Drexel Morgan Capital Advisers FOURTH QUARTER 2017

Global Economic and Market Commentary

Summary

- Global equity markets are expected to advance in 2018 supported by improving worldwide economies, earnings, ample liquidity and sentiment momentum.
- We believe volatility will increase and that the US and other equity markets are vulnerable to corrections in the year ahead.
- Capital markets and the world economy are highly vulnerable to policy mistakes which could easily occur if inflation/interest rates move higher than expected.
- We expect earnings multiples to contract slightly and profit margins to be resilient and not encounter downward pressure from higher wages and interest rates until 2019.
- Non-US developed equities have greater potential for above trend earnings growth due to higher excess capacity and greater operating leverage.
- Emerging Market (EM) economies are likely to outperform the US but not nearly to extent that they did in 2017.
- We expect moderately higher yields in the US and Europe. The US yield curve will likely flatten and may invert by the end of 2018 or early 2019.

"This problem of making ever greater investments as the market rises is a classic cycle that is not likely to abate."
– Martin Leibowitz

The passage of the tax plan in late 2017 put a cherry on top of 12 straight months of gains in the S&P 500 which historically had never occurred in a calendar year. Volatility in equities and bonds languished near historic lows with modest, ephemeral spikes occurring only 4-5 times throughout the year. Investors pursued an appetite for longer duration risk assets and ignored the noise in Washington and geopolitical events in North Korea. Emerging Market (EM) equities led all asset classes, returning 37.3% for the year and 7.4% for the quarter. Stable or increasing commodity prices, declining inflation expectations, robust growth in earnings and a steady Chinese economy have contributed to this outperformance. OECD estimates for global growth are 3.7% in 2018 following 3.6% in 2017 with Developed Markets (DMs) and EMs expected to grow 2.4% and 4.9%, respectively.[1]

We expect global growth to drive positive equity returns in 2018

The uptick in global growth has benefitted developed non-US equities which had lagged the S&P 500 since the global financial crisis until last year. Depressed earnings in these regions and US dollar strength were two headwinds which reversed in 2017. Both growth and inflation data surprised to the upside in Europe and Japan, and survey data reflect surging consumer and business confidence. For the year, the MSCI Europe index returned 25.5% and the MSCI Japan Index returned 24.0%. We continue to prefer non-US equities primarily based on valuations.

[1] OECD Economic Outlook, Volume 2017 Issue 2: General Assessment of the Macroeconomic Situation

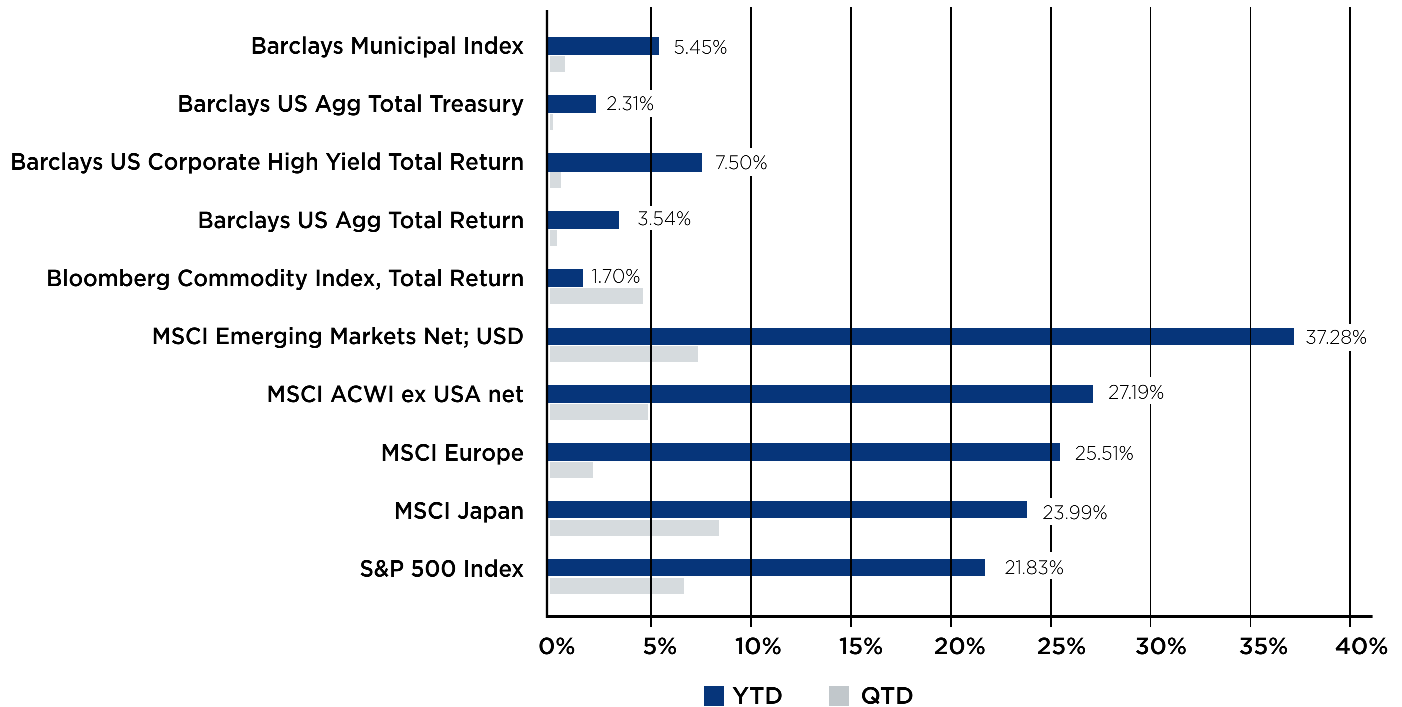
While overshadowed by international equity markets, the S&P 500 Index gained 6.6% in the fourth quarter of 2017 and 21.8% for 2017 as a whole. As the largest sector in the Index, technology companies drove performance throughout the year, returning 36.9%. US equities are expensive compared to Europe, Japan and EMs, but the tax bill will likely boost earnings in 2018 supporting the recent gains.

Fixed income markets ground upward in 2017 with the riskiest parts of the market; high yield and EM bonds, performing the best. Longer term yields remained stubbornly low throughout the year despite three Federal Reserve rate hikes, strong economic data and an uptick in growth. The Bloomberg Barclays US Aggregate Index returned 3.5% for the year. We anticipate modestly higher Treasury yields in 2018 and a flatter yield curve by year end.

We are not yet at euphoric levels, but the current trajectory of global equity markets will not continue indefinitely. Catalysts for increased volatility in the near term are scarce, while larger budget deficits and tightness in the labor market give us caution into the end of 2018 and 2019. We do not forecast a recession but rather a potential rerating (multiple compression) of equities later in the year. For now, we remain invested with a target weight to domestic equities and an overweight to international equities. We are cognizant that aggressive investor behavior has been rewarded thus far and a final rush into equities may occur sometime in 2018. At that time, we will likely change our views and become more defensive. We have already begun reducing equity exposure.

A correction in equities is overdue

EXHIBIT 1: GLOBAL CAPITAL MARKET RETURNS YTD AND QTD THROUGH DECEMBER 31, 2017



Source: Bloomberg, Barclays Live

The US Economy and Stock Market

Despite quarterly tightening by the Fed starting in December 2017, broader financial conditions indices continued to ease substantially. This has produced a growth boost currently worth about 75 to 100 basis points which is likely to persist through the first half of 2018. The easing in overall financial conditions has been driven by a weaker dollar, declining credit spreads and increasing equity prices.

The acceleration over the last four months represents the first time since 2012 that US growth finally surpassed expectations. Our current trailing estimate that GDP grew 2.6% in the fourth quarter of 2017 is solidly above our 1.75% estimate of the economy's long-term potential growth rate and even further above the roughly 1% short-term potential of recent years.

We anticipate that real GDP will grow at an annual rate of around 2.7% in 2018, which is above trend though still below the 3% rate touted by President Trump. Projections are based on the following factors. First, wage gains and wealth effects associated with rising house prices, and continued, albeit slower, employment growth should contribute positively to consumer demand growth, which should exceed 2%. This is likely to occur even though the household savings rate may revert to its historic mean, having been unusually depressed in 2017. Second, we expect business investment to continue growing at a roughly 4% pace, driven by high capacity utilization rates, substitution of capital for increasingly scarce labor, more rapid tax write-offs and a pickup in energy capital expenditure. A period of continued strong world economic growth, combined with further dollar weakness, should enable exports to grow at a comparable 4% pace.

> The short and long term impacts of the tax bill are difficult to determine

It is difficult to determine the long and short term economic effects of the Tax Cuts and Jobs Act (TCJA) of December 2017. Based on conventional static scoring of the Tax Bill's impact on growth, the Bill is estimated to cost $1.46 trillion over 10 years. Based on dynamic scoring the bill is estimated cost over $1 trillion.[2] The tax policy changes are estimated to raise the debt to GDP ratio from the current level of 91% to 95% or 98% depending on which of the two scoring methods is used. The impact of the tax reform on final demand is likely to be moderate, reflecting both the size of the net cut and the main share of the benefit going to higher income households, with lower marginal propensity to spend, as opposed to the corporate sector. Goldman Sachs estimates the total package would boost real GDP growth by about .3 percentage points in each of 2018 and 2019. The impact of the tax cut, when combined with an increase in federal government spending, should produce a noticeable uptick in fiscal impulse to growth in 2018 and keep the probability of recession in 2018 low.[3]

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[2] Congressional Budget Office.

[3] Goldman Sachs US Economic Analyst; 2018 Economic Outlook, November 17, 2017.

Labor Market Tightness

While it is quite possible that all surplus labor has been absorbed, it is still difficult to establish the exact level of full employment that will lead to significant wage pressure. In light of both the stronger growth momentum and faster than expected decline in the fourth quarter, we forecast the unemployment rate to fall to 3.7% by the end of 2018 from 4.1% at the end of 2017. Goldman Sachs estimates that the unemployment rate in the mid-threes would lead to an increase in wage growth from the current range of 2.5% to 3% to the 3% to 3.25% range in 2018.[4] However, the risk of this forecast is high on both sides.

Inflation Outlook

We expect inflation to surprise on the upside this year, not simply because of higher wage growth but as a result of other factors. Specifically, we forecast a roughly .6 percentage point acceleration in the core PCE deflator to 1.9% by the end of 2018, driven by the dropping out of the weakest base effect in March of 2017, rising labor costs, higher energy prices, a weaker dollar and the increase in healthcare costs. By the end of 2019, we expect core inflation to exceed 2% in the context of a very tight labor market. However, there is an upside risk to this forecast. It is easy to underestimate the inflationary pressures that have resulted from the flood of cheap money in the global financial system over the past decade. Additional inflationary pressures may be beginning to appear in commodity prices and the price appreciation in copper and other commodities could be a harbinger of upside inflation surprises in 2018.[5]

> Inflation is likely to surprise on the upside later in 2018

Fed Policy, Interest Rates and the Yield Curve

We expect monetary policy to remain favorable to economic expansion. This tightening cycle has been characterized by a slow pace relative to historic averages and low core inflation, which have characterized prior non-recession inducing cycles. The balanced framework that has guided the FOMC during this period is likely to make a strong case for steady further tightening in 2018. The latest increase in the Fed Funds target was adequate or too little based on Taylor's rule, depending on which inflation measure is used (see Exhibit 2). Goldman Sachs has estimated that the Taylor rule rate will be more than one percentage point above the projected policy rate increases through 2019, even when the Taylor rule rate is based upon the Holstein, Laubach and Williams estimate of a real neutral rate near zero at the start.[6] Even if the Fed estimate of three quarterly rate hikes in 2018 and three more in 2019 were to remain unchanged, though quite hawkish relative to market expectations, these quarterly rate hikes would remain fairly dovish in coming years relative to the rule applied rate. For this reason, we expect Fed policy to remain accommodative through 2019 in our base case.

> The Fed has room to hikes rates 3-4 times this year

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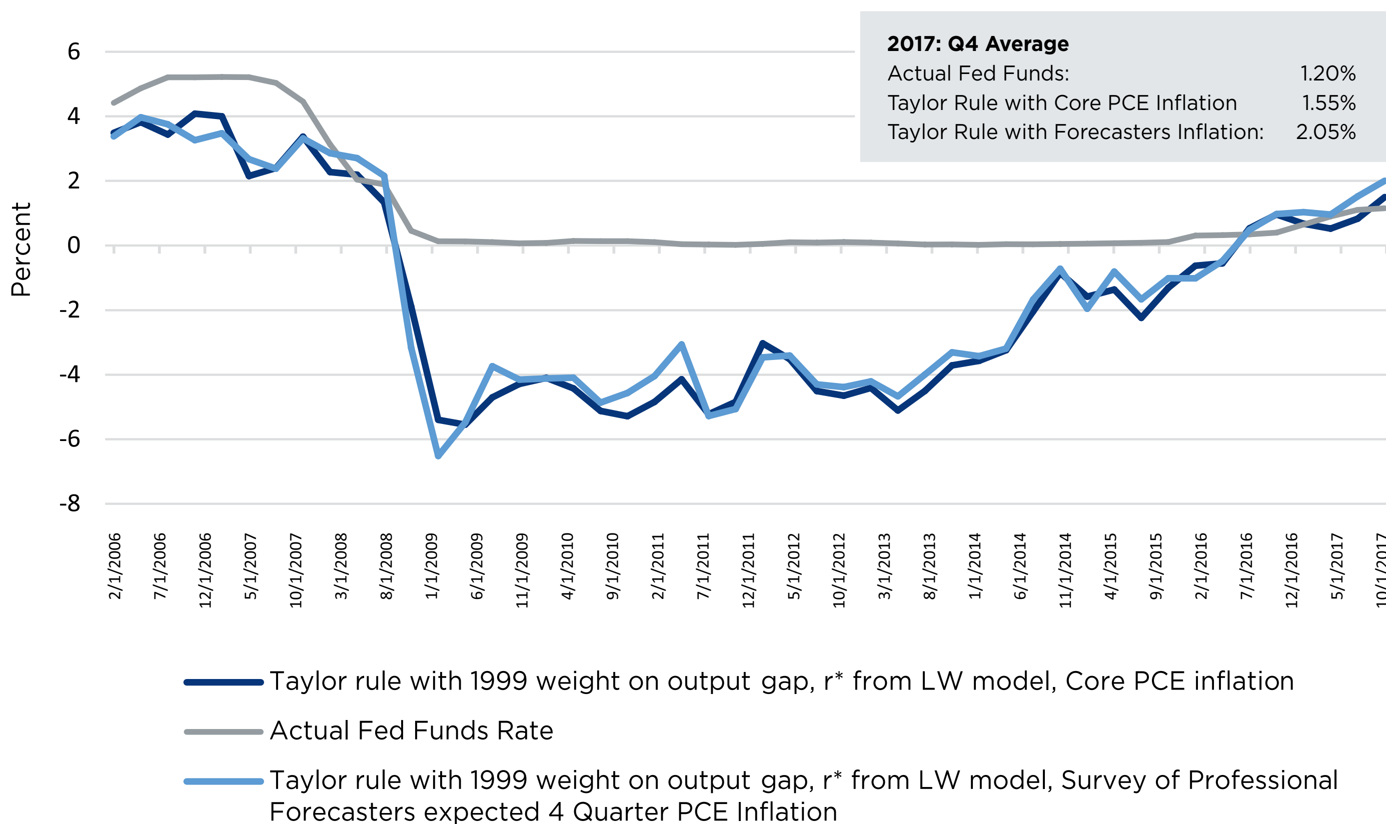
4 Goldman Sachs Outlook: "(Un)Steady as She Goes," January 2018.

5 Goldman Sachs, US Economic Analyst, op. cit.

6 Ibid.

EXHIBIT 2: TAYLOR RULE CHART



One of the biggest financial surprises in 2017 was sustained low longer term bond yields as the Fed raised short-term rates, which resulted in a significant flattening of the yield curve. The Fed has raised rates four times since December 2016, lifting the Fed funds target to 1.5%, while the 10-year Treasury bond yield was virtually unchanged in 2017 ending the year at 2.4%, five basis points below the starting yield of 2.45% (though it has started to rise in early 2018). Perhaps the largest concern about the flattening yield curve is whether it is predicting slower growth or recession. In past cycles, while the yield spread has been positively associated with future economic growth, with a flattening statistically correlated with weaker subsequent growth, the correlation could have occurred by chance alone. On the other hand a recession eventually ensues whenever the yield curve is inverted, i.e., short rates are higher than long rates. This is mainly because an inverted yield curve chokes off financial institutions' incentive to lend.[7]

Empirical research supports the view that the relatively flat yield curve is not pointing toward an economic slump or recession. The probability of recession is estimated at 6% based on the current spread between the 10-year Treasury bond yield and the three-month Treasury yield, with the Fed Funds Rate still modestly below inflation. This result is based upon earlier empirical studies conducted by Fed researchers and academics. Raising the Fed Funds Rate toward a neutral policy usually does not harm growth during economic expansions or periods of monetary ease. Provided imbalances do not arise in the real economy, the Fed can continue to raise rates along the path that it forecasts as appropriate, that is, three or four hikes in 2018, without materially raising the probability of a recession.[8]

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7 'Higher Fed Rates and Lower Bond Yields Don't Spell Trouble:' Seeking Alpha, January 8, 2018,

8 Ibid

Our base case outlook calls for the Treasury bond yield to increase by about 25 basis points less than the increase in the Fed Funds Target in 2018. This is not suggestive so much of slowing growth as it is of highly anchored inflation expectations and a very gradualist approach by global central banks toward unwinding their balance sheets. We also expect estimates of potential growth, which have declined materially to 1.8% from 2.5% before the financial crisis, to continue to remain low as productivity growth remains below pre-crisis levels. However, the gradual flattening of the yield curve in our base case outlook may be overly optimistic. There may be a temporary steepening of the yield curve due to economic overheating. Nowcast estimates suggest that actual growth may well substantially exceed potential global growth in the first half of 2018.[9] This, combined with an increased fiscal deficit from the TCJA, may cause the 10-year Treasury yield, which is positively correlated with global growth, to rise more rapidly than expected to near 3% in the first half of the year. This countertrend steepening of the yield curve may be reversed as global growth prospects deteriorate in the second half of the year. In particular, China could slow more than expected as a result of policy tightening already in place. This would cause foreign central banks to backtrack on exit strategies which would cause the increase in the 10-year Treasury yield to reverse. Thus, an eventual inversion of the US yield curve may well occur in early 2019.

The yield curve will continue to flatten into 2019

The US Dollar

On a purchasing power parity basis, the trade-weighted US dollar is still overvalued. The trade-weighted dollar has been at its purchasing power parity level (PPP) every two to three years. The dollar moved higher in 2014 to 2015 on the back of monetary policy diversions. However, we view the dollar's recent weakening as a correction of this move and a return back to PPP levels, although the trade-weighted dollar may appreciate temporarily due to a higher 10-year Treasury yield in the first half of the year. Higher inflation in the US and lower inflation elsewhere should continue to drive the PPP toward a weaker trade-weighted dollar with the greatest deterioration occurring against the Euro.

The US Equity Market

Bullish Case

This revolves around a continuation of the favorable environment for buying stocks. In this scenario, the global recovery sees no natural pause, earnings are lifted by tax cuts and inflation remains benign, along with the US dollar. This leaves the Fed to maintain an accommodative stance by keeping the target rate below the Taylor rule levels. The strong momentum in the tech sector should not dissipate rapidly and the S&P moves to 2950 or 3000.

Base Case

Even though the positive impulse extends into the early part of 2018, obstacles ratchet up as the year progresses. In this case, the S&P 500 should register a single digit return of 4.3%, substantially below the estimated rate of 2018 earnings growth (12%) and somewhat below the estimated rate of 2019 earnings growth (5%) due to forward multiple compression.

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[9] Gavyn Davies, "Can Secular Stagnation Morph into Secular Expansion?" Financial Times, January 7, 2018.

Bearish Case

This comes into play when the market realizes that growth interventions are ineffective or have unintended consequences. Either strong earnings growth does not materialize or inflation and GDP growth pick up more than expected and the Fed shifts into a more aggressive mode. In both cases, the S&P 500 falls in price either because of earnings disappointment or greater than expected multiple compression due to higher interest rates. Other factors mentioned above may diminish the prospects for global growth in the second half of the year, with yield curve inversion becoming more likely in 2019. As a result, the S&P 500 finishes the year at between 2152 and 2200 against 2674 at the beginning of 2017.

We are assigning a 50% probability to the base case and 30% and 20% probabilities to the bearish and bull cases, respectively.

We will now outline in greater detail our base case outlook for the US equity index. This outlook centers around our revised 2018 and 2019 per share earnings estimates based on the TCJA and on an upward revision in our estimate of 2018 and 2019 pre-tax cut base earnings to $142 from $136 and $149 from $143. Our new estimates of 2018 and 2019 earnings, including the effect of the TCJA, are $150 and $160, about 4.6% and 6.0% higher than our prior estimates. Our new estimate for the return of the S&P 500 in 2018 is 4.3%. This assumes a forward multiple on S&P 500 earnings of 17.1 at the end of 2018 against the forward multiple of 17.8 at the end of 2017. The forward multiple compression is the result of an increase in the Treasury yield to near 3% by the end of 2018 and a decrease in the expected earnings growth of 12% in 2018 to 5% in 2019 (see Exhibit 3).[10]

Our base case for US equities factors in slowing 2019 earnings and multiple compression

EXHIBIT 3: PROJECTED S&P 500 INDEX EARNINGS AND VALUES

Base Case Estimate for S&P 500	
End of 2017 Value	2674
2018 Dividend Payments	53
Estimated 2018 Adjusted Earnings	150
Estimated 2019 Adjusted Earnings	160
Estimated Forward Multiple on 2019 Earnings	17.1
Estimated end of 2018 Value	2736
Estimated Value Including Dividends	2789
Estimated 2018 Return	4.3%

The difference in the estimated value for the S&P 500 compared to our third quarter report was primarily due to an increase in estimated 2019 earnings which was a compounding of a small percentage increase in the 2018 estimate. Our latest estimate for the value of the S&P 500 at the end of 2018 is only 6.0% higher than our prior report excluding dividends.

[10] The trailing 12 month multiple compression is substantially more than the 12 month forward multiple compression due to an expected decline in the earnings growth rate in 2019.

International Equity Markets

Japan

During the fourth quarter of 2017, Japanese equities, as measured by the MSCI Japan Index, appreciated 8.5% and outperformed the MSCI EAFE Index by over 400bps. For the year-to-date period, Japanese equities returned 24% compared to 25% for the MSCI EAFE Index.

In our last letter, we noted that Japanese Prime Minister Shinzo Abe called for snap elections at the end of October. The decision to hold the election proved worthwhile and Abe's Liberal Democratic Party was able to secure more than two-thirds of Parliament's seats. We believe this election was a mandate for policy reforms in light of geopolitical risks and will not lead to any significant deviation from current economic policy.

Data released in November indicated that Japanese GDP had expanded 0.3% in the third quarter compared to 0.6% in the second quarter. This is the seventh consecutive quarter of GDP growth and the December Markit Purchasing Managers' Index (PMI) was 54.2 indicating that the Japanese economy may continue a slow and steady expansion for several more quarters.[11] Growth in the third quarter was driven by exports, while domestic demand subtracted from GDP. We believe that domestic demand, related to employment ratios and wage growth, is the key to driving Japanese GDP growth in the future. In November, the unemployment rate dropped to 2.7%, the lowest level since 1994, but inflation data continues to lag the 2% target of the central bank and shows no indication of rising substantially.[12] Japanese policy makers believe inflation should increase as citizens gain confidence in the strength of the economy. However, after two decades of little inflation and deflation, we do not believe that the expectations of Japanese citizens will change quickly.

The official central bank position is that current policy is enough to push the inflation rate towards the 2% target from the current level of 0.6%, and during December, the Central Bank of Japan made no changes to monetary policy and continues to employ a combination of quantitative easing, yield curve control, and negative interest rates. The Bank maintained its 0% target on the 10-year yield, and the -0.1% rate on excess reserves held at the Bank.[13]

Japanese equities are poised to perform well in 2018

Our managers continue to find attractive investment opportunities in the region as the effects of Abenomics unfold. Business confidence has increased on higher profits and cash flow in 2017. Also, corporate board reform is progressing, albeit slowly, and the number of independent directors at Japanese corporations is increasing. Payout ratios should have increased in 2017, and we expect an increase in 2018 as well. The forward P/E of the MSCI Japan Index was 14.6x at the end of the quarter, compared to 14.3x as of the end of June, considerably lower than the US.[14] We believe that earnings growth will continue in Japan and the upside of multiple expansion makes the region attractive.

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11 Lockett, Hudson, "Japan Q3 GDP Growth Solid as Exports Outperform," Financial Times, November 14, 2017

12 Harding, Robin, "Unemployment in Japan Hits 24-year Low," Financial Times, December 26, 2017

13 Yen Nee Lee, "Japan's Central Bank Leaves its Monetary Policy Unchanged," www.cnbc.com, December 20, 2017 accessed 12/26/2017

14 Yardeni, Ed, Abbott, Joe, Quintan, Mali; "Global Index Briefing: MSCI Forward P/Es;" www.yardeni.com December 19, 2017; accessed 12/26/2017

Europe and the UK

During the fourth quarter of 2017, the MSCI Europe ex-UK Index appreciated 0.9% and the MSCI UK Index appreciated 5.7%. Year-to-date, the indices have appreciated 26.8% and 22.3%, respectively.[15] The strong equity performance reflects continued better than expected economic growth and an improving outlook across the Eurozone. In local currency terms, European equities significantly underperformed the US and Japan, continuing to make the region attractive.

As we have discussed, the key story of global markets in 2017 and into 2018 has been the synchronization of global growth. Very few countries are contracting currently which creates a favorable backdrop for equities. Eurozone PMI reached 60.6 in December, which is the highest level since the survey began in 1997.[16] Additionally, all 19 eurozone member states are expected to record positive real GDP growth in 2017; a stark contrast to previous years which featured high unemployment, negative GDP growth, and potential sovereign defaults in peripheral countries. Coordinated broad growth has led to very high consumer and business sentiment. Lending has begun to increase, and we expect capital expenditures to be rejuvenated alongside potential balance sheet releveraging.[17] Finally, growth has surprised to the upside with the eurozone economy growing at an expected 2.4% pace in 2017, compared to the expectation of less than 2% at the start of the year.[18] This synchronized growth should continue to drive revenues of companies that do business within the eurozone, and with the embedded high operating leverage in European equities, we expect earnings to grow at near a double digit pace. We maintain our overweight exposure in the region.

Peripheral countries are no longer a drag on European growth

Given the strength of growth within the eurozone, we expect the European Central Bank (ECB) to end its quantitative easing program towards the end of 2018 and to end its negative interest rate program during the first half of 2019. The withdrawal of these programs will mark the beginning of the end of ultra-loose global monetary policy that has been in effect since the financial crisis a decade ago. A primary risk to our outlook for European equities is an overly hawkish ECB.

Brexit negotiations will continue to be a focus for investors for at least two more years. Our "wait and see" approach to Brexit has proven correct. While rumors surrounding the eventual path of Brexit continue to bubble up in the news, we have seen little that will have a large effect on our investment outlook.

One effect from Brexit present in UK markets is a recent increase in inflation to levels approaching the top of the Bank of England's comfort zone. In October, inflation in the UK reached 3%. Subsequently, the Bank of England increased the bank rate from 0.25% to 0.50% and maintained its current level of quantitative easing at £10 billion per month.[19] After years of benign inflation, we do not believe the recent overshoot in the UK is a serious concern, but we will continue to monitor price signals from the country for potential insight into a post-Brexit Britain.

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15 Source: Bloomberg

16 Megaw, Nicholas; "Eurozone Manufacturing Sector Growth Hits Record;" Financial Times; January 2, 2018

17 Net debt/equity in European equities has remained stable at 50% since 2010 compared to U.S. companies which have increased net-debt/ equity to 68% as of November 2017. Yianis Kontopoulus et al. "UBS Global Macro Strategy: 2018 Markets Outlook: Is there room to grow and normalize?" November 9, 2017

18 Gudin, Phillippe, Pascual, Antonio Garvia; "Euro Themes: Economy at Fully Speed;" Barclays Economics Research December 11, 2017

19 "Bank Rate Increased to 0.50%;" bankofengland.co.uk; November 2, 2017; accessed 12/27/17

We do believe, however, that Brexit remains a risk hanging over the European economy. A disorderly "hard" Brexit could potentially disrupt the economies of both the UK and the eurozone. In the event that a deal is not reached and the economies default to World Trade Organization (WTO) rules governing trade, we believe that the British economy will suffer the brunt of the downside, but the rest of the European Union (EU) will not be spared due to the large trading relationship. We believe that it is in the best interest of all parties to reach a deal before Brexit in 2019, and thus we are maintaining our exposure to the region. As events unfold, we will update our outlook and exposures as necessary.

Forward P/E ratios in the EU and The UK were 14.6X and 14.3X at the end of December, which is marginally higher than the end of the last quarter.[20] As we stated in our last letter, we do not believe that forward P/E ratios in these markets will meaningfully expand in 2018. However, the continued strength of the global economy should allow earnings growth to continue and equity markets to appreciate without the boost from significant multiple expansion.

Emerging Markets

China

Chinese growth, at 6.8%, surprised on the upside in 2017. We expect a modest 60 basis point decline in 2018. In 2018, property sales, construction and infrastructure investment should slow on tighter policies and reduced local authority financing. Credit growth is likely to diminish and supply side reforms should dampen industrial activity. Resilient consumption and improving net foreign trade should at least partly counteract these growth restricting factors.

At a certain point, however, cumulative policy tightening measures will cause growth to slow dramatically. According to the Bank Credit Analyst, "Chinese households have been uneasy about the lack of growth in the real, inflation-adjusted, value of their deposits and have been opting for speculative investments," which offer higher returns than bank deposits. Hence, policymakers cannot ignore household desires for higher real returns if they want to dampen speculative investment activity and certain systematic risks in the system. However, it is difficult to raise real rates and keep inflation under control while still maintaining acceptable economic growth. Controlling leverage, putting a curb on financial markets' excess and dampening speculation in the real estate market are all part of the domestic reforms that China's top policymakers committed to at the party's Congress in October. Thus far, greater external demand and resilience in global financial markets, combined with a gradualist approach to credit restraint, have prevented further tightening from precipitating a hard landing. Regulatory changes, such as stronger emphasis on pollution control, have had only a marginal dampening effect on growth. Thus far, China has been able to continue navigating two competing objectives, inflation containment and achieving decent growth, successfully. The odds that it will be able to do so in the longer term are diminishing and may be lower than complacent markets perceive them to be. [21]

> Policy tightening measures will slow growth in China

[20] Yardeni, Ed, Abbott, Joe, Quintan, Mali; "Global Index Briefing: MSCI Forward P/Es;" www.yardeni.com December 19, 2017; accessed 12/26/2017

[21] Bank Credit Analyst, Weekly Report, "Are EMs at their Zenith?" January 10, 2018.

Still, our base case forecast calls for only a marginal growth reduction in 2018. The government should contain leverage and financial risks and take limited steps in the direction of reform and rebalancing the economy in favor of domestic demand and consumption. Strong world demand for Chinese goods and healthy global financial markets have enabled the Chinese to take this gradualist approach. [22]

While the People's Bank of China (PBOC) maintains its monetary and regulatory policy tightening bias, we expect the authorities to enhance macro policy coordination further. We do not expect a significant shift in currency policy, with a widening of the Chinese Yuan band unlikely anytime soon. These factors, combined with a slowdown in capital outflow, should produce a stable currency and avoid the volatility which created a major reduction in global markets in August 2015.

We expect China's GDP growth to slow only modestly to 6.2% in 2018 from an estimated 6.8% in 2017. The forecast risks, at least the longer term ones, are biased to the downside, especially if one takes into account China's high and rising debt to GDP ratio.

Emerging Markets In General

We have a neutral weight on EM equities in 2018. We expect substantially more modest return this year than the 37% total return attained in 2017. One of the main reasons for our less bullish view is the likely reduction in technology stock returns. In fact, 10% of the 37% gain in EM equities last year is attributable to the impressive 59% appreciation in technology shares. We believe that supply has now caught up with demand in the hardware space, pushing memory prices lower, and that technology earnings growth is likely to decline precipitously which should limit appreciation in the EM share index. [23]

Our base case for 2018 assumes that the global macro and financial market backdrop for EM equities remains supportive, although in some cases less so than in 2017. Global growth is expected to be slightly higher than last year, with the key factors being a slowdown in China, a modest pickup in the US and stronger growth in Brazil and India. Rising bond yields, expected to reach nearly 3% for the US Ten-Year by year end, will be a headwind, while EM equities should receive major support from dollar weakness against the euro and commodity prices. Commodity prices, including those of oil, gas and metals, should rise further, though at a slower rate. This should benefit the commodity exporting, EM countries, especially those in Latin America.

EM equities are expensive at nearly 13 times forward earnings, against a historic average of 11 times forward earnings. Although this is justified by low current bond yields, we expect some multiple compression in 2018 as developed country interest rates rise. Still, the decline in earnings multiples should be more than offset by high single digit earnings growth, estimated at 9% (against a 13% consensus). This still pales in comparison with last year's 24% earnings gain.[24] The anticipated earnings growth decline is attributable

> We expect EM value to outperform EM growth in 2018

22 Bank Credit Analyst, op. cit.

23 UBS EM Equity Strategy, 2018 Outlook, January 11, 2018.

24 IBID.

to smaller increases in EM nominal GDP growth, more modest memory chip price increases and slower gains in the prices of exported goods. In contrast to last year, we expect value stocks to outperform growth stocks. Financials should become the biggest earnings contributor rather than tech, with commodity sectors dropping near the bottom from near the top.

Despite the attractive expected return, estimated at 7%, relative to that in the US estimated at slightly above 4%, we are reluctant to overweight EM equities because risks in this volatile asset class are skewed to the downside. These risks include a sharper than expected increase in US short-term interest rates, a selloff in global equity markets, a more hawkish shift in US trade policy, elections in several key countries and a more severe contraction in the Chinese economy than anticipated.

Fixed Income

For the past two years, we have positioned portfolios for moderately higher Treasury rates without adhering to a "sky is falling" view of rates rising rapidly. Both 2016 and 2017 followed the similar pattern of rates falling mid-year but finishing the year largely unchanged. Returns have been modest for core fixed income, and spread product, namely US corporate high yield, has outperformed. The US Treasury yield curve flattened in 2017 and the difference between the two-year and 10-year Treasury yields ended the year at 52 bps, a decline of 75bps since January. Three Fed hikes pushed yields up on the front end of the yield curve and modest inflation expectations kept long rates anchored in 2017.

EXHIBIT 4: US TREASURY DIFFERENTIAL: TWO-YEAR VS 10-YEAR YIELDS

We have not changed our opinion on the path of the Federal Reserve due to Jerome Powell's appointment as Federal Reserve Chair. While Powell is not a trained economist, he has been a member of the Federal Reserve Board of Governors since 2012 and has voted alongside Yellen throughout her term as Chairwoman. We expect Powell to continue Yellen's conservative path of measured tightening with a watchful eye on capital market events, although future appointments to the Board could alter this view.

As we have stated, we expect three hikes next year with a chance of a fourth if volatility remains low. The cumulative effect of multiple Fed hikes, Fed balance sheet runoff, an uptick in US inflation, budget deficits and above trend global growth will be higher rates by year end across the yield curve. However, we see 3% yield on the 10-year Treasury as an important psychological threshold unlikely to be breached. As seen in Exhibit 5, our estimate of the present equilibrium 10-year Treasury yield has increased to 2.80% from our September estimate of 2.78%. Based on our model, which uses the geometric mean forward Fed Funds rates, the ten-year zero coupon yield is expected to rise to 2.97% in 12 months against a current rate of 2.52%. Given our outlook of modestly higher rates across maturities, we continue to maintain our positioning in shorter dated, higher yielding fixed income strategies. Portfolio risk reduction through the use of cash or short dated maturities outweighs the purchase of long dated Treasuries until yields move materially higher.

We expect higher yields across the Treasury curve

EXHIBIT 5: ESTIMATED EQUILIBRIUM YIELD FOR 5- AND 10-YEAR TREASURIES GIVEN LIKELY HIKES IN THE POLICY RATE

	Now	End of 2018 Assuming 75 bp incr in 2018	End of 2019 Assuming 75 bp incr in 2019	End of 2024 Assuming 0 bp in 2024	End of 2025 Assuming 50 bp incr in 2025	End of 2026 Assuming 0 bp in 2026	End of 2027 Assuming 0 bp in 2027	End of 2028 Assuming 0 bp in 2028
DMCA Estimated Nominal Fed Funds Rate*	1.33%	2.08%	2.83%	2.83%	3.33%	3.33%	3.33%	3.33%
Subtract Projected Inflation	1.96%	1.85%	1.96%	1.96%	1.96%	1.96%	1.96%	1.96%
Real Fed Funds Rate	-0.63%	0.23%	0.87%	0.87%	1.37%	1.37%	1.37%	1.37%
Average Short-Term Rate		1.71%	2.46%	2.83%	3.08%	3.33%	3.33%	3.33%
Yields Constructed Using Product of Nominal Fed Fund Rates for Each Year	5yrs	2.53%						
	10 yrs	**2.80%**						
	10y 1y fwd	2.97%						
	5y 1y fwd	2.75%						
10 year Treasury Strip (Actual yield, Bloomberg):		**2.52%**						

Data as of Dec. 31, 2017. Source: Bloomberg, Federal Reserve Bank of St. Louis
* Fed Funds rate shown is the average of the day before and day after.

Municipal Bonds

Municipal bond returns were more volatile in the fourth quarter while Congress hashed out the details of the tax plan. Municipals finished up 0.8% in the quarter and 5.5% for the year. Once the dust settled, the net change to future tax exempt issuance was less than anticipated. Looking forward, there should be a muted impact on the balance between supply and demand. Barclays estimates $90-100 billion in supply will be removed from the market primarily due to the ban on issuance of tax exempt debt for advanced refundings.[25] Private activity bonds will retain their tax exempt status under the final Bill. Demand in 2018 will also decrease as municipal bonds are less valuable to corporations now paying a lower tax rate. State and local tax (SALT) deduction limitations may lead to increased demand in high tax states but not enough to offset corporate demand. In November and December, supply increased as many municipalities issued bonds before year end. Municipals outperformed Treasuries in the fourth quarter, and

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we expect municipals to outperform in the near term as the supply is digested. As the year progresses, municipals will likely perform in line with Treasuries. Longer term, municipal bonds are attractive for buy and hold investors compared to Treasuries, particularly in high tax states.

Spread Product

Corporate bonds performed well in 2017 following a strong 2016. The Bloomberg Barclays Investment Grade Index returned 1.2% in the fourth quarter and 6.4% for the year and the Bloomberg Barclays High Yield Index returned 0.5% in the fourth quarter and 7.5% for the year. Spreads versus comparable maturity Treasuries in both investment grade and high yield are now very tight historically and we see little room for additional tightening looking forward. Fundamentals for corporate bonds should improve due to a favorable macro backdrop and the benefits of a lower corporate tax rate; however, the tailwinds from declining Treasury rates, asset purchases in Europe and retail flows may reverse. Coupon income will likely exceed the total return for corporate bonds in 2018 due to higher Treasury rates and spread widening. We are most concerned about the lowest rated credits (CCC and below) at current spread levels due to the negative impact of the interest expense limitation and the compounded effects during periods of poor earnings. [26]

EM bonds returned 1.2% for the fourth quarter and 10.3% for the year as measured by the JP Morgan Emerging Market Bond Global Diversified Index. The US trade-weighted dollar strengthened in the quarter, but higher yields on EM sovereign bonds contributed to positive performance. Looking forward, the Organization for Economic Co-operation and Development (OECD) growth estimate for EM economies is 4.9% for 2018 and inflation is predicted to remain stable. [27] Overall EM inflation declined in 2017, helped by Russia and Brazil, and commodity prices have stabilized. The growth and inflation outlook for EMs should lead to more predictable central bank behavior, and we expect EM bonds to outperform US Treasuries in 2018. Our global fixed income managers still favor EM to developed sovereign bonds although country selection remains important due to currency fluctuations and geopolitical risk.

Conclusion

The year of 2017 provided a near perfect storm of bullish catalysts for equity investors, one we underestimated a year ago. Global growth surprised to the upside, particularly outside of the US and global inflation remained low. Low inflation gave the Fed room to normalize rates and unwind its balance sheet gradually, and other central banks maintained transparent, easy monetary policy. Domestic earnings grew substantially and future earnings received a boost from the passage of the TCJA while earnings of companies outside the US also grew at double digit rates. Risks we identified also did not materialize or were ignored by global equity investors. China's policies to curb credit growth did not lead to a bubble bursting or introduce volatility into EM and commodity markets. Also, populist concerns in Europe which were front page news in the spring were all but forgotten by investors by year's end. Finally, the current Administration, an unforgettable feature of 2017, did not upset markets, only the media.

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[26] Beginning in 2018, corporations will only be able to expense interest which amounts to less than 30% of EBITDA. In 2021, the denominator changes to EBIT. This will provide an additional negative impact on a leveraged company in a year in which earnings decline (i.e., it will lose the expense.)

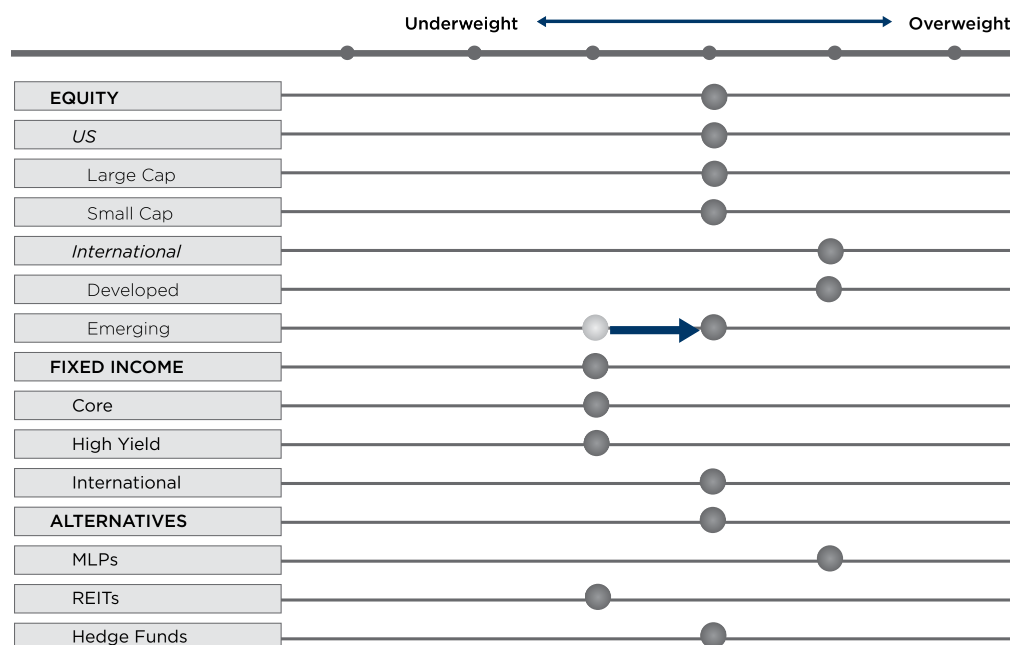
[27] OECD General Assessment of the Macroeconomic Situation

Our base case scenario for 2018 largely reflects a continuation of 2017 trends; however, we do not forecast equity returns similar to 2017. Our forecast reflects our outlook for slowing growth in 2019, continued quantitative tightening and rate normalization by the US Federal Reserve and the reduction of other central bank accommodation towards the end of 2018 and into 2019. This will result in higher bond yields and multiple compression limiting the advance of equities despite earnings growth. While inflation has not yet reached 2% in advanced economies (outside of the UK), businesses have underinvested in growth for nearly a decade and now output gaps are closing globally and labor markets are tight. We believe these inflationary pressures will mandate the ECB and BoJ to follow the Federal Reserve's path of exiting quantitative easing and begin a path of interest rate normalization. We expect single digit returns from US equities and high single digit returns from non-US equities coupled with more downside in a risk-off scenario. We cannot predict when the current ultra-low volatility regime across virtually all asset classes will end, but an uptick in volatility and a drawdown in equities in excess of 5% is long overdue and would likely lead to investors reassessing the risk in their portfolios.

Despite strong growth, inflation and higher yields will lead to multiple compression and limited equity returns

Even if they are not derailed, but an unexpected rise in inflation/interest rates occurs, global equity markets are vulnerable in the year ahead given their steady, rapid rise and growing investor optimism/complacency. For this reason, the most recent advance in equities has caused us to trim the equity weightings in portfolios back to target weights. We remain equal weight in domestic equities while overweight in developed international equities and slightly underweight in EMs. In fixed income, our underweight in core fixed income reflects our concern that long-term rates may move higher. We favor cash or short duration strategies as risk mitigants in portfolios, and we are conservatively positioned in credit. Finally, we had increased our exposure to master limited partnership (MLPs) during the second half of 2017. They have started to rebound and we believe they will continue to recover in 2018 with tax loss selling and tax plan uncertainty behind us. Our current recommended asset class weightings are in Exhibit 6.

EXHIBIT 6: DMCA ASSET CLASS VIEWS AS OF DECEMBER 31, 2017



Source: DMCA

Risks to our Outlook

Our outlook is subject to the following left tail risks not fully reflected in market prices:

- Geopolitical risks discussed in earlier reports.
- Unexpected cyberattacks.
- A severe slowdown in China with the Chinese Yuan coming under pressure.
- Sharply higher global inflation as growth rates accelerate.
- 10-year US Treasury yields rising much faster and to a higher level, e.g., 3.5%.
- Renewed steps toward trade protectionism and more aggressive Fed rate hiking pace as inflation unexpectedly rises in the US.

We wish you a Happy and Prosperous New Year.

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