Drexel Morgan Capital Advisers

FIRST QUARTER 2018

Global Economic and Market Commentary

Summary

- The S&P ended its 15-month streak of positive returns in February. Deficit concerns and a potential trade war caused investors to reconsider equity valuations.
- Despite strong earnings growth expectations, equity multiples contracted during the quarter. Growth outperformed value and domestic equities modestly outperformed international equities.
- We expect volatility to remain at elevated levels; however, equities should end the year in positive territory.
- Developed non-US earnings growth will lag the US, but cheaper valuations cause us to favor international equities over domestic equities.
- Emerging Market (EM) equities were the strongest performing asset class, reflecting expectations of continued growth, low inflation and commodity price stability.
- US Treasury yields ended the quarter higher and led to negative absolute returns for all fixed income asset classes.

"Economically, both the US and China would lose a trade war."[1]

February marked the end of 15 consecutive months of positive returns for the S&P 500. Domestic equities and bonds ended the quarter in negative territory with the S&P 500 returning -0.76% and the Bloomberg Barclays US Aggregate Index returning -1.46%. Concerns about the impact of additional fiscal stimulus on the budget deficit and more aggressive Federal Reserve policy pushed inflation expectations and real yields higher. Elevated Treasury yields sparked the equity market sell off and concerns about a potential trade war fueled the increase in volatility. US dollar weakness contributed positively to the returns of international equity markets, but performance varied by region. European equities ended the quarter down -1.98% while Japanese and Emerging Market (EM) equities posted positive returns, up 0.83% and 1.42%, respectively. Overall, non-US equities were down -1.18%, as measured by the ACWI ex-US Index.

Volatility returned to the bond and equity markets

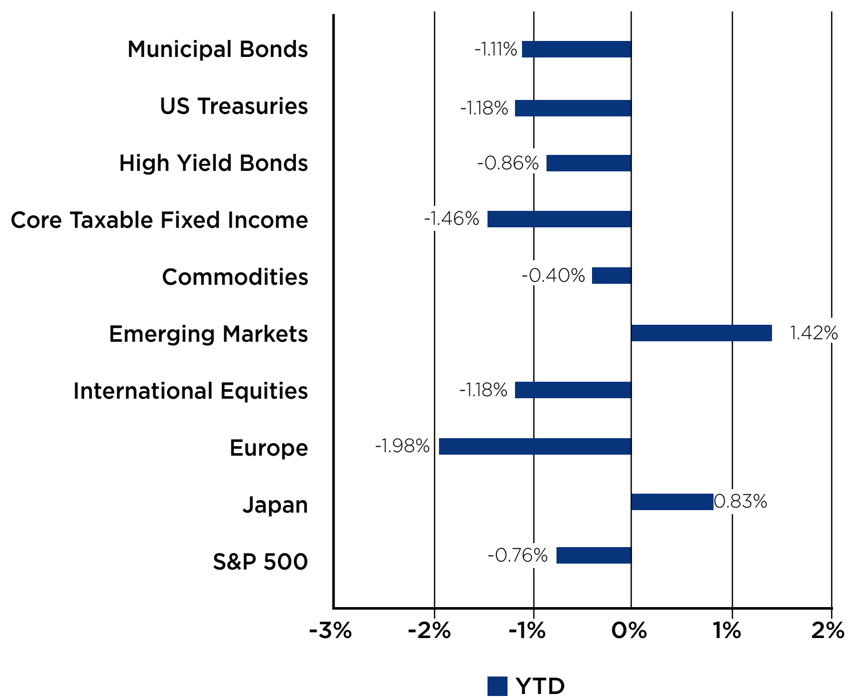
The fundamental backdrop of the global economy has not changed much since the end of 2017. The synchronization of global growth has boosted earnings estimates globally for 2018 and OECD estimates of growth are expected to exceed 2017.[2] Inflation pressures remain benign; however, additional fiscal stimulus in the US could push core inflation measures above 2%. We believe that the Federal Reserve will continue to raise overnight rates and unwind its balance sheet leading to overall tighter financial conditions domestically. We do not believe the ECB and BOJ will move from their easing stance for several quarters due to a moderation in growth from 2017 and a need to push inflation closer to target ranges.

1 Foreignpolicy.com

2 OECD report

Due to earnings growth and price declines, valuations of US equities are now near long-term averages. International equities are priced at a discount to US equities, but earnings growth is expected to be slower outside the US in 2018. Longer term, the excess capacity and operating leverage present in non-US companies should lead to outperformance. Within emerging markets, sector leadership has transitioned from technology to financials and other consumer related sectors which underperformed in 2018. EM equity valuations are attractive; however, we are cognizant that they will be the asset class most impacted by trade policy errors. We remain equal weight in domestic and EM equities and overweight non-US developed equities.

EXHIBIT 1: GLOBAL CAPITAL MARKET RETURNS YTD THROUGH MARCH 31, 2018



Outlook for the US Economy and Equity Markets

President Trump's "tariffs first" policy toward China and a more aggressive Fed policy reinforce our base case that, while earnings will increase significantly this year, forward price earnings multiples are likely to contract, leading to only a modest US stock market return.

> We expect modest US equity returns in 2018

With an expected acceleration in growth to an annualized rate of about 2.8% in 2018 in the base case, the US may regain its growth leadership among advanced economies. US growth is driven by significant fiscal stimulus resulting from tax cuts and additional government spending. We forecast the federal budget deficit to increase by 1.9% of GDP in the next two years to 5.1% in 2019. The associated increase in the national investment savings gap should also raise the external current account deficit to 3.4% of GDP in 2019 from 2.4% in 2017. Such a twin deficit enlargement would come at a time when the economy is in late cycle, operating close to full employment and government debt is well above 100% of GDP on a gross basis.

Excess fiscal stimulus creates the risk of an overheating scenario in which the domestic demand boom starts to create price pressure, resulting in higher interest rates and crowding out private investment.

Our current, base case forecast still calls for only a modest increase in inflation. The risk is that the pickup could be higher. This will depend on whether the fiscal stimulus boosts private investment, which would contain the increase in unit labor costs by raising labor productivity growth. Higher than expected inflation would put downward pressure on equity prices given its inverse relationship with P/E multiples and its positive association with the degree of Fed tightening.

Our base case calls for only a modest increase in inflation

Until April 10, trade tensions between China and the US were increasing. President Xi Jinping on that date renewed his earlier promise to reduce tariffs and open up the Chinese economy to greater direct investment. Until April 10, exchanges of tariff announcements increased the risk that both the US and global GDP growth would slow. Each side was imposing stiffer penalties on the other and each was trying to bluff the other party. These types of negotiations are normally conducted behind closed doors where positions can be presented, discussed clearly and a compromise can be reached. By appearing to give into his pressure and without making any new concessions, President Xi Jinping is nudging President Trump toward private discussions.

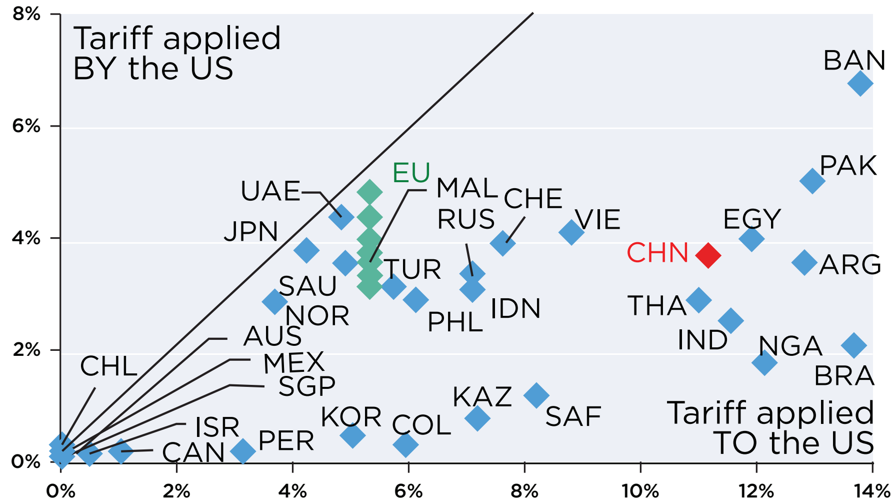
Markets were concerned that if China and the US were to act on their own threats, both sides could lose, with unpredictable consequences that could go beyond the immediate economic impact. Witness the collapse of global trade that occurred after the US initiated the Smoot-Hawley tariff in 1930.

There was no doubt that reduced trade with China would disrupt the US economy. Even without Chinese retaliation, higher tariffs on Chinese imports will increase inflation and are unlikely to reduce the US trade deficit with China, which now is only 2% of Chinese GDP, as compared with 8% five years ago. First, many Chinese imports are intermediate goods. Putting tariffs on these inputs will simply raise the price of final output produced in the US, hurting the US consumer and undermining the competitiveness of US exports in world markets. Second, because the US dollar is the world's reserve currency, it is already overvalued. If tariffs on Chinese imports succeed in reducing the US trade deficit with China temporarily, they will prove counterproductive, eventually causing the dollar to become even more overvalued and the size of the trade deficit to revert to its original level. Third, the major cause of rising US trade deficits is the lack of US national savings, not Chinese trade policies, and a widening national investment savings gap brought on by the rising fiscal deficits discussed above. The US and China are still in the stage of shadowboxing; no actual tariffs are expected for another two months. Nonetheless this dispute has escalated rapidly.

Trump is right that, although enforcement of Chinese technology protection has improved, Chinese companies still steal US intellectual property. China abuses free trade principles, forces US companies to give up their technology to a Chinese partner and limits access to its markets unfairly. These concerns are spelled out in a March 22nd report on Chinese trade practices under Section 301 of the Trade Act of 1974. The lack of tariff reciprocity is clearly demonstrated in Exhibit 2 (CHN is the acronym for China). However, a lot could go wrong if Trump's "Tariff first

A trade war with China would disrupt the US and other EM economies strategy" were carried out. It was fortunate that in response to Xi's April 10 statement, Trump 'said', "We will make great progress together."

EXHIBIT 2: US TRADE RECIPROCITY



Source: WTO, World Bank, JPMAM. 2015, or most recent available. Tariff is simple average of tariffs on traded goods.

J.P.Morgan Asset Management

US trade representatives are well aware that there are irreconcilable differences between US interests and Chinese industrial policy. They are legitimately concerned that the Chinese are taking advantage and eventually will move ahead of US industry in new technology areas such as artificial intelligence and robotics. President Xi's repeated promises on April 10th to cut tariffs and relax investment restrictions are inadequate for US negotiators who, in recent secret bilateral talks, wanted more sweeping change, including an end to Chinese subsidies for high tech industries.[3] Either there will be a conflict down the line or an agreement that is "shallow and fragile." Our base case is the latter.

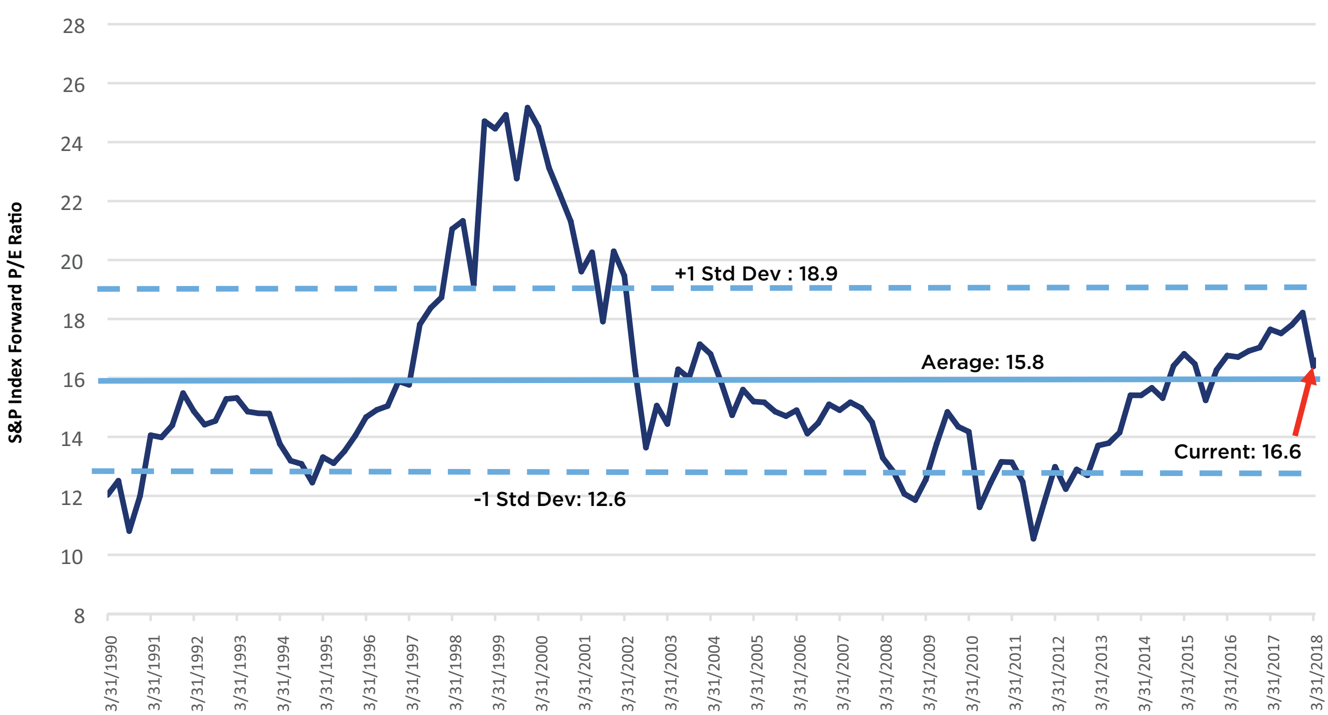
3 The Economist, April 14, 2018: "Drawing the Battle Lines."

The US Equity Market

Valuation Issues

Given the fall in stock prices in February and March, the US equity market is not substantially overvalued at present levels based on valuation metrics collected over the last 28 years. For the most part, the forward P/E ratio and other measures of absolute valuation show a slightly overvalued to fairly priced market (see Exhibit 3). The dividend yield is .2 standard deviations above the mean, suggesting slight undervaluation. Except for the Schiller cyclically-adjusted P/E, other measures indicate that at the end of the first quarter, the S&P 500 was less than one standard deviation overvalued. The Shiller P/E, which is one standard deviation above its 25 year mean, is somewhat biased upward for reasons cited by Jeremy Siegel.[4]

EXHIBIT 3: S&P 500 FORWARD P/E RATIO 1990-2018



Source: Bloomberg

The price-to-book ratio for the S&P 500 at 3.3 is substantially above that predicted by its historical relationship with the return on equity. However, in 2018 the return on equity is predicted to reach 17.6%, a record level, which would predict a price-to-book ratio below 3.3 based on projections of book value even if the S&P 500 rose by 5%.[5]

While equities are modestly expensive on an absolute value basis based on recent history, they remain relatively attractive against the bond market. For example, on April 3, the Morgan Stanley estimate of the cyclically-adjusted earnings yield for the S&P 500 was 3.9% and the estimate of the real 10-year Treasury yield was .9%. The difference between the two

4 Jeremy Siegel, "The Shiller CAPE Ratio: A new look," Volume 72, FAJ, 2016.

5 Goldman Sachs. "US Weekly Kickstart," March 23, 2018.

was 3.3%. This was at the twenty-year median, suggesting that stocks were fairly valued in relation to bonds on a risk-adjusted basis. The cyclically-adjusted earnings yield does not take into account estimates of 2018 earnings, which should increase by an extraordinary 14% increase over prior year levels. Using the Fed's valuation model, which compares a 12-month forward P/E ratio with the reciprocals of the Treasury bond yield and the corporate bond yield, stocks were about 25% and 50% undervalued in relation to corporate and Treasury bonds.[6]

Equities remain attractive relative to the bond market

This analysis does not reflect the association between the bond yield and the equity risk premium. A higher Treasury yield might justify a higher P/E ratio if it is associated with a lower equity risk premium and possibly a lower required return on stocks. US equities are slightly stretched given the historical association of valuation with bond yields. Prior to the tech collapse, between 1976 and 1998, the correlation was quite high and very clear. Lower bond yields justified higher P/E ratios (see Exhibit 4) so that stock and bond prices tended to go up and down together. Since the tech bubble, the relationship has changed. As shown in Exhibit 5, lower bond yields have been associated with lower P/E multiples than would have previously been the case.

An increase in the 10-year bond yield during the post Great Financial Crisis .(GFC) period was associated with less political uncertainty or higher real growth prospects which justified a lower equity risk premium and hence a higher P/E multiple. A one percentage point increase in the bond yield results in a near to 10 percentage point decline in bond prices and about a comparable percentage increase in the P/E ratio. The implied negative association between stock and bond returns meant that an appropriate weighting of bonds would increase the risk-adjusted return of the portfolio despite a high equity risk premium.

The regression line relating P/E ratios to bond yields is positively sloped. The 16.6 forward multiple at the end of March seems to be fairly placed in relation to this more recent linear association. This forward P/E is only .2 standard deviations above the predicted level. If growth and/or political concerns are fading, the more typical inverse relation between P/E ratios and bond yields (positive stock/bond correlation) and abnormally low P/E ratios during the 1980s and early 1990s would suggest that a P/E ratio other than 16 is indicated. The average forward P/E ratio over both periods combined was 15.1 when the nominal Treasury yield was between 2% and 3%.[7]

6 Yardeni Research, "Fed's Valuation Model, April 9, Figure 9

7 Goldman Sachs, "Where to Invest Now," April 2018.

EXHIBIT 4: 1980 TO 1998

Relationship Between S&P 500 Valuation and Interest Rate

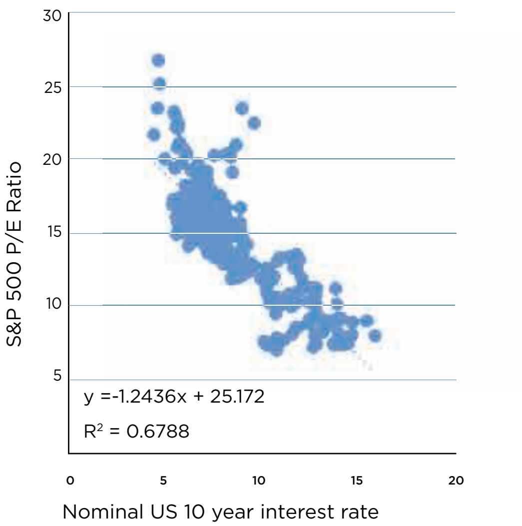
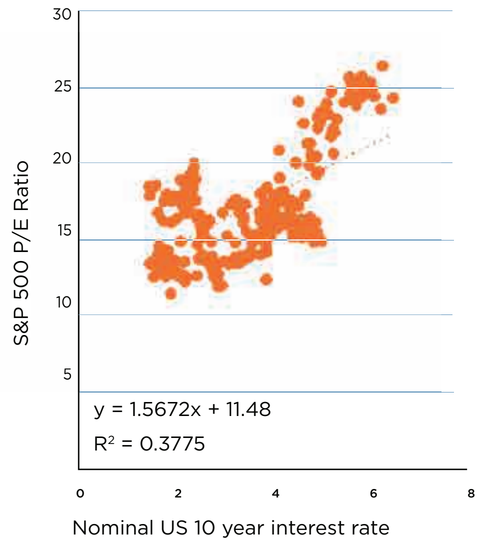


EXHIBIT 5: 1990 TO 1998

Relationship Between S&P Valuation and Interest Rate



Our outlook for the US stock market centers around the bullish case, base case and bearish case scenarios:

Bullish Case

The US and China agree not to go through with threatened tariff increases. The world and US economy are unaffected by the current dispute, there are only modest rate hikes by the Fed and present forward multiples on the US equity market rise. Under these circumstances, we anticipate that S&P 500 will end the year at the 2900 level.

Bearish Case

A full-blown trade war, which Trump has claimed is good and easily won, occurs; this disrupts US manufacturers dependent on Chinese inputs and reduces overall consumption exports and capital expenditure growth. The increase in pretax corporate earnings, particularly for companies that depend on Chinese inputs, directly or indirectly, falls sharply or turns negative.

Higher than expected inflation prevents the Fed from postponing planned interest rate hikes. Under these conditions we anticipate that the equity market will end the year at 2300 or below. We assign 20% probabilities to the bullish base and bearish case scenarios.

Base Case

The tension between China and the US escalates somewhat, but a limited negotiated agreement is reached, which provides limited technology protection and relaxes the Chinese affiliate requirement for US direct investment in China. Trump comes under substantial pressure from the Republican Congress in states producing aircraft, soybeans and other products that China has earmarked for tariff restrictions.

The US earnings growth rate is higher than anticipated in our earlier report, but multiples compress at a higher rate due to increased uncertainty regarding inflation and Fed policy, as well as the trade relationship with China.

Our base case estimate is for the S&P to end the year at the 2700 level

Our outlook in this scenario centers around an upward revision of the 2018 and 2019 earnings estimates presented in our fourth quarter report to more accurately reflect the effects of the Tax Cuts and Jobs Act, TCJA. Our new estimate of 2018 and 2019 adjusted earnings for the S&P 500 are $155 and $162 as compared with $150 and $160 in our prior report and consensus estimates of $158 and $173.[8] The estimated total return for the S&P 500 Index is 4.4% in 2018. The estimated appreciation in the index during 2018 is 2.4%. This and the total return estimates are slightly lower than those in the last report. The upward revision in the earnings estimates is more than offset by a greater decline in the estimated forward multiple at the end of 2018. We expect this multiple to end the year at 16.9, as compared with 17.1 in our prior report. The greater forward multiple compression is due to an increase in the equity risk premium associated with greater stock market volatility and policy induced and political uncertainty.

Europe and the UK

During the first quarter, the MSCI Europe ex. UK index declined -1.2% and the MSCI UK Index declined -3.9%, reflecting a general sell-off of global equities coupled with uncertainty surrounding Brexit. Both the Euro and Pound appreciated versus the dollar through the end of March. Over the past year ending March 2018 these indexes have appreciated 13.1% and 9.7%, respectively.

As we have mentioned over several letters, Brexit negotiations continue to be the largest question mark looming over the markets in Europe, especially the United Kingdom. We remain cautiously optimistic that the negotiations will not derail the economic growth that has strengthened over the last year in Europe, but realize the negotiations may increase volatility. During the quarter, negotiators from the UK and EU reached a provisional agreement on how Britain will withdraw from the EU over a two year transition period ending December 31, 2020.

During the transition, Britain will remain a non-voting member of the EU. We believe this transition period will allow Britain to negotiate trade agreements to take effect at the end of the transition period. However, given the recent rise of trade posturing elsewhere in the world, favorable trade agreements may be difficult to accomplish.

Political uncertainty remains prevalent throughout the European continent. In previous letters, we noted Angela Merkel's loss of support within Germany. France's Emmanuel Macron continues to push economic reforms that we believe will improve the economy. However, recent labor strikes and pushback from unions increase the uncertainty that Macron will be able to realize his vision for liberalizing the economy. Finally, Italian elections during the first quarter failed to select a clear winner and far-right parties garnered significant votes. The country is currently deadlocked as the Democratic Party decides whether to negotiate with the Five Star Movement in order to form a government.

Growth in Europe surprised to the upside in 2017, but recently, there have been some cracks exposed in the European growth story that we continue to monitor. Nowcast data from Fulcrum show that growth is estimated to drop to 1.2%

8 Yardeni, Ed, Abbott, Joe; "Stock Market Briefing: S&P 500/400/600 Weekly Forward Earnings and Valuation;" www.yardeni.com April 19, 2018.

in April, with each of the major economies showing a slowdown.[9] Benign explanations for the slowdown include exceptionally poor weather on the continent earlier in 2018, a bad flu season, and political uncertainty discussed above.

Despite political turmoil throughout Europe, we see attractive investment opportunities in select areas

However, Gavyn Davies suggests that much of the slowdown has been caused by the waning effects of the ECB's quantitative easing program and the inability of the economy to grow above the potential growth rate for an extended period of time. If this is the case, then growth in the EU may be significantly below current forecasts in the year ahead.

Amidst the political uncertainty, our managers continue to find attractive investments in both the UK and the Continent and maintain our overweight to these regions. The UK currently trades at a forward P/E of 13.1x and the EU at a forward P/E of 13.4x compared to 16.5x in the US.[10] The Eurozone Composite PMI remains strong at 55.2 in March.[11] In the UK, the Manufacturing PMI remained strong while growth in the services sector was affected by abnormal weather in March. Although there is some concern from the most recent data, we do not see a major risk of recession in the Eurozone and expect continued strong growth in the rest of the world.

Japan

During the first quarter of 2017, Japanese equities, as measured by the MSCI Japan (net) Index, appreciated 0.8% and outperformed the MSCI EAFE Index by over 200bps. Over the past year, the MSCI Japan Index has outperformed the MSCI EAFE Index by over 400bps.

Japanese equities are attractive

Data released in March indicated that Japanese GDP expanded at a 1.6% annualized rate in the fourth quarter of 2017 and private consumption grew by 0.5% quarter over quarter.[12] Weak consumption growth in the third quarter appears to have been an aberration, and the Japanese economy has demonstrated it can continue to grow. Central bank officials believe they will achieve the 2% target inflation in 2019. However, we remain skeptical given persistently low wage growth in spite of near record low unemployment levels. In January, core consumer prices in Japan increased by 0.9% on a year over year basis.[13] This is still well below the BOJ's target, and thus we expect the loose monetary policy in the country to remain in place.

We continue to watch the effects of Abenomics play out, and our managers continue to find attractive investment opportunities in the region. The forward P/E of the MSCI Japan Index declined to 12.9x at the end of the quarter, compared to 14.6x as of the end of 2017.[14] The decline reflects a growth in earnings estimates and a relatively flat return over the quarter. We have been bullish on Japanese equities for some time, and the attractive valuations continue to

9 Gavyn Davies, "The Mystery of the Eurozone Slowdown," The Financial Times, April 15, 2018.

10 Yardeni, Ed, Abbott, Joe, Quintan, Mali; "Global Index Briefing: MSCI Forward P/Es," www.yardeni.com April 4, 2018.

11 IHS Markit Eurozone Composite PMI – Final Data; www.markiteconomics.com; April 5, 2018.

12 Kajimoto, Tetsushi, "Japan Fourth Quarter GDP Growth Revised Up, BOJ Seen in no Rush to Exit Easy Policy." www.reuters.com; March 7, 2018; accessed 4/11/2018.

13 Fujikawa, Megumi, "Japan's Core Inflation Maintains Steady Growth," www.marketwatch.com, February 22, 2018; accessed 4/11/2018.

14 JP Morgan 2Q Guide to the Markets, p. 47.

give us confidence to remain overweight. Additionally, appreciation of the Yen relative to the Dollar over the quarter may have constrained earnings of export-focused industries. Given the expected tightening by the Federal Reserve and the continued easing by the BOJ, we expect that the worst of the appreciation is over and that export-focused industries should exhibit growth above expectations.

Emerging Markets

We anticipate that growth in China in 2018 will be 6.5% versus 6.9% in 2017. According to Morgan Stanley, "The cabinet reshuffle and government restructuring should enhance policy execution and coordination."[15] Continued debt reduction efforts will restrict both public investment and discretionary consumer spending. However, the risk of a significant demand choke off is low as the rate of tightening is measured, and policymakers are reigning in credit under favorable economic conditions, including strong exports and robust job growth. The rebound in the Purchasing Managers Index (PMI) suggests that China's economy has carried more momentum into the first quarter than expected.[16]

As China slows, the probability of continued trade improvement for EM commodity exports diminishes. A necessary condition for EM growth rising further from here is strong growth improvement in domestic demand and demand for manufacturing exports. Developed markets (DM) growth should be sustained, although it will not be as strong as we anticipated earlier. We expect that US growth will rise from 2.1% to 2.8%, which should offset some slowing in European and Japanese growth. This makes us optimistic that investment in EMs, having remained weak thus far, can be stimulated enough to offset diminished Chinese export demand. As a base case, we see EM growth rising slightly above the 4.5% achieved in 2017. We anticipate earnings per share growth will fall to 15.2% in 2018 from 22.5% in 2017.

Reasonable external balances, slowly improving GDP growth and stable commodity prices should limit "The volatility breakouts in EM currencies this year." (See UBS EM Economic Perspectives, March 6, 2018).[17] However, flattening global trade growth should mean that EM currencies see some trade-weighted depreciation, while still remaining stable against the dollar.

Our end of 2018 base estimate for the MSCI EM Index is 1200, which implies a 2.6% appreciation for the rest of the year from the end of the Q1 level and a 6% return for 2018 as a whole.

The global economic backdrop of strong growth, combined with our forecast of a weaker US dollar and stable long-term US yields, is fundamentally supportive of EM equities. Our assumed 12-month forward P/E at the end of 2018 (11.1x) stands near the median for its 20-year history.[18] While the difference between the cyclically-adjusted P/E and the real 10-year bond yield is only 2.4 percentage points, as compared to 3.0, 6.0 and 5.9 percentage points in the US, Europe and Japan, it is only slightly above the median of its 20-year range; thus the equity risk premium in EMs seems reasonable.[19]

However, there is a wide range between the bear and bull case values of 740 and 1400 for the MSCI index at the end of 2018. The possibility of a trade war between the US and China poses the greatest risk. Our base case is for a negotiated settlement between the US and China on trade, though such a settlement is likely to be less than complete. However,

15 Morgan Stanley, "Cross Asset Playbook," April 6, 2018.

16 Morgan Stanley, "Cross Asset Playbook," April 6, 2018.

17 Morgan Stanley, "Cross-Asset Strategy; Global Inflow," April 2018. This assumes that the recent capital outflow from EMs, associated with concerns about tariffs and European weakness, will end soon.

18 Ibid

19 Ibid

an escalation in trade tensions over the weeks ahead would be particularly negative for EM equities. First, there would be a flight to quality from EM to DM equity markets. Second, there would be weaker trade growth and a slowdown in the global economy which would reduce demand for EM exports in general. Third, high tech components that are made in South Korea, Taiwan and Singapore and used as intermediate inputs for final goods made in China would fall precipitously. Fourth, the US dollar could appreciate which is a negative for EM equities because much of EM debt is dollar denominated. We believe that these risks are more serious than the likelihood of greater than expected dollar interest rate gains.

We favor EM value over growth

Last year, information technology stocks in the EM Index appreciated much more than the Index itself. We believe that these stocks will not continue to outperform the general EM Index this year and that value stocks, especially those in the financial and energy sectors, will significantly outperform the Index. There have already been downward revisions in earnings estimates for EM technology stocks whereas DM technology stocks have undergone upward revisions.[20] We believe that EM value stocks, whose earnings outlook is improving, should provide a higher risk-adjusted return in 2018 than DM value stocks.

Fixed Income

The 10-year US Treasury yield rose to its highest level since 2014 in February, 2.95% from 2.41% at year end. The 10-year ended the quarter at 2.74% and currently yields 2.91%. Fiscal stimulus, a robust growth outlook and an increase in inflation expectations served as the catalysts for the move. The Federal Reserve, under the leadership of Jerome Powell, announced a 25bps increase in the Fed Funds Target Rate in March, bringing the overnight rate to 1.75%. The Fed expects to raise rates 2 more times in 2018 and 3 times in 2019 based on its "dot plot" forecasts. This would bring the overnight rate to 2.25% and 3.0% at year-end in 2018 and 2019, respectively.

We expect 2-3 more Fed rate hikes in 2018

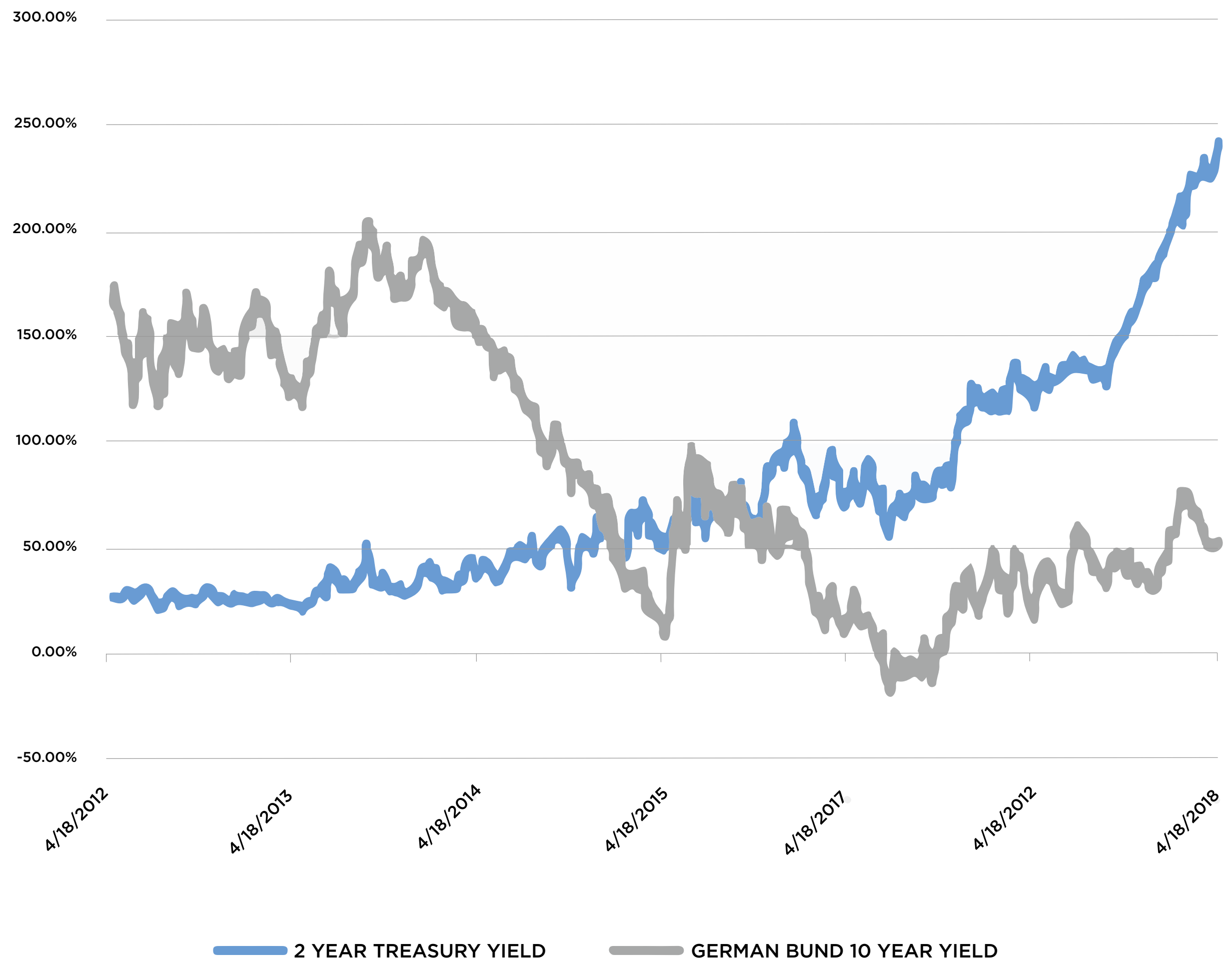
Based on our 2018 GDP growth and earnings forecasts, we believe the Fed will hike 2-3 additional times in 2018 and 2-3 times in 2019 on the premise that the Fed does not want to fall behind the inflation curve, the Fed needs additional ammunition to conduct traditional monetary easing when needed and robust growth and earnings afford additional tightening without significant consequence. Once the fiscal stimulus wears off, investors will realize we remain in a low growth and low inflation environment and will likely be more sensitive to Fed actions.

We remain underweight core fixed income and particularly longer dated maturities due to low absolute yields and more attractive yields from shorter dated Treasuries and spread product. The Treasury curve remains flat with the yield difference between the 2 year and 10 year Treasuries at 47bps at the end of March, down from 52 bps at the start of the year. We expect continued flattening with additional Fed hikes in 2018 driving short maturity bond yields upward. Low German and Japanese yields coupled with a limited uptick in US inflation should keep long dated maturities range bound. Additionally, the majority of the runoff from maturing Treasuries will likely be reissued at shorter maturities.

20 UBS, EM Equity Strategy, April 13, 2018.

Depending on absorption from non-Fed buyers, short rates could feel additional upward pressure or the Treasury may shift the maturity profile of new issues. In Exhibit 6, we plot the US 2 year Treasury against the German 10 year Bund to highlight the relative attractiveness of US yields.

EXHIBIT 6: US TWO-YEAR TREASURY YIELD AND GERMAN TEN-YEAR BUND YIELD



As seen in Exhibit 6, our estimate of the present equilibrium 10-year Treasury yield has increased to 2.89% from our September estimate of 2.80%. Based on our model, which uses the geometric mean forward Fed Funds rates, the ten-year zero coupon yield is expected to rise to 3.06% in 12 months against a current rate of 2.91%.

EXHIBIT 7: ESTIMATED EQUILIBRIUM YIELD FOR FIVE- AND TEN-YEAR TREASURIES GIVEN LIKELY CHANGES IN THE POLICY RATE

	Now	End of 2018 Assuming 50 bp incr through end of 2018	End of 2019 Assuming 75 bp incr in 2019	End of 2024 Assuming 0 bp in 2024	End of 2025 Assuming 50 bp incr in 2025	End of 2026 Assuming 0 bp in 2026	End of 2027 Assuming 0 bp in 2027	End of 2028 Assuming 0 bp in 2028
DMCA Estimated Nominal Fed Funds Rate*	1.67%	2.17%	2.92%	2.92%	3.42%	3.42%	3.42%	3.42%
Subtract Projected Inflation	2.05%	1.85%	1.96%	1.96%	1.96%	1.96%	1.96%	1.96%
Real Fed Funds Rate	-0.38%	0.32%	0.96%	0.96%	1.46%	1.46%	1.46%	1.46%
Average Short-Term Rate		1.75%	2.55%	2.92%	3.17%	3.42%	3.42%	3.42%
Yields Constructed Using Product of Nominal Fed Fund Rates for Each Year	5yrs	2.61%						
	10 yrs	**2.89%**						
	10y 1y fwd	3.06%						
	5y 1y fwd	2.84%						
10 year Treasury Strip (Actual yield, Bloomberg):		**2.84%**						

Data as of March 31, 2018. Source: Bloomberg Federal Reserve Bank of St. Louis
* Fed Funds rate shown as of quarter end.

Municipal Bonds

> We favor shorter duration and high quality in Municipal bonds

Municipal bond yields followed Treasury yields upward in the first quarter and the Bloomberg Barclays Municipal Bond Index (-1.11%) slightly outperformed the Bloomberg Barclays US Treasury Index (-1.18%). Following December's outsized supply, issuance was limited in the first quarter, and demand remained strong despite investors' concerns about waning demand from banks and property and casualty insurers due to tax rate changes. The 10-year municipal to Treasury ratio increased to 88% from 80% in the quarter, but demand following tax season will likely reverse most of this move.[21] Similar to our core income exposure, we favor shorter duration and callable municipals and will likely avoid lower rated credits.

Spread Product

Spreads of high yield and investment grade bonds finished the quarter modestly wider after tightening rapidly in January and widening in February and March. Additional carry helped high yield corporates to outperform US Treasuries; however, investment grade corporate bonds underperformed US Treasuries returning -2.32%. Corporate spreads reside at the narrow end of the historical range; however, absolute yield levels in shorter maturities are the highest they have been compared to the recent past. We prefer maturities inside 5 years and BB or better credit ratings currently.

Floating rate loans offer attractive yields due to the recent spike in Libor and a low default environment for the next 2-3 years; however, virtually all new issuance feature very few restrictive covenants which protect bond holders. Libor floors, which set minimum yields on loans, are being eliminated as well. There is no imminent danger, but investors

21 Barclays Municipal Weekly: "Getting Closer to an Inflection Point," April 6, 2018.

need to be aware of the additional risk embedded in these securities. The JP Morgan Emerging Market Bond Global Diversified Index returned -1.74% for the quarter. EM Sovereign bond spread levels remain near historical highs amidst the improved fundamental backdrop for emerging markets. Our global bond managers prefer local currency emerging market bonds to dollar denominated emerging market bonds as numerous emerging market currencies are undervalued on a purchasing power parity (PPP) basis. Country selection remains a focus, and as most recently evidenced by Russia, policy unpredictability will contribute to volatility in the future.

Conclusion

In our opinion, a change from the market environment of the last nine years is occurring. Both markets and the economy are becoming more volatile as the recovery becomes more mature. Despite two cyclical bear markets in 2011 and 2015–16, the MSCI All Country World Index increased by a factor of 3.3x since March 2009, driven by earnings growth and significant multiple expansion. The S&P 500 did substantially better; its cyclical downturns were shallower and it rose by a greater factor (4.3x) from the March 2009 lows. The equity market environment going forward is likely to be more difficult with low returns as a tug-of-war develops between earnings increasing and valuations declining. Driven by an expanding but only moderately robust global economy, we believe that higher earnings, cash flow, share buybacks and dividends will prevail in most of the world's equity markets faced with valuation challenges. These challenges include rising interest rates, tariff/trade concerns, domestic political uncertainties and geopolitical turmoil.

While some believe that global economic growth will peak this year and interest rates will be stable if not declining, we believe the risk to interest rates is to the upside as inflationary pressures grow and two main central banks, the Fed and the People's Bank of China, remove accommodation. In the US case, it is inconsistent to argue that while quantitative easing was beneficial, quantitative tightening (reduction in the Fed's balance sheet now being undertaken) will not have the opposite effect.

While we are still moderately overweight equities, we tend to favor sectors which have low interest rate sensitivity and are likely to deliver higher earnings gains this year, such as industrials, financials and energy and growth for the future in the case of technology. To hedge against higher interest rates and inflation, we favor US firms with strong balance sheets and low wage costs. We are neutral weight the US and EM equities and overweight non-US DM equities.

> We favor international equities and US small-cap equities

Although it has gone through a temporary growth pause recently, we think that the EU slowdown is temporary. Europe is less exposed to cyclical risks than other regions because it is earlier in the economic/earnings and policy cycle. Equity markets tend to peak shortly before economies reach full capacity, especially full employment. Europe is the only major economy where unemployment rate is closer to its long-term average than previous cyclically low levels. In addition, there is potentially more upside to European profitability due to greater operating leverage than elsewhere if the global economic upturn continues. European equity valuations do not appear excessive and the ECB remains behind most other central banks when it comes to starting to normalize/tighten monetary policy. According to Morgan Stanley, when we compare the current gap between nominal GDP growth and bond yields, the ECB is running the most dovish monetary policy of any central bank.[22] For these reasons, we are slightly overweight European equities.

We find US small-cap equities to be attractive as they are less sensitive to tariff changes and greater beneficiaries of the TCJA.

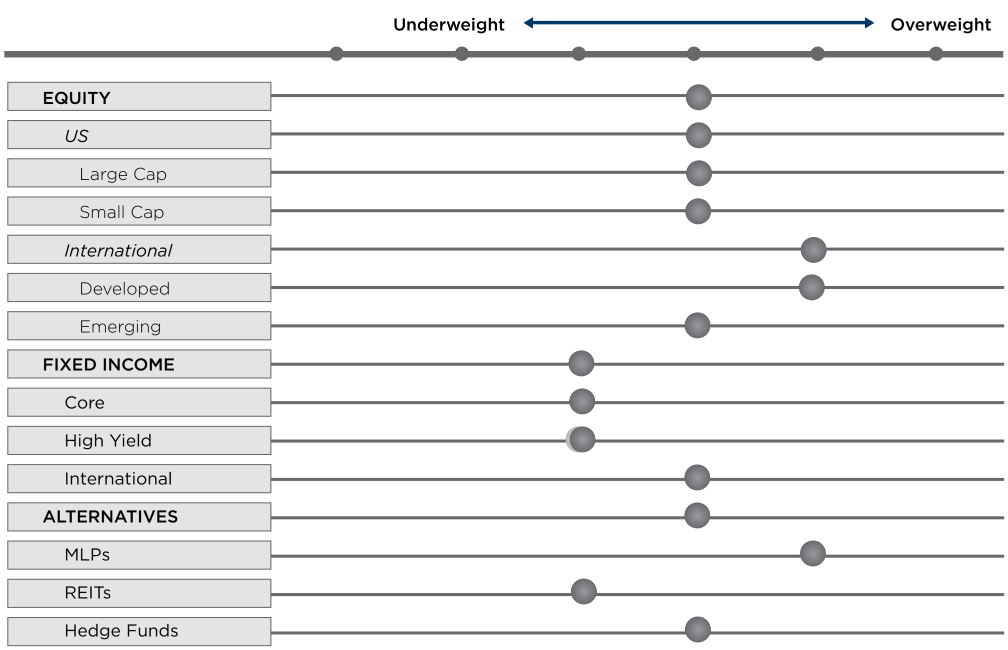
With regard to fixed income, we believe that late cycle economic expansion with rising interest rates and still low near-term but rising medium-term recessionary risks is hard to deal with. Under these circumstances, some US Treasury exposure is warranted. Although they are not cheap, they should provide some diversification benefits in adverse scenarios in which Treasury gains should still accompany stock losses. Credit spreads tend to widen before equities peak.

> We are maintaining a defensive posture in fixed income

With credit spreads tight we have been moving into a safer part of the credit space and focusing on shorter maturities. For example, mortgage-backed securities are more attractive than low rated corporate credit.

As we enter the last volatile stages of a long expansion, spare capacity is diminishing, central banks are removing stimulus and the risks of market and economic accidents are increasing. Thus we are increasing liquidity, diversification and flexibility to protect portfolios. Our present allocation targets are shown below.

EXHIBIT 8: DMCA ASSET CLASS VIEWS AS OF MARCH 31, 2018.



Source: DMCA

22 J. Garner and G. Secker, "Why we think equities may have peaked for the cycle in Asian EM – Europe looks better." Morgan Stanley, April 12, 2018.

Tail Risks

While we remain optimistic for continued global growth, we are always monitoring for risks in our thesis that could derail financial markets. The following is a list of tail risks that we believe could have a significant effect on financial markets should they occur.

- A major disruption in global trade – In our December 2016 letter, we noted that trade policy could be a major tail risk for the economy during Donald Trump's presidency. While no major trade disagreements have surfaced over the first year of the term, recent events have made the risk greater. First, recent tariffs on China and the reciprocity from the Chinese government led to a market sell off during the first quarter. Second, the resignation of Gary Cohn as Trump's economic advisor and the subsequent appointment of Peter Navarro have increased the probability of a trade war.
- Disruptive legislation – Technology giants have contributed significantly to equity gains over the last several years. However, companies such as Google, Facebook, and Amazon have recently come under fire from various worldwide legislatures. Most recently, Facebook has been dragged through the wringer by the US Congress for its data collection policies. Legislation that disrupts these companies may have an adverse effect on markets in the short term as positions are unwound. In the longer term, poorly constructed legislation could stifle innovation within this key industry.
- A major conflict or natural disaster - Wars over the last few decades have been confined to regions with relatively minimal effect on the global economy. However, war is always a negative sum game (i.e. even a small war, in a small economy leaves the world worse off than before) and the potential for a large conflict will remain non-zero for the foreseeable future. While the probability of a large conflict remains minimal, the costs would be extremely high. The recently announced negotiations with North Korea are a positive move towards peace, however, the events in Syria and posturing by Russia and Iran remain a key risk.

  As with war, natural disasters destroy wealth. However, we believe that the ability of people to recover from disasters and adapt to new conditions is significant and hope that the effects from a disaster would be short-lived. The US economy was able to rebound quickly from a devastating hurricane season, but we remain wary of continued risk.
- A major credit crisis – As the US embarks on monetary tightening and the EU and Japan set to follow over the next 12 to 24 months, the risk to credit markets remains significant. We are uncertain how markets will react to the unwinding of the unprecedented monetary policy of the last decade. Additionally, deteriorating underwriting standards, loose covenants, and large issuance over the last several years leave financial markets vulnerable to a shock.
- "Unknown Unknowns" – The greatest risk to our portfolios is an event which we and others are unable to predict. These so-called black swans can emerge out of nowhere and leave devastation in their wake. By necessity, our approach and diligence remain the best defense against events which are impossible to predict.

IMPORTANT INFORMATION

All information contained herein is based on past performance and is not intended to be indicative of future results. The indices used are unmanaged and return figures reflect the reinvestment of dividends and earnings. There is no guarantee that historical risk and rate of return will persist in the future.

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