Drexel Morgan Capital Advisers

THIRD QUARTER 2018

Global Economic and Market Commentary

Summary

- Economic and policy divergence will extend through the end of the year for U.S. vs. non-U.S. developed markets. The Fed will tighten into 2019 and interest rate differentials will support the U.S. dollar. U.S. GDP growth will likely moderate throughout 2019 from its current unsustainable pace.
- We expect higher volatility and modest gains in U.S. equities due to slowing earnings growth.
- International equity returns reflect a slowdown in non-U.S. growth, although a resolution to the U.S.-China trade war would be a major positive catalyst.
- Emerging market economies are the most susceptible to a trade war and growth rates are beginning to slow. Risk of contagion is low. Valuations reflect slowing earnings growth and do not warrant overweight in portfolios.
- We expect modestly higher 10 year yields in the U.S. and Europe and higher short term rates. We continue to favor short duration strategies and have reduced our credit exposure.

"There are signs that global growth has plateaued. It is becoming less synchronised. Rhetoric on trade barriers is hurting not only trade itself, but also investment and manufacturing as uncertainty continues to rise." –*Christine Lagarde, IMF, 1 October 2018*

Investors have been rewarded for owning U.S. equities through Q3. Strong GDP growth, loosening financial conditions and a well-insulated economy provided a constructive backdrop for substantial earnings growth despite tighter monetary policy. The S&P 500 appreciated 7.7% in the third quarter (10.6% YTD). Non-U.S. equities also appreciated in the quarter, up 0.7% but remain in negative territory for the year, down -3.1%. Emerging market (EM) equities have been the worst performing asset class, declining -1.1% in the quarter and -7.7% for the year. This year, a confluence of factors (politics, trade tensions and divergent growth rates) has led to much lower returns on the global stock market index than those of last year.

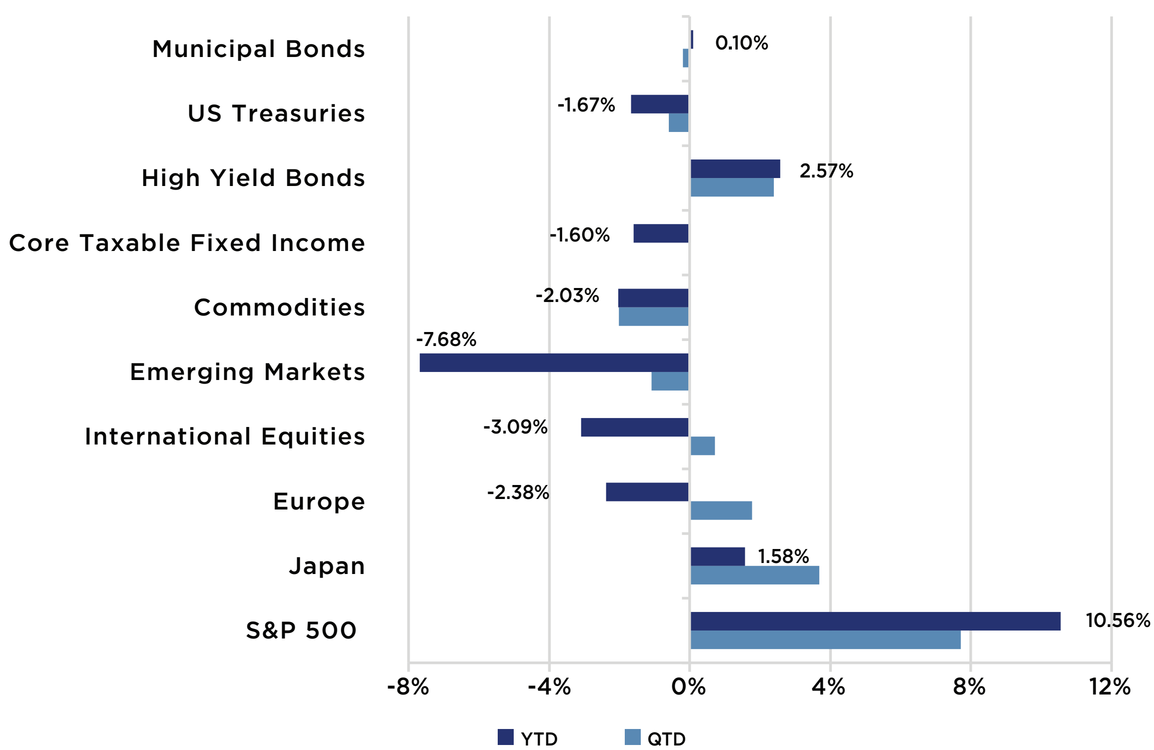
> Domestic equities outperformed due to strong earnings growth

During the quarter, non-U.S. developed market (DM) currencies stabilized versus the dollar, but EM currencies, in aggregate, continue to depreciate and may be susceptible to further declines. Interest rate differentials are unlikely to close, so we do not foresee material U.S. dollar weakness vs. DM currencies. The Federal Reserve has articulated a clear path toward higher short term rates and recent releases point toward higher inflation data through year end. Long maturity Treasury yields have resumed their upward path with the 10 year Treasury yield ending the quarter at 3.06% (currently 3.21%). Credit spreads tightened in the quarter contributing to outperformance of high yield bonds. The Bloomberg Barclays U.S. Aggregate Index was flat for the quarter while high yield and municipal bonds returned 2.4% and -0.2% in the quarter, respectively.

As 2018 comes to an end, we believe the risk of recession in the developed economies is low in 2019. Economic data and recent surveys indicate continued economic expansion, financial conditions remain loose and inflation expectations are anchored. In the U.S., domestic companies have enjoyed wide margins and the recent tax cuts boosted profitability. Looking forward, these tailwinds will subside and headwinds from interest rate increases, tight labor markets and higher input costs will slow economic and earnings growth, especially in the U.S. Future tariffs would increase the pace of a slowdown and will have a greater impact on non-U.S. equity performance. We remain invested in equities cognizant that volatility may return in Q4 and/or 2019. It already has in the first half of October. We favor companies with strong balance sheets and significant pricing power. Within international equities, compelling valuations are offset by moderating growth and trade policy risks, so we are keeping exposure equal weight versus policy benchmarks. In fixed income, we reduced our exposure to credit, specifically high yield bonds, as spreads are near historically tight levels, and we allocated the proceeds to short duration investment grade bonds, which are insensitive to the rapid increase in the 10-year Treasury yield which occurred recently and in January/February of this year.

We favor companies with strong balance sheets and significant pricing power

EXHIBIT 1: GLOBAL CAPITAL MARKET RETURNS YTD THROUGH SEPTEMBER 30, 2018

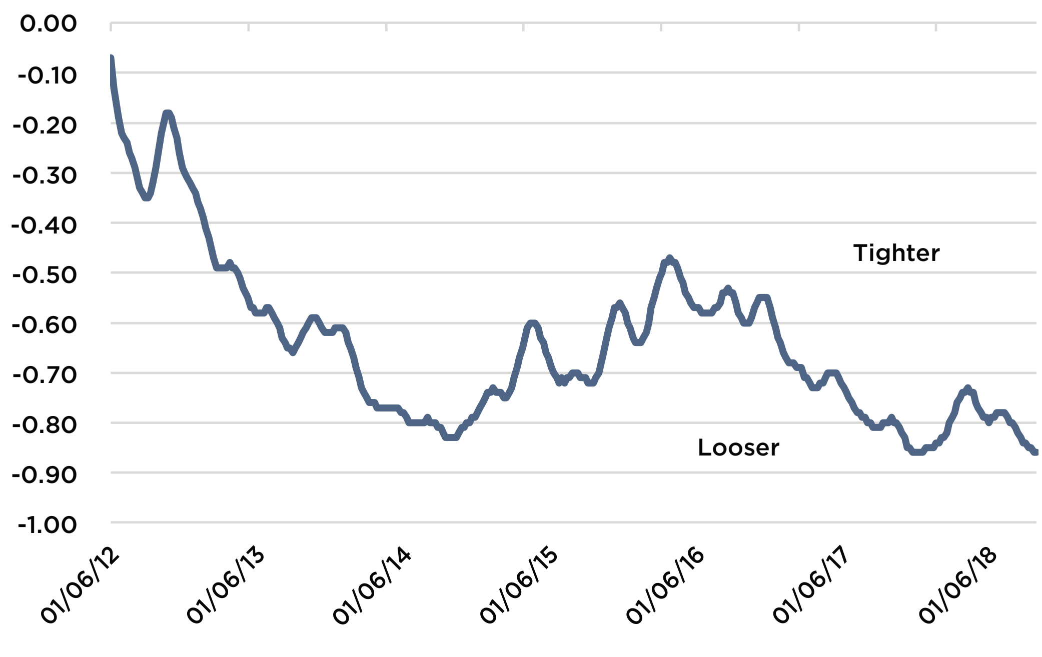


Source: Bloomberg, Barclays Live

Outlook for the U.S. Economy and Stock Market

The U.S. economy will still grow substantially above trend for the remainder of 2018, though at a slowing rate. Consumer and business confidence and the financial conditions index are crucial in this regard. The Conference Board Consumer Confidence Index is at its highest level since 2000 and the ISM Manufacturing Index is slightly below the 2004 peak. The ISM non-manufacturing index was at 61.6 in September, its highest level since August 1997. Despite numerous Fed rate hikes, the Chicago Fed Financial Conditions Index is still at expansionary levels. A strong labor market is driving consumer spending forward and the recent increase in the revised household savings rate suggests that further consumer spending increases will occur next year if the wage bill continues to rise. Corporate tax cuts, combined with high capacity utilization rates, will boost investment in most sectors though lower profit margins will slow investment growth in other sectors. Elevated government spending levels will also contribute to growth through the middle of next year. Save for softer housing and some profit margin compression, the same confluence of factors that contributed to peak economic expansion since the beginning of 2017 is still present.

EXHIBIT 2: CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX JAN. 2012- SEP. 2018



Source: Federal Reserve Bank of Chicago

We expect GDP growth to moderate in Q4 and 2019, although it should remain above trend. Fiscal stimulus should gradually diminish. The drop in the unemployment rate to 3.7% for the first time since 1969 has elevated consumer demand and confidence. Private sector job creation was unexpectedly strong in September and should continue next year as long as businesses expect higher demand for their products. According to the Conference Board, increased investment in capital equipment, software and R&D during 2018 could cause workers to be more productive in 2019.[1]

[1] The Conference Board Economic Forecast for the U.S. Economy. Updated: September 12, 2018.

However, tariffs on final and intermediate goods imports may act as a cost push shock to the economy, somewhat similar to an oil shock, and reinforce other factors such as drum tight labor markets causing quarterly growth to diminish throughout the year. Business confidence should start to suffer as the first order impacts of tariffs on U.S. input prices and sales start to appear.

Wage growth has been gradually increasing and now stands at 2.7%, only about half a percentage point below the peak rates seen at the top of the last two expansions.[2] A sharper acceleration in U.S. wage inflation than that observed thus far is highly likely. One event not included in the average hourly wage rate is Amazon's increase in the minimum hourly wage to $15 announced at the beginning of Q4. This in and of itself will add .1 percentage points to the month over month growth rate for hourly earnings in November. Amazon is a very large employer, and it may set a precedent for wage increases in competing U.S. firms. The historical relationship between unemployment and wage growth, which was much more pronounced than that recently observed, may suddenly reappear, resulting in a pickup in wage inflation following Amazon's decision.

Outlook for Per-Share Earnings

Baseline earnings per share for the S&P 500 are estimated to rise by 19% in 2018 due to corporate tax cuts, greater than normal share repurchase and strong final demand growth. In 2019, earnings of U.S. corporations will face some strong headwinds. These include higher unit labor costs, interest rates and material costs.

If it were not for the trade war with China, we would expect profit margins to remain at their present high level in the first half of 2019. Without a major tariff increase, above trend GDP growth, higher labor productivity and further increases in core PCE inflation would outweigh the depressing effect of higher wage growth and interest and material costs. The most significant earnings drag is likely to be attributable to higher tariff rates on imported inputs.

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Tariffs on $200 billion of imports from China were implemented at the end of September and more tariffs are likely to come. Tariffs on final goods were historically thought of as resulting in an increase in profits of import competing industries. However, this effect is minor in the case of U.S.-China trade. With deindustrialization, the production of final goods that compete against Chinese final goods imports is low in relation to these imports. In addition, a large share of the goods imported from China are either intermediate goods or capital goods which are not produced domestically.[3] If domestic companies are unable to pass on higher input costs resulting from tariffs, their profit margins will be squeezed. This reduction in profits will be much greater than that resulting from retaliatory tariff increases on U.S. exports to China, since as Barclay's notes in its September Outlook, exports to China are still a very small percentage of the sales of U.S. companies. Even tariffs on final good imports from China are likely to have a depressing effect on the profits of U.S. companies if their final goods are produced in China.

[2] Davies, Gavyn. "Why Investors Should Worry about Rising Wages." Financial Times September 23, 2018.

[3] Krugman, Paul. "How to lose a trade war." NY Times July 7, 2018.

EXHIBIT 3: U.S. EARNINGS EFFECTS OF TARIFF INCREASES OF 20% ON U.S.-CHINA TRADE

A*	Imports as % of US COGS	30.0%
B*	China imports as % of total US imports	18.0%
C	Increase in tariff from 7.5% to 20%	12.5%
D = A x B x C	Tariffs as % of COGS	0.7%
E*	COGS as % of US companies revenue	65.0%
F = D x E	Tariffs as % of revenue	0.4%
G*	Profits margin of US companies	9.1%
H = G - F	Net margin after tariffs	8.7%
I = F/G	Effect of new import tariffs on profits	4.8%
J*	Profit effect of new Chinese tariffs on US exports	0.5%
K = I + J	Total effect on US company profits	5.3%

A*, B*, E*: Goldman Sachs Weekly Kickstart September 20, 2018

G* : Source: Bloomberg using TTM Profit margin for CY 2017 for S&P 500 index

J* - adjusted estimate of earnings effect of tariff increase
(Source: Barclays World Outlook)

In Exhibit 3, we estimate the impact on S&P 500 earnings of an increase of 20% on tariffs imposed on all U.S.-China trade. The per-share earnings of U.S. companies would be reduced by 5.3%, under three conservative assumptions:[4]

1. No substitution to other suppliers.
2. No pass-through of cost to consumers.
3. Tariffs do not result in any benefit for U.S. import competing companies.

In estimating the effect of retaliatory tariffs on profits of U.S. exporters, it is assumed that U.S. exporters will not change their pricing due to these higher export costs and will take the full hit to their profitability. In reality, they would opt to pass on some of their costs to their customers and accept some reduction in profit in market share.

For all U.S. industry, roughly 15% of cost of goods sold is imported. Given that S&P 500 constituent firms are more global in nature and have more complex supply chains than overall industry, Goldman Sachs estimates that imports account for roughly 30% of S&P 500 cost of goods sold and imports from China account for 18% of total imports.[5]

Under these assumptions a 20% tariff imposed on U.S./China trade is estimated to reduce S&P 500 earnings for 2019 by 5.3% from a $170 baseline estimate. If we relax assumptions one through three and allow for some increase in profits of import competing U.S. companies and assume U.S. exporters are able to raise prices somewhat, a net 3% hit to S&P 500 profits may be more reasonable and is more consistent with Barclays estimate published in its September global outlook (see Exhibit 4).

[4] President Trump has promised an increase to 25% on US imports of Chinese goods, but we are assuming some compromise will be reached.
[5] Goldman Sachs, US Weekly Kickstart, September 28, 2018.

EXHIBIT 4: S&P 500 PRICE AND EARNINGS PER SHARE PROJECTIONS

Year End	SPX price	Estimated forward P/E	EPS	% increase in EPS
2017	2673	16.8	133	
2018	2766	16.9	159	19.5%
2019	2974	16.9	164	3.1%
2020	3012	16.4	176	7.3%
2021			184	4.5%

EPS figure for 12/31/17 is from Goldman Sachs 'Where to Invest Now', page 13. Reflects Adjusted EPS to remove non-recurring items in Goldman Sachs' view. EPS for 2018 - 2020 is based off DMCA estimates.

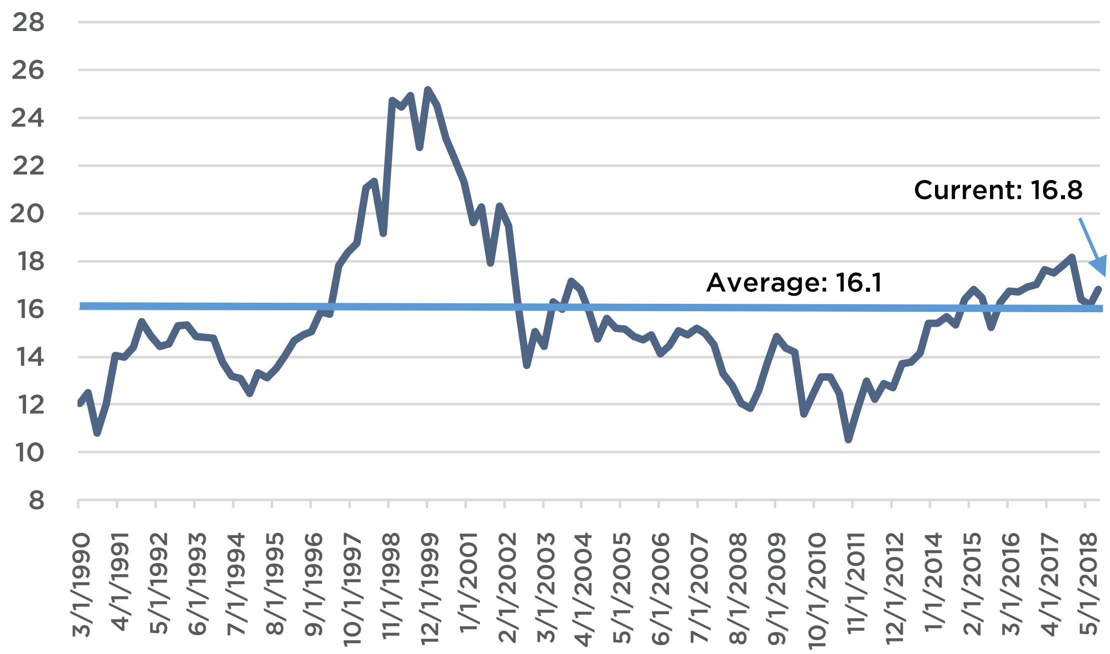
The outlook for the S&P 500 over the next two years depends critically on projections of earnings and forward earnings multiples. We anticipate that the forward earnings multiple (based on top down estimates) will be 16.9 by the end of the year and through 2019 and will contract to 16.4 by the end of 2020. These multiples are consistent with a 3.5% 10-year Treasury yield and a 2.4% and 2.6% risk premium.

> We are looking to overweight value stocks in the energy, healthcare and financial sectors

The 16.9 forward earnings multiple is 5% above the post 1989 average of 16.1 and the 16.4 multiple is 2% above that average.[6] They are at least 9% above the 50 year average of 15. Economic expansions are much longer than they used to be and inflation rates more anchored, which is evidence of a secular decline in macroeconomic volatility ("the Great Moderation."). As a result, equity valuations tend to be higher than their post 1925 averages during the post 1989 period. Absent a reversal of the great moderation, forward earnings multiples and other valuation metrics are unlikely to revert to their post 1925 averages.

[6] JP Morgan Guide to the Markets 3Q 2018.

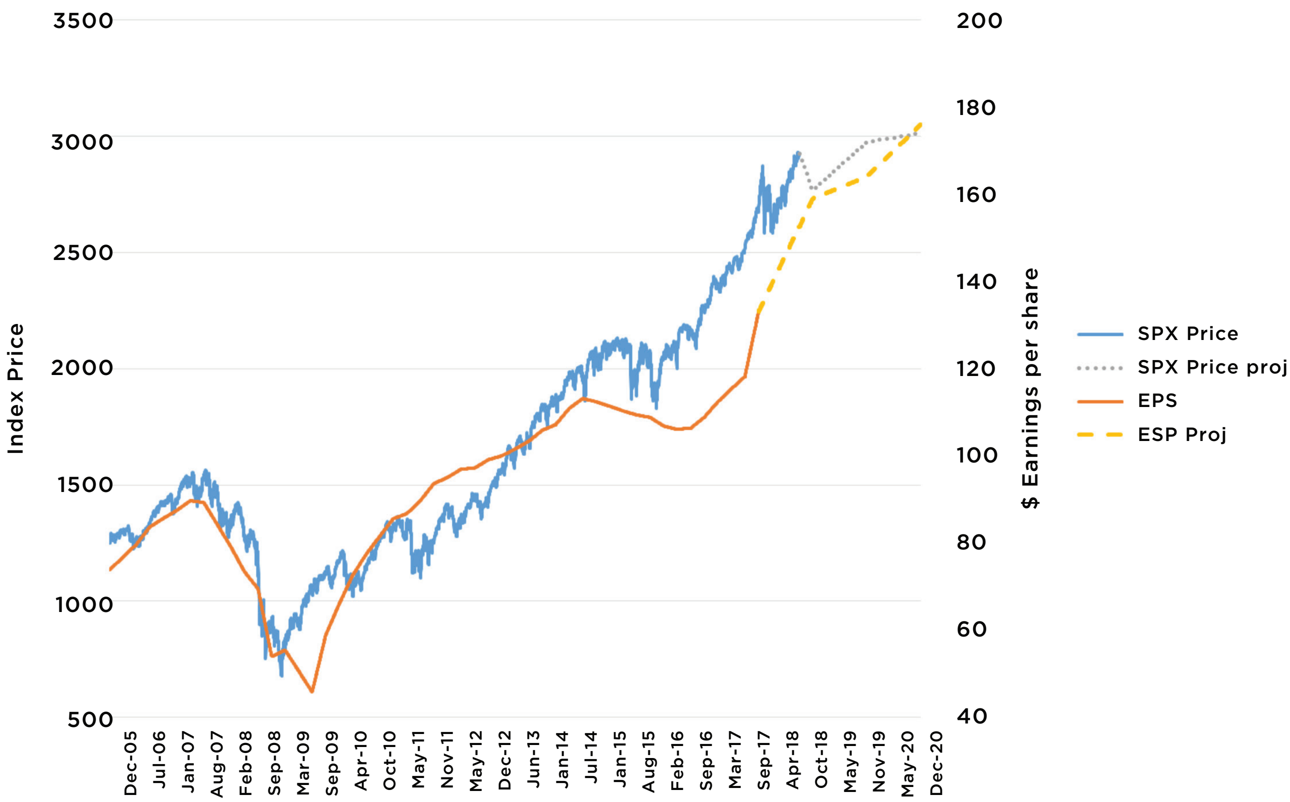
EXHIBIT 5: S&P 500 FORWARD P/E RATIO SINCE 1990 - 2018



Source: Bloomberg, JP Morgan

As shown in Exhibit 4, our estimates for S&P 500 earnings at the end of 2018, 2019 and 2020 are 159, 164 and 176, respectively. These suggest equilibrium S&P 500 values of 2766, 2974 and 3012 at the end of 2018, 2019 and 2020 given a 4.5% forward earnings growth rate at the end of that year. At its present level of 2838, the S&P 500 is overvalued and would provide price appreciation of only 2.8% annualized through 2020 which is substantially below the projected earnings growth rate. The total return on the S&P 500 is estimated at 4.8% during this period. The pattern is similar to that of the beginning of 2017 to present when the index advanced at a lower rate than the underlying earnings per share (see Exhibit 6, on the following page):

EXHIBIT 6: VALUE OF S&P 500 VS. EARNINGS PER SHARE – DECEMBER 2005 TO DECEMBER 2020



Source: Bloomberg

While the expected return on the S&P 500 through 2019 is very low, the value component of this index seems to be compellingly cheap. For example, the price-to-book ratio of value stocks is 40% that of growth stocks and is at a 15 year low point. While the price to forward earnings ratio for growth stocks is a well above the historic average, that for value stocks is in line with that average. At this point, according to Morgan Stanley, the 12 months forward earnings growth rate is improving for value stocks relative to that of growth stocks, which is inconsistent with the latter's outperformance.[7] We are looking to overweight value stocks in the energy, healthcare and financial sectors which are relatively insensitive to tariff increases but underweight value stocks in the industrial sector which is highly sensitive to tariff increases as shown in the September Barclays Global Outlook. Because earnings growth has become more unpredictable due to tariff and other cost pressures stocks of those undervalued companies with a narrow range of analyst earnings estimates are also attractive. Even though we may tilt somewhat more toward value stocks, we are still looking to overweight quality growth companies at reasonable prices. These companies have strong balance sheets, significant pricing power and high, sustainable profit margins.

[7] Morgan Stanley, Cross Asset Playbook: A Value Bias. October 2, 2018.

Europe and the UK

During the third quarter, the MSCI Europe ex-UK Index appreciated 1.8% and the MSCI UK Index declined -1.7%. Year to date, the returns have been -2.4% and -2.7%, respectively. In addition to negative trade policy feedback, the unexpected slowdown in growth within the Eurozone, continued political uncertainty, Brexit issues and increased volatility have weighed on European equity markets.

> Brexit continues to dominate the headlines in Europe

Brexit continues to dominate the headlines in Europe. As of the end of the quarter, we still do not have much clarity into potential outcomes and negotiations will most likely continue to the last minute. In July, the cabinet in the UK reached an agreement known as the "Chequers Plan." This agreement (more of a wish list from the UK) essentially seeks to establish a common area for manufactured and agricultural products between the EU and the UK, but not for services. The agreement also plans for the ending of the free movement of people, and the establishment of a joint authority to resolve trade disputes. According to most analysis we have reviewed, this plan is unlikely to garner any support within the European Union and is also opposed by a large portion of the British government.

Meanwhile, governments throughout Europe are preparing for the possibility of a no-deal Brexit in order to minimize the disruption to local economies. On the other end of the spectrum, leaders in Brussels have plans to unveil tough contingency issues that would provide the maximum amount of pain to the UK if no deal is agreed to before the deadline. We believe this is simply a negotiating tactic and will be rolled back as negotiations continue in mid-October.

It is our view that much of the strong rhetoric from both the UK government and the EU commission is political posturing. In the end, we still believe a deal will be announced before the end of the year that outlines a "soft" Brexit with new norms being phased in over a period of time. It is in the best interest of all parties to avoid the "hard" Brexit damage that would arise if no deal is reached.

In Italy, the spread on Italian debt to its German counterpart widened again at the end of the third quarter, and the yield on the 10-year Italian Bond was the highest level in four years at 3.63% during the first week of October.[8] In September, the Italian government presented a budget that significantly increased the deficit spending, the sustainability of which has been questioned by the bond markets. Additionally, strong anti-EU rhetoric from the ruling coalition has contributed to volatility.

In France, the momentum from the election of President Macron last year has quickly dissipated as his push for reform has hit resistance. Over the past several months, amidst growing tensions within his government, Macron has been seen as arrogant and out of touch with French citizens. While it is clear that reform is needed within France to kick-start the economy and ease the restrictions on business creation, it remains to be seen if Macron can usher in the needed reforms before opposition derails his presidency.

During the second quarter, UK GDP increased by 0.4%, which is a slight acceleration from the 0.2% pace of the first quarter 2018.[9] Inflation is above the 2% target of the Bank of England, although BOE decided to hold the Bank Rate at 0.75% and to maintain its purchases of bonds, a reasonable approach by the bank due to uncertainty surrounding Brexit negotiations and the potential effect on the economy.

[8] Cocco, Federica; "Italy's bonds under fresh pressure on budget worries;" Financial Times; May 8, 2018.

[9] "GDP first quarterly estimate, UK: April to June 2018;" Office for National Statistics GB; August 10, 2018.

Second quarter GDP also increased by 0.4% in the EU. Germany and Spain contributed significantly to the increase, while growth in France and Italy lagged. Although headline inflation rose to 2.1%, core inflation remains at 0.9%, and the European Central Bank (ECB) will maintain its plans to reduce its bond purchases by the end of the year and holding interest rates low at least through the summer of 2019. We expect the ECB to continue to scale back its monetary intervention as growth remains relatively strong (although below our original expectations), and inflation remains close to targets.

The slowdown in the European economy this year has taken us by surprise

The forward P/E ratios of Europe and the UK have declined from the end of the second quarter to 13.2x and 12.8x respectively, and remain at a discount to U.S. Equities.[10] However, earnings growth in the region continues to lag the strong growth in the U.S. The slowdown in the European economy this year has taken us by surprise, as we thought the strong results from 2017 would continue into 2018. The uncertainty surrounding Brexit along with the political uneasiness in France, Germany, and Italy have weighed on equity valuations in the region. Over the last several months, we have tempered our expectations for European market outperformance, but continue to monitor the situation for improved signals.

Japan

During the third quarter of 2018, Japanese equities appreciated 3.7%. Year to date, the MSCI Japan Index has outperformed the MSCI EAFE Index by approximately 3.0%. Since the end of the first quarter, the U.S. Dollar has appreciated by approximately 7% vs the Japanese yen (JPY) including 2.7% in the quarter. We noted in our last letter that we expected the strength the JPY exhibited in the first quarter to reverse due to divergent monetary policy.

> Overall, no news was good news for Japanese markets during the third quarter

Data released in September indicated that Japanese GDP grew at a 3.0% annualized rate in the second quarter of 2018, reversing the disappointing decline in GDP during the first quarter.[11] The degree to which the economy accelerated in the second quarter exceeded our previous expectations of continued slow growth, but we believe the most recent quarter's data was an outlier and that GDP growth in Japan will moderate towards 1.5%.

The BOJ remains an outlier to the Fed and ECB with no formal timetable for removing accommodative monetary policy. However, there is potential that the Bank of Japan will modestly relax its yield curve control and allow interest rates to float within a wider band during the next twelve months. While the pace of expansion is expected to slow, most market prognosticators expect the BOJ to continue to grow its balance sheet through the end of 2019.

The forward P/E of the MSCI Japan Index was 13.3x at the end of the quarter, which is still below the year-end 2017 level of 14.6x.[12] Low relative and absolute valuations coupled with modest yet consistent growth continue to make Japanese equities attractive on an absolute basis as well as relative to other developed nations, including the United States.

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

[11] Lockett, Hudson; "Japan GDP revised higher in Q2." Financial Times, September 9, 2018.

[12] JP Morgan Guide to the Markets 3Q 2018, p. 45.

Overall, no news was good news for Japanese markets during the third quarter. The economy, valuations, and outlook have remained stable for much of the year, and we do not anticipate much change over the next several quarters. We continue to maintain a slight overweight to Japan compared to other developed markets outside of the U.S., and we expect to maintain this position until new information changes our outlook.

Emerging Markets

The MSCI Emerging Market Equity Index is down -7.7% in the first three quarters of 2018 and is lagging the 5.4% positive return for the MSCI World Developed Market Index, which has been driven almost entirely by continued strength in the U.S. market, up 10.6% year to date. The peak to trough correction for EM stocks is now over 20%. We do not see the recent weakness in EM equities as a sign of global crisis. A breakdown in internal fundamentals is evident in only a few countries. They are Argentina, Brazil and South Africa. Every other problem in the in EMs in 2018 has been driven by the strong dollar as evidenced by the difficulties in Indonesia, or by the U.S. China trade war.

> Emerging market currency weakness has reached critical breakpoints for select countries

The consensus EM earnings-per-share growth for 2018 had been in a narrow range of 15% to 16% for several months since late April. It has finally started to fall to 14.3% currently. EM valuations have contracted with a 12-month forward PE on the MSCI EM dropping to a cyclical low of 10.7, below its long-term average of 11 times, and rising to only 11.3 at the end of Q3.[13]

There may be a short-term increase in the MSCI Index due to a possible weakness in the dollar and anticipated China stimulus provided the recent increase in U.S. long-term yields remains contained. These factors should contribute to a brief recovery in investor sentiment toward EMs and in increased valuations. However, 2019 EM earnings growth prospects are dismal. UBS estimates a 6.8% EM earnings-per-share growth rate next year down 7.5 percentage points from this year's consensus estimate.[14]

EM GDP growth ended H1 2018 steady at the Q1 rate of 6.8% year-over-year, but that concealed a reasonably sharp sequential slowdown. Momentum slipped through Q2 in China and India. Bigger drops were seen in Argentina, Turkey, Malaysia, Korea, Thailand and Mexico. South Africa and Brazil remain close to or already in recession. We see a further deceleration of 20 basis points in EM growth from 4.8% in 2018 to 4.6% in 2019, as tariffs actually begin to hit margins, investment and growth in the U.S.

> Weakness in EM equities is not a sign of a global crisis

Though China's sequential growth was a respectable 6.5% in Q2, retail sales and external data suggest Q3 was weak. We expect fiscal stimulus and improved credit growth to limit a slowdown, but unlike 2015/2016, we do not expect the coming stimulus to raise growth. The size of any stimulus is going to be smaller. We expect Chinese growth to slow to 6% over the next 6 to 12 months. This will weaken the terms of trade and tighten conditions for commodity producing countries exporting to China. These countries accounted for most of the GDP growth rebound in the last two

[13] UBS Emerging Market Economic Perspectives, September 25, 2018.
[14] IBID.

years.[15] The growth of the manufacturing economies is also likely to slow as global growth declines as a result of the ongoing moderation in China and a slowing of the U.S. economy in Q4. According to Barclays Global Outlook, EM economies can expect rising funding costs along with slower export growth to slow domestic income, consumption and investment growth which will reduce the growth differential between EM and DM economies and lower external capital flowing into EM stocks.

Fiscal stimulus and improved credit growth will limit a slowdown

Because we expect a higher than consensus earnings growth decline, we have a neutral weighting on EM equities, even though their earnings multiple is lower in relation to the historic norm than that of DM equities and positioning is not as crowded as the market thinks.

Fixed Income

After temporarily breaching 3.0% at the beginning of August, the yield on the 10-year Treasury slipped back down before resuming its upward trajectory ending the quarter at a 3.06% yield. This rise in yield from 2.86% at the beginning of the quarter was almost wholly due to a rise in real rates as inflation expectations increased negligibly. With the FOMC's medium term inflation expectations tethered to 2%, the rise in real rates reflected a strong domestic economy and expectations for future rate increases, a pattern we've seen in the first three quarters of this year.[16] As we have discussed, forecasted domestic growth for 2018 and 2019 should exceed trend growth and the unemployment rate will likely pursue its downward path necessitating further increases in the overnight rate.

The Fed is forecasting three more hikes in 2019 and one in 2020

The Fed chairman, Jerome Powell, announced another 25 bps increase in the Fed Funds target rate in September, bringing the overnight target to 2.00-2.25%. In his comments, he highlighted the continued path of interest hikes in accord with the strength of the economy. In addition to a hike in December (currently an 80% probability via Fed Fund futures), the Fed is forecasting three more hikes in 2019 and one in 2020 which would bring the Fed Funds Rate to a range of 3.25 – 3.50%. It is difficult to forecast beyond 12 months, but in our view, the Fed is performing a simple function amidst moderate inflation and low unemployment—raise rates as much as possible without ending the expansion.

The spread of the 10 year to 2 year treasury decreased from 0.33% at the beginning of the quarter to 0.24% by the end of September. Given the pace of projected Fed hikes, we believe the curve will flatten further and may invert in 2019 depending on how much longer maturity Treasury yields adjust. We hold this view despite the sharp selloff in the U.S. bond market in the first week of Q4, which drove the 10-year Treasury yield temporarily past 3.21%. This long term rate is still below the estimated terminal Fed Funds rate (3.25% to 3.50%). European and Japanese yields remain anchored by zero or negative short term rates and low inflation, and we do not foresee material change in ECB or BOJ policy in 2019. Yield differentials support flows into U.S. Treasuries which caps Treasury yields and bolstering the U.S. dollar.

[15] IMF World Economic Outlook: Cyclical Upswing, Structural Change. April 2018.

[16] FOMC economic projections for September 26 meeting; https://www.federalreserve.gov/newsevents/pressreleases/monetary20180926b.htm

Given our expectation for a flattening yield curve, we have adjusted the fixed income allocation in client portfolios to minimize exposure to the intermediate part of the curve (3-10 year maturities). We now have a "barbell" exposure by allocating to short maturities with attractive relative yields, low risk and high liquidity and also overweighting the longer end of the curve which protects portfolios in a risk off scenario. Overall, we are underweight interest rate risk and we will be underweight credit risk and spread duration as well.

> We are underweight interest rate risk, credit risk and spread duration

Municipal Bonds

In the third quarter, AAA Muni yields rose across the board, and flattened similar to Treasury yields, with short term maturities rising 0.45% and longer term maturities rising 0.25%. The increase in municipal yields relative to similar maturity Treasuries was in part due to a reversal from the previous quarter in which fears of reduced supply lowered yields even though Treasury yields rose. The third quarter primary issuance and selling by institutional buyers increased in the third quarter. The Bloomberg Barclays Municipal Bond Index returned -0.15% for the quarter compared to +0.02% for taxable bonds as measured by the Bloomberg Barclays U.S. Aggregate Index. The 10-year municipal to Treasury ratio decreased slightly to 84% in the quarter. Similar to taxable fixed income, we favor a barbell approach with an overweight in short and long maturities and less exposure in intermediate maturities. We also prefer better quality credits.

Spread Product

U.S. Investment Grade bond spreads tightening by 17 bps during the quarter while High Yield Bond spreads tightened 47 bps from the beginning of the quarter. At 316 bps, high yield bond spreads have reached levels last touched in the summer of 2007, before the Great Financial Crisis. While fundamentals are strong and default risk is low currently, technical factors could easily erase returns given the lower level of carry. Also, covenant lite loans and bonds dominate new issuance and corporate leverage has steadily increased. Interest coverage ratios, currently at favorable levels, will likely begin to deteriorate as current debt is refinanced or floating rate coupons reset at higher rates. We favor Treasuries and investment grade corporates over high yield bonds and have shortened maturities in the corporate bonds we own. We have recently rebalanced our client's fixed income allocations to move in this direction. Finally, U.S. housing fundamentals remain strong and buoyed by a strong rise in LIBOR, especially in September, and we maintain our allocation to non-agency MBS.

> Current trends in the high yield market give us caution

Emerging market currency weakness has reached critical breakpoints for select countries. These countries had pre-existing conditions such as current account deficits or substantial hard currency debt issuance that dramatically increased the probability of a devaluation at some point. Broad contagion is unlikely due to many larger emerging market economies having improved their external imbalances. As we mentioned previously, EM central banks have instituted monetary tightening to offset currency declines. This may slow growth, but in countries with sound governance and central bank policy, shorter term maturity hard currency EM sovereign debt looks attractive. The JP Morgan EMBI Global Index was up 1.87% in the quarter. Based on our outlook on the unpredictable nature of trade policy, we do not view current weakness as an opportunity to add broadly to the asset class.

Conclusion

Though there is more divergence across countries, global GDP should grow at 3.9% in 2018. We expect the rate of GDP expansion to decline to 3.7% next year and this weakening is mainly the result of the anticipated fall of U.S. and EM growth rates.

The risk of a systematic global financial crisis still remains low. The private sector financial balance, total income minus total spending of all households and firms, is a very good predictor of financial instability. In contrast to 2007, the largest DM economies (the U.S., the euro area and Japan) are all showing significantly positive private sector surpluses, indicating a limited probability of a major global downturn.[17]

Rising wage inflation in the advanced economies is likely to cause concern for investors in the next 12 to 18 months. Evidence from other sources and smoothed Bureau of Labor Statistics data for the U.S. indicate that wage inflation is accelerating, although the year-over-year number in the recent Bureau of Labor Statistics (BLS) employment report has remained slightly below 3%.

More surprising, wage inflation seems to have risen recently in the euro zone even though these economies, with the exception of Germany, are not yet at full employment. Japan seems to be the exception with wage inflation only slightly above 1.5%, even though labor market indicators indicate overheating.[18]

The outcome of accelerating wage inflation as the unemployment rate diminishes in developed countries depends on the relationship between real wage inflation and productivity in the products in the corporate sector. The ideal situation is one in which real wages rise in line with productivity growth, so the profit margins do not fall and central banks do not need to raise interest rates. We believe that there is a possibility that real wages will rise above productivity growth in the U.S. if not in other developed economies by the end of next year, resulting in profit margin compression and unexpected rate hikes.

> Real wage growth may compress profits margins in 2019

The outlook for EMs has deteriorated this year and downside risks loom larger. A number of chronically vulnerable EMs have experienced continuing crises as a result of appreciation in the U.S. dollar that accompanied the U.S. growth surprise in Q2. We do not believe that these pressures, though substantial, will result in contagion for the world economy.

The prospects for the global economy and financial markets will be determined in large part by China and the advanced economies not by non-China EMs. Among the systematically significant parts of the world economy, the outlook for China is the most uncertain. Credit policy tightening has historically been associated with a more substantial economic decline than the one we have observed thus far and higher tariffs on U.S. China trade are taking us into unchartered territory. Martin Wolf estimates that the fall in Chinese GDP would be at most 2% even with a prohibitive U.S. tariff on all exports, and that would not be hard for China to offset.[19] We expect Chinese

[17] Goldman Sachs Global Economic Analyst, August 23, 2018.
[18] Gavyn Davies, "Why Investors Should Worry About Rising Wages." Financial Times, September 23, 2018.
[19] Wolf, Martin. "Donald Trump is Wrong. China is not Mexico." Financial Times October 2, 2018.

expansionary policies to prevent the Chinese growth rate from falling below 6% in 2019 although they will not result in a growth increase as they have in the past.

We believe that U.S. interest rates will continue to rise and as a result the U.S. dollar will continue to strengthen against EM currencies but slightly weaken against the euro and the yen with a net negative effect on U.S. MNC earnings. The combination of increased competition for capital flows within the U.S. and a weak effort at regaining policy credibility in several EM economies imply higher risk premiums and continued underperformance for EM foreign exchange. A significant Q4 U.S. growth slowdown, expectation of a potential end to the Fed hiking cycle toward the end of next year and anticipation of higher rates in other advanced economies in the coming years should cause the dollar to depreciate slowly against advanced country currencies despite the recent, temporary rebound.

The outlook for EMs has deteriorated this year

We are keeping average duration short in our bond portfolios and increasing credit quality. We are doing this not only because we expect risk-free bond yields and credit spreads to increase in our base case, but because long-term Treasury yields are rising to a point where the correlation between Treasury prices and equities turns from negative to positive. In such a situation longer term Treasuries do not provide a good hedge against an equity market decline, especially one brought on by an unexpected increase in inflation.

We are maintaining our equity overweight. In the past, a lot of equity market return has been lost by an early reduction in equity exposure in an aging bull market.[20] Moreover, equity prices are high but not extremely high (except for certain, unsustainable growth situations in tech and social media groups) at least in relation to other asset classes such as levered loans and privately placed middle market debt. Equities are unlikely to be the main cause of disruption for financial markets. The equity risk is more one of declining sentiment than fundamental weakness. We are leaning toward managers who focus on companies with pricing power (with the ability to pass on higher input costs to consumers) and with strong balance sheets, which will provide protection against rising interest rates and credit spreads. We favor contrarian value strategies that concentrate on sectors that are relatively immune to tariff increases. We also prefer strategies that emphasize limiting downside capture above ensuring full upside capture.

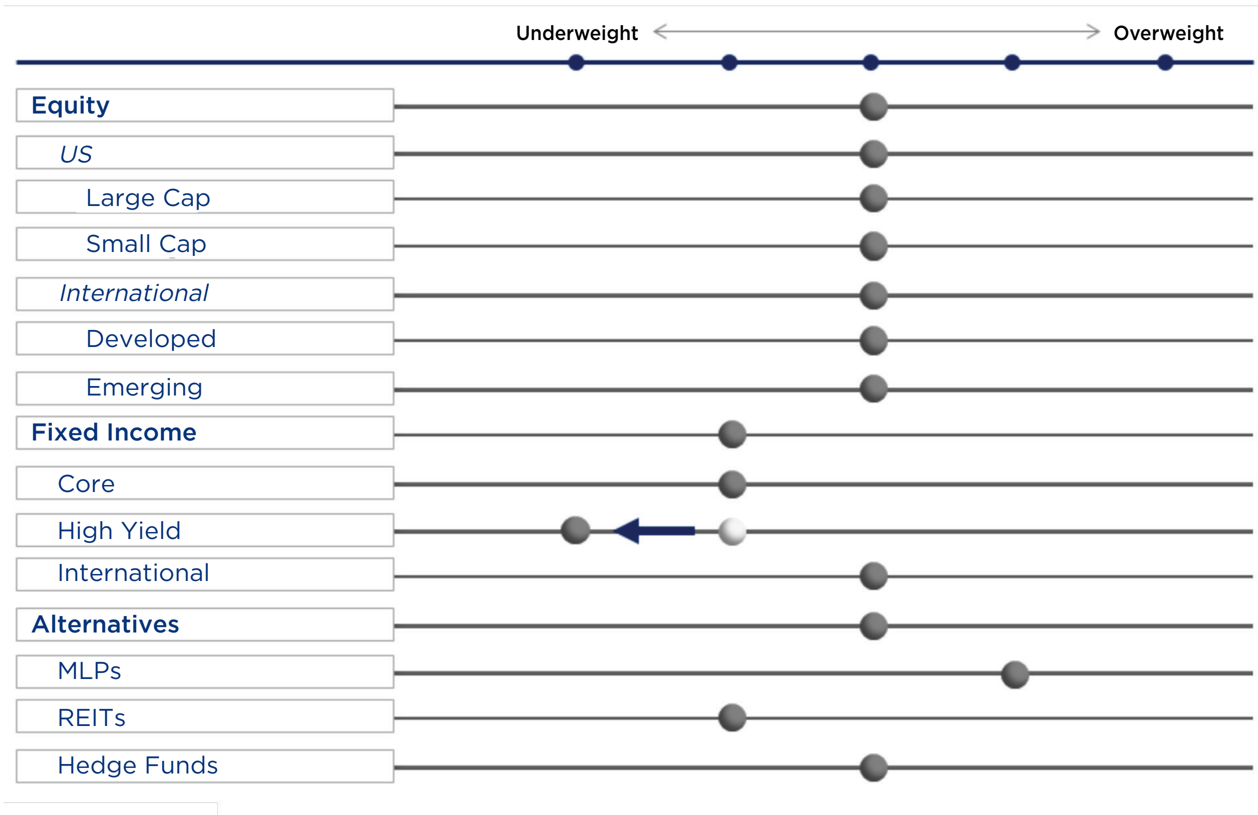
European, Japanese and EM equities appear to be less overvalued than U.S. equities, mainly because they have underperformed the U.S. market since 2009, in contrast to past periods where the difference in risk-adjusted return has been relatively small.[21] Eventually regional returns will converge. However, an unfavorable earnings outlook, substantial dependence on exports to China and political uncertainty make us cautious about Europe in the near term, while the Japanese market lacks a clear catalyst to produce outperformance. Higher tariffs in the U.S. China trade and lower global growth are likely to reduce earnings gains in the emerging markets. For these reasons, we have a neutral weight on non-U.S. equities, even though their valuation metrics are mostly at or below post 1989 averages. Our asset allocation strategy is summarized in Exhibit 7.

[20] Goldman Sachs Global Strategy Paper No. 31. The Balanced Bear Part 2: Chasing your tail risk and balancing the bear. October 2, 2018.

[21] Goldman Sachs, EM Strategy Views, October 11, 2018, page 2.

Clients are understandably concerned about the possibility of a bear market with the recent abrupt selloff and with the U.S. late in the economic cycle, and they also worry about global risks such as political uncertainty in the U.S., Italy and the UK, a possible oil shock, a trade war and EM risks. These concerns are likely to increase near term volatility. Extended stock market valuation, especially in the U.S. and extended bond market valuation outside the U.S., create asymmetric risk. The probability of a major upside move is substantially less than that of a major downside move. However, absent a substantial growth or inflation shock, neither a global bond nor equity bear market seems likely in the near term.

EXHIBIT 7: DMCA ASSET CLASS VIEWS AS OF SEPTEMBER 30, 2018



Source: DMCA

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.

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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Drexel Morgan Capital Advisers
Three Radnor Corporate Center, Suite 305
Radnor, Pennsylvania 19087
T 610-971-1901
drexelmorgancapital.com