Drexel Morgan Capital Advisers

2ND QUARTER 2017

Global Economic and Market Commentary

Summary

- We expect continued synchronization in global growth for the remainder of 2017.

- Recent inflation soft patch is likely temporary. The Fed will continue to tighten through 2018 and other DM central banks will begin removing QE.

- US equity valuations are stretched. Earnings growth and/or fiscal easing is needed to justify current prices.

- We believe non-US developed global equity markets have begun a multi-year period of outperformance.

- US core fixed income is unattractive due our forecast for Fed tightening and Fed balance sheet shrinking. Global fixed income will hinge on currency performance.

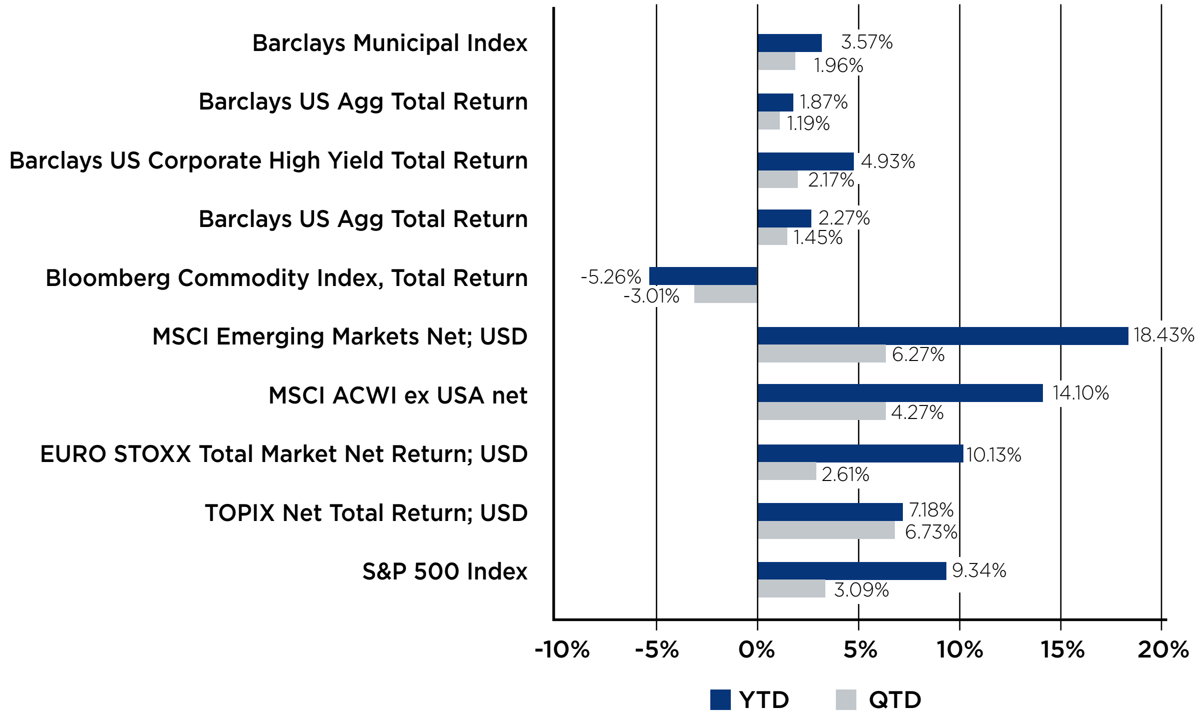
"We are monitoring the global economy's 'driving-without-a-spare-tire' risk in the next recession, whenever it happens."
– PIMCO June Secular Outlook.

"If the banking industry becomes a complete mess, I will resign."
– Guo Hulging, Chairman of the China Banking Regulatory Commission.

The second quarter witnessed a further appreciation in risk assets and decline in volatility despite numerous political events in the European Union. The S&P 500's total return was 3.21% in Q2 and 9.34% year to date, the best first half year performance for the S&P 500 since 2013. The MSCI Emerging Market Index was the best performing equity market in Q2 and year to date. The strong performance of emerging market (EM) equities runs counter to the historic positive correlation between EM equity and commodity price returns. The Bloomberg Commodity Price Index was down 4.47% for the quarter and 5.26% year to date, which historically would have predicted a negative return for emerging market equities.[1] Since commodity prices are denominated in dollars, they tend to rise when the dollar weakens provided that their local currency prices remain the same, yet the usual inverse relationship between the trade-weighted dollar and commodity prices was not present in the first half of the year. The Trade Weighted US dollar Index was down 4.7% during this period, but the expected positive commodity price response was not forthcoming. The decline in the Bloomberg Commodity Index in the first half of the year was attributable to weaker Chinese demand and declining oil prices.

[1] Part of the reason for this is that the energy and materials weight in the MSCI Emerging Markets Index has fallen by half since 2007.

EXHIBIT 1: SECOND QUARTER AND YEAR TO DATE ASSET CLASS RETURNS



Source: Bloomberg, live.barclays.com

In general, non-US equity markets denominated in dollars outperformed the US equity market both during the second quarter and year to date. The Euro Stoxx 50 Index returned 2.61% for the quarter and 10.13% year to date. The first quarter return was substantially ahead of that for the S&P 500, although the second quarter return was slightly behind. The Topix outperformed the S&P 500 for the quarter. The MSCI ACWI ex US Index had a return ahead of that of domestic US equities both for the second quarter and year to date.

> The "Goldilocks" economy has increased the appetite for risk assets

Q2 and H1 were also periods of significantly positive returns for dollar-denominated credit. The Barclays Aggregate US Total Treasury Index returned 1.19% and 1.87% in Q2 and H1, respectively with yields moving surprisingly lower over the quarter. The Barclays US Corporate High Yield Index returned 2.17% in Q2 and 4.93% in H1, respectively, as spreads narrowed. The US high yield credit spread has tightened over the past 12 months from 594 basis points to 364 basis points. Of particular note, the spreads on high yield energy issues, which are a large part of the index, have narrowed even though the price of Brent crude has fallen from $59 to $49 per barrel over the past 12 months (which would typically cause spreads to widen). This dramatic spread tightening is attributable to reduced volatility in the market for risky assets, underwhelming global yields and to a lower than normal default rate. However, there has been some undershoot since the credit spread on US High Yield Bonds is 100bps less than the average for low volatility periods in the past. This suggests that US High Yield Bonds may be overvalued.[2]

[2] Goldman Sachs as cited in "Seeking Alpha," Heisenberg, July 5, 2017.

The conflicting signals seen in equity, bond, and commodity markets imply that we may be reaching an inflection point in global expansion. The equity markets are suggesting that global GDP growth will increase, whereas bond and commodity markets are suggesting the opposite.

The Outlook for the US Economy and Markets

It is not clear why risky assets continued to be strong in Q2 and H1 despite the increasing realization that US fiscal stimulus or corporate tax reform would not occur this year. One explanation is that economic and earnings fundamentals have improved more than expected in world markets. First quarter US corporate earnings and revenues exceeded expectations and first quarter European growth was also higher than anticipated. Risky assets tend to outperform risk-free assets during periods of extremely low market volatility and during the first half of the year this may have been induced by two factors. First, the US Treasury flooded the market with liquidity to avoid exceeding its debt ceiling; and second, there was a major movement from active to passive equity and bond funds which resulted in a decline in equity trading activity. We are of the opinion that the recent market calm will not continue much longer and that mounting political risks will make it impossible to ignore any significant pause in economic or earnings growth.

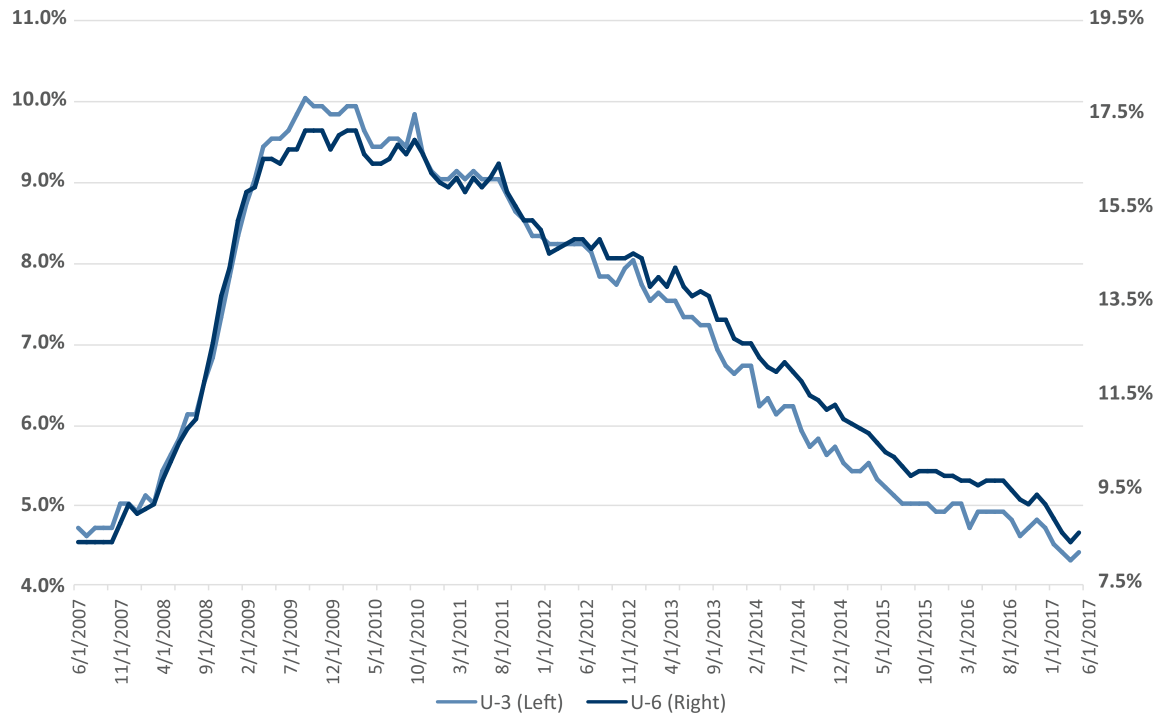
> Volatility will emerge…but when?

The US expansion should remain intact for the rest of 2017. Household spending continues to be solid. The weakening witnessed earlier in the year was due to the temporary impact of unseasonably warm weather reducing heating requirements, delayed tax refunds, and higher energy prices slowing real disposable income growth. Additionally, the first quarter downward bias in GDP growth was present. The estimated annualized GDP growth rate in Q1 was 1.4%; however, some consumer expenditure recovery is anticipated in Q2. Given an estimated GDP growth rate of 2.8% in Q2, we expect an average annual growth rate of 2% in the first half of the year consistent with the Fed's target. For the year as a whole, we have maintained our projected GDP growth rate of 2.2%. We expect final domestic demand to rise by the same rate as private consumption, 2.4%. We expect a 3.9% increase in gross and fixed investment, mainly as a result of a pickup in residential construction, but business fixed investment has also picked up recently. Fiscal policy should remain neutral, and with regard to external demand, net exports should decline slightly.

> Synchronized global growth through year end

The labor market continues to strengthen. The June unemployment rate, at 4.4%, has fallen below the estimated structural rate, though hourly wage rate growth continues to be muted. This U3 measure and the underemployment rate, U6, are now at levels not seen since 2007. The labor force participation rate has generally been edging up, but wage growth at 2.5% in June is no higher than it was a year earlier. Unexpectedly low inflation in March, April, and May has left prices lower than they were in January. Inflation expectations have declined since March, and the Fed's preferred index, core inflation, which excludes volatile food and energy prices, has fallen to 1.5%, down from 1.8% earlier this year and well below the Fed's 2% target.

EXHIBIT 2: U-3 AND U-6 UNEMPLOYMENT RATES SEASONALLY ADJUSTED JUNE 2007- JUNE 31, 2017



Source: Bloomberg

The Fed remains concerned about inflation

Nor does a sudden rise in inflation seem imminent. For a brief period, the President's promises to cut taxes and spend freely on infrastructure made anti-inflationary measures by the Fed seem all the more urgent; however, the probability of fiscal stimulus this year seems to fall each week. Despite the prospects for continued low inflation, the Federal Open Market Committee (FOMC) raised the Federal Funds target to 1.25% on June 14 and left its policy guidance for another rate hike in 2017 intact. Clearly, the Fed and the FOMC are not abandoning their central case outlook that the core inflation rate will eventually resume its upward trend and approach its 2% per annum target. They believe that energy prices will stabilize and that final demand is growing fast enough to eliminate economic slack, which should put upward pressure on wages and unit labor costs. The FOMC continues to withdraw monetary policy stimulus, mainly to "forestall excessive labor market overheating."[3] Given the underlying strength of the economy and the Fed's confidence in its inflation outlook, the FOMC is likely to take further steps to reduce the supported policy stance. Our base case calls for the policy target rate to rise to 1.5% and gradually to 2.25% by the end of 2017 and 2018, respectively. Specific moves will be dependent on incoming data, though the Fed has become less data dependent and more committed to normalizing rates.

Fixed income markets are ignoring the FOMC's forward guidance. Interest rate cash and futures markets suggest that deflation is a greater risk than inflation. Federal Funds futures indicate that the probability of another increase in the policy rate this year is less than 50%, and two-year Treasury yields, which are below the Fed's end of year target rate, suggest that we are unlikely to see as much as one rate rise in the next two years. Admittedly, with a more pro-

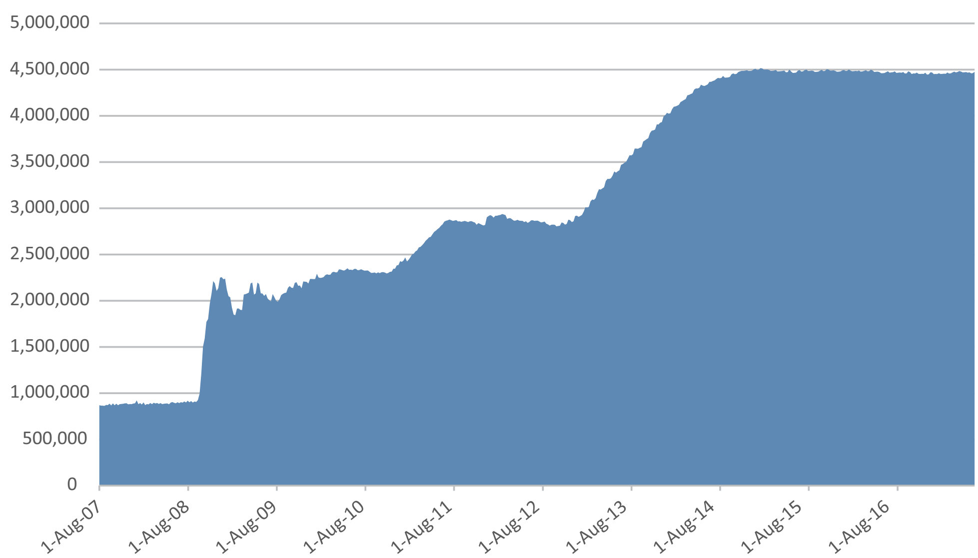
[3] Janet Yellen statement made after June 14, 2017 FOMC meeting.

tracted period of inflation disappointments than the recent one, the Fed should delay further rate hikes. However, we believe that the bond market's expectation of an economic downturn and continued negative real short-term rates is premature. Labor markets are just as important as an economic indicator of slack as inflation. Not only is the jobless rate at its lowest level since 2007, but indicators show households' perception of the ability to find work, the rate at which workers are quitting and the rate of jobs opening up all point to further improvement in the labor market. We expect that in the next 12 months the labor market will tighten enough to increase inflation, provided the economy continues to grow at its present pace.

At its June 13-14 meeting, the FOMC announced that it would reduce monetary stimulus by decreasing the size of the Fed's balance sheet. It promised to "Reduce the Federal Reserve's holding of Treasuries and agency securities once normalization of the level of the Federal Funds rate is well underway." This will involve reductions in the reinvestment of principal from maturing Treasuries and mortgage-backed securities, and the run off will be controlled. At first, the FOMC will let only $6 billion of its Treasuries and $4 billion of its mortgage-backed securities expire each month. This will later rise to $30 billion and $20 billion. Goldman Sachs estimates that the reduction will continue until mid-2020 and that the total balance sheet will shrink 25% to a terminal size of $3.3 billion.[4] We do not expect the balance sheet run off to begin until late in the year since the Fed will not want to exacerbate the market impact of the national debt showdown likely to occur in October. The gradual runoff should not seriously affect long-term fixed income markets.

In our previous quarterly report, we cited reasons why our economic outlook may be overly optimistic. We were concerned about the deviation of soft from hard economic data, with the former predicting substantially greater economic strength than the latter. More recently, the two have been much more consistent with one another. For example, retail sales are up 3.9% in the first five months of 2017 as compared with the same period in 2016, which is in line with the high consumer confidence reading. Nevertheless, we are still concerned about the possible peaking of the credit cycle and the uncertainty regarding the size and timing of corporate investment.

EXHIBIT 3: TOTAL ASSETS OF THE FEDERAL RESERVE JULY 30, 2007-JUNE 14, 2017



Source: Board of the Governors of the Federal Reserve System

4 Goldman Sachs US Daily, "June FOMC Wrap Up: Unfettered," June 14, 2017.

Political distractions impede economic reform

There are also other sizable risks, not mentioned earlier, that should be considered now. First, we have may have underestimated the adverse effect on consumer and business confidence of mounting political and policy uncertainty given the extent of Congress's agenda and its preoccupation with the Trump Administration's apparent relationship with Russia. It is difficult to see how, given the current distractions, the Senate can completely revise the House's healthcare proposal, the Congress can agree on a 2018 budget in September, and raise the debt limit in the next month, let alone initiate tax reform and other fiscal stimulus measures. Households and many businesses are reluctant to make long-term commitments with the increased potential for a government shutdown and uncertain future tax rates and employment prospects. Second, the Fed's gradual balance sheet reduction may not be as benign as we expect. Anticipation of it occurring late in the year may cause bond and mortgage interest rates to spiral upward. Third, the labor market may tighten more rapidly than projected, creating wage pressure and ultimately requiring the Fed to react more strongly than anticipated. Fourth, emerging interest rate differentials between the United States and other major currency areas may cause greater US dollar appreciation than we currently expect, reducing the profits of US multinationals and the competitiveness of US exports. Fifth, possible protectionist measures instituted by the current administration could interfere with US growth by disrupting the global supply chain.

The Outlook for Corporate Tax Reform

Although we assign a low probability for passage this year, we believe that there is a significant chance that limited corporate tax reform will take place in 2018. How substantial the effective tax reductions are will depend on whether or not substantial cost savings or revenue enhancement can be achieved by replacing the Affordable Care Act or by imposing a 20% border adjustment tax (BAT). The reduction in healthcare benefits required to eliminate the 3.8% tax surcharge on dividends and capital gains would be difficult for moderate republicans to support. Because of the substantial decline in their after-tax earnings that it is likely to produce, the BAT could wreak major harm on import dependent companies. These are some of the largest employers in the economy, including retailers and automakers.[5]

As indicated in our Q1 report, a modest revenue-neutral corporate tax reform involving no BAT has the highest probability of enactment in 2018. This would involve a reduction in the statutory corporate tax rate to 28%, the OECD average, leading to an effective tax rate of 22%.

We expect a watered-down version of corporate tax reform in 2018

On April 27, President Donald Trump proposed a fundamental change from the current global system of corporate income taxation to a territorial system in which US resident companies would be taxed only on their domestic profits. We do not believe that this proposal will be approved by Congress in its present form. The ability of US resident corporations to defer taxes by not repatriating them makes the US system more territorial than political rhetoric suggests. In addition, while it increases the attractiveness of headquarters in the US and creates greater incentive to repatriate foreign earnings, the territorial system increases the after-tax return on foreign country investments relative to US investments unless the effective US corporate tax rate does not exceed the foreign country corporate tax rate.

[5] Reynolds, Alan. "The border adjustment tax is not a free lunch." Investor's Business Daily, June 19, 2017.

Outlook for the S&P 500

Since we are assuming that no tax reform will be enacted this year, we are projecting a 4% increase in adjusted per-share earnings for the S&P 500, which would bring the adjusted earnings per share to $123 from $118 in 2017.[6] Our methodology for determining the likely S&P value for year-end follows that in our Q1 report. Once we have estimated the base value for the S&P 500, we then estimate the potential effect of the most likely fiscal policy scenario, and its rough probability.

Our base value for the S&P 500 is driven by 2018 estimated net earnings per share of $129 and a forward 12 month P/E multiple that falls to 17.5 from its current 19.3 value due as much to political uncertainty and late cycle multiple compression as an increase in year-end bond yields. This results in an S&P 500 price of 2257.5 which would equal a 5.9% increase over the 2016 end of year value.

Upside limited in US equities

The fiscal option is based on the assumption that a $1 trillion tax cut over 10 years ($500 billion for corporations and $500 billion for individuals) is proposed but not passed in 2017 and has a 40% probability of enactment in 2018. This would result in a 28% statutory corporate tax rate (equal to the OECD average) and an effective corporate tax rate of 22% versus the current 26%. If the market viewed passage as a certainty, expected corporate earnings would increase by 5.4% in 2018 which would translate to $7 additional earnings from fiscal stimulus.* With a perceived 40% probability of passage, the probability weighted increase in earnings would be $2.80 in 2018 which translates into a fiscal option worth 49 S&P 500 points given a forward P/E of 17.5. When this option is added to the base case value of the S&P 500, the resulting end of 2017 value for the S&P 500 is 2306.5 as compared with the current 2423.5 level of the S&P 500. These calculations are summarized in Exhibit 4.

EXHIBIT 4: CURRENT ESTIMATE FOR YEAR-END 2017 S&P 500 LEVEL

	Effective Tax Reduction	No Fiscal Stimulus
Base 2018 Earnings	$129	$129
Probability	40%	
Additional Earnings from Fiscal Stimulus*	$7.00	
Probability Weighted Additional Earnings	$2.80	
Forward P/E	17.5x	17.5x
Expected S&P 500 Value	**2306.5**	**2257.5**

*Ratio of the complements of the expected tax rates x $129: ((1-.22)/(1-.26)-1) X 129

While neither overly optimistic nor pessimistic, we believe the upside to the S&P 500 Index is limited through the end of the year unless earnings grow substantially or a massive fiscal program is introduced and enacted. We remain invested in US large cap and do not advocate reducing our allocation at this time given the low risk of a recession and the unattractiveness of risk free assets.

[6] Based on Goldman Sachs estimates. See Dave Kostin "Where to Invest Now, Two Americas: Inside and Outside the Beltway" June 2017, p21.

Europe and the UK

During the second quarter of 2017, the MSCI Europe ex-UK index appreciated 2.0% and the MSCI UK Index appreciated 0.8%. The strong equity performance reflects better than expected economic growth and an improving outlook across the Eurozone, as well as encouraging election results signaling a more stable political landscape.

Recent data indicate that the EU economy continues to expand and equities remain attractive. As of June 15, the forward P/E multiple of the EMU was 14.7, which is largely unchanged from last quarter, close to the long-term average, and attractive relative to that of U.S. equities.[7]

Annualized Eurozone and the U.K. GDP growth rates were 1.8% and 2.0% in the first quarter, respectively. Although growth in the U.K. slowed in the first quarter, the country has avoided the recession predicted by many in the wake of the Brexit vote a year ago. Recent PMI surveys in the region indicate that the economies of Europe continue to expand. In May, Eurozone PMI was estimated at 56.8 and the U.K. Composite PMI was 54.4. A reading above 50 indicates expansion. Finally, headline and core inflation rates turned down in May, consistent with the US and other developed economies. This alleviates pressure on the ECB to accelerate the removal of quantitative easing, a positive for equities in our view. Mario Draghi spoke citing recent weak inflation data as "temporary," but he confirmed central bank support would be needed as a rise in inflationary pressures was "not yet durable and self-sustaining."[8] If ECB can achieve their 2.0% inflation target in the current growth backdrop, European equities, particularly value stocks, should experience expansion of profit margins and the Euro should also strengthen.

European value stocks are attractive

Turning to politics which dominated headlines in Q2, we received clarity on the French election which was held on May 7. Emmanuel Macron, of the La République en Marche party, defeated the far-right candidate, Marine Le Pen, who advocated leaving the EU. Macron campaigned as a pro-EU and pro-economic reform candidate and amassed a significant base despite the nascency of his political career. In parliamentary elections in June, his party was able to secure 350 of the 577 seats of the National Assembly, the lower house in parliament.

German elections are scheduled for September 2017, when German Chancellor Angela Merkel will seek re-election. We believe the current Chancellor will maintain her position following her party's mid-May election upset in Germany's largest state. It appears Merkel is open to improving her country's relationship with France, the first step towards a more unified EU which will be important in upcoming Brexit negotiations and centralizing future EU policy.[9]

In mid-April, worried about her thin majority, British Prime Minister Theresa May called for an early election which was held in June. Although early polls indicated that Ms. May's Conservative Party would strengthen its majority, a poorly run campaign, misunderstanding of the public's stance on social programs and perceived callousness to

[7] Yardeni, E., Abbott, J., Quintana M.; "Global Index Briefing: MSCI Forward P/Es." June 19, 2017; https://www.yardeni.com/pub/mscipe.pdf
[8] Jones, Claire. "Draghi optimism on inflation sends euro higher." Financial Times, June 27, 2017.
[9] Wagstyl, Stefan. "Angela Merkel warms to Emmanuel Macron's Eurozone reform vision." Financial Times, June 20, 2017.

terrorist attacks caused her party to lose seats after the June 8 election. The Conservative Party has now formed a coalition government with the Northern Irish Democratic Unionist Party (DUP), and we believe Mrs. May's days are numbered. The loss of the majority will likely lead to a "softer" Brexit or significantly delay the timing of the process. In our view, this may translate into a more positive outcome for both the British and European economies and the option of the UK remaining in the single market is back on the table.

Entering the quarter, the French election was the key barometer we used to gauge the level of political uncertainty in the Eurozone. Post-election, we increased our allocation to the continent as the clouds of political machinations broke. We believe investors will shift their focus to economic fundamentals and opportunities. We still believe that political uncertainty will continue to contribute to the risk of our investments. The economies of Italy and Greece continue to lag the rest of the continent, and we can expect headline risk from these countries over the years to come. However, we believe this is nothing new, and the uncertainty is accurately priced by markets.

French election cleared the political skies

Japan

During the second quarter of 2017, Japanese equities, as measured by the MSCI Japan (net) index appreciated 6.0% and under-performed the MSCI EAFE (net) index by 28bps.[10] The Japanese Yen remained relatively stable against the dollar, and the tight currency range reflects relatively stable inflation expectations within each country. In our base case, we expect the long-term inflation expectations in Japan to remain stable, while expectations in the U.S. should reverse recent weakness. This difference should lead to a modest depreciation of the Yen in the coming months.

Data released in the second quarter of 2017 indicated Japanese GDP grew by 1.0% annualized during the first quarter after being revised down from an initial estimate of 2.2% annualized growth.[11] In spite of the downward revision, the expansion in the first quarter marks the fifth straight quarter positive GDP growth, and we expect the annualized growth rate to remain well-above the 20-yr average of 0.7% in the near-term. During the first quarter, private consumption contributed 0.6% to GDP growth, after no change fourth quarter of 2016. Bolstering private demand is an important step if the country wishes to end the deflationary environment of the last two-plus decades.

During the quarter, the Bank of Japan made no changes to monetary policy, and continues to employ a combination of quantitative easing, yield curve control, and negative interest rates. The quantitative easing program in Japan is likely to undershoot the current 80 trillion Yen target, as the central bank focuses on interest rates and yield curve control. Therefore, a modest form of tapering is occurring, but this should not have a significant effect given the still ultra-loose monetary policy.

Although the effects of Abenomics are still playing out, we remain confident that the Japanese equity markets provide an attractive area of investment. Japanese companies continue to improve their corporate structure and governance which should boost returns to shareholders. Second, the 12-month forward price-to-earnings ratio of 14.2x remains

[10] Source: Bloomberg

[11] Japan GDP Growth Revised Down to 1%; FT.com; https://www.ft.com/content/2403efec-4bef-11e7-919a-1e14ce4af89b?mhq5j=e3; accessed 6/20/2017

attractive relative to the twenty-five year historical average of more than 25x and to elevated U.S. equity valuations.[12] A key risk to our outlook relates to continued strong anti-trade rhetoric of the Trump administration and a potential slowdown in China. In 2015, these two countries accounted for approximately 38% of Japanese exports.[13] Although little of the President's bluster has been directed at Japan, anti-trade regulation in the United States, or a sizable decline in exports to China, will have a significantly negative effect on the ability of the Japanese economy to continue its expansion.

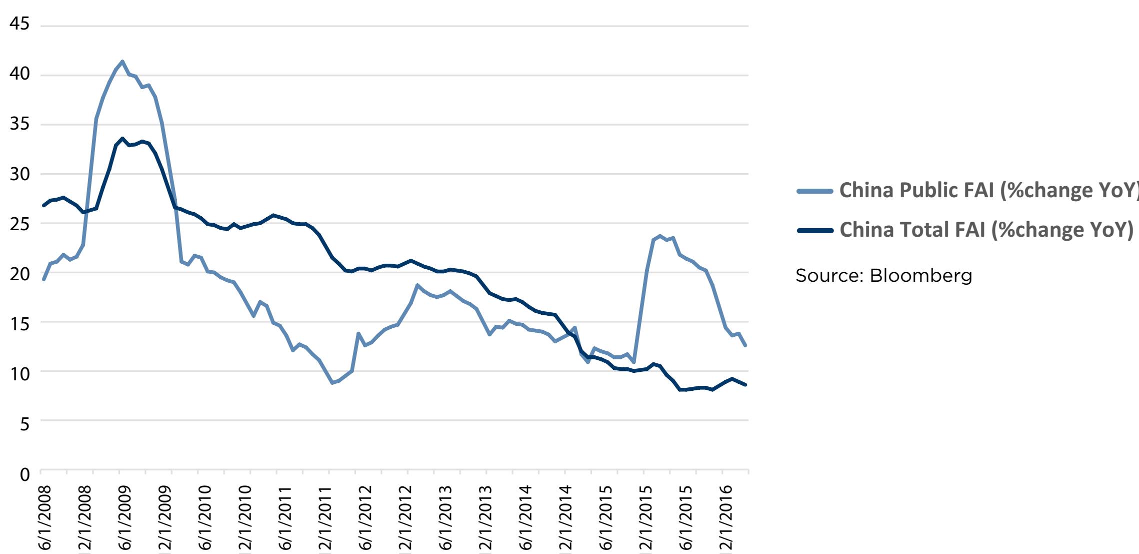
Optimistic on Japanese earnings growth

China

We earlier thought that the Chinese authorities would not tolerate any noticeable pause in GDP growth until after the National Congress in November, but we were wrong. Our conclusion has now been disproved by weaker activity data and by indications that the authorities are more concerned about excessive credit growth than seemed likely earlier. These concerns have been a major factor behind the recent decline in world commodity prices.

The current tightening began in December but intensified during the end of the first quarter. "Maturity mismatches," "debt refinancing risks," and "opaque collateral arrangements" have brought on periods of major stress in the overnight and 3 month Shanghai Interbank Offered Rate (SHIBOR) market. The tightening has resulted in large hikes in short- and long-term interest rates, overturning the declines in rates seen during the 2015-2016 period of aggressive monetary easing.[14] It has led to a yield curve inversion. The yield on two- and five-year bonds now exceeds that on the 10-year bond. This monetary and regulatory tightening has reduced credit growth from an annual rate of 25% in early 2016 to only 15% now as shadow banking and wealth management sectors have been crunched. However, the more zealous tightening seems to be ending. Thus far, we have found no evidence of an over tightening in Chinese policy that could seriously exacerbate the recent weakness in economic activity.

EXHIBIT 5: CHINA PUBLIC AND TOTAL FIXED ASSET INVESTMENT 2008-MAY 2017



[12] Yardeni, E., Abbott, J., Quintana M.; "Global Index Briefing: MSCI Forward P/Es." June 19, 2017; https://www.yardeni.com/pub/mscipe.pdf
[13] http://wits.worldbank.org/CountrySnapshot/en/JPN accessed 6/20/2017
[14] Davies, Gavyn. "China squeeze dents global growth." Financial Times, May 7, 2017.

The authorities' objective seems to be twofold. First, they intend to crack down on rapidly growing leverage in the shadow banking sector. At the same time, they are avoiding exposing the financial sector to wider systematic risk through rapid liquidity injection at any sign of cracking.[15] Second, while still providing credit for legitimate economic expansion, they are trying to prevent banks from lending to nonbank financial intermediaries, which are using their bank borrowings to finance shadow banking activities and stock and bond purchases. These tightening measures probably mean an end to the period of unexpectedly strong Chinese GDP growth. This may reverse global reflation expectations in the short run, since tighter regulation of Chinese wealth management products is reducing the speculative demand for commodities worldwide. In the past, however, Chinese authorities have stopped credit tightening whenever it put the GDP growth target at risk.

China's official purchasing manager indices showed a decline in May to below 50 indicating slight contraction. Non-manufacturing, which includes construction, peaked in November, while manufacturing peaked in March. The early signs of a slowdown mean that the pressure from President Xi Jinping to keep raising the heat on the financial sector leverage may soon abate.

Admittedly, regulatory crackdowns can take on a life of their own. In April, regulators competed to show leaders that they were heeding the Chinese President's warnings to control credit risks. Even in the third week of June, shares in several big listed Chinese companies fell sharply as Chinese banking regulators asked leaders to evaluate the "systematic risk" in loans.[16] Thus, while regulators are concerned about wider systematic risk to the financial sector, they are not engaged in further overall tightening of credit conditions in the face of a slowing economy. However, this represented an effort to prevent banks from becoming overexposed to excessive risk, rather than one aimed at reducing overall loan growth. It is clear that Chinese equity investors are not seriously concerned about tightening measures choking off growth, rather than gently reducing it. Chinese A shares have still returned more than 8% year to date.

In our view, China's growth is slowing in a measured way. We think that fears over a sharp downturn in Chinese growth brought about by rapid deleveraging this year are highly exaggerated. Trade data have been firm and real estate investment has held up despite macroprudential tightening measures. There has been a small decline in corporate profits which will eventually reduce employment, but the housing market has been more resilient than expected.[17]

China's growth is slowing in a measured way

We expect the rate of growth of credit flowing to the real economy to gradually decline and approach the steady-state rate of growth in nominal GDP of about 9% per annum. We expect corporate profits and economic activity growth to bottom later in the year. While domestic demand growth should stabilize, export growth should remain solid on the back of a synchronized global recovery and contribute 20 basis points to GDP growth in 2017, compared with -50 basis points in 2016. We expect real GDP growth to moderate slowly to 6.2% in Q2 and remain above 6% in H2.

[15] Ibid.

[16] Taplin, Nathaniel; "China's Debt Crackdown Could Get Out of Hand." Wall Street Journal, June 23, 2017

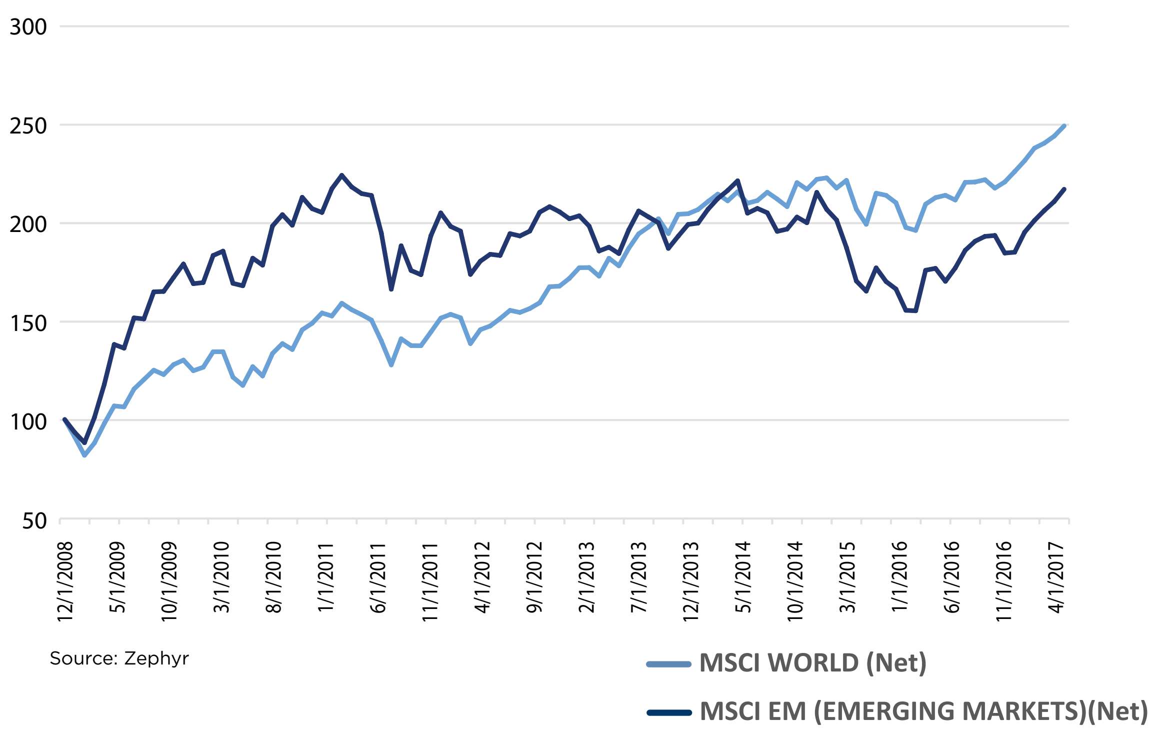
[17] Barclays Global Outlook, June 2017

Longer-term, however, the Chinese banking sector is faced with a high level of nonperforming loans due to a very low return on investment in the industrial sector. The latter is evidenced by an excessively high incremental capital output ratio which has risen from about 3 prior to 2015 to over 13. According to the Bank of International Settlements, China has the largest credit to GDP gap of the 43 countries it measures. To reduce its credit gap and limit the growth of nonperforming loans, China must not only reduce the rate of credit growth, but re-aim credit expansion at more productive activities. China has the resources to recapitalize its state owned banks and substantially reduce its credit gap but it remains to be seen whether it has a government system better equipped to contain credit-boom and bust cycles than Japan in 1990 or the US in 2008.[18]

Emerging Market Economies

Q2 was a second consecutive strong quarter for emerging market (EM) assets, with both EM bonds and EM equity funds benefiting from strong and steady inflows. The post 2008 return on these assets is now catching up with that on the world equity index (see Exhibit 6). This strength was partly attributable to the continued fading of Trump's protectionist rhetoric and partly attributable to improving fundamentals as GDP growth continues to be strong across the group as a whole.

EXHIBIT 6: DEVELOPED MARKETS (MSCI WORLD) VS MSCI EMERGING CUMULATIVE PERFORMANCE SINCE 2009



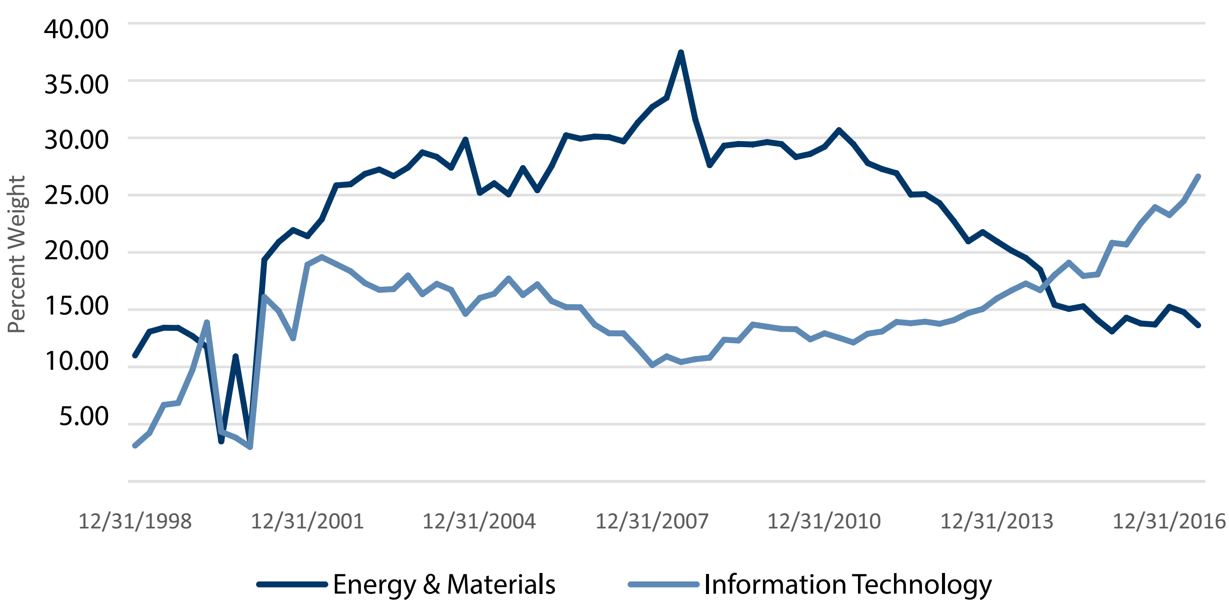
Source: Zephyr

[18] Brown, Andrew. South China Morning Post, April 21, 2017 and May 6, 2017

EMs have and should continue to be supported in H2 by recovery in global growth even if the peak momentum is behind us. Annual growth in global GDP should uptick over recent gains to 3.5%, with EM growth in aggregate exceeding 5%, restoring the gap over DM growth. The increase in investment into DM economies has led to recovery in global trade, as investment is more trade intensive than other components of demand. This rebound of trade and investment is occurring from very low levels after a multiyear trough suggesting that it has further to run.[19]

Other factors contributing to the EM rally have been the global technology mania, low US bond yields and a weakening trade-weighted dollar. Large tech companies such as Samsung and Baidu, Alibaba and Tencent (BATS) have a high weighting in the MSCI Emerging Markets Index (See Exhibit 7). These stocks, along with DM tech stocks, have led global markets by a large margin in H1.[20] We expect some retracement of their advance in H2. With respect to the last two factors, US long-term real interest rates have been declining, even though the Fed has been hiking the short-term policy rate. This, along with accelerating growth outside the US, has strengthened EM currencies vis-à-vis the US dollar. Thus far, the positive effect of a weakening dollar and falling US real rates has more than offset the potential depressing effect of a decline in commodity prices and a moderate decline in Chinese growth on EM equity prices.[21] However, EM equities should get less support from these factors in H2. Long-term US real interest rates and the trade-weighted dollar are likely to start moving upward again. Moreover, the global growth picture as a pull factor has become more mixed in recent months. China's recent slowdown, following a very strong Q1, has mainly been driven by reduced investment activity associated with declining credit growth. In H2, we expect a further easing of China's commodity-intensive, investment stimulus policies from those which supported EMs in H1.[22]

EXHIBIT 7: PERCENTAGE WEIGHT OF COMMODITY SENSITIVE SECTORS COMPARED TO INFORMATION TECHNOLOGY IN THE MSCI EMERGING MARKETS INDEX THROUGH JUNE 2017



[19] Barclays Global Outlook, June 2017

[20] Bank Credit Analyst, "Can Tech Drive EM Stocks Higher?" March 17, 2017

[21] Bank Credit Analyst, "EMs: Contradictions and a Resolution." June 14, 2017

[22] Bank Credit Analyst, "EM profits, China, and Commodities, Redux" 2017

Country selection is critical in the emerging markets sector

The reduction in exports to China could mean differentiated performance across countries in the EM space. The expected slowdown in China, combined with appreciation of the US dollar, would be particularly risky for commodity dependent economies, such as Russia, Malaysia, Indonesia and those in Latin America, the Middle East and Africa. However, certain EMs may continue to outperform. For example, those in Eastern Europe should continue to benefit from increased infrastructure spending in the euro zone and the outlook for the Indian and Philippine economies, which are relatively insensitive to China, still looks positive. For this reason, active management in the EM space with the ability to tactically overweight and underweight countries and regions is essential.

When one adjusts for sector weightings, the price to earnings ratios of EMs are not substantially lower relative to DMs than they have been in the past. Given that the valuation basis for investing in EMs is not as compelling as it was at the beginning of the year, the significant earnings downgrades in certain sectors caused us to continue to underweight the overall asset class.

Fixed Income

Despite the FOMC continuing its tightening process, the ultimate destination of policy normalization lies far off in the distance. As described earlier, the economy now resides in a "Goldilocks" scenario of benign growth, low inflation and financial conditions that have uncharacteristically eased amidst Fed tightening. These conditions allow the FOMC to take a more aggressive stance in removing some of the current accommodation. We expect one or two more rate hikes in 2017 and at least three hikes in 2018, noting an increased vigilance on wage inflation, the desire to push real yields into positive territory, and the goal of regaining control of risk taking in the equity market. Despite a more aggressive than anticipated balance sheet reduction announcement, market reaction was limited. We believe this mechanism may be more effective at combatting a wage-price spiral than raising the overnight rate.

The Fed will continue on its tightening path into 2018

While we do not see a recession looming, the cumulative result of policy tightening will enable the FOMC to ease in the event the economy turns down, but it may result in inflation expectations residing below the Fed's target and decreasing the "inflation safety margin against deflation" when the economy does shrink.[23] Even with declining future Fed open market purchases, we anticipate a flatter yield curve near term due to the absence of global inflationary pressures, which impact longer maturities. We continue to monitor the employment situation domestically and wait for more color on fiscal stimulus which would put upward pressure on growth and inflation. In Europe, inflation has plateaued and growth is unlikely to exceed 2% in 2017 which douses speculation that the ECB might taper its asset purchase program before 2018. We continue to believe the move toward policy normalization in Europe remains the primary risk for higher rates in the US.

[23] PIMCO blog: "The Prize and the Price of Opportunistic Tightening," Joachim Fels June 21, 2017.

There was a less publicized announcement from Brussels in May which may transform global sovereign bond markets in the future. A European Commission paper called for the creation of "sovereign backed securities." The paper proposes packaging the national debt of European countries into a new asset which could be tranched and sold based on yield requirements of investors.[24] Currently the ECB is purchasing Eurozone country debt en masse, but as the ECB reduces its purchases, the new sovereign-backed paper would theoretically maintain a broad based demand for Eurozone debt and reduce the risk of substantial increased funding costs in peripheral countries. We remain curious about the development of these "sovereign backed securities" as well as the risks. While Italy has a better chance of avoiding default than a sub-prime borrower in 2008, we might suggest that a copy of Michael Lewis' "The Big Short" be included with the offering memorandums that will be sent to potential investors.[25]

As seen in Exhibit 8, our estimate of the present equilibrium ten-year Treasury yield has remained unchanged from our March estimate of 2.57%. Based on our model, which uses the geometric mean forward Fed Funds rates, the ten-year zero coupon yield is expected to rise to 2.78% in 12 months against a current rate of 2.45%. This is consistent with our view that Treasuries are unattractive and should be used as a risk offset in diversified portfolios. We continue to favor other securities with shorter duration and higher yields than comparable Treasuries in the corporate credit and non-agency MBS sectors.

EXHIBIT 8: ESTIMATED EQUILIBRIUM YIELD FOR FIVE AND 10 YEAR TREASURIES GIVEN LIKELY HIKES IN THE POLICY RATE

	Now	End of 2017 Assuming 75 bp incr in 2017	End of 2018 Assuming 75 bp incr in 2018	End of 2019 Assuming 25 bp incr in 2019	End of 2020 Assuming 0 bp in 2020	End of 2027 Assuming 0 bp in 2027
DMCA Estimated Nominal Fed Funds Rate*	1.06%	1.31%	2.06%	2.81%	2.81%	3.31%
Subtract Projected Inflation	1.73%	1.85%	1.95%	1.95%	1.95%	1.95%
Real Fed Funds Rate	-0.67%	-0.54%	0.11%	0.86%	0.86%	1.36%
Average Short-Term Rate		1.19%	1.69%	2.44%	2.81%	3.31%
Yields Constructed Using Product of Nominal Fed Fund Rates for Each Year	5yrs	2.18%				
	10 yrs	2.57%				
	10y 1y fwd	2.78%				
	5y 1y fwd	2.51%				
10 year Treasury Strip (Actual yield, Bloomberg):		**2.45%**				

Data as of June 30, 2017. Source: Bloomberg

*** Fed Funds rate shown is the average of the day before and day after.**

24 Brunsden, Jim and Chazan, Guy. "EU presses plan to bundle debt of Eurozone countries." FT, May 31, 2017

25 The proposed sovereign-backed securities are similar to collateralized loan obligations that proved very vulnerable to systematic risk during 2008/2009 financial crisis. Michael Lewis indicated that these obligations had an inflated rating from credit rating agencies (e.g. Standard and Poors, Morningstar) because diversification did not prevent risk under these circumstances even though highly-rated and low-rated paper was being used as collateral.

Municipal bonds have outperformed taxable equivalents year to date and 10-year municipal ratios has declined significantly since the start of the year.[26] The 10-year AAA municipal Treasury ratio stands at 0.95 as of June 30, 2017.[27] Treasury Secretary Steven Mnuchin indicated that, "The administration 'strongly' supports the preservation of the tax exemption for municipal bonds" during a Senate Finance Committee hearing in May.[28] Near term tax reform is also unlikely, which has increased marginal demand for municipals and supply is down approximately 10% through May compared to the first five months of 2016.[29] We foresee little upside for municipal bonds compared to taxable asset classes looking forward. For tax sensitive buy and hold investors, fundamentals are constructive and we recommend delaying reinvestment until yields move higher. For total return investors, we recommend rotating into other asset classes that will likely outperform municipals during the remainder of 2017.

Spread Product

Yield spreads of corporate bonds ground tighter and the Barclays High Yield Index option adjusted spread stands at 364bps as of June 30. The Barclays HY Index has returned 4.93% ytd and the Barclays IG index has returned 2.67%. For comparison, HY spreads declined to under 250 bps in 2007, though Treasury yields were much higher at that time and central banks were not purchasing hundreds of billions of dollars of bonds in the open market quantitative easing.[30] Lower rated credits have outperformed year to date, but recalling a quote from a hedge fund manager from a 2007 letter, "How long do you stay on a train that you know is going to crash?" We believe BB rated credits offer the best value relative to the risk of spread widening and losing principal. Additionally, these credits are less levered and the impact of the tax changes we discussed last quarter should be minimal.

> Avoid broad market high yield strategies

We compare the current market to 2007 because realized volatility is very low, bond and loan covenants continue to be less and less restrictive, and more leverage is being used by alternative credit managers and buyout funds. We are not staring over the precipice of a credit downturn, but spreads are factoring very low default rates. Retail companies are now under increasing pressure and we are only 2 years removed from the most recent energy crisis. It is conceivable that a large retail default could impact other retailers as well as the commercial real estate market and holders of retail property CMBS. At current spreads, we view broad market high yield strategies as unattractive and prefer specialist managers that focus on higher rated credits.

Low volatility and a weak dollar have contributed to steady investor flows into EM bonds as well. The JP Morgan EMBI Global Diversified Index was up 2.24% in the second quarter, has appreciated 6.19% year to date. Low global bond yields and synchronized global growth have benefited emerging markets as a whole, but as evidenced by recent political events in Brazil, country specific risks in emerging markets are omnipresent and unpredictable. This makes country selection increasingly important going forward. EM debt remains attractive relative to developed sovereign bonds and high yield, and we maintain our exposure through global fixed income managers.

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26 The municipal Treasury ratio refers to the yield of a municipal bond divided by the yield of a Treasury bond of comparable maturity. A period of declining ratios refers to yields of the municipal bonds declining at a faster rate than Treasuries (or Treasury yields rise at a faster rate) translating into Municipal outperformance.

27 Source: JP Morgan Guide to the Markets, 3Q2017, p37

28 "Mnuchin: Administration wants to preserve muni bond tax exemption." Bond Buyer, May 25, 2017

29 Barclays: "Municipal Strategy Monthly." June 1, 2017.

30 As measured by the BofA Merrill Lynch US High Yield OAS (https://fred.stlouisfed.org/series/BAMLH0A0HYM2)

Conclusion

Following the FOMC meeting in June, multiple Fed speakers have consistently delivered the message that the FOMC will continue on their path of tightening while financial conditions are loose and that it was keenly aware of the lofty valuations of risky assets.[31] We believe it will take years for the ECB and BOJ to catch up to the US, but global easing should end soon. To use the spare tire analogy from the quote at the beginning of this letter, the US has one with limited mileage, but Europe and Japan would be forced to take more creative action if a downturn materializes in 2017/2018. Fortunately, global growth remains synchronized and should exceed 3.5% in 2017 with emerging markets outpacing advanced economies. We do not foresee any advanced economies retrenching in the near term, although we expect more volatility across global equities and fixed income while investors digest the removal of billions of dollars of monetary stimulus in the coming quarters.

The repeated behavior of bond, commodity, and equity markets since the end of 2008 indicates that the same signs of economic stagnation keep appearing. The ten-year treasury rate hit a high ahead of economic setbacks as it did in early 2011 and late 2013, the yield curve flattens, commodity prices dip along with inflation expectations, and investors shift their preferences from cyclical value to defensive growth stocks. We seem to have entered such a period in the last 2 months of 2016: a higher ten year treasury yield has been followed by weak growth in 1Q 2017 and other indications of disinflation. However, unlike other post-2008 periods, global growth is synchronized and corporate revenue and per share earnings growth is solid in developed countries. We favor a more optimistic view involving a stronger synchronized expansion rather than one involving rolling economic weakness and "bad" deflation resulting from demand being depressed over supply. Some meaningful progress in fiscal stimulus and tax reform in the US and some pick up in foreign growth should provide the sustained reflation necessary for a decisive departure from the pattern of recurring economic weakness by next year.[32]

Part of the reason for low inflation when the US economy is at full employment is that "good" deflation, i.e. that arising from larger productivity forces, is having significant effects. These forces include new technology in North American oil and gas production, ridesharing, and retail that are pushing down prices. Since the main beneficiary of these technologies is the consumer, acceleration of consumer spending, rather than business investment, could result in the next major upward move in the US economy.

Consumer spending versus business investment may drive the upward move in the US economy

Our base case outlook has not changed, and we expect single digit returns for US equities and low double digit returns for non-US developed markets in 2017. The "Trump Trade" has fully reversed and both the US equity and bond markets share our skepticism regarding 2017 tax reform/cuts. Non-US developed equities have outpaced domestic equities year to date which we believe will continue in the medium term due to higher European and Japanese

[31] "When financial conditions tighten sharply, this may mean that monetary policy may need to be tightened by less or even loosened. On the other hand, when financial conditions ease—as has been the case recently—this can provide additional impetus for the decision to continue to remove monetary policy accommodation." William C. Dudley, Remarks at the Bank for International Settlements' Annual General Meeting, Basel, Switzerland June 25, 2017.

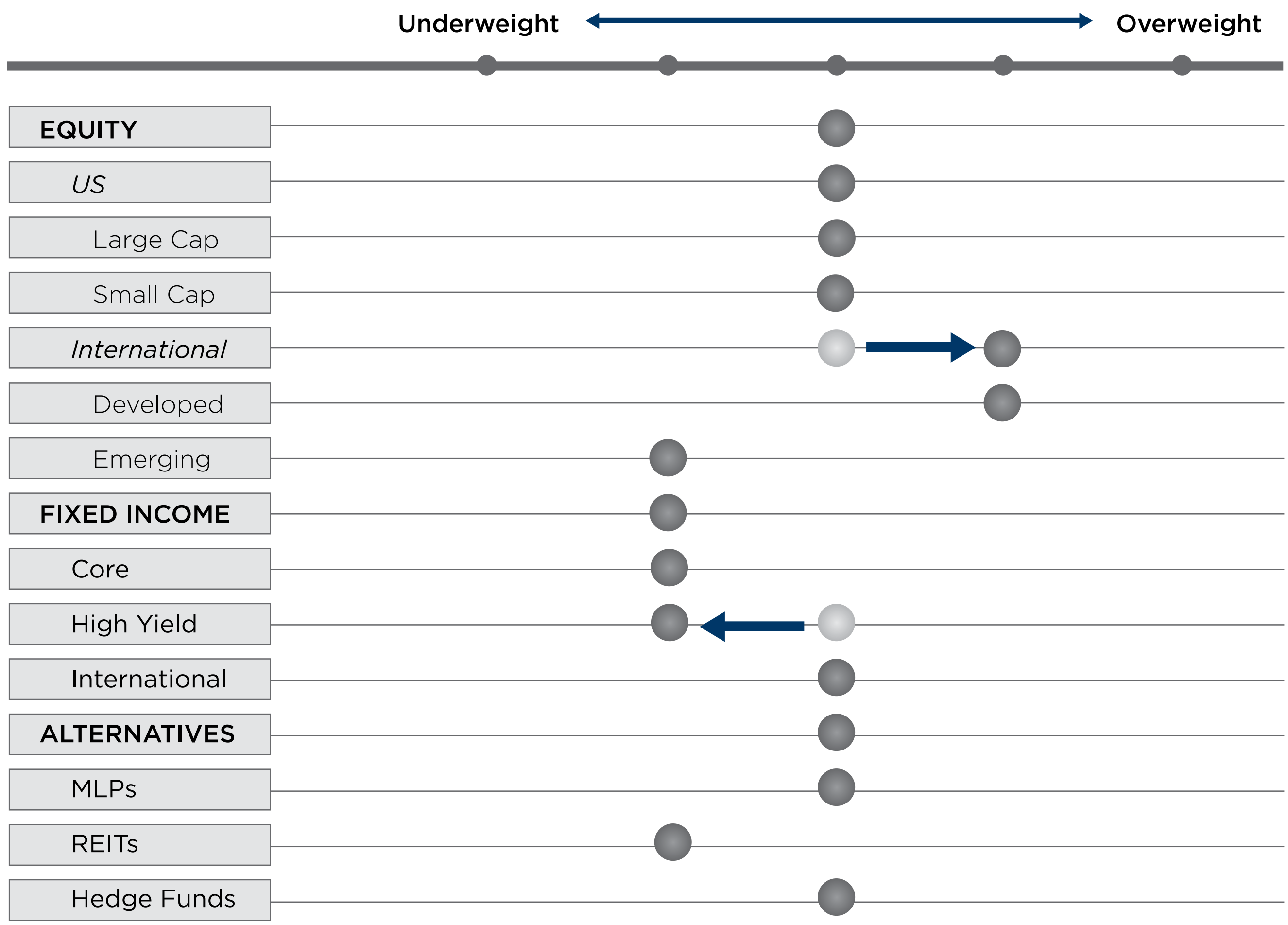
[32] Blavine, "Reaching the Macro Inflection Point" Seeking Alpha, July 5, 2017

earnings growth, lower non-US developed market valuations and a stable to declining dollar. Near term, dollar weakness or fiscal easing could lead to US outperformance. Additionally, it is our view that emerging market equities will likely underperform developed market equities for the remainder of the year due to earnings downgrades, reversal of BATS outperformance and lack of Chinese stimulus.

Finally, we agree with the Fed that the soft patch in inflation data is ephemeral, so we remain underweight duration in our fixed income allocations.

> We expect single digit returns for US equities and low double digit returns for non-US developed markets in 2017

EXHIBIT 9: DMCA ASSET CLASS VIEWS AS OF JUNE 30, 2017



Source: DMCA

Our outlook and asset allocation recommendations are subject to left and right tail risks not currently reflected in global asset prices. We acknowledge risks to our forecast including:

- Passage of corporate tax cuts and additional pro-growth fiscal policy in 2017.
- Shocks in Europe that disrupt the current growth forecasts and stable outlook.
- Reversal of positive growth and inflation trends in Japan.
- Additional Chinese stimulus.
- U.S. recession or significant slowdown brought on by tightening of overall financial decisions (stronger dollar, weakening equity market, and higher bond yields).
- Greater trade restrictions and a reduction in global trade growth due to a downturn in Chinese investment.
- Rising geopolitical risks and the risk of conflict in areas such as North Korea, the Middle East, and Ukraine.
- Wage price spiral in US due to tight labor conditions and low productivity.
- Anchor retailers failing, leading to domino effect on smaller retailers and CRE related debt.

IMPORTANT INFORMATION

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Any third-party information contained herein has been obtained from sources believed to be reliable; however, no assurance can be given that all external information is correct. All market prices, data and other information are not warranted as to completeness or accuracy, may not be audited information and are subject to change without notice.

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