Drexel Morgan Capital Advisers

Global Economic and Market Commentary

Third Quarter 2016

"…investors would be well advised to remember that there is an impending limit to how much liquidity injections can protect markets from underlying economic reality."[1]

Summary

- *A rebound in per share earnings is likely in the US, and US equity markets are not as stretched as they first appear.*
- *A global pivot toward fiscal policy is occurring.*
- *Excess pessimism about the outlook for global growth exists.*
- *Inflation is underpriced and TIPS are attractive.*
- *Risk of combined equity and bond sell-off has become more pronounced.*
- *EM equities are vulnerable to higher than expected rate hikes in the US.*
- *China's short-term outlook has improved, but large credit and housing bubbles pose long-term threats.*

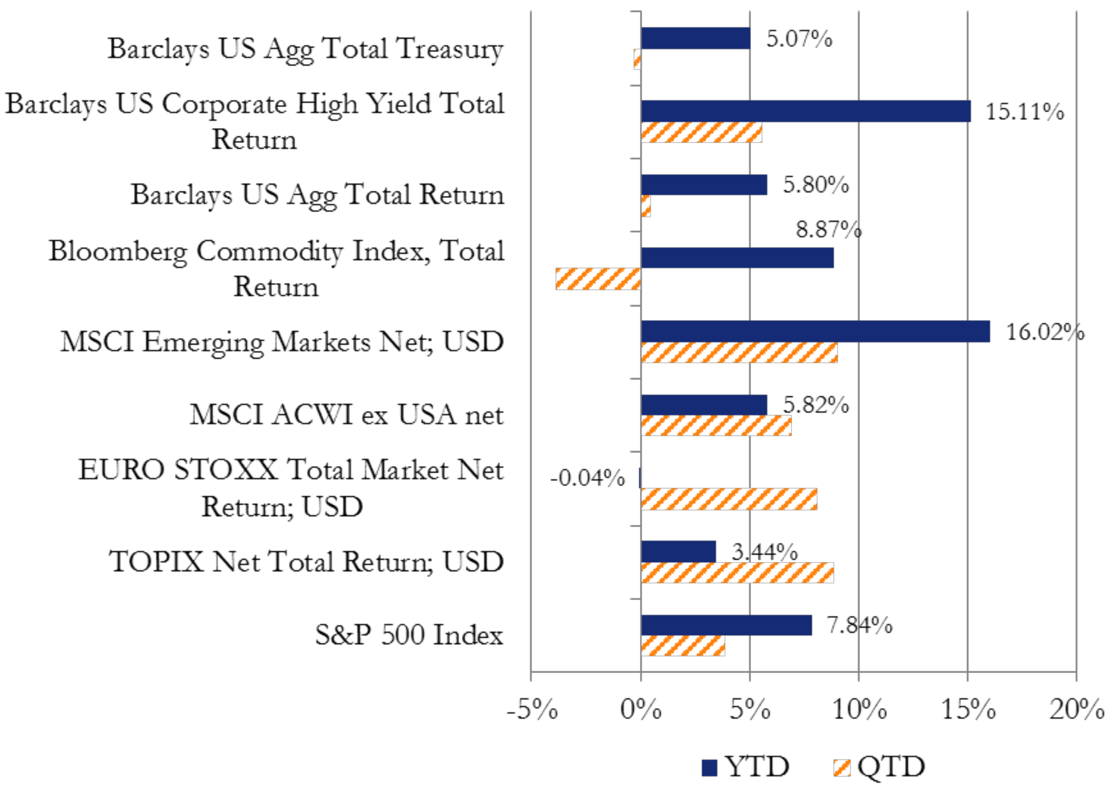
The surprising strength of financial markets in the third quarter was the result of an increase in risk appetite, positive macroeconomic surprises in July and August in the G10 countries, and the belief of market participants that interest rates would stay lower for longer. Relentless liquidity expansion caused further declines in global bond yields, while the MSCI World Index continued to rally despite downgrades in global growth forecasts by the IMF and other institutions. The 5.6% quarterly return on global equities was attributable to multiple expansion since aggregate per-share earnings were flat or declining.

Central banks became increasingly resourceful in the third quarter. The unconventional monetary tools included negative interest rates on reserves at the ECB and the BOJ, as well as continued quantitative easing by central banks outside the United States. Even though the US economy is operating at full capacity, the Fed has continued to keep real short-term rates at emergency levels. The low and even negative long-term interest rates resulting from these policies induced investors to accept lower earnings yields in the equity markets and to bid up bond prices.

Possibly due to greater monetary accommodation outside the US, non-US equities outperformed US equities, with the return on the MSCI AllCountry World ex-US Index outperforming the S&P 500 by 2.5 percentage points. Emerging markets and Japan saw the largest equity gains, with their markets returning 7.6% and 7.2%, respectively. The Chinese market returned to 13.9% as a result of stronger-than-expected macroeconomic data. Capital flows were also a factor driving emerging market (EM) equity markets higher.

[1] Mohammed El-Erian, Chief Economic Advisor, Allianz.

Exhibit 1: Global Capital Market Returns YTD and QTD through September 30, 2016



Source: Bloomberg, Barclays Live

The contrast between real economic and financial market performance remained marked. Despite the run-up in stock prices, the same low growth environment seems to characterize many advanced and EM economies. The main characteristics of this environment are stagnant productivity growth, low investment rates and subdued private sector confidence.

Until recently, global growth indices illustrated the general malaise in the global economy that swamps isolated signs of strength in some economic indicators in a few countries. The global economy seemed to be caught in a low level equilibrium trap. Such factors as negative real interest rates, low growth, fragile business and consumer confidence, financial system stresses, trade tensions and political instability have fed into and reinforced each other.[2]

In most countries there were only limited signs of strong policy actions, including structural reform and government finance of infrastructure investments needed to break this negative feedback loop. Rather, many of these countries kept depending on the expansion of global liquidity. That said, in certain advanced countries, there is increased recognition that monetary stimulus has become ineffective and the only alternative is fiscal stimulus. According to JP Morgan,[3] there are

[2] Global Economy Remains Mired in Swamp of Low Growth, Eswar Prasad, Financial Times, October 3, 2016.
[3] As cited by Gavyn Davies in "The Global Pivot Toward Fiscal Policy," Financial Times, September 25, 2016.

indications that fiscal policy in developed countries has become "slight expansion" following several years of intentional austerity. This, along with major fiscal stimulus in China, explains the recent improvement in the Nowcast estimates of GDP growth.[4]

US Economic and Market Outlook

The US economy continues to send mixed signals. The leading economic indicators have been declining since February and industrial production was subdued through most of the third quarter, although a marked upturn in the manufacturing and non-manufacturing PMIs occurred in September. Investment and productivity growth have remained somewhat subdued, but employment growth has continued to be strong, labor force participation is recovering and wage growth has picked up.

The recovery of the shares of financial firms in recent months raised the S&P 500 return to 3.9% in the third quarter and eased concerns that advances in stocks were not sustainable without financial sector participation. In the third quarter, the S&P 500 rebounded from the turbulence created by the UK in June to reach a new record. The Index went two months without a move of 1% or more per day until September, when investors more aggressively sold and repurchased stocks and bonds amid conflicting signals from the Fed.

The quarter's gains in financial shares, as well as a rally in technology stocks, marked a shift in market leadership and may have been an encouraging sign of the durability of the 6.1% rally that the S&P 500 has seen this year. Investors have been shifting to those more aggressive sectors and out of shares of utilities and telecom companies that tend to do well in bad markets.

With the Fed signaling it wants to raise rates by the end of the year, financial shares should be poised for a further gain. However, the US elections (the Congressional more than the Presidential) could prompt additional bouts of volatility and aggregate corporate earnings per share have been weak. Earnings are expected to fall by 2.1% from a year earlier in the third quarter. According to Factset, this would mark the sixth consecutive quarter of falling aggregate per-share earnings in the S&P 500 Index,[5] which supports the view that the third quarter rally may have been due to a temporary change in risk attitudes.

Even though certain leading economic indicators have been negative since February and the economy is close to full employment, we do not believe that the US economy is at a cyclical peak and about to decline. We believe that rising employment and increasing wage gains will keep household consumption growth high through next year and we expect the year-over-year aggregate per-share earnings growth to turn positive in the fourth quarter and remain so in 2017. This should help support the US equity market though valuations are extended.

[4] Nowcast estimates are released from Fulcrum Asset Management monthly.
[5] As cited in the Wall Street Journal, October 2-3, 2016.

Note that the aggregate per share earnings numbers in the US are misleading due to the overweighting of energy sector profits. Even though aggregate earnings declined in the second quarter, the median S&P 500 company reported a 6.5% increase in earnings per share on a year-over-year basis. Most of the declining earnings were the result of the 76% decline in energy company profits. Seven of the 11 S&P 500 sectors are expected to have positive year-over-year earnings growth in 2016, five of them in excess of 10%; thus the outlook for sectoral median earnings gains flies in the face of the lack of growth reflected in 2016 aggregate earnings expectations.[6]

There has also been a marked reduction in the incidence of downward earnings revisions as reflected in the diffusion index for the S&P 500 for the next year earnings. While the current expected growth of aggregate earnings for 2016 is -.1%, 2017 earnings are expected to increase by 13.8%.[7] Admittedly, consensus estimates for a period ending 12 months in the future have on average been revised downward by 10.2% over that period. Still, there are reasons to believe 2017 earnings will be more resilient relative to consensus than average. Because they have experienced two years of zero earnings growth and have had to make larger than average downward revisions in 2015 and 2016, analysts are likely to be more cautious in their earnings estimates for the next year. Thus, the current 13.8% growth estimate for 2017 might be less of an overstatement than would be suggested by the average revision pattern. Moreover, the two main drivers of recent revisions, falling oil prices and a rising US dollar, have stabilized, at least for now. For these reasons and because stocks are not as dangerously overvalued as the standard cyclically adjusted Price to Earnings (CAPE) ratio indicates, we would not be surprised by an earnings-driven market gain in the US in 2017, although there is likely to be some multiple compression.[8]

Other Advanced Countries

The UK economy appears to have survived the worst of the immediate fallout from the leave vote, with most of the financial market indicators recovering quickly from their post referendum declines. Business, more than consumer, confidence remains subdued.

The longer term outlook for the UK seems to be fraught with uncertainty. For example, by announcing that she will start the formal negotiations for Britain to leave the EU by March 2017, Theresa May, the UK Prime Minister, has painted herself into a corner. She committed herself to a date for invoking Article 50 of the Lisbon Treaty, which marks the beginning of formal departure

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[6] Smith Asset Management Market Perspectives, September 2016.

[7] Ibid.

[8] There is evidence that Shiller's cyclically-adjusted price to earnings ratio (CAPE) is biased upward due to the use of GAAP earnings data, which have been inconsistently estimated. Using national income and product account (NIPA) data for after tax earnings, the Wall Street Journal estimates a CAPE of 19, well below the current estimate of Shiller's CAPE of 27. Jeremy Siegel uses a similar methodology to show that the market is 19% overvalued, not 56% overvalued. See "Shiller's Powerful Market Indicator is Sending a False Signal About Stocks This Time," WSJ, October 6, 2016 and Jeremy Siegel "CAPE Ratio: a New Look," FAJ, Volume 72 #3, 2016.

negotiations, without insisting that the EU commit to an interim agreement. This agreement would become effective if a definitive understanding had not been reached by the two-year deadline specified in the Lisbon Treaty. Given this deadline, the EU can simply delay, aware that time is not on the UK's side without an interim arrangement. At the end of two years, Britain would be out of the EU and would face WTO tariffs on all traded manufactured goods, independent of source and destination, and the loss of passporting that allows financial service firms based in the UK to do business in the EU. The economic damage from this kind of "hard" Brexit would be substantial.[9]

The euro area remains a source of concern. Deflationary pressures have eased slightly and growth has picked up in some countries. However, an environment of negative interest rates has exacerbated the problems of undercapitalized banks, insurance companies and pension funds, exposing the general weakness of the European financial system. Some countries in the region have been wracked by social and political instability, hampering business confidence and investment.

Goldman Sachs currently forecasts fiscal easing in the euro zone of around 0.5% of GDP in 2016 and 0.25% of GDP in 2017 and sees risks to these estimates moderately skewed to the upside.[10] This is in sharp contrast to the major fiscal drag in the euro area during the 2012 to 2014 period. Positive fiscal stimulus should result in continued demand growth in 2016 and 2017, especially when combined with stronger consumer purchases. European exports should be stronger in 2016-17 because we anticipate a pickup in global GDP growth. Corporate earnings should contract by approximately -5.0% in 2016 and increase by around 11.0% in 2017. The banking sector still remains a major source of risk as indicated by the recent Deutsche Bank debacle. However, over time we believe that a strengthening of European bank balance sheets will occur mainly as a result of support from the ECB.

The drivers of the euro zone domestic demand recovery lost traction in the second quarter, causing GDP growth to slow to a two-year low. However, data for the third quarter suggest that the economy's momentum has picked up and we see quarterly growth rising 0.4% from 0.3% in Q2. We are calling for GDP growth of 1.6% in 2016 and 1.7% in 2017 which is substantially above the IMF's estimate of 1.0%. While elevated political uncertainty and sluggish loan growth are obscuring the outlook, supportive monetary conditions, an increase in fiscal stimulus and improving labor market conditions continue to underpin the region's growth prospects.

We are underweighting stock of companies exposed to the UK economy and have a neutral weight on MSCI Europe ex-UK. Even though we anticipate above trend growth in Europe, the spread between European and US valuations is close to normal and we are concerned about political uncertainty and financial sector stresses as well as rising euro skepticism. Still, we are putting a neutral weight on the EAFE ex-Japan Index which includes Australia, New Zealand, Hong Kong and

[9] Gideon Rachman: "Theresa May walks into a Brexit Trap." Financial Times, October 3, 2016.
[10] Gavyn Davies, Op. cit.

Singapore as well as Europe. The outlook for these markets is good given the rebound in the Chinese economy. The Cyclically Adjusted Price to Earnings Ratio (CAPE) for EAFE ex-Japan relative to that of the S&P 500 is more than one standard deviation below the historic average, indicating significant relative undervaluation.

Japan

The MSCI Japan 12-month forward P/E, at 13.5, is cheaper than the MSCI Europe's 12-month forward P/E of 14.4.[11] In addition, we forecast a modest reacceleration in Japan's volatile growth. Our forecast for the Japanese economy calls for heightened expansion of over 1% per annum in the second half of this year and in 2017, a pace that is above Japan's potential growth rate and which comes against the backdrop of an already very low unemployment rate. This forecast is based on the assumed positive effect from the large multi-year fiscal stimulus announced by the government in August, which Barclays estimates as 5.6% of annual GDP.[12] Thus, overestimating the effects of these measures or the ease of their implementation presents downside risks to our projected growth path.

Nor is this the only reason for staying neutral on Japanese equities. The effects of Japanese monetary policy remain highly uncertain. In particular, the Bank of Japan is doing a highly experimental reverse operation twist (i.e., it is selling long dated maturities and buying short dated maturities). Given Japan's slow import growth, we see potential for further Yen strength, which is counter to the objective of Japanese policymakers, who are relying on a weaker Yen to stimulate exports. Moreover, Japanese equities have the highest volatility of any of those of any developed region or country, together with a lower dividend yield than that of any other developed market except for the US. These problems, combined with Japan's extraordinary debt overhang, make us doubtful about continued outperformance of Japanese equities.

EM Equities

EM equities have outperformed those from most other developed markets this year. This strength is attributable partly to some improvement in the real economic environment but mainly to a rally in commodity prices from a cyclical low, stronger-than-expected Chinese economic performance and a continued low interest rate environment in the DMs.

Many forecasters see the EM/DM growth gap expanding in 2017. First, better activity data in China has improved Asia's growth outlook. Our GDP forecast for China is now 6.6% in 2016 and 6.2% in 2017 which may be biased downward given recent Nowcast estimates.[13] China remains a secularly slowing economy that needs to be driven more by consumption and services. China's

[11] Yardeni Research, October 12, 2016
[12] Barclays Global Outlook
[13] Fulcrum Asset Management.

first efforts in facilitating this shift involved liberalization of the capital account, the domestic financial system and the exchange rate. Because it was accompanied by sharply slowing growth, this liberalization caused large capital outflows, equity market selloffs and general anxiety about the authorities' economic management. To counter these difficulties, China has partly reverted to strictly controlling capital outflows, while supporting growth through monetary and fiscal stimulus and exchange rate depreciation. This partial reversion to the old drivers of growth is leading to rising financial risks. For example, credit and housing prices are growing at an unsustainably high rate in relation to nominal GDP. The ratio of corporate debt to EBITDA is also becoming excessive.[14] However, the near-term implication is a less pronounced slowing of China's economy.

Steadier Chinese growth and its supportive effects on global commodity markets also support a shift in EM growth momentum. Some large EM economies, such as Brazil and Russia, are exiting long and deep recessions. Their growth rebound may be limited, but together with a steadier China, continued strong growth in India and PMIs back above 50 throughout developing Asia, this should be large enough to increase the positive gap between EM and DM growth.[15] However, there are significant macro risks that could offset these positive developments. These include political uncertainty shocks, a China growth shock, and a dollar interest rate shock. We see the China growth shock as potentially the most serious but unlikely to occur in the short term unless recent weak trade data indicate an imminent retrenchment. By contrast the political uncertainty and rate shock seem more threatening. The most obvious political uncertainty involves the US presidential election and the threat of higher tariffs on EM exports if Trump wins, which we view as unlikely. We believe that higher US short-term rates and resulting dollar appreciation could have adverse effects on EM equities in 2017. We view this as a serious problem, in that headline inflation in the US is likely to substantially exceed core inflation resulting in a sharper than expected increase in US short-term rates. In the past, Fed tightening cycles and associated dollar strengthening have resulted in relative underperformance of EM stocks, partly because commodity prices are tied to the dollar and partly because the dollar-denominated debt in EMs becomes more expensive to service. For these reasons and due to EM valuations being more stretched than other EM asset classes, we believe that EM equities are likely to underperform global equities in 2017.[16]

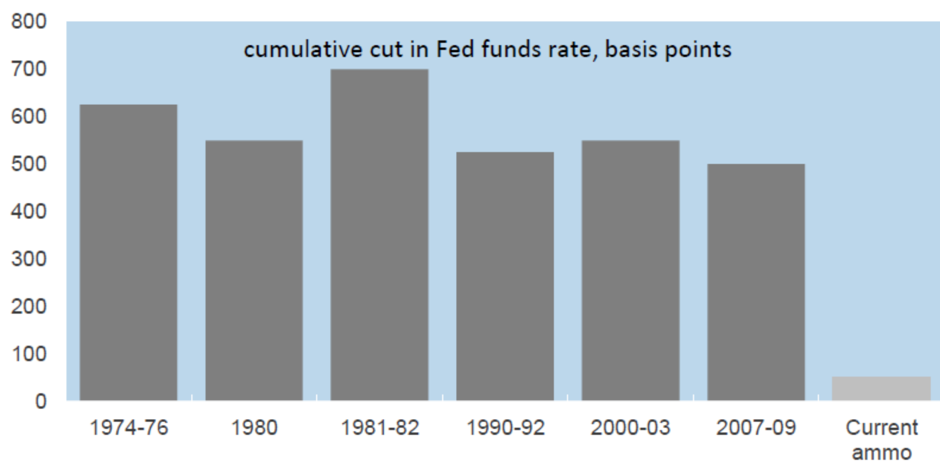
Fixed Income

As we have expressed in previous letters, the Federal Reserve's unofficial third mandate of stabilizing global markets continues to carry the most weight in FOMC decisions. Fundamental data supported a tightening in September, and we were disappointed that the Committee chose not to increase the Fed Funds rate. Another rate hike, albeit a simple concept, gives the Fed additional ammunition to counteract a recession in the coming quarters. The capital markets were

[14] Bank Credit Analyst, "EM Corporate Health is Flashing Red" and "What's Next for Risk Assets?"
[15] Mark Haefele, Global CIO, UBS Wealth Management, CNBC, August 1, 2016.
[16] Goldman Sachs, EM Strategy Views, "Breathing Room for EM but not Shock Proof," September 28, 2016, Exhibits 2,3 and 4.

prepared for a rate hike and likely would have supported the decision, i.e., an extended sell off was unlikely. We do not foresee a downturn in the near term; however, if one emerged, other forms of easing, including negative interest rate policy (NIRP), yield curve manipulation and asset purchases, have had questionable impact in Japan and Europe, making traditional easing the most favorable form of neutralizing recession-related impacts on the broad economy. In the past, the Fed has cut the Fed Funds rates by over 400 basis points (4.00%) to restimulate the real economy during economic downturns. Exhibit 2 shows how much the Fed Funds rate was cut in historical recessions compared to what is available today.

Exhibit 2: How the Fed Responded to Previous Recessions



Source: Datastream, Lombard Street Research

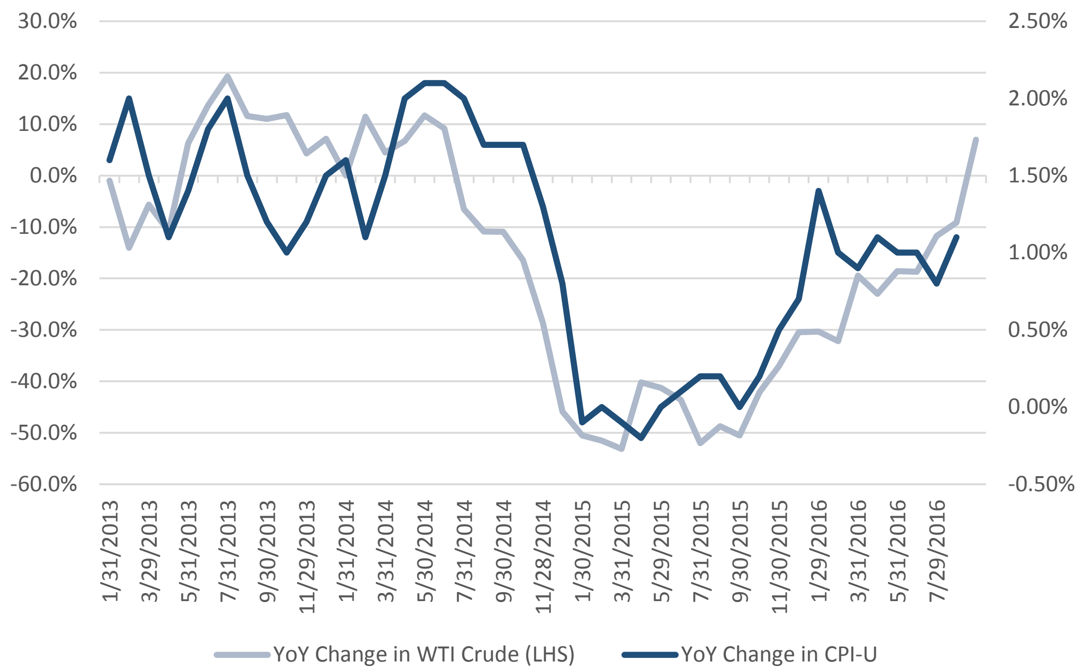
The FOMC has enacted the opposite of the famous phrase "speak softly and carry a big stick." Their hawkish communications have deterred excessive risk taking, and employing a dovish policy has ensured market participants that the Fed will err on the side of caution creating a floor when volatility has increased. Barclays refers to this as the Yellen "corridor,"[17] replacing the Bernanke-Greenspan "put," and risk assets on the whole have followed the Fed's lead by trading in a range. We foresee a rate hike in December 2016, and at least two hikes in 2017 based on our outlook for growth and the increased probability of higher than expected inflationary surprise.

Given the cautious policy stance from the Fed, the only data that forces the Fed to enact more hawkish policy is a material uptick in inflation. Core inflation (ex food and energy) has averaged 2.24% in 2016, while headline figures have barely been over 1% primarily due to depressed commodity and more specifically energy prices. We foresee the headline inflation rate rising during Q4 2016 and it may exceed 2% for 2017. The latest release for the year over year change in the headline CPI was 1.1%; however, as seen in Exhibit 3, headline inflation has a close relationship with the percentage year over year change in oil prices. If oil remains at $50 for the next year,

[17] Barclays Global Outlook Page 6.

prices will be approximately 20% higher on average for 2017, consistent with an inflation rate of 2% or higher based on Exhibit 3 below.

Exhibit 3: Year over Year Change in CPI-U and Year over Year Change in Front Month Oil Futures Contracts



Source: Bloomberg

We do not predict runaway inflation, but for accounts holding Treasury bonds, we now prefer to hold Treasury Inflation Protected Securities (TIPS). Breakeven yields are currently at or about 1.5% for most maturities, which is below our inflationary expectations. In other words, if inflation exceeds 1.5% for 10 years, TIPS would outperform a comparable maturity treasury bond.

Yields on Treasuries finished the quarter higher and the ten-year Treasury yield is currently 1.75%. The ten-year yield touched 1.32% in early July, a historic low dating back to 1790, amidst Brexit, NIRP and global growth concerns. It is an understatement that Treasury yields do not reflect fundamentals of the US economy, and the interest rate market can be best described as manipulated. For example, Treasury yields rose in late September following the speculation that the ECB may taper its bond purchases. From our view, the Fed will hike multiple times in 2017 and inflation data should apply upward pressure on yields; however, foreign demand will remain consistent and keep yields anchored below 2% in the near term. As seen in Exhibit 4, which does not take non-US central bank policy into account, our estimate of the present equilibrium ten-year yield has increased to 2.48% from our June estimate of 2.18%. Based on our model, which uses the geometric mean forward Fed Funds rates, the ten-year zero coupon yield is expected to rise to 2.67% in 12 months against a current rate of 1.81%.[18]

Exhibit 4: Estimated Equilibrium Yield for Five and Ten Year Treasuries Given Likely Hikes in the Policy Rate

	Now	End of 2016	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*	0.40%	0.75%	1.50%	2.25%	3.00%	3.00%	3.00%
Subtract projected inflation	1.60%	1.70%	1.70%	1.90%	1.95%	1.95%	101.95%
Real Fed Funds Rate	-1.20%	-0.95%	-0.20%	0.35%	1.05%	1.05%	-98.95%
Average short-term rate		0.58%	1.13%	1.88%	2.63%	3.00%	3.00%
Yields constructed using product of nominal Fed Fund rates for each year	5 yrs	2.30%					
	10 yrs	2.48%					
	10y 1y fwd	2.67%					
	5y 1y fwd	2.60%					
10 year Treasury strip (actual yield, Bloomberg):		**1.77%**					
Data as of September 30, 2016. Source: Bloomberg							

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

* This trajectory is slightly below that estimated by Curdia using real time estimates of the real equilibrium interest rate (natural weight). Ref: Vasco Curdia "Why so slow" FRB-SF October 12, 2015; http://www.frbsf.org/economic-research/publications/economic-letter/2015/october/gradual-return-to-normal-natural-rate-of-interest/

Municipal Bonds

Municipal bonds have performed well, up 4.08% year to date, and the municipal bond yield curve has flattened (long end yields have declined) in concert with the Treasury curve. For the last 12 months, municipal mutual funds have had positive weekly inflows due to investor demand for income, money market reform causing investors to substitute money market funds for longer maturity funds, and the relative attractiveness of municipal bonds versus Treasuries. The ratio of Municipal yields to Treasury yields is 95.5% as of September 30th. New issue supply has been robust to meet demand as municipal issuers are taking advantage of current low yields and the cloudy outlook on the path of interest rates in the future. BBB spreads have now compressed near historical lows, so we favor better quality credits and expect coupon income to provide the majority of returns for the next 12 months.

[18] Strip Data- WSJ or Bloomberg.

Spread Product

Corporate credit, both investment grade and high yield, performed very well in the third quarter. Investment Grade (IG) (as described by the Barclays Corporate Index) returned 1.41% and High Yield (HY) (as described by the Barclays High Yield Index) returned 5.55%, tightening 114 bps in the option adjusted-spread in the third quarter. Corporate bonds in aggregate benefitted from a number of factors. First, investor flows sought out US credit en masse (and EM debt) once concerns about a post-Brexit crisis quickly abated. Second, the ECB's Corporate Sector Purchase Program (CSPP) has pushed European fixed income investors into the US corporate market due to low absolute yields and excessively tight spreads in Europe. Third, fundamentals are attractive for credit. Energy defaults have been minimal and a slow growth environment benefits corporate bonds. Issuance in the US is set to break previous records as corporations are terming out debt and demand remains strong in the primary market. Absent a severe correction in commodity prices, US corporate credit remains attractive. We advocate lower rated investment grade bonds and higher rated high yield bonds which are fundamentally sound but offer potential spread compression without taking significant risk. Lower rated high yield credits performed extremely well in Q3 (CCC up 21.00% and 25.55% YTD), and we see more downside than upside at current spreads.

EM debt has also been a beneficiary of a dovish Fed, commodity price stability, better than expected growth from China and an increased appetite for risk from global investors. Both local currency bonds and dollar-denominated debt have performed well year to date with local currency bonds returning 15.09% (as described by the Barclays Emerging Market Broad Local Currency Bond Index) and dollar denominated bonds (as described by the Citi Emerging Markets US Dollar Government Bond Index) returning 14.88%. However, the spread in nominal yield between EM sovereign debt and comparable US treasuries has not dipped below its historical average but was well above at the beginning of the year.[19] The stable US dollar has enabled EM currency appreciation despite China's steady devaluation of the Yuan over 2016. Similar to US corporate credit, EM debt offers attractive yields relative to developed sovereign bonds and fundamentals have improved. Inflation has declined in many EMs, widening the gap in real rate differentials versus the US and broadening the appeal for EM bonds. Also, EM central banks can embark on easier monetary policy which should decrease sovereign yields. Our outlook of a widening growth gap between EM and DM countries and stable or increasing commodity prices keeps EM debt attractive despite the year to date gains. The primary risk is dollar strength due to multiple rate hikes, but we don't foresee the trade-weighted dollar appreciating nearly as rapidly as it did in 2015. Moreover, most EM currencies are still substantially undervalued in relation to the US dollar, and thus, are unlikely to weaken much especially in view of the substantial carry trade opportunities.[20]

[19] Goldman Sachs op. cit.

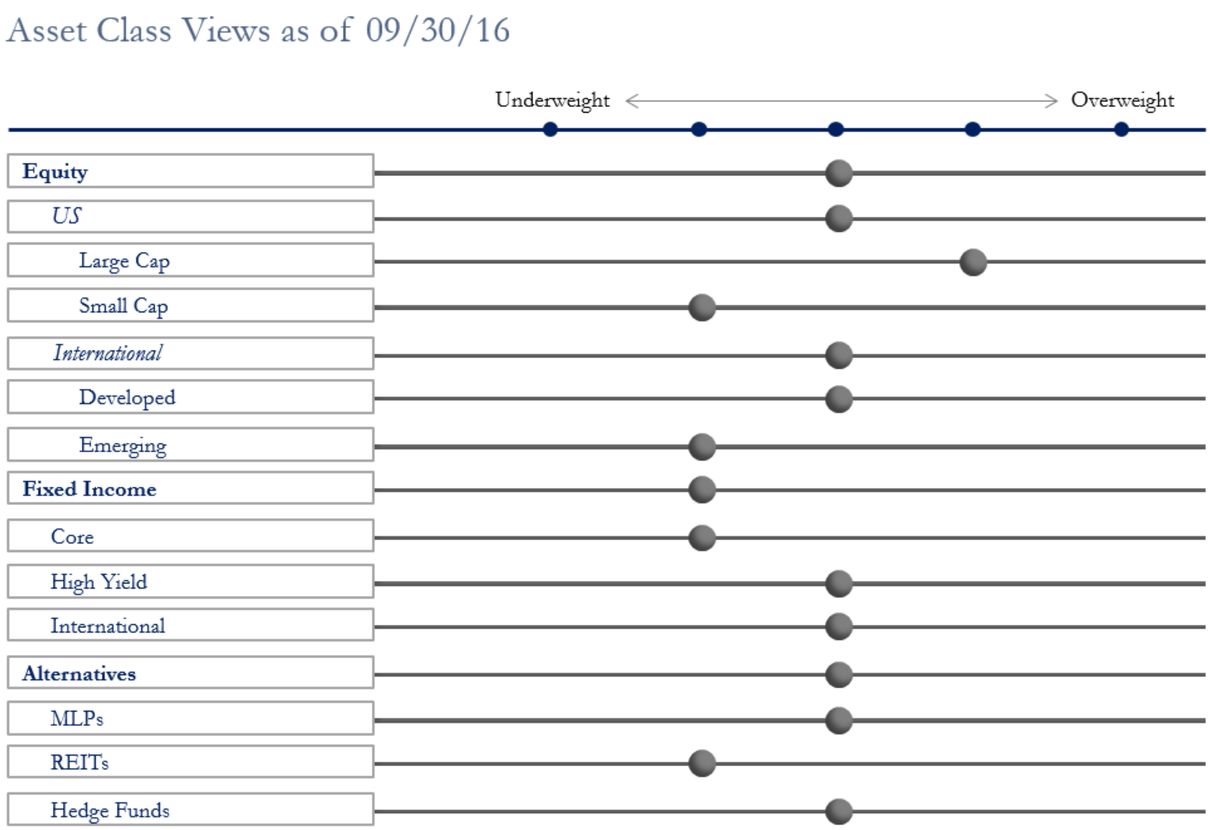
[20] Goldman Sachs estimates that EM currencies are the most undervalued of the EM asset classes. See Goldman Sachs op. cit.

Conclusion

We expect a modest 20-30bps increase in the global GDP growth rate in 2017. Our outlook is for improved advanced country consumption growth as a result of higher employment levels, greater income gains, and strengthening balance sheets. The Chinese economy also appears steadier, which has enhanced the prospects for higher income growth and increased or stabilized commodity prices.

If oil prices remain roughly constant and there is only a modest rate hike by the Fed and modest appreciation in the trade-weighted dollar, global equities should deliver mid-single digit returns along with BB high yield bonds and EM credits. At the same time, we anticipate negative returns for advanced country sovereigns and investment grade bonds. We are neutral on MSCI EAFE stocks, underweight EM equities, and slightly overweight US equities.

Exhibit 5: DMCA Asset Class View as of September 30, 2016



Source: DMCA

There are a number of left tail risks, not fully discounted in market prices, which could result in our base case outlook for risky assets being overly optimistic.

- Britain's decision to lean toward a hard Brexit might have more far reaching consequences than the highly local ones we expect.
- Housing is now 70% of the net worth of Chinese households as a result of housing returns being in double digits for some time.[21] Efforts to deflate this pronounced housing bubble, as well as reign in overall credit growth, could result in a Chinese hard landing.
- In the US, 12-month forward earnings multiples as high as the current ones (about 17x) have resulted in a higher probability of significant drawdowns averaging 24% in the past.[22]
- The Fed could be substantially behind the curve and forced to make more than two 25 basis point hikes in 2017 as a result of inflation surprises, even modest ones. With bonds priced for persistent low inflation, these surprise hikes could cause significant volatility and a sustained rise in yields which would undermine equity valuations.
- The resumption of dollar strength may be more significant than expected leading to greater weakness in US multinational corporate profits and EM equities than we call for in our outlook.

Because the abnormally low interest rate environment and below trend expansion in most countries leave little room for policy error and little cushion for macroeconomic surprises, we are taking a modestly defensive stance despite our base case outlook for improving global growth. In addition, with both stock and bond market valuations artificially high, the margin of error against earnings or interest rate disappointments becomes very thin. Risks associated with slower Fed easing, a sharp increase in the dollar and a sharp decline in Chinese growth have materialized in 2013, 2014 and 2015, respectively, but markets then were in a better position to absorb them than they are now.

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

Sincerely,

James L. McCabe, Ph.D. Erich M. Hickey, CFA

[21] "China's Housing Gets Scarily Expensive," Bloomberg View September 15, 2016.
[22] See Goldman Sachs Global Asset Allocation Outlook, September 2016.

Important Information

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

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

Statements in this commentary that are not historical facts are forward-looking statements based on the investment team's current expectations and assumptions of economic and other future conditions and forecasts of future events, circumstances and results. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied by such statements.

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The analysis provided should not be relied upon as the sole factor in an investment decision, but as illustrations of broader economic themes.

We assume no obligation to update any forward-looking statement made by us or on our behalf as a result of new information, future events or other factors.

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