.05%	-0.95%	-0.20%	0.35%	1.05%	1.05%	1.05%	1.05%
Average short-term rate (based on average of start and ending nominal Fed Funds rates for a given year)		0.63%	1.13%	1.88%	2.63%	3.00%	3.00%	3.00%
Yields constructed using product of nominal Fed Fund Rates for each year	5 yrs	1.85%						
	10 yrs	2.42%						
	10y 1y fwd	2.66%						
	5y 1y fwd	2.32%						
Ten-year Treasury strip (actual yield, Bloomberg):		**1.95%**						
Data as of March 31, 2016. Source: Bloomberg								

* This trajectory is slightly below that estimated by Curdia using real time estimates of the real equilibrium interest rate (natural weight). Ref: Vasco Curdia "Why so slow" FRB-SF October 12, 2015; http://www.frbsf.org/economic-research/publications/economic-letter/2015/october/gradual-return-to-normal-natural-rate-of-interest/

Inflation watchers re-emerged from a multi-year slumber in the first quarter due to more robust core Consumer Price Index (CPI)and core Personal Consumption Expenditures (CPE) deflator data (ex-food and energy). The core CPI now stands at2.2% year over year and the core PCE deflator

rose to 1.68%,[15] the highest since February 2013. We do not believe that consumers need to panic about the purchasing power of their cash; however, continued inflation momentum, coupled with the current trend in wage growth, could pressure the Fed to act. Absent these pressures, we the Fed could stall until after the elections.

Evidenced by many countries' negative sovereign yields, deflation is more of a concern than inflation globally. The relatively large differences in yields in comparable maturities in the US versus Japan and the Eurozone will likely widen near term before normalizing. The relative attractiveness of US Treasury yields has, amongst other factors, led to a multi-year strengthening in the trade-weighted US dollar which we see coming to an end in the next two years, if it has not already occurred. A stable or weakening trade-weighted US dollar increases the attractiveness of global sovereign bonds. While we advocate remaining short in duration, currency appreciation versus the US dollar will likely be a primary driver of return on non-US sovereigns, as it was in the first quarter.

US municipals performed well again in the first quarter returning 1.67%. Municipals continue to offer attractive after-tax yields compared to investment grade taxable bonds. For example, a ten year AAA municipal yield is 99% of the comparable ten-year Treasury yield. We expect a large portion of return to come from coupon in 2016, which favors bonds with lower ratings (BB- A Ratings) and wider spreads compared to AA rated or better issuers.

Spread Product

US investment grade bonds ended the quarter at approximately the same spread to US Treasuries as on December 31, 2015. Energy led all sectors following the February recovery in oil prices, and financials were the worst performing sector in the first quarter due to profitability concerns related to Negative Interest Rate Policy (NIRP) and oil loan write offs. Our outlook for US Investment Grade (IG) Corporate bonds is positive for 2016, and we expect spread tightening. Most of the energy and materials "fallen angels" moved from the IG index to high yield in 2015, leaving the best capitalized credits in the IG index. Additionally, the ECB announced expanding purchases in European IG credits. This will have a follow through effect for US names as there will be a crowding out effect from the ECB leading to more bond managers purchasing US credits.

High Yield

High yield spreads followed the equity markets in the first quarter, widening significantly to 839 basis points in mid-February and violently reversing course to finish the quarter four basis points tighter. There was little dispersion in returns amongst credit ratings (3.63% for BB and 3.37% for

[15] Bureau of Economic Analysis.

CCC),[16] a stark comparison to 2015, a year in which returns between BB and CCC credits were over 1000 basis points. As stated in our fourth quarter letter, our outlook for high yield in 2016 is positive. However, technical factors will continue to pressure lower rated credits (sub BB). More specifically, sovereign wealth funds, pensions and other institutional investors have begun redeeming underperforming hedge funds, many of which are credit focused. New regulations have eliminated broker dealer inventory and proprietary trading groups which have exacerbated price changes due to lack of liquidity and willing buyers. Outside of energy and mining, fundamentals are stable and most companies have access to capital without paying a material premium in spreads. We expect issuance to expand in the second quarter following the tightening in spreads and full year issuance for 2016 will likely be similar to 2015. We remain equal weighted, but defensively positioned with a manager which focuses on BB credits and has avoided energy and commodity related companies.

Master Limited Partnerships (MLPs)

Our longer term outlook for MLPs has not changed; however, additional events are likely to occur throughout 2016 which will prolong the opportunity to invest in midstream partnerships. In particular, the current futures curve for oil prices is very flat, with oil predicted to be $45 at year end 2016 and $47 at year end 2017. We forecast a more robust recovery in 2017, but if prices remain at current levels for 9-12 months, energy and production (E&P) company bankruptcies will increase casting doubt on take-or-pay contracts with pipeline companies. Regardless of the true net impact on revenues, the heightened state of investors will lead to pricing pressure. We are maintaining our current positioning and will add on material weakness.

SUMMARY AND CONCLUSIONS

After an impressive rally at the end of the quarter, risk assets look more challenged going forward. For this reason, we are being more defensive. We are recommending a slight global equity underweight and reduced duration US Treasuries. We are overweighting cash and higher quality credit, i.e., at least BB rated. The US dollar will eventually depreciate further; however, a substantial additional decline is unlikely this year. In a world of low growth and negative or low interest rates, small shifts in fundamentals can have a greater impact on investment returns than they would have in an environment where these returns were less highly valued and volatility was less pronounced. However, although there are substantial tail risks, the probability of a sustained global bear market is not high.

[16] Barclays.

This low but sustained growth outlook is subject to certain left tail risks:

- The Brexit vote is positive on June 23rd which would put the Eurozone under further stress and cause a great deal of uncertainty until the final departure terms are negotiated.
- A surge in populist policies in the US and other countries leads to tariff and currency wars or confiscatory taxes which would weigh heavily on global growth.
- Heightened terrorist activity in Europe and the US leads to a major catastrophe
- A hard Chinese landing or a sharp devaluation of the trade-weighted yuan which exports deflation to the rest of the world.
- Low commodity prices, high corporate debt and volatile capital flows create stresses in developing economies which spill over to the rest of the world and compromise EM sovereign debt.

We believe that these left tail risks will be managed but are including them since there is a small chance that they will not.

Sincerely,

James L. McCabe, Ph.D. Erich M. Hickey, CFA

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