Drexel Morgan Capital Advisers 4TH QUARTER 2016

Global Economic and Market Commentary

Summary

- We expect global growth and inflation to be higher in 2017.
- The US dollar should appreciate further as the US Fed tightens and other large economies (EU, China and Japan) do not.
- GDP near full capacity and a debt to GDP ratio at a demand-constraining 353% of GDP limit the potential of growth stimulative policies in the US.
- Our central case outlook calls for another year of single digit returns in both DM and EM stock markets.
- With both equity and high quality bond valuations stretched and a high degree of policy and geopolitical uncertainty, the distribution of returns on financial assets is likely to be more fat-tailed than usual. There is a high probability that markets will substantially under- or outperform the central case outlook.
- The Republicans' proposed reduction in the top corporate tax rate will benefit high effective tax rate companies much more than low effective tax rate companies, which among other things, provides opportunity for active management.
- We expect Treasury bonds to have a very low or negative return and to provide a less than normal hedge against equity weakness.
- Our asset class views include an overweight in developed international equities and US high yield, and an underweight in core bonds and emerging market equities (Exhibit 8, p.21).

"[T]he Trump administration could have a much bigger impact on the US economy than one would calculate on the basis of changes in tax and spending policies alone because it could ignite animal spirits and attract productive capital…"
– Ray Dalio, Bridgewater Associates. December 19, 2016.

"The US markets are wise to bet that Mr. Trump will shelve his threats of global trade wars in the short term in favor of an expansive Reaganite boom. His nomination of investment bankers to the key economic roles – mostly from Goldman Sachs – has reassured Wall Street. The first phase of Mr. Trump's presidency will be "Government Sachs" as normal. But that will change when things turn difficult." [1]
– Edward Luce, Financial Times, December 11, 2016.

The Post-Election Rally

Donald Trump's surprising presidential victory, along with the Republican sweep of the Congress, generally lifted risky asset prices in the remainder of the fourth quarter and increased nominal yields of investment grade bonds. This shift to risky assets was largely unpredicted, as were the results of the election itself. The expectation of greater fiscal stimulus in subsequent years resulted in the US monetary policy outlook diverging from that of other countries to an even greater extent than the markets had forecast. For this reason, the trade-weighted dollar continued to appreciate

[1] Edward Luce, "The dangers of Donald Trump's coming boom," Financial Times, December 11, 2016.

in the fourth quarter and by December it had exceeded its 14-year high.[2] The strength of the domestic currency, combined with the anticipation of accelerating growth, caused the dollar return on US equities to substantially exceed that of non-US equities, both for the fourth quarter and 2016 as a whole. In fact, in the case of emerging market (EM) stocks, the dollar return in the fourth quarter was negative because of concerns about protectionism and the ability of certain EM economies to service dollar-denominated debt.

We anticipate a strong US dollar in 2017

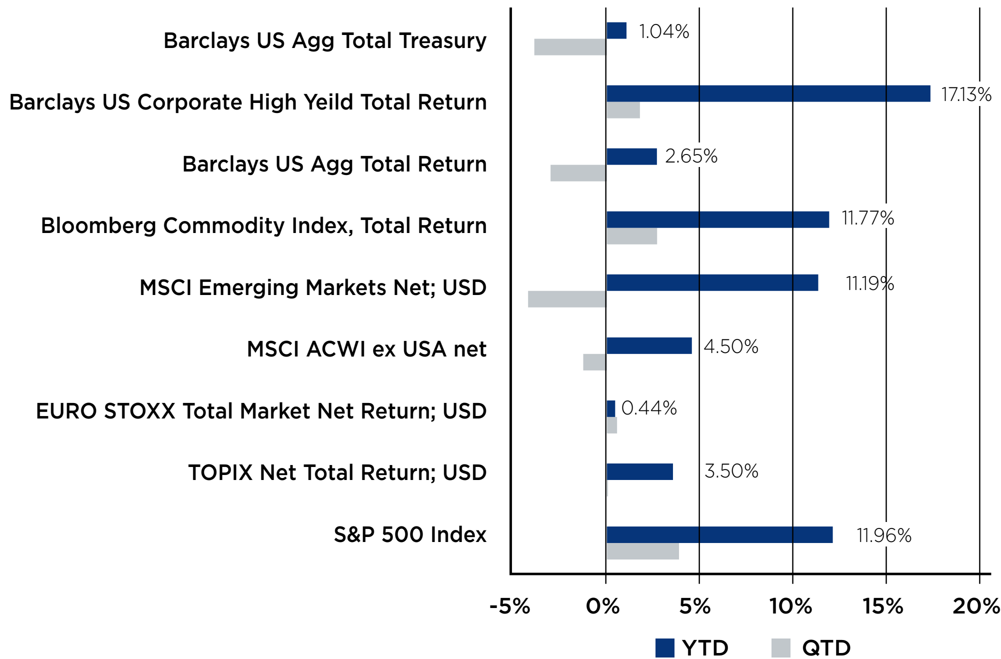
The US rally, which carried through until the end of the year, was led mainly by deep value and small-cap stocks. Deep value issuers consist of highly cyclical companies, such as Caterpillar, which are not likely to achieve positive earnings until 2019, and banks and other financial companies which benefit from the yield curve steepening that was already underway. Small company issuers are mainly exposed to the home market and thus immune from adverse dollar translation. They also tend to pay taxes at the highest corporate rate which means that they will benefit more from the proposed corporate tax reductions.

There is a great deal of controversy over whether the strong rally in local currency in the US, and to a lesser extent, other developed market (DM) equities, is a temporary aberration and the consequence of excess exuberance regarding economic and earnings outlooks. The question is: Will stocks start to fade two months after the election, as has been the case with past post-election rallies, or will they be able to exceed the 2016 close by the end of the year, even though analysts have not yet downgraded earnings for dollar appreciation and possible protectionist measures?

In fixed income, having been left for dead with an 8% spread above Treasuries during the February selloffs, US high yield (HY) dominated other fixed income indices, returning 17.1% against 2.1% for the Barclays US Aggregate and 1.1% for the BofA ML US Treasury for 2016 as a whole. High yield also eked out a positive return for the fourth quarter when other fixed income groups had significant negative returns. This outperformance was the result of US growth expectations and a strong recovery in oil prices with energy companies representing a large percentage of US issuers.

[2] April 10, 2002 was the last time the Broad Trade Weighted US Dollar Index exceeded the 12/28/2016 value of 128.8.
Source: Federal Reserve Bank of St Louis Trade Weighted US Dollar Index: Broad, Index Jan 1997=100, Weekly, Not Seasonally Adjusted.

EXHIBIT 1: ASSET CLASS RETURNS



Source: Bloomberg, Barclays Live

Since the macro-driven rebound that lifted all commodity sectors alike during the first half of 2016, differentiation has gradually taken hold with the CRB Raw Industrials Index continuing to rally as the general CRB Index flat-lined. A more sanguine global demand outlook has put a floor under oil prices over the last six months, but the prospect of sustained increases in crude supply has consistently kept a lid on rallies. As a consequence, oil prices have remained in a relatively tight trading range, bound by the low $40s and the mid-$50s, a level that has been identified as a sustainable equilibrium price implied by the oil markets' ongoing rebalancing. There was no evidence in the fourth quarter that oil prices would break out of this trading range on a sustained basis despite an agreement by OPEC and non-OPEC suppliers to limit production. All evidence suggests that US shale producers are the new OPEC or marginal producers. With US shale production costs in decline, extraction more efficient and suppliers keen to hedge future production around breakeven costs, the upside for oil prices is capped.

> Oil prices are stable with modest upside potential

Before turning to an examination of major regional economies and their markets for risky assets, let us turn to the global macro situation.

Perspectives on the World Economy

We expect a pickup in global growth from 3.1% in 2016 to 3.5% in 2017, with some further increase in 2018. After 2018, the risk of stagflation or a global growth recession occurring increases. The global economy is vulnerable to overheating despite a relatively slow speed of recovery from the global financial crisis (GFC). Consumption in countries with large external surpluses has not led the global economy higher. Clearly in the deficit countries, including the US, UK and southern Europe, the need for greater savings and debt reduction has required fiscal constraint. Under these circumstances the recovery of the world economy should have been led by significant consumption growth in countries with large external surpluses, but this did not occur. When it came to consumer stimulus, Japan had the willingness but not the capacity to supply it, while Germany had the ability but not the willingness. China recognized the need for aggregate demand expansion but resorted to its prior growth strategy. Instead of depressing the savings rate of 50% of GDP by consuming more, it increased the investment rate from 42% of GDP to 48%. The consequence of the failure of the surplus countries to step up consumption was that the GFC had to be addressed disproportionately by austerity in the countries with large external deficits. Without increased export demand from the excess savings countries, GDP and imports had to be constrained in order to correct large external deficits. According to Lombard Street Research, such retrenchment contributed to a "low growth hysteresis" effect on expansionary potential. Excessive austerity also made some savings countries slow to take advantage of high tech opportunities.[3]

We expect higher global growth and inflation in 2017

Because the surplus countries would or could not expand consumption at a high enough rate, the run-up from the global recession has not corrected the global imbalances that contributed to the GFC in the first place. Excessive debt is still present and linked to the tendency for desired global savings to exceed desired global investment at normal interest rates. This savings glut persists in undermining the world economy. The present imbalance is not simply due to the aggregate current account surplus of the savings glut countries having returned to 2006-2008 levels. It is also attributable to two of the three major excess savers, Japan and China, having incurred significantly more domestic debt since the GFC and to a significant rise in corporate savings in domestic economies. However, the recent debt run-up is not as serious as that which occurred in the US household sector prior to 2008. It is likely the Chinese central bank will bail out the Chinese banking system, which is the source of much of China's excess credit expansion. Much of Japan's additional debt is government backed and can be serviced through higher taxation or helicopter money issuance. Thus, we do not have the problem that occurred in the US which precipitated the 2008 crisis when overrated obligations backed by subprime US mortgages with

[3] LSR View "2017 Bond Bear Rampant" December 6, 2016.

no public sector recourse were held globally. The more likely scenario for the next global market downturn is stagflation or stalled growth. The US will probably experience the greatest inflationary pressures, since it is more capacity constrained than other major economies. Because of the economic programs proposed by President-elect Trump and the GOP-led Congress, the shift to fiscal stimulus is likely to be more pronounced in the US.

Declining labor productivity growth in advanced countries is limiting the rate of expansion in their potential GDP and increasing the probability of capacity constraints and overheating. This is attributable to the lack of plant and equipment investment by corporations even though they have more than enough free cash flow to fund it. Such investment has been held back by a low return on private sector investment in advanced countries. This return has fallen due to reduced incremental demand for capital intensive goods and services and deteriorating infrastructure. In addition, globalization has also held back capital deepening in advanced countries. Investment is being relocated to less developed countries where real wage rates are lower and the return on capital is higher.[4]

The Outlook for US Equities and the US Economy

The post-election rally has added nearly 4.6% to US equity values through year end.[5] The outlook for growth and inflation is positive for 2017, even though fiscal policy will probably not change significantly until 2018. The most immediate and arguably the most powerful effects are likely to be from regulatory changes, which may be effected by executive order or by different guidance from department heads.

We expect that congressional Republicans will moderate Trump's tax plan. Even the tax cuts proposed by Paul Ryan, Speaker of The House of the Representatives, are expensive though much less so than the tax cuts proposed by President-elect Trump. We expect that the maximum corporate tax rate may end up at 25%, which is higher than Mr. Ryan's proposed 20% and Mr. Trump's desired 15%. Both agree that there should be three individual tax rates, 12%, 25%, and 33%, but there will be debate over the generosity of the deductions. We expect the effective corporate rate to fall from 26% to 18%.

We expect that the Republican Congress will design the tax plan to stimulate corporate investment as much as possible. They recognize that lack of investment has resulted in lower potential GDP growth as discussed above. An additional depreciation allowance, even one-year write offs, for domestic capital investment seems very likely. If these incentives are enacted and the top corporate tax rate is reduced to at least 25%, this may significantly raise the US investment rate and potential US GDP growth.

From a cyclical perspective, the outlook for profits is compelling if tax rates are reduced significantly. This, combined with the ability to repatriate foreign earnings, will lead to additional buybacks and dividends.

[4] Martin Wolf "Corporate Surpluses are Contributing to the Savings Glut" Financial Times, November 17, 2015.

[5] The S&P 500 Index returned 4.6% from November 8, 2016 through December 30, 2016.

Our expectation is that the total tax cut will end up being around $150 billion, which is less than 1% of GDP. We estimate that $70 billion will go to corporate tax reduction and $80 billion will go to personal tax cuts, spread evenly between upper and middle class individuals. We expect new spending to be about $20 billion. This should produce a budget deficit of about $770 billion in 2017, up from $439 billion in 2015. The enlarged deficit is about 5% of GDP, and high for an economy close to full employment. Market participants believe that with such a big fiscal stimulus, higher rates will be needed to keep inflation down and have already driven up Treasury yields in anticipation. Further increases in Treasury yields would send the dollar even higher than its recent rise, hurting import-competing and export-oriented manufacturers, raising the trade deficit and increasing the attractiveness of protectionism. That is our greatest concern regarding US growth prospects.

US corporate tax cuts are on the horizon

We anticipate average annual US growth of 2.2% in 2017 and 2.4% in 2018 in our base case projection. However, depending on policy assumptions, 2017 growth could range from 2.1% to 2.3%, while growth in 2018 could range from 1.3% to 2.9%. From a sensitivity perspective, a 100 basis point shift in domestic GDP growth translates into $5 per share on the S&P 500 2017 operating earnings forecast of $120 and the adjusted EPS estimate of $127.[6] We estimate that the combined tax reform and fiscal policy initiatives of the Trump administration and Republican Congress could boost our adjusted 2017 EPS forecast by $6 per share to $133 from $127 on the outside chance that they are enacted in 2017.

However, our base case projection assumes that the average effective tax rates for S&P 500 companies remain unchanged in 2017 and that the proposed corporate tax changes do not become effective until the beginning of 2018. We also assume that the ten-year Treasury yield will rise from 2.4% at the end of 2016 to 2.8% at the end of 2017. We anticipate that the higher interest rates associated with the Trump policies and the fact that the economy is close to the end of a cyclical expansion will lead to earnings multiple compression. The forward and trailing price to earnings (P/E) ratios at the end of 2016 were 17.3 and 19.1, respectively, against ten-year averages of 15.0 for forward and 16.0 for trailing P/E ratios. We expect the equity risk premium to rise to 3.4% from 3.2% at the end of 2016. This, along with a 2.8% ten-year Treasury yield, is consistent with a 16.1 forward P/E ratio and a trailing P/E ratio of 18.0. The trailing P/E ratio is based on 12% earnings growth in 2018 due to implementation of the proposed corporate tax reform. Applying a P/E ratio of 18 to our 2018 adjusted earnings per share estimate of $127 implies an S&P 500 Index of roughly 2300, which is about 2.8% above the S&P's 2016 year-end level.

[6] Barclays "US Equity Strategy: Five Predictions for 2017," December 13, 2016.

If we assume that the average effective corporate tax rate declines from 26% to 18% in 2017, there will be some adverse feedback on the US economy. We expect a 4% increase in the trade-weighted US dollar from its year end level, a 0.1% reduction in nominal GDP due to the large trade deficit and a further 100 basis point increase in the producers price index as a result of higher inflationary pressure. Taking into account these negative effects, in addition to the 12% increase in adjusted corporate earnings due to the eight percentage point decline in the effective tax rate, earnings-per-share should rise to $133 by the end of 2017 and the S&P 500 would be at about 2400.

In the worst-case scenario, we are more concerned with the potential return of tighter financial conditions in 2017 without taking into account a possible recession. Under these circumstances greater strengthening of the US dollar and higher ten-year Treasury bond rates will result in a much greater tightening of financial conditions by the end of 2017. Investor risk aversion may also be higher than we expect in our base case scenario. Assuming a Treasury yield of 3.5% and a higher equity risk premium, the trailing 12-month P/E ratio would fall to 15.1, which would lower the S&P 500 to 1918, without even correcting our $127 adjusted EPS downward. We are assigning 70%, 20% and 10% probabilities to the base, best and worst case scenarios, respectively (Exhibit 2). The bottom line is that there should not be significant stock market appreciation in 2017 unless equities enter bubble territory.

Beware of elevated US equity markets

EXHIBIT 2: PROBABILITIES OF BASE, BEST AND WORST CASE SCENARIOS FOR THE S&P 500 IN 2017

	Estimated Probability	End of Year Level on S&P 500	2017 Estimated Earnings & Multiple	% Change from 2016 Year End
Base	70%	2300	$127 @ 18x	2.7%
Best	20%	2400	$133 @ 18x	7.2%
Worst	10%	1918	$127 @ 15.1x	-14.3%

Source: Barclays, DMCA

The sensitivity of companies to corporate tax rate changes also varies. Some sectors, such as energy, already benefit from lower effective tax rates through loopholes and sometimes inversions. These sectors may actually see their effective tax rates increase. By contrast, telecoms and utilities, which now face high effective tax rates, stand to benefit the most from the proposed reduction in the maximum rate. We believe active managers will be able to substantially increase their returns relative to passive managers by buying stocks of companies whose prices understate the potential gain from corporate tax reform and selling stocks whose prices overstate the gains from proposed tax changes.

Developed Market Equities

EUROPE

In the fourth quarter of 2016, European equities as measured by MSCI Europe Index returned -0.36% and returns for 2016 were 0.22%. This marks the fourth year that European equity markets have trailed the S&P 500. In our opinion, European equities offer an attractive valuation compared to the US and comparable earnings growth. However, growing populism and geopolitical uncertainty continue to concern us, and we are reluctant to overweight the region until 2H 2017 (after the French presidential election) at the earliest. Currently, we remain roughly neutral in our allocation to Europe relative to the MSCI ACWI ex US Index.

The year of 2016 was filled with significant events that we have discussed in previous letters. The headline grabbing "Brexit" vote in the UK has significantly decreased the probability of EU stability, although equity markets generally reacted positively in the aftermath of the vote. We believe there are two possible paths to Brexit. A "soft" Brexit would have the EU invoke Article 50 after having negotiated a clear path to exit with Brussels. Under this scenario, the UK would have to offer concessions on immigration in order to maintain its trading relationships with the EU. While this may be politically unacceptable, especially to those who voted leave in order to close the borders, we believe this option will minimize the impact on the British economy.

In the third quarter, we noted Theresa May's indication that she would invoke Article 50 by March 2017 even in the absence of an intervening agreement. We continue to believe that the lack of such an agreement gives the upper hand to the EU in terms of negotiations for an exit. According to the Economist, there is greater support for a transitional deal with the EU to avert a hard landing.[7] Over the fourth quarter, the UK courts have deliberated whether article 50 can be invoked using "royal prerogative." If the Supreme Court upholds the high court's decision for only Parliament, not the Prime Minister, to have authority to send notification, the March 2017 deadline can be kept only if the legislation is rushed through Parliament. Whether such legislation would comply with Mrs. May's self-declared March 31 deadline is unclear.

[7] Economist December 24, 2016, pages 80-81.

There is also concern that Brexit does not auger well for the future of the Euro, with France, Holland, Italy and Germany holding presidential elections in 2017. Even Germany may reconsider saving the Euro if the anti-Euro movement gains momentum elsewhere. This seems very unlikely since a referendum for leaving the EU would require a majority or supermajority parliamentary vote in France and Holland which would be a high hurdle.

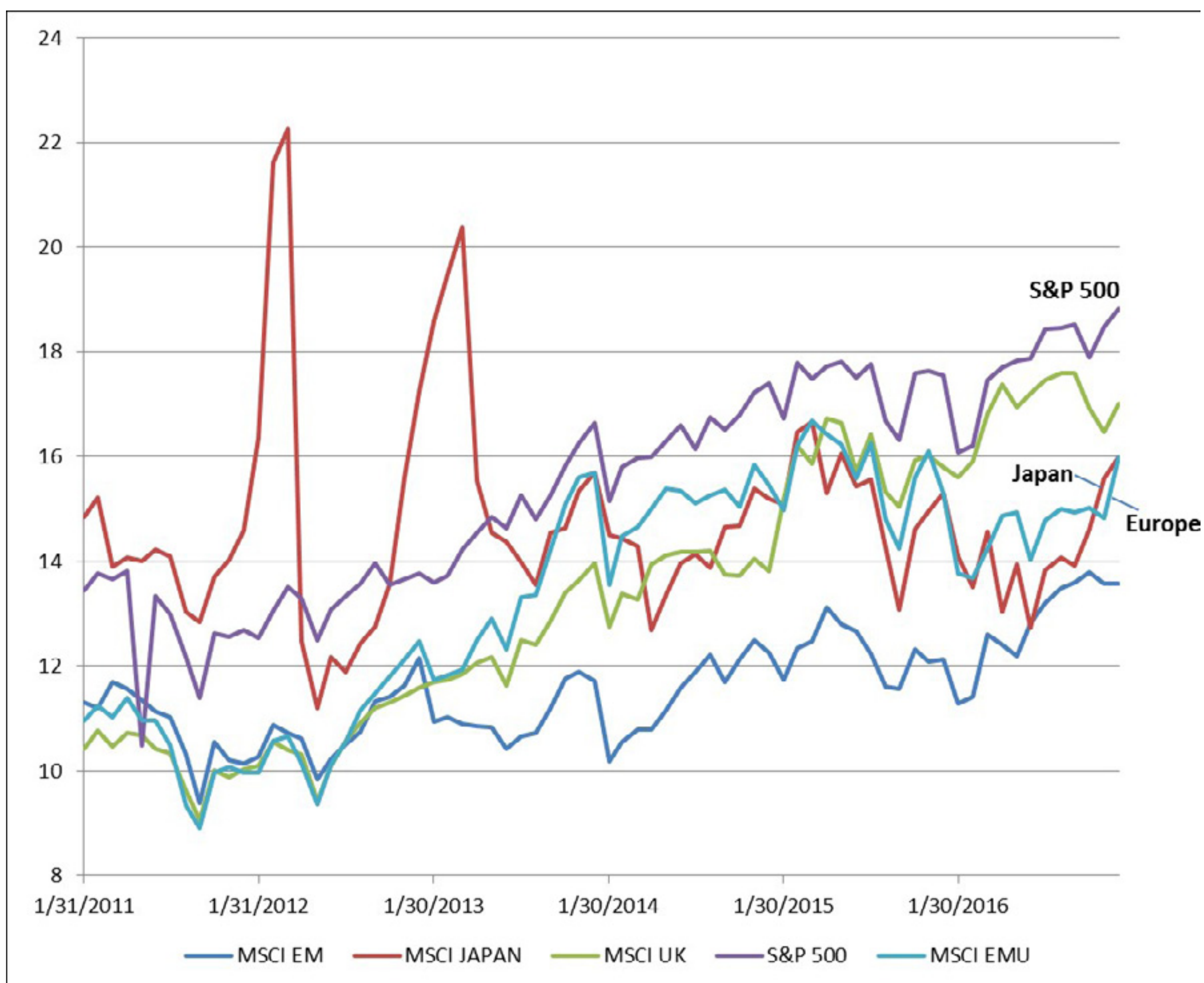
Europe is cheap – but uncertainty looms

A second source of uncertainty on the Continent remains the state of the financial system and the banks. In the first quarter of 2016, financial markets were significantly affected by the potential fines levied by US courts against Deutsche Bank that could have pushed the organization into insolvency. As those fears subsided, the solvency of periphery banks again came into question. The Italian government has agreed to bail out Italy's third largest lender, Banco Monte dei Paschi di Siena, SpA. The weakness of the Italian banking system will continue to be a source of uncertainty for some time.

While extraordinary uncertainty limits the upside on European equities, we remain neutral for these reasons: First, Fulcrum Research Nowcasts have indicated a pick-up in Euro Area growth from 1.1% in 2Q2016 to 2.3% in 1Q2017 and they expect the economy to expand at a 1.9% pace during 2017.[8] Further, the most recent Markit Flash Eurozone PMI, released on December 31, 2016, show both services and manufacturing sectors continuing to expand.[9] Additionally, the weakening of the Euro vis-à-vis the US dollar should contribute to GDP through increasing exports. If these trends continue, we may be in the early stages of moderate economic growth supporting higher equity prices similar to that experienced by the US markets beginning in 2010. Finally, EU equities remain attractively valued in terms of P/E ratios compared to US equities. According to Yardeni, the European Monetary Union 12-month forward P/E was 14.1 and the UK's was 14.4 compared to 17.5 for the S&P 500 as of 12/15/2016.[10] As the graph on page ten shows, the gap in relative valuation has widened substantially since early 2015. In our previous letter, we noted that the relative P/E of Europe was greater than that of Japan. That gap closed over the past three months. Finally, most measures of valuation for European stocks are in line with or below European averages and should not be an obstacle to positive market returns as long as there are significant per share earnings gains.

[8] https://www.fulcrumasset.com/assets/6/5714_document.pdf?1481127762
[9] https://www.markiteconomics.com/Survey/PressRelease.mvc/0d5a2f2a59af4e8d906183cd0fc9d9c6
[10] http://www.yardeni.com/pub/mscipe.pdf

EXHIBIT 3: MSCI 12 MONTH FORWARD P/E* BY REGION



*P/E Ratio calculated by dividing the price of the security by BEst (Bloomberg Estimates) earnings per share
Source: Bloomberg

Top line growth should continue as a result of the expected growth of nominal GDP and exports in 2017. Barclays has shown that the pickup in global inflation, combined with supportive fiscal policy should result in an increase in European profit margins and that a 10% gain in both continental Europe and UK earnings should ensue[11].

In conclusion, while the MSCI Europe stock index should appreciate by 10% in the base case, we remain neutral in our allocation given the political uncertainty surrounding Brexit and the looming elections. We are closely monitoring the situation, and may increase our allocation to EU equities as we gain clarity that value can be realized within a reasonable timeframe. This is likely to occur after the Dutch and French presidential elections have taken place, likely sometime in the third quarter.

[11] Economist December 24, 2016, pages 80-81.

JAPAN

The Japanese Central Bank continues to aggressively pursue quantitative easing to jumpstart the economy and revive inflation after more than twenty years of flat and falling price levels. During 2016, the Japanese Central Bank began targeting interest rates on longer dated maturities in addition to the more traditional short-term target utilized by most central banks. The bank also has been purchasing equities in large quantities to further pump money into the economy. So far, the bank has not been able to meaningfully increase inflation and we believe the government may be reaching the limit of quantitative easing as the quantity of Japanese bonds available for purchase continues to decline. However, GDP growth rebounded in the third quarter to an annualized rate of 2.2% which we see as an encouraging sign for the economy.[12] Fulcrum NowCast estimates that the Japanese Economy will grow at a pace of 0.9% in 2017 versus 0.8% in 2016.[13]

Over the first half of 2016, the Japanese Yen appreciated against the dollar from about 120 to a high of close to 100 in July and August.[14] We believe that this appreciation was fueled by Japanese firms purchasing US Treasuries (due to a lack of Japanese Government Bonds) and hedging the currency exposure. Since August, the currency has depreciated back to the 115-120 range. Clearly, we were wrong in our third quarter assessment that we would see a continued strengthening of the Yen and a resulting weakening of exports. The depreciation of the currency is in line with the central bank's objectives, but may have been more influenced by global economic factors (e.g., improved prospects for US Federal Reserve tightening) rather than Japanese Central Bank policy.

The "trump trade" with an unexpectedly strong dollar has reduced the Yen to values the Bank of Japan could not have achieved on its own. The result has been a sharp recovery in the Topix Index. Because they believe Yen weakness will continue, Morgan Stanley and other strategists are recommending large increases in their Japanese equity weighting. [15]

Whether such weakness will persist is very difficult to predict. The main case for Japanese equities lies in structural reform, improvement at the micro level and political stability. For example, there has been labor market reform, improved corporate governance, visa deregulation for foreign workers, and expansion of childcare centers under Abe who is likely to remain prime minister. The effectiveness of the new corporate governance code is evidenced by a 30% increase in the number of companies that have appointed at least two independent directors in the last year. It has also contributed to a larger portion of corporate cash being distributed to shareholders.

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[12] http://fortune.com/2016/11/13/japan-economy-gdp-growth-abenomics/

[13] https://www.fulcrumasset.com/assets/6/5714_document.pdf?1481127762

[14] Bloomberg

[15] Morgan Stanley "2017 Global Strategy Outlook: Sparkle and Fade," November 27,2016

Overall, we remain slightly overweight in our exposure to Japanese equities which are cheaper relative to bonds compared to US or European equities. As we stated in our previous letter, the effects of monetary policy will continue to drive uncertainty and we expect Japanese equities to remain more volatile than other developed markets. On the other hand, the recent depreciation of the Yen and reforms at the corporate level should provide a boost to share prices, and we remain optimistic about consumption trends. Given the reliance on policy changes at the central bank and individual company levels, we prefer to allocate to active managers in Japan. Specialist managers, who have a greater understanding of company-specific factors and can identify mispricing opportunities resulting from changes to corporate governance and dividend policy, may generate significant alpha versus general index exposure.

Emerging Market Equities

Even though total EM GDP grew less than expected again in 2016 on a year-over-year basis, there was an intra-year pickup in growth, which we expect to carry over to 2017. Our base case calls for GDP to increase by 4.8%, against an estimated 3.9% in 2016. This growth estimate is consistent with a widening EM-DM growth differential.

Japanese equities are reliant on structural reform

Our outlook for strengthening expansion in emerging markets is based on four factors. First, as a group, manufacturing economies have restored their external surplus, while the deficits of commodity exporting countries have been reduced. Second, according to the IMF, the debt to GDP ratios of emerging market countries are generally below those of developed countries, giving them greater growth potential and less need to de-lever balance sheets. Third, interest rate differentials between the two groups are wide. Thus, EM central banks have more room to cut rates during recessions. Fourth, EM purchasing managers indices as a group are above 50 and have been strengthening while firm commodities prices have stimulated exports.[16]

In terms of valuations, the MSCI Emerging Markets Index has traded at a significant discount to the MSCI World Index, for example, on a price to earnings multiple basis. Earnings growth trends have improved markedly during 2016 and we expect this turnaround to continue, with economies of corporate fundamentals across the asset class stabilizing (Exhibit 4).

[16] Mark Mobius "Emerging Markets Equity 2017 Outlook" December 20, 2016 and Markit PMI estimates.

EXHIBIT 4: RATIO OF PRICE TO EARNINGS MSCI EMERGING MARKETS TO MSCI WORLD (DEVELOPED MARKETS) TO (JANUARY 2007- DECEMBER 2016)

Source: Bloomberg

Right now, the prevailing EM outlook for the year predicts that, under the Trump administration, macroeconomic policy, consisting of fiscal stimulus that leads to a higher interest rate and a stronger dollar, will severely constrain EM returns. We disagree with this view. First, because of the Fed rate hike last month, investors have had to reduce their carry trade positions in EM currencies and are thus more comfortable about expecting EM economies and markets to disappoint. Thus, as Jim O'Neill notes, unexpected news about Trumponomics might result in a positive surprise and in EM "risk on" trade.[17] Additionally, while the secular bull market in US Treasuries might finally be coming to an end, it is not obvious that the dollar will remain strong indefinitely, even if it does appreciate relative to EM currencies in the near-term. EM currencies are highly undervalued on a purchasing power parity basis and higher inflation may hold down the US dollar. EM skeptics have not recognized that fiscal expansion could benefit commodity exporting countries by strengthening cyclical and global growth. Finally, current expectations for Chinese growth are not optimistic, but China modestly exceeded expectations for growth in 2016 and could do so again this year.

It is crucial to recognize that EMs in the aggregate are better protected from a moderate rise in core interest rates and the US dollar than they were in previous cycles for two reasons. First, the macroeconomic vulnerability of major EMs, i.e., the US dollar debt risk has diminished since 2010 as foreign exchange reserves have been restored. Second, as Goldman Sachs notes, the balance sheets of most EM corporations are relatively strong, with better interest coverage ratios.[18]

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[17] Jim O'Neill "Which Way for Emerging Markets in 2017," Strait Times January 2, 2017

[18] Goldman Sachs EM Strategy Views, December 16, 2016

The restoration of EM competitiveness occurred between 2012 and 2015. By 2016 and there was modest improvement in the earnings outlook for the EM corporate sector and a stabilization of portfolio inflows into EM countries along with some strengthening of EM currencies. Prior to November 8th, EM equities had substantially outperformed US and other DM stocks since the beginning of 2016. After the November 8th election, EM equities have underperformed DM equities partly as a result of tariff concerns and partly as a result of an increased cost in dollar debt service. Once the EM real exchange rate vis-à-vis the US dollar begins to stabilize, we would expect the relative underperformance of EM equities to diminish and eventually reverse. Due to reduced dollar sensitivity, this underperformance should be less than it was in past periods when dollar appreciation was of the same magnitude.

Select emerging markets are attractive, but near term risks suggest an underweight

In 2017 we anticipate another year of stabilization in China similar to what occurred in 2016. While the coordinated stimulus in late 2015 produced the intended stabilization in 2016, China's corporate sector is still highly indebted and suffering from overcapacity due to increases in an exceptionally high investment rate, which we have discussed previously. JP Morgan estimates that 25% of listed Chinese companies have cash flow that is less than the interest they owe to banks and bondholders and that the return on assets at state owned companies is a skimpy 1.5%. Lombard Street Research has pointed out that excess investment in China has crowded out investment in savings starved economies where returns are much higher.[19] [20] In view of the difficulty of running massive investment led stimulus indefinitely, we expect growth to decelerate in 2017 and the Renminbi to depreciate against the dollar despite ongoing interventions by the Chinese authorities. We also expect the transition from an export oriented industrial economy to a more stable middle income service economy to be carried on.

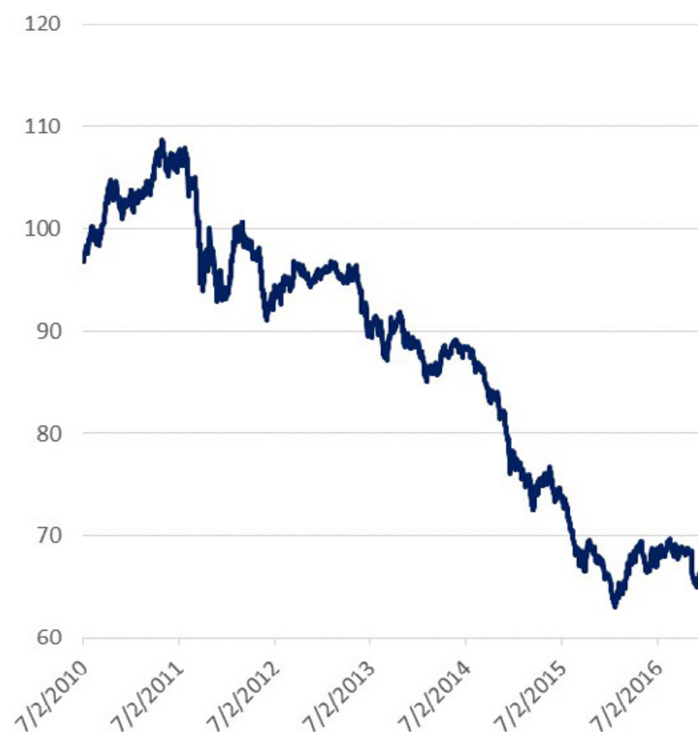
Admittedly, EMs face renewed risks from Trump's protectionist policies and a worldwide trend toward de-globalization, but they are entering this period of uncertainty from a strengthening base. Domestic growth momentum in many EMs has accelerated, which is making them more resistant to worsening external conditions. Actual protectionist measures initiated by Trump may not be as extreme as his rhetoric suggests. There are substantial limitations on the ability of Mr. Trump to impose import tariffs unilaterally through executive order. Under the origination clause in the constitution, the path to imposing tariffs clearly begins with the Congress and tariffs on intermediate goods produced by US companies in Mexico and other countries would be heavily opposed by business and other lobbying groups.

[19] JP Morgan "Eye on the Market Outlook 2017: True Believer," Jan 1, 2017.

[20] LSR Daily Note "US productivity slow/ CAPEX crowded out" December 21, 2016.

Our base case calls for EM equities to remain on track in 2017. It forecasts earnings growth of 6% in US dollar terms, driven by faster GDP growth and the lagged impact of easier financial conditions. However, there is little scope for multiple expansion. EM P/E ratios are already at post crisis highs, though substantially below those of DMs, in an environment of rising global rates. There is also the increased probability of a harsher US protectionist stance. Adding on an expected dividend yield of 2.5%, produces a base case expected total return on EM equities of 8.5% in 2017. Given the very fat-tailed nature of the EM return distribution, the risk adjustments would cause us to underweight EMs even though the base case expected return is higher than or roughly equal to that of the US and other DM equities.

EXHIBIT 5: JP MORGAN EMERGING MARKET CURRENCY INDEX JULY 2010 – DECEMBER 2016



Source: Bloomberg

Country selection is still very important. India, Indonesia, African countries and perhaps Russia should provide above average investment opportunities. At the same time, countries with large current account deficits and external borrowing requirements such as Brazil, South Africa and Turkey should be avoided due to major geopolitical problems and poor growth prospects, as well as external vulnerability.

Fixed Income

Is this the end of the bull market for bonds? As we wrote in our last letter, we thought inflation would become a realistic concern in the United States, and 2.0-2.5% inflation in 2017 now appears a reality. Oil prices have moved significantly higher than a year ago, and wage growth remains moderate; however, we underestimated the effect of a Trump presidency on inflation expectations and the subsequent market reaction. A 1.60% ten-year Treasury yield was not consistent with our inflation outlook and we expected higher yields in the fourth quarter, but the pace of the increase in US Treasury yields was surprising. The ten-year Treasury yield stood at 2.45% at year end, up 85 bps from the end of the third quarter and up 59 bps since November 8th.

The removal of the uncertainty surrounding the election contributed to fund flows away from longer dated Treasuries, but we attribute most of the move to adjustments in inflation expectations tied to fiscal stimulus speculation. The bond bull market is dead for now, in our opinion, and we remain underweight core fixed income. Simply translated, the bond market will not retest the July lows in Treasury yields in the coming quarters. We also don't see a sustained bear market for bonds forming at this time due to other advanced economy central banks maintaining an easing bias. Non-US developed market global yields having trended only modestly higher, and the yield differential between comparable maturity US Treasuries and German Bunds as well as other developed markets has widened and now stands at historically wide spreads in some cases.[21] Foreign market participants have had the dual benefit of investing at higher yields in an appreciating currency in the United States, although these benefits are clearly linked. In addition to foreign demand, other factors that will restrain US Treasury yields from increasing significantly in 2017 are a Federal Reserve that has consistently erred on the dovish side of global uncertainty and lack of sufficient evidence of a material positive output gap to provide upward pressure on the real growth rate in wages. Due to geopolitical events, 2017 seems likely to be volatile. Uncertainty already surrounds Trump's unpredictable policymaking, and we believe this will be especially true after his inauguration. Also, Euroscepticism will persist into the June French presidential elections. Wage growth has been consistent, but based on the underlying data in the recent employment reports, fiscal easing will be needed to push wage growth beyond the 3% threshold. The participation rate remains stubbornly low and it will take time for the proposed stimulus to feed into corporate and government hiring.

The bond bull market is dead for now

As of September 30th, the inflation breakeven rate was approximately 1.60% for a ten year maturity and now it stands at 1.95%.[22] We expect this rate to increase to approximately 2.25% in early 2017, at which time we would be indifferent between owning Treasury Inflation Protected Securities (TIPS) and nominal Treasury bonds of similar maturities. As seen in Exhibit 6, our estimate of the present equilibrium ten-year yield has increased to 2.54% from our September estimate of 2.48%. Based on our model, which uses the geometric mean forward Fed Funds rates, the ten-year zero coupon yield is expected to rise to 2.77% in 12 months against a current rate of 2.67%. While yields have risen, we remain underweight taxable core fixed income and favor securities with shorter duration and higher yields in the corporate credit and non-agency MBS sectors.

[21] The yield spread between the "on the run" 10 year US Treasury and 10 year German Bund stood at 2.24% and reached 2.36% on December 27th.

[22] Federal Reserve Bank of St. Louis. 10 year breakeven inflation rate as of 12/30/2016.

EXHIBIT 6: 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*	0.55%	1.30%	2.05%	2.80%	2.80%	3.30%
Subtract Projected Inflation	1.95%	1.70%	1.90%	1.95%	1.95%	1.95%
Real Fed Funds Rate	-1.40%	-0.40%	0.15%	0.85%	0.85%	1.35%
Average Short-Term Rate		0.93%	1.68%	2.43%	2.80%	3.30%
Yields Constructed Using Product of Nominal Fed Fund Rates for Each Year	5yrs	2.12%				
	10 yrs	2.54%				
	10y 1y fwd	2.77%				
	5y 1y fwd	2.50%				
10 year Treasury Strip (Actual yield, Bloomberg):		**2.67%**				

Data as of December 30, 2016. Source: Bloomberg
* Fed Funds rate shown is the average of the day before and day after.

Municipal Bonds

Municipal bonds were the hardest hit fixed income asset class following the Republican election sweep and returns for the year were barely positive at 0.25%. The tax exemption embedded in municipal bonds will be less valuable following the proposed tax reforms and could impact demand in the future. First, elimination of the tax exempt status of municipal bonds is being discussed; however, we believe the exemption will remain. A worst case scenario is the exemption may be capped, but previously issued securities will likely be grandfathered. Municipal finance accounts for a large portion of infrastructure spending in the US and many municipalities are already underfunded and could not afford the increased financing costs.

The impact of tax reform on demand for municipal bonds is mixed. Individual tax rates may decline on the margin, but the impact on retail demand should be negligible. Retail investors tend to follow the herd, as evidenced by over 52 straight weeks of inflows in Muni bond funds through October 2016 and outflows since yields have begun to increase. [23] Stabilization in yields is more important for the psychology of individuals to resume buying, and we expect retail demand to return in early 2017 as tax changes are unlikely to be implemented in the next 12 months. Changes in corporate tax rates will likely impact demand more significantly, especially for large holders of municipal bonds. Corporations can also benefit from the tax exemption and due to yields on creditworthy municipal bonds being attractive to taxable bonds on an after tax basis, institutions with potential

[23] Lipper Fund Flow Reports.

liquidity needs tend to hold large portfolios. Examples are banks and insurance companies. Theoretically, yields will adjust to the corporate tax rate changes, leading to higher yields and underperformance of municipal bonds in the near term. This has been the case since November 8th with the ten-year Municipal yield ratio now in excess of one (municipal yields are higher than comparable maturity Treasuries).

The year of 2017 will be a challenging one for municipal bonds due to the dual headwinds of rising yields and tax reform speculation. Issuance in 2017 will likely decline modestly from 2016, a record breaking year, but will likely remain strong. Additional rate hikes loom, and issuers would be wise to lock in lower rates if they have not already done so. We view liquidity as very important given the uncertainty around tax reform, so we prefer better quality credits in the municipal universe. For buy and hold investors, yields are more attractive now and we do not foresee material degradation in credit quality, so cash can be reinvested at higher rates.

> 2017 will be a challenging year for Municipal bonds

Spread Product

Despite Treasury yields moving higher in November and December, investment grade bond and high yield bond indices held onto their year to date gains and finished the year up 6.1% and 17.1%, respectively. This far exceeded our outlook from a year ago. Expectations of an increase in the default rate in the energy and mining sectors in the first quarter pushed spreads wider as we predicted; however, significantly fewer defaults occurred and the Fed softened its stance leading to risk taking and strong gains in 2016. Foreign demand for corporate bonds also provided a tailwind that should continue into 2017. The ECB and Bank of England purchases have crowded out many private investors who traditionally purchased European and UK corporate bonds and forced them into the US market. We expected tapering of foreign central bank purchases, but this artificial demand will persist throughout 2017 keeping spreads tight.

Looking forward, we expect both investment grade and high yield bonds, including loans, to outperform Treasuries, and spreads should finish the year tighter than current levels. Default rates will likely decrease now that oil and commodity prices have stabilized due to the improved global growth outlook and OPEC announcement. Absent a correction in the equity markets, lower rated credits are poised to outperform if the President-elect's agenda is enacted, but we are cautious about increasing our allocation to B and CCC rated bonds at current spread levels. These sectors will be the most sensitive to policy shifts, and we prefer allocating to riskier parts of the credit markets through our hedge fund and private equity allocations. We question whether the current spreads of lower rated credits adequately compensate for potential volatility, and additionally, liquidity risk has

been exacerbated since Dodd Frank implementation and reduction of dealer inventories. We remain invested in high quality high yield and investment grade corporate bonds in the liquid portion of our credit allocation and would consider moving down in credit quality if spreads widened by more than 150bps from current levels.

EXHIBIT 7: BROAD TRADE WEIGHTED DOLLAR INDEX DECEMBER 1995-DECEMBER 2016

Source: Federal Reserve Bank of St. Louis

Unlike US corporate bonds, emerging market bonds suffered post-election, especially local currency denominated debt. The JP Morgan Emerging Market Bond Index returned-3.38% from November 8th through December 31st vs 1.91% for the BofA Merrill Lynch US High Yield Index. The trade weighted dollar hit 14 year highs in December, and the market has developed a sincere fear of Trump's protectionist stance impacting EM assets. (Exhibit 7).

The decline of EM currencies has moved EM bonds into a more favorable light although spreads have quickly retraced to pre-election levels. While we expect a strong dollar in 2017, much of the strengthening has already occurred, and we doubt trade policies will change significantly. Strong recent EM growth should continue and Nowcast estimates support this view. [24] Also, inflation has been decreasing in many EM countries, enabling central banks to ease and making local real yields more attractive. Fundamentally, strong US consumption trends are positive for Asia and commodity stabilization supports Latin American economies. Relative to core fixed income, we view EM debt, particularly local currency debt, as attractive; however, we expect volatility in 1H 2017 due to speculation about trade policy, upward pressure on US interest rates and foreign flows supporting the US dollar. EM debt outperformance in 2017 and 2018 will be generated from a decrease in local EM rates due to EM central bank easing and appreciation in currencies likely starting in 2H 2017. Given the near term risks, we prefer allocating to global managers with flexible mandates to move capital between developed and emerging markets and who actively manage their currency exposures.

[24] As cited by Gavyn Davies in "Global Reflation continues into 2017," Financial Times, January 2, 2017. Nowcast estimates are released by Fulcrum Asset Management monthly.

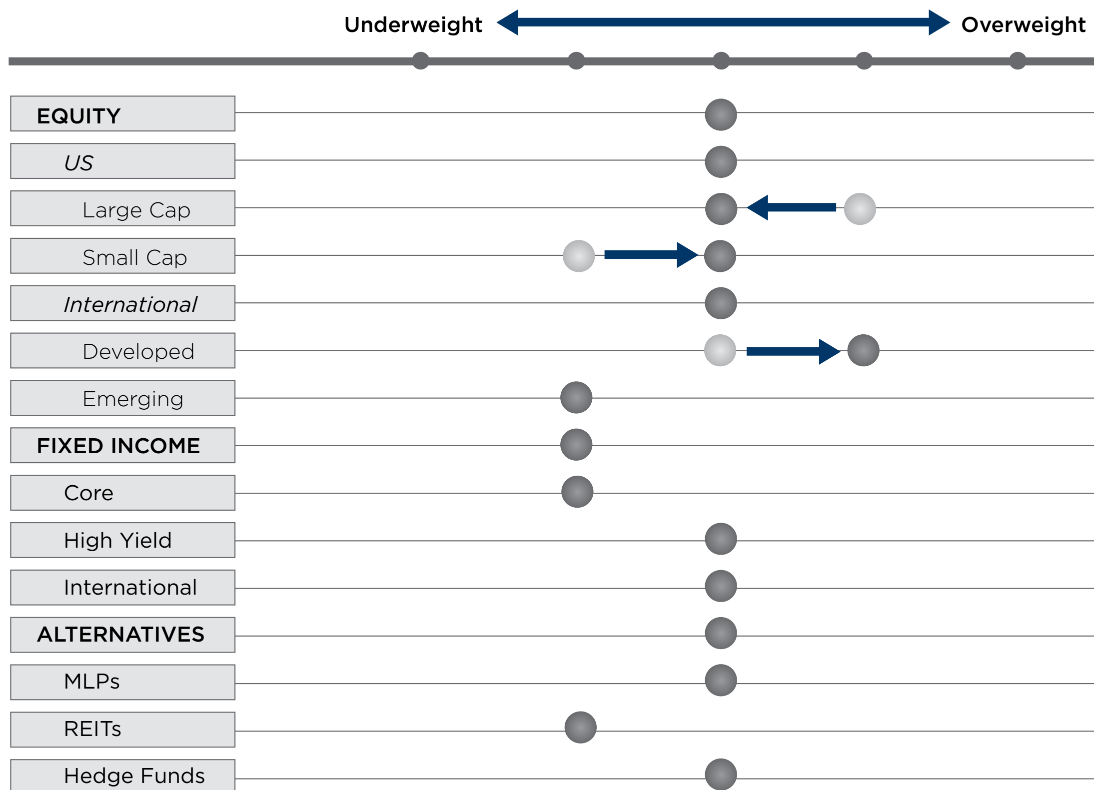
Conclusion

We have raised our base case forecast for the increase in global GDP growth in 2017 to 40bps from 20-30bps in our third quarter 2016 letter. Most of the anticipated pickup in advanced country growth is due to greater expansion of business fixed investment and in the case of Japan, Europe and the UK, more competitive exchange rates. We do not believe that fiscal stimulus by the Republicans will begin to support the US economy before late 2017 at the earliest. The EM economies are gaining strength as a result of interest rate reductions following a period of significant monetary tightening. Absent major tariff hikes or destination adjustment in the US tax code, improved advanced country growth should also lead to higher demand for exports from EM countries. Preliminary evidence indicates the global economy has already picked up steam. For example, the JPMorgan global manufacturing PMI rose to 52.7 in December from 52.1 in November, its highest level since 2014. The December reading is consistent with global manufacturing growing at 4-5%.

> Despite identifiable tail risks, we remain optimistic about global markets

In our fourth quarter 2015 report, we predicted that advanced country equities would return 4.7% as a group in 2016 which understated the actual return by 2.8 percentage points or by 1/7th of the historic standard deviation for global equity returns. Our base case outlook is consistent with 2017 being another year of single digit average return for advanced country equities. We are still anticipating negative returns for risk free bonds but not for high quality corporates. Although we are slightly overweight MSCI EAFE equities currently, we would consider a greater tactical tilt in the second half of the year if European political risk diminished. Similarly, we are underweight EM equities for the time being. In line with this view, we would decrease our slight overweight in US equities in 2H 2017 if risk in non-US equities diminishes.

EXHIBIT 8: DMCA ASSET CLASS VIEWS AS OF DECEMBER 31, 2016



Source: DMCA

Our return outlook and asset allocation strategy are subject to certain tail risks that are not fully reflected in market prices. The following is a list of the major tail risks we are concerned about from the most to least likely:

- Significant Policy Errors by the Incoming Administration
- The Downside of Accelerating Growth
- A Major Credit Crisis / Bursting of a Credit Bubble
- The Collapse of the European Union
- A Major Conflict or a Major Natural Disaster
- "The Rise of the Robots"
- "Unknown Unknowns"

Each of these tail risks and their investment implications are explained in the Addendum to this letter.

The collective impact of these various tail risks is not great enough to undermine our core view: we are in a longer than normal global recovery that supports equity returns which are likely to exceed those of cash and bonds. We recommend staying invested in global equities with some tactical tilt to US high yield bonds and TIPS. However, we will try to be as nimble as possible, monitor tail risks carefully, and employ a strategy of DARP (defensive assets at reasonable prices) which includes buying low volatility and high quality stocks at opportune times. Treasury bonds are not a good hedge against equity downturns caused by higher interest rates and inflation, which increases the importance of other forms of risk control.

Thank you for your continued confidence in us. If you have any questions, please do not hesitate to contact us.

We wish you a Happy and Healthy New Year.

Sincerely,

James L. McCabe, Ph.D.

Erich M. Hickey, CFA

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Addendum to Fourth Quarter Global Economic and Market Commentary[25]

While our near-term outlook for the US and global economy are generally positive, we are remaining vigilant of a number of tail risks that could significantly disrupt the market. The following is a list of some of the major tail-risks we are concerned about in order from most to least likely.

Significant Policy Errors by the Incoming Administration

The incoming Trump administration runs the risk of making significant policy errors early in the year that could put expected reforms in danger and derail economic growth. Trade policy will be a key area of potential tail risks. The Trump campaign focused on "making America great again" often at the cost of punishing industries that rely on the free flow of goods and services across borders.

There are two key risks to consider from potential protectionist legislation. First, input costs for US companies could rise substantially. A clear example is US clothing retailers, who import the vast majority of their products from abroad. Import restrictions can have significant effects on this industry with spillover effects to various others (e.g. clothing prices rise and there is less demand for other products). Similarly, almost every major US industry relies on the importation of commodities, intermediate, or finished goods and services from abroad and trade restrictions will have unexpected consequences.

Second, extreme policies imposed on imports into the United States will not be accepted without pushback from our trading partners. The most benign outcome would be trading counterparties devaluing their currencies to an extent that largely offsets imposed tariffs and reduces the attractiveness of American exports. A more serious effect will be "trade wars" that can significantly disrupt global supply chains and cause a sharp decline in global aggregate demand for goods and services.

There is also the risk of a significant policy error from an unknowable source, whether economic or geopolitical, that reduces the potential for reforms that have already priced into US equity markets. If the new administration's policies destroy its political capital and cause a fracture within the GOP, there is significant risk that baseline assumptions regarding tax reform, infrastructure spending, or other reform will become less likely and have serious effects on equity markets.

The Downside of Accelerating Growth

If the Trump Administration's fiscal stimulus proves to be successful, GDP growth may accelerate to an unsustainable level. Given that the US is near full employment and productivity growth remains low, this may cause inflation to accelerate beyond 3% faster than anticipated. In this case, the Fed would have to tighten more quickly than expected and raise the cost of borrowing in corporate debt markets. This outcome would depress the ability of companies to invest and disrupt the trend of issuing debt to fuel stock repurchases.

[25] Prepared by Joseph Zaccardi, CFA

A Major Credit Crisis / Bursting of a Credit Bubble

A major global credit crisis remains a possibility as global interest rates remain incredibly low and financial engineering by world governments remains extremely high. Elsewhere in this letter, we have noted the inability of China to reign in debt levels and their potential effects on global markets. We believe the risk of asset price declines on the credit markets in China are underappreciated while the ability of Chinese authorities to balance the outcomes of credit market reforms with political objectives is deemed more likely than warranted.

The continued measures taken by the Japanese and European Central Banks that continue to push liquidity and potentially distort markets. Unexpected consequences from continued extraordinary monetary policy will continue to hang over global markets for years to come.

The risk that a credit event causes a cascade of illiquidity across global markets remains, and we continue to look for potential sources of dislocation.

The Collapse of the European Union

We continue to believe that the European Union remains vulnerable to a disorderly collapse where populist sentiments outweigh the clear benefits of the economic union and cause the dissolution of the bloc. Concerns over immigration, terrorism, and economic policy could help to destabilize the EU to such an extent to make the union infeasible as an ongoing entity. Elections in France and Germany during 2017 will provide a clearer outlook for the EU, and we will write more in depth as we gain a better picture of potential outcomes and risks throughout the year.

A Major Conflict or a Major Natural Disaster

Wars over the last few decades have been confined to regions with relatively minimal effect on the global economy. However, war is always a negative sum game (i.e. even a small war, in a small economy leaves the world worse off than before) and the potential for a large conflict will remain non-zero for the foreseeable future. While the probability of a large conflict remains minimal, the costs would be extremely high. Continued or escalating conflicts in various parts of the world, such as the Middle East, will continue to have a negative effect on global economies.

As with war, natural disasters destroy wealth. However, we believe that the ability of people to recover from disasters and adapt to new conditions is significant and hope that the effects from a disaster would be short-lived.

"The Rise of the Robots"

The potential disruption from the continually accelerating progress of technology remains a potential risk to the global economy and aggregate demand that has been much discussed over the last few years. Martin Ford's "The Rise of the Robots: Technology and the Threat of a Jobless Future" provides an excellent overview on the potential obstacles. In essence, technology continues to develop at an advancing rate, but productivity improvements have not been as clear as in the past. Therefore, as technology overtakes humans in more and more complicated tasks, we run the risk of destroying aggregate demand.

Our baseline view is much less apocalyptic than Mr. Ford's, and we believe that technological advancement will continue to increase global wealth and productivity. However, there will be disruption along the way with significant effect on some industries and economies. These potential effects will remain the focus of our ongoing research.

"Unknown Unknowns"

Donald Rumsfeld famously spoke of "unknown unknowns" in a news briefing approximately fifteen years ago and the phrase has become a favorite among investment prognosticators. We cannot always predict where, when, or by what mechanism economic dislocations may occur, or have a clear grasp of potential effects on portfolios. However, we believe that building diversified portfolios with clear understanding of our clients' needs puts us in the best position to achieve desired objectives. By necessity, our approach and diligence remain the best defense against events which are impossible to predict.

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