Drexel Morgan Capital Advisers

FIRST QUARTER 2017

Global Economic and Market Commentary

Summary

- Easy policy and fiscal optimism, which supported the US market through Q1, are fading.
- The global business recovery, which started in the first quarter of 2016, is continuing.
- We prefer equities with low downside capture to fixed income and selected credit over government bonds.
- We prefer Japanese and European equities absent a euro-skeptic French president.
- The valuations of these non-US equities look more reasonable and gains have been driven mainly by expected earnings growth rather than multiple expansion.

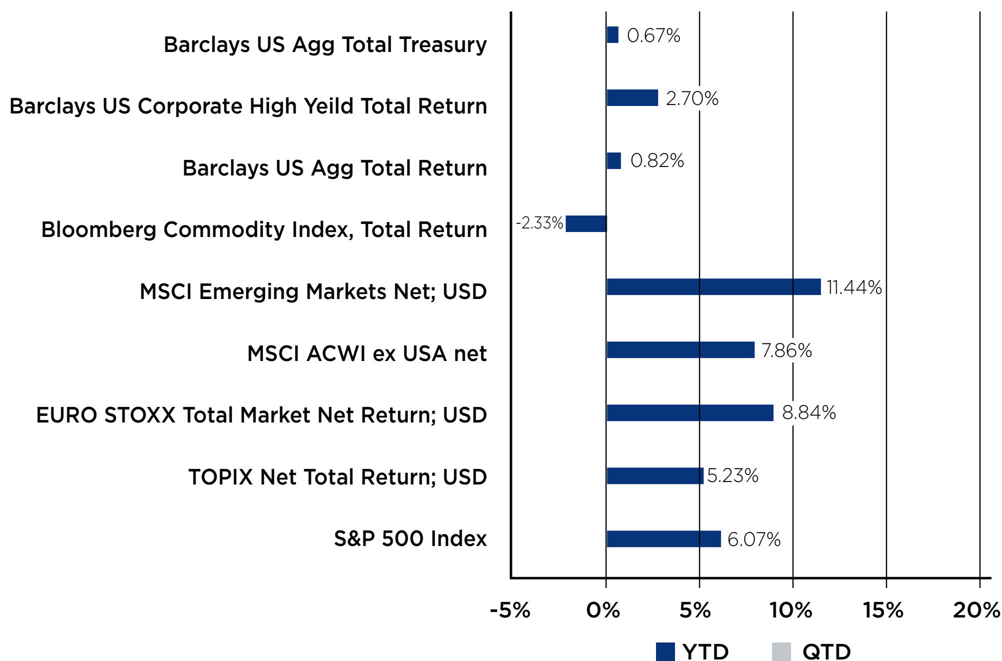
"A recent suggestion that policy gridlock should now be embraced as a buying opportunity is too convenient as those same strategists urged us to buy last November in anticipation of what a Republican controlled government would accomplish."

– Kopin Tan, Barron's, "The Pause that Refreshes."

Before US markets paused in March, January and February 2017 witnessed an extension of the post-election rally. The S&P 500 and the Dow returned 6.07% and 5.19%, respectively, for the first quarter. Notwithstanding the rise in these indices, there was a reversal of many popular post-election trades, indicating reduced policy optimism. Investors reasoned that if Mr. Trump could not repeal and replace his predecessor's healthcare bill in late March, he would have difficulty meeting his campaign promise to effect major tax cuts which investors had been relying on to push up profits and improve economic growth.

With respect to global stock market leadership, both country and sector leadership were transposed in Q12017. For example, the Russell 2000 Index of small-cap stocks, which outperformed the large-cap indices in Q42016, returned only 2.5% for the quarter. In contrast to Q4, information technology stocks delivered the largest gain of 13%, while financials and industrials had modest returns. The performance of non-US equities in relation to US equities also reversed. Emerging market (EM) stocks, which had been weak in Q42016, returned 11.4% as a result of a lack of follow through on certain protectionist trade proposals by the Trump Administration and the weakness of the dollar against EM currencies. The MSCI Index of Developed Market equities, which had stalled in Q4, saw an increase of 7.25%. Eurozone equities delivered robust gains amidst upbeat economic releases and receding political worries following the win from the center right candidate in the Dutch elections. Japanese stocks saw positive but muted returns, with the yen gradually appreciating against the dollar.

EXHIBIT 1: FIRST QUARTER 2017 ASSET CLASS RETURNS



Source: Bloomberg, Barclays Live

With respect to fixed income, the 10-year US Treasury bond gained 1.4% in Q1 despite a 25 basis point increase in the Fed Funds rate. As a result, US Treasury bonds returned slightly more than their coupon and the yield curve for US Treasuries flattened. Because of the anticipated strengthening in US economic growth, corporate credit spreads tightened and high yield bonds returned 2.7% for the quarter. Fixed income markets seemed less convinced that there would be a major fiscal thrust in 2017.

Commodity price changes were mixed and the overall Bloomberg Commodity Index was down 2.3% for the quarter, mainly because of weakness in oil and gas prices. At the same time, the price of certain industrial commodities, such as copper and iron ore, rose over 9%. This was partly a reflection of strengthening nominal world GDP growth.

The Outlook for US Equities and the Economy

The Q1 rally has added over 6% to US equity values through the end of the quarter. We are sticking with our positive growth outlook even though we anticipate that legislation that promotes corporate tax reform and a reduction in individual tax rates will not be enacted until 2018. We are still anticipating that real GDP growth will be approximately 2.2% in 2017 and rise only slightly in 2018. We are expecting relatively low GDP growth in the first quarter (the Fed Reserve Bank of Atlanta's GDP Now estimate shows GDP growing at less than 1% annualized), but we expect the recovery in growth to begin in April.

Our economic outlook may be overly optimistic for three reasons. First, the pronounced deceleration of loans made to companies and consumers has astonished and perplexed many analysts who fear that the credit cycle may already be turning over.[1] Second, soft data for the US economy, comprised of various poll-driven reports, such as consumer confidence and business surveys, have been running strong for several months, but the hard data have not supported that optimism. For example, despite the Conference Board Consumer Confidence Index reaching a decade high, retail sales in the last two months have been down. A warm winter and delayed tax refunds may have contributed to the decline in retail sales; however, the year-over-year pace of consumption through February was down to 2.6% from 3.2% in December, with a three-month annualized rate falling to 0.4%.[2] Excluding auto and gasoline sales, retail sales rose by 0.1% in March. The third area of concern relates to uncertainty regarding the exact form that tax reform will take. Under these circumstances, companies tend to postpone investments in additional plant and equipment, which could present a drag on final demand growth.

Hard data is needed to support optimism

We expect that increases in US exports due to a strengthening global economy, continued increased US manufacturing output and a recovery in consumer spending gains will help drive US economic expansion during the remainder of the year. As Gavyn Davies notes, there is evidence that soft data predict the future behavior of hard data when there is a difference between the two.[3] Thus, even though there has been a decline in retail sales in the last two months, the decade high level of consumer confidence should eventually result in a sustained pickup in consumer spending.

Overly ambitious growth hopes

At the beginning of the year, overly enthusiastic analysts had hastily concluded that the pro-growth agenda of the Trump Administration would rapidly translate into much higher corporate profits. After three years of virtually flat earnings of approximately $118, consensus estimates for S&P 500 earnings call for an increase to near $133 in 2017, a gain of 12% per annum.[4] Our call for an increase in S&P earnings of 7% to $127 does not involve any further fiscal stimulus and is based on a 5% nominal sales growth with most margin improvement coming from the recovery in the energy sector. While sanguine about the positive effects of deregulation, infrastructure spending and a pro- business agenda on potential growth, we are still doubtful about the application of the fiscal initiative in 2017 and, as Coho notes, "The ability of a very divided Congress to move forward quickly."[5]

---

[1] The growth rate in the real money supply, which has turned negative before most recessions, fell to 3.7% year over year in late March, the slowest since the 2008 recession. This does not indicate an imminent downturn, but needs to be monitored. See: Kopin Tan, "Are Stocks Finally Topping Out?" Barron's, April 8, 2017.

[2] Department of Commerce, Bureau of Economic Analysis.

[3] Gavyn Davies, "Global Savings or Hard Data – Which are the Fake News?" Financial Times, April 2, 2017.

[4] Fact Set Earnings Insight, January 20, 2017.

[5] Coho Partners, Ltd., First Quarter Economic Commentary.

There is no doubt that major corporate tax reform has become more difficult to achieve after the Administration's failure to pass the American Health Care Act (AHCA) in March. The estimated $1 trillion savings over 10 years from the AHCA replacing the Affordable Care Act is necessary to fund the reduced revenue resulting from lowering the corporate tax rates toward 20%.[6] With the border adjustment tax (BAT) lacking broad support, the likely reduction in the corporate tax rate will be much smaller and have a much more muted impact on corporate earnings than the market has been anticipating. It is now more likely that a maximum statutory tax rate of 28% may be required to achieve the objective of revenue neutral reform.[7] We expect that the smaller reduction would bring the effective tax rate, what firms actually pay after deductions, from around 26% for S&P 500 companies to around 22% and even part of that decline would only be temporary.[8] Thus, the ultimate impact of corporate tax reform on earnings will be much less than hoped for at the beginning of the year.

Tax reform is likely a 2018 event

Since we are assuming that no tax reform will be enacted this year, we are projecting a modest 7% increase in adjusted per share earnings for the S&P 500, which would bring the 2017 adjusted earnings per share to $127 from $118. Our methodology for determining likely values for the S&P 500 Index at year-end is the following. Once we have estimated the base value for the year-end S&P 500, we then estimate the potential effect of various policy scenarios on 2018 earnings, valuation of the S&P 500, and rough probabilities for each scenario. We provide best, intermediate and worst cases.

Our base value for the S&P 500 is driven by 2017 estimated earnings per share of $127 and a trailing 12-month P/E that falls to 18.9 times owing to a higher year end bond yield and a late-cycle multiple compression. This results in a base S&P 500 price of 2,400, which would equal a 7.2% increase for the year.

Our estimate of the fiscal option in the best case scenario, to which we assign a 50% probability, is based on the assumption that realistic corporate tax reform in 2018 is viewed as certain by the end of this year. The increase in S&P earnings as a result of the reduction in the effective corporate tax rate from 26% to 22% would raise 2018 earnings per share by 5.6% above their trend level and increase the fair value of the S&P 500 at the end of the year by 135 points, if it materializes. Thus, in this best case, which has a 50% probability of occurring, the fiscal option would have a probability-weighted value of 67.5 S&P 500 points (135 points times 0.5), raising the current fair value of the S&P 500 from a 2,400 base value to 2,467.5.

---

[6] President Trump told Maria Bartiromo on Fox Business that he apparently insists on first passing healthcare reform and eliminating healthcare taxes. This means that the August timetable for presenting tax reform to Congress may be at risk.

[7] Coho Partners, Ltd., First Quarter Economic Commentary.

[8] Even if Congress accepts that such a reduction is dynamically tax neutral because of the revenue benefits of higher growth, it is likely to want to fund part of the initial revenue decline by phasing in a BAT or a tax on unrepatriated earnings. The latter is more attractive since it might have an additional positive effect on domestic growth. A reduction in the effective corporate tax rate that is fiscal deficit-neutral should increase capital expenditure and potential GDP growth. However, it will not stimulate overall activity unless it encourages repatriation of overseas earnings by multi-national corporations and foreign direct investment.

This should be compared to two other cases. The first is an intermediate case, in which the Ryan plan with a BAT is enacted and to which we assign a 30% probability. The potential value of the fiscal option if this scenario materializes is -100 S&P 500 points. The probability-weighted value is -30 S&P 500 points. In the worst case, in which fiscal reform is perceived as totally hopeless, the probability-weighted value of the fiscal option is -56 S&P points, i.e., 20% of -280 points. This by itself would reduce the expected year-end value of the S&P 500 from 2,400 to 2,344. These scenarios and their accompanying probabilities are shown in Exhibit 2.
The expected value of the S&P 500 at year end is 2,376.5, consisting of the probability-weighted average of the three fiscal option values plus the 2,400 points base value. This expected year end value is close to the current S&P 500 level of 2,349, which suggests that a flat market for the remainder of the year should not be unexpected.[9]

EXHIBIT 2: FAIR MARKET VALUE UNDER VARIOUS FISCAL SCENARIOS

Scenario	Probability	Maximum Option Value	Expected Option Value	Expected Year End Value	Maximum Year End Value
Base Value				2400	2400
Best Case	50%	135 pts	67.5 pts	2467.5	2535
Intermediate Case	30%	-100 pts	-30 pts	2370	2300
Worst Case	20%	-280 pts	-56 pts	2344	2120
Sum	100%		-23.5 pts		
				2376.5	

EUROPE AND THE UK

During the first quarter of 2017, the MSCI Europe ex-UK Index appreciated 8.4% and the MSCI UK Index appreciated 5.0%.[10] The strong equity performance reflects better than expected economic growth over the second half of 2016, positive earnings growth and an improving outlook across the Eurozone for 2017. Additionally, Eurozone currencies and the British Pound were strong compared to the US dollar in the first quarter.

Flat market for remainder of year

The UK economy managed to avoid the recession predicted by many analysts following Brexit, and the economy grew by 0.7% in the fourth quarter of 2016 and 1.8% for the year.[11] Similarly, the European Union ("EU") as a whole grew at a 1.6% pace in the fourth quarter and the Markit Eurozone composite PMI increased to 56.7 in March, a 72 month high (a reading above 50 indicates economic expansion). Further, EU banks have continued

[9] This methodology is similar to that employed by Barclays in the March 17, 2017 Global Outlook except for a different estimate of the best case fiscal option and 2017 earnings per share for the S&P 500 and the resulting base value.

[10] Source: Bloomberg.

[11] Office for National Statistics, https://www.ons.gov.uk/economy/grossdomesticproductgdp, accessed on April 4, 2017.

to see increasing loan demand over the last several years which may indicate that the economy will continue to expand.[12] Despite this positive backdrop, political uncertainty continues to prevent multiple expansion and gives us pause to overweight European equities.

On March 29, 2017, Theresa May invoked Article 50 and triggered the two-year negotiation period for the United Kingdom to exit the EU. The notice to Donald Tusk, the European Council President, indicated a willingness on the part of the British to offer concessions to maintain access to the Eurozone. We believe that the invocation of Article 50 puts significantly more pressure on the UK than the rest of the EU due to the UK's reliance on the EU for a substantial percentage of its exports. Ultimately, the UK may be forced to make significant concessions in order to leave the EU with a favorable trade deal, especially if the EU takes a hard line in the early negotiations. On the other side, the governing body in Brussels can simply wait out the two year period and apply pressure on the UK economy, especially the banking and financial sectors. Prime Minister May has called for a general election to strengthen her party's majority in parliament, but we do not expect negotiations to begin in earnest until the fourth quarter following the German elections.

The rise of Euro-skepticism

Elsewhere in the EU, populism continues to rise and far right and left candidates continue to do well in election polls. A recent study released by Bridgewater Associates indicates that the share of votes received by populist and anti-establishment candidates is at the highest levels since the 1930s (though the candidates are not nearly as extreme as during that era).[13] This trend has the potential to have far reaching effects across the economic and political order of the European Union.

Several elections scheduled for this year should provide more clarity and allow equity markets to reflect the improving fundamentals of the region. In March, voters in the Netherlands rallied to defeat the far-right candidate, Geert Wilders, and in France, in the first round of voting in the Presidential Election on April 23rd, French voters chose Emmanuel Macron and Marine Le Pen who will face off in the second round of voting on May 7th. Marine Le Pen is a far-right candidate who has vowed to exit the European Union and has cozied up to Russia in recent weeks and Emmanuel Macron is a former investment banker who campaigned on a pro-European Union platform. Current polls show centrist Macron handily defeating Le Pen in the likely head to head second round of voting, but Le Pen has a non-negligible chance of winning the election. A Le Pen victory would likely result in significant volatility in both the European equity and bond markets.

Although the political uncertainty has caused us some trepidation towards European equities, we remain neutral, with a positive long-term outlook, on the region due to their strengthening economy, earnings growth and valuations. The twelve month forward P/E of 14.9 times in Europe is close to the 25-year average, and valuations

---

[12] JP Morgan 2Q2017 Guide to the Markets.

[13] R. Dalio, S. Kryger, J. Rogers, G. Davis, "Populism: The Phenomenon" Bridgewater Daily Observations, March 22, 2017

remain attractive relative to U.S. equities.6 Additionally, the ECB's quantitative easing program has appeared successful in boosting inflation to date, with headline inflation approaching 2% and inflation exceeding consensus estimates.[14] According to Barclays, many European companies are dependent on prevailing inflation rates for pricing increases because they sell commoditized products. In an environment of higher inflation, margins should expand, leading to greater profits.[15]

European earnings should improve if election results are benign

Given the recent uptick in inflation measures and sustained GDP growth, we believe that European equities could experience both margin and multiple expansion over the intermediate term. As patient investors with a long-term outlook, we do not wish to expose our portfolios to short-term political volatility. Therefore, we will continue to monitor the political landscape and plan to increase our allocation to European equities as political uncertainty recedes and equity markets refocus on the improving economic landscape of the continent.

JAPAN

During the first quarter of 2017, Japanese equities, as measured by the MSCI Japan (net) Index, appreciated 4.5%, underperforming the MSCI EAFE (net) Index by 2.76%. Japanese equities outpaced the broader international developed Index during the first two months of the year, but lagged significantly in March.[16]

Data released in the first quarter of 2017 indicated that Japanese GDP continued to expand at a modest pace during 2016. GDP grew at a 1.2% pace for the year, but declined from a growth rate of 0.6% quarter over quarter in the first quarter to 0.3% quarter over quarter in the fourth quarter.[17] This marks the first time in several years that GDP has expanded for four consecutive quarters and the 1.6% year-over-year increase in 4Q2016 is well-above the 20-year average of 0.7%. Growth has been driven by an increase in exports rather than by domestic consumption, and a key goal of Abenomics has been to spur domestic demand and to boost inflation as Japan continues to face demographic pressures, such as an aging population, low birth rates, and a culture of saving. Given the recent consumption data, it appears that the plan has been unsuccessful so far; however, the transmission mechanism from policy action to economic reality could easily be longer than just a few quarters. It is well known that Japan has been mired in a deflationary, low growth environment for more than 20 years. The Abe government has been aggressive in its actions to combat these headwinds and only time will tell if these efforts are enough to break out of well entrenched trends.

[14] Barclays European Equity Strategy, March 20, 2017

[15] Barclays European Equity Strategy, April 04, 2017

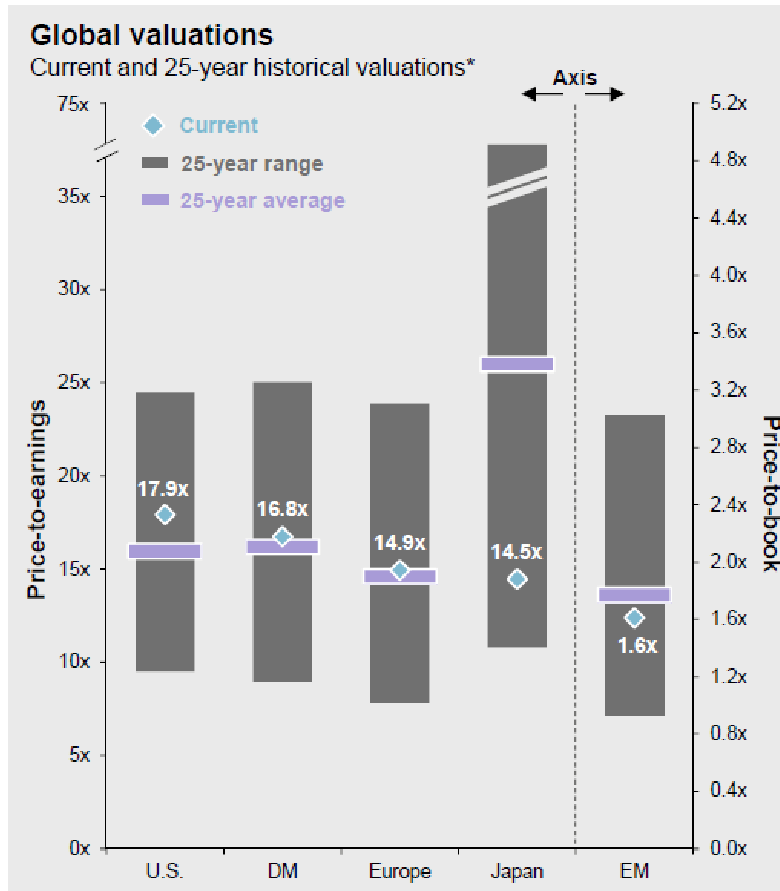
[16] Source: Bloomberg

[17] K. Ujikane; "Japan's 4Q Growth Raised to 1.2% as Exports Drive Investment." https://www.bloomberg.com/news/articles/2017-03-07/japan-s-fourth-quarter-economic-growth-revised-up-to-1-2 Accessed on 4/4/2017.

Shareholder friendliness on the rise

In spite of these macroeconomic headwinds, we remain constructive on Japanese equities over the intermediate and longer-term. First, our equity managers tend to favor a bottom-up analysis that identifies companies in a position to succeed independent of macroeconomic trends. These companies continue to improve their corporate structure and governance which should lead to additional increases in dividends and buybacks boosting returns to shareholders. Second, the 12-month forward P/E ratio of 14.5 times remains attractive relative to the 25-year historical average of more than 25 times and compared to elevated US equity valuations (see Exhibit 3).[18] Further, Japan does not have the level of political uncertainty that has prevented us from increasing our allocation to European equities. Finally, technical factors related to the Japanese Central Bank's purchase of equities and increasing flows of investor capital into Japanese equity markets should support multiple expansion above current levels.

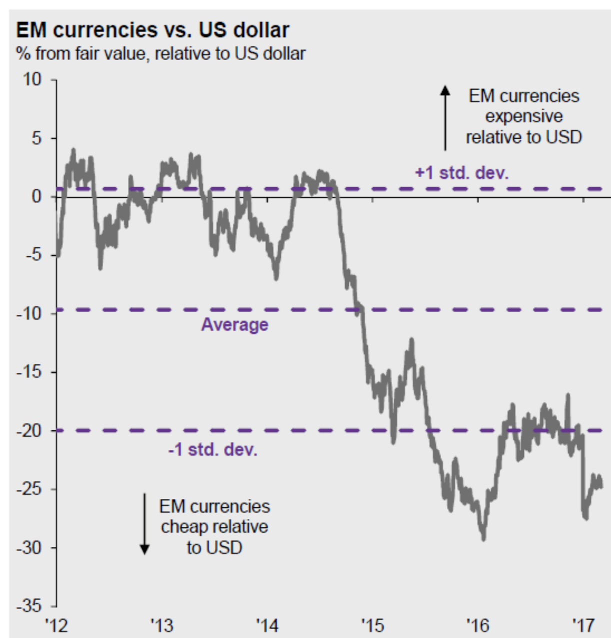
EXHIBIT 3: GLOBAL VALUATIONS



Source: Factset, MSCI, JP Morgan, JP Morgan Guide to the Markets

18 JP Morgan 2Q2017 Guide to the Markets.

EXHIBIT 4: EM CURRENCY VALUATIONS 2012-2017



Source: JP Morgan, JP Morgan Guide to the Markets

Emerging Markets

According to data from the Bank for International Settlements (BIS), US dollar-denominated debt to EMs doubled from 2009 to the end of 2015, reaching $3.3 trillion. Given the magnitude of the exposure, the mere 25% appreciation of the US dollar from mid-2014 to early 2016 created a massive headwind for EM economies. To control their external deficits, they had to use contractionary fiscal and monetary policies to hold down GDP growth. Thus, the stabilization of EM currencies against the dollar over the last year has reduced this external constraint on domestic expansion (see Exhibit 4).

EM growth rates have picked up substantially despite modest dollar interest rate hikes by the US Federal Reserve. In Q1, EM currencies recovered after a brief spate of weakness following the US presidential elections. The anti-trade rhetoric emanating from the Trump Administration has been dying down. Trade volume in the EM countries is estimated to be growing by more than 4% in the first quarter. As a result, real GDP growth in these countries is estimated at 4.5% per annum in Q1, more than twice the rate of expansion in the developed economies.[19]

Stronger currencies are leading to reduced internal price pressure. The rate of inflation has declined from a recent peak of 5.2% in late 2015 to 3.8% year-over-year in February (3.2% when excluding Venezuela and Argentina).[20] This lower inflation rate enables central banks to cut policy rates and generally adopt more expansionary monetary policies. We expect a continuation of improving growth in these countries and relatively attractive equity markets through Q2. However, in the second half of 2017, there is a significant risk of policy tightening from China and the associated feedback on EM economies could cause EM earnings growth to decline sharply. Greater protectionist policies from the US are still a concern though the threat of them seems to have diminished.

Relative, but not absolute, cheapness

EM stocks are not so much absolutely inexpensive as relatively inexpensive, particularly in relation to the S&P 500. EM companies are trading at an average of 12.2 times next 12-month earnings estimates. In comparison to the ten-year average of less than 11 times, the forward P/E is on the low end of its historic range but the forward P/E of US stocks is 50% higher, 18 to 19, versus 12.[21]

[19] Coho Partners, Ltd. First Quarter Economic Commentary.
[20] Ibid.
[21] Jason Zweig, "Why Emerging Markets are Looking Better than the USA," April 2, 2017.

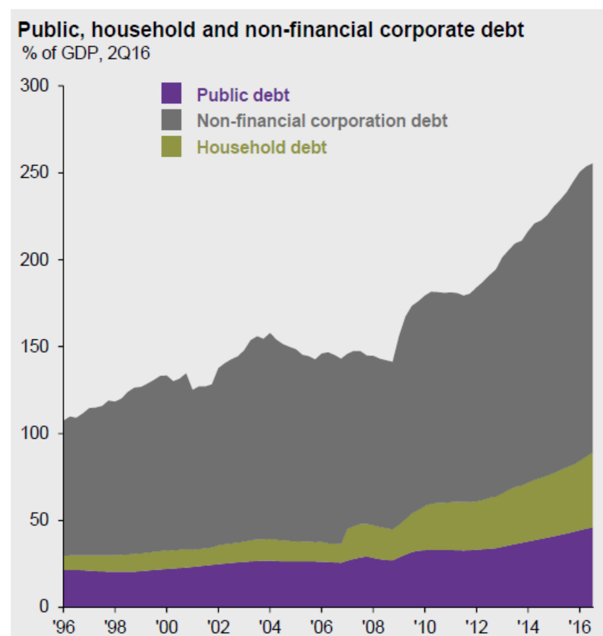
According to research affiliates, the EM cyclically-adjusted P/E ratio (CAPE) is 14. This is the equity price divided by the average earnings over the past decade adjusted for inflation. The current CAPE is very close to the low of 13 times earnings, which was registered during the global financial crisis.

The lower valuation of EM stocks provides at least some cushion against Chinese policy tightening, a trade war or other change in US policy that would hurt developing countries, but EM stocks will not outperform developed market (DM) stocks based on relative valuations alone. According to the Bank Credit Analyst, "The fact that EM stocks are indeed cheaper versus the S&P 500 only reflects the fact that US equity valuations are expensive and EM valuations are neutral in absolute terms."[22] While equity valuations affect the magnitude of upside and downside movement, they do not determine the direction of share prices which is mainly influenced by earnings trends.

Chinese credit growth is a looming concern

In our view, the health of the Chinese economy remains the main driver behind the relative performance of EM equities and a major source of risk. Many of the major EMs are heavily involved in China's supply chain. These countries include South Korea, Brazil and South Africa. Chinese demand has a strong influence on global commodity prices. There has been little "China is doomed" discussion in the financial press since 2016. The Chinese economy has been propped up by a lingering credit bubble. This has provided interim economic stability ahead of the Plenum late this year, but will only exacerbate China's long term structural issue of overindebtedness. Underlying the steady GDP growth has been a sharply rising debt to GDP ratio which, according to Goldman Sachs, is close to crisis levels (see Exhibit 5). Zi Jinping is well aware of these issues and should go back to resolving them after the Plenum has ended. His actions and those of Zhou Xiaochuan are likely to take the form of rising borrowing costs and regulatory tightening of banks and the shadow banking system.[23] Once they fully anticipate or see a decline in credit origination and Chinese economic growth and the reemergence of financial risks in the system, global financial markets will return to dwelling on the effects of China on other EMs and assign a higher risk premium to EM assets and a lower P/E ratio for EM equities. This will be reinforced by the subsequent decline in EM earnings growth as a result of diminished Chinese trade. We expect the selloff in EM equities to occur late this year and for this reason we are maintaining a cautious view on them in the medium term, although the prospects for long-term profitability have improved.

EXHIBIT 5: CHINESE PUBLIC HOUSEHOLD AND NON-FINANCIAL CORPORATE DEBT



Source: JP Morgan, JP Morgan Guide to the Markets

[22] Bank Credit Analyst, "Signs of an EM/China Growth Reversal," Emerging Markets Strategy: Weekly Report, April 12, 2017.

[23] Cameron Joyce, "Time to Think About Shorting Emerging Markets," Seeking Alpha, April 19, 2017.

Fixed Income

US Treasury yields were largely unchanged for the first quarter and have traded in a narrow band for several months. While more hawkish than this time last year, the Fed continues to be engaged in a waltz with investors that has led to successful policy tightening without negatively impacting global capital markets. We foresee two to three additional hikes in 2017, but we believe the FOMC will err on the side of caution, particularly due to the scarcity of inflationary pressures. In addition, we believe the Federal Reserve's balance sheet will begin to decline starting late in 2017 because of underinvestment of maturities. This will be a deliberate, multi-year process which will add volatility to the fixed income markets, particularly agency mortgages, but will not cause long term yields to rapidly rise.

Expect tighter Fed policy in 2017 and 2018

We have not deviated from our stance that the US Treasury bond bull market has passed, but we do not foresee material upward pressure on longer maturity domestic interest rates. US Treasuries remain an investor safe haven, evidenced by yields moving to 2017 lows amidst the recent uptick in geopolitical tension. We anticipate a flatter yield curve while comparable global sovereign bonds yield significantly less than US Treasuries. In past economic cycles, a flat or inverted yield curve has been a recession indicator, but we believe if the yield curve inverts, it will be temporary as longer term Treasury yields are artificially low. If needed, the Fed should be able to move long term yields higher through balance sheet manipulation, FOMC minutes or Fed Governor speeches.

As seen in Exhibit 6, our estimate of the present equilibrium ten-year yield has increased modestly to 2.57% from our December estimate of 2.54%. Based on our model, which uses the geometric mean forward Fed Funds rates, the ten-year zero coupon yield is expected to rise to 2.79% in 12 months against a current rate of 2.56%. 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.

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*	0.82%	1.32%	2.07%	2.82%	2.82%	3.32%
Subtract Projected Inflation	1.97%	1.70%	1.90%	1.95%	1.95%	1.95%
Real Fed Funds Rate	-1.15%	-0.38%	0.17%	0.87%	0.87%	1.37%
Average Short-Term Rate		1.07%	1.70%	2.45%	2.82%	3.32%
Yields Constructed Using Product of Nominal Fed Fund Rates for Each Year	5yrs	2.17%				
	10 yrs	2.57%				
	10y 1y fwd	2.79%				
	5y 1y fwd	2.52%				
10 year Treasury Strip (Actual yield, Bloomberg):		2.56%				

Data as of December 30, 2016. Source: Bloomberg

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

Municipal bonds outperformed US Treasuries year to date, and the Bloomberg Barclays Municipal Index is up 1.58% through March 31, 2017. Following a difficult fourth quarter, US Treasury yields have stabilized and municipals have largely followed movements in Treasury yields since the end of 2016. We expect this to continue in 2017 as it is unlikely tax reform will occur this year. Investor flows into mutual funds have been positive in 2017 and through March, issuance has been below Q1 2016 supply. We expect modest returns for municipal bonds for 2017 with the majority of the return coming from coupon income. Due to compression in municipal credit spreads, we recommend owning liquid, high credit quality bonds as protection against unforeseen changes in taxes.

Spread Product

Corporate bonds outperformed comparable Treasuries year to date, and this is in line with investor optimism about equities and expectations of a low default rate in 2017. Two themes which contributed to 2016 performance, the recovery in energy credits and increasing European demand, were less dominant in the first quarter. First, energy related corporate bonds posted modest positive performance year to date due to soft oil prices in the first quarter and energy related equities have endured most of the pain this year. We believe there is considerably more upside in energy equities compared to credit. Second, European demand remains strong for US corporate bonds, but demand is no longer increasing. This translates into an environment in which most performance will come from carry.

Lower rated credits outperformed higher rated credits in Q1 2017, but the disparity was less than in 2016. For example, CCC rated credits returned 4.66% versus 2.06% for BB rated credits and 1.30% for the Barclays US Credit Index in the first quarter of 2017. Looking forward we expect this to continue, but given the compression in yield spreads, investors are not compensated for taking on the downside risk in CCC rated credits at a spreads of under 700 basis points. Credit selection should enable active managers to outperform in 2017, especially on a risk-adjusted basis.

> Low quality credits increasingly risky

The results of tax changes will also impact the performance of corporate bonds, particularly in high yield, and may alter the corporate bond landscape looking forward. First, a lower tax rate would increase cash flow to service debt, thereby increasing the likelihood of repayment. Investors should require a lower yield given a decrease in default risk, and corporate bond spreads should contract versus comparable US Treasury bonds. Second, companies are less incentivized to use debt for financings or maintain a levered balance sheet because the after tax benefits of using debt decrease at lower rates. This could likely cause supply to decrease.[24] Third, proposed additional changes such as the removal of interest deductibility and implementation of border adjustment taxes will have differing impacts on corporate bonds when factoring in overall individual corporate leverage and import/export exposure. Highly levered companies may have

[24] Interest on corporate bonds is deductible making debt a generally preferred method of financing corporate activities.

significant cash flow shortages if interest is no longer deductible, and border adjustment taxes will have a negative impact on companies in industries which rely on imports. This additional uncertainty underscores our positioning in higher rated credits with underleveraged balance sheets or material cash flow to cover interest expense.

EM bonds performed well in the first quarter, up 5.18%.[25] Sustained global growth and a weaker dollar provided a tailwind for EM bonds and fears of protectionism have waned causing investors to favor the asset class after a difficult fourth quarter. Additionally, commodity prices have stabilized amidst better than expected Chinese growth. Country selection will continue to be important as EM central banks have very divergent policies which impact currency performance. EM debt remains attractive versus developed sovereign bonds due to interest rate differentials and our view that the US dollar will not appreciate dramatically in 2017.

Conclusion

Absent uncertainty related to politics and policy, we are sanguine about the direction of global economies in 2017. For the first time in several years, global growth is synchronized, as evidenced by consistent and improving expansionary global and regional PMI surveys. We now await the beginning of a pronounced capital investment cycle to expand global capacity and prolong the current expansion without inflationary consequences. A path for removal of central bank stimulus is underway in the United States, and benign French and German elections would likely enable the ECB to follow suit in 2018, albeit conservatively. The consensus view of a stronger dollar has faded; however, we do not foresee material weakness in the trade weighted dollar until the gap between US Treasury yields and the yields of Japanese and European bonds closes.

Back to reflation on trade?

We maintain our base case outlook of single digit returns for US equities, and evidence of double digit earnings growth is needed to upgrade our forecast. We are skeptical of tax reform occurring in 2017 which may deflate current domestic equity valuations; however, we are aware any progress toward reform increases the value of the embedded fiscal option in equity prices. Indeed, the reflation-off trade may already have been overdone and may be partially reversed. For example, the Goldman Sachs bundle of stocks of highly taxed companies has more than given back its gains since the election and the decline in inflation expectations priced by the bond market seems to be too great. Still, we would not bet on a return towards reflationary optimism until:

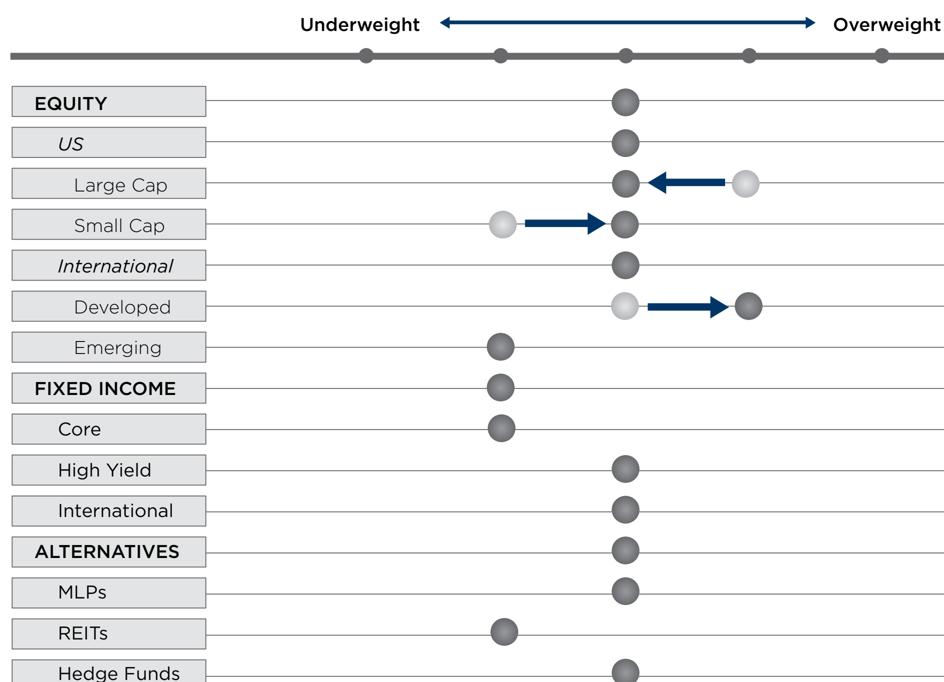
- Better hard data on the US economy appears.
- President Trump proposes a smaller, but meaningful corporate tax cut that is deficit neutral and potentially acceptable to Congress.
- Oil prices show signs of stabilization.

[25] As measured by the JP Morgan EMBI Global Diversified and GBI EM Diversified Composite Index.

Upside surprises in growth and inflation in non-US developed economies justify our slight overweight in MSCI EAFE equities, and we anticipate increasing our tactical tilt once political risk subsides. Despite a growth rate in excess of developed markets and stability in commodity prices, our underweight in EM equities remains primarily due to our concerns about the growing probability of a credit crisis in China in 2018 or 2019. We advocate for higher quality corporate bonds and spread product in fixed income allocations, as risk free fixed income asset returns will likely be modest or slightly negative.

Upside surprises in non-US equities

EXHIBIT 7: DMCA ASSET CLASS VIEWS AS OF MARCH 31, 2017



Source: DMCA

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

- The fate of Trump's pro-growth agenda.
- A Chinese hard landing.
- A euro-sceptic French president who derails the Eurozone.
- Earlier than expected reduction of monetary stimulus in Europe.
- Slowing credit growth and declining real take home pay which may auger an earlier than expected US recession.
- Geopolitical risks which are at nearly the highest level in the post-World War II period.
- Greater sensitivity of the real economy to a major US stock market correction.[26]

[26] Dennis DeBusschere of Evercore ISI has observed that aggregate demand change has become increasingly related to consumption change, which has become increasingly dependent on equity prices since stocks and mutual funds represent 29% of household net worth. This share is 5% above the trend and is growing. See Kopin Tan, "The Burt Reynolds Market," Barron's, April 24, 2017.

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.

The forecasts and opinions in this piece are provided for informational purposes only and may not actually come to pass. The views and opinions expressed above are those of the portfolio management team at the time of writing and are subject to market, economic and other conditions that may change at any time, and, therefore, actual results may differ materially from those expected. They should not be construed as recommendations to buy or sell securities in the asset classes or countries discussed.

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.

The financial instruments described may not be suitable for all investors. All investments contain associated inherent risks including possible loss of principal. Please be aware that portfolios may be subject to certain additional risks. For details on additional risks, please review Drexel Morgan Capital Advisers, Inc. Form ADV Part 2A.

Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than the risks generally associated with foreign investments.

This material does not constitute a recommendation to the suitability of any product or security and does not constitute an offer to buy or sell any financial instrument or to participate in any trading strategy.

This material may not be reproduced, shown or quoted to members of the general public or used in written form as sales literature.

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