Drexel Morgan Capital Advisers

McCabe Global Economic Commentary
First Quarter 2015

"Bull Markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."
– Sir John Templeton

We believe that we are between the skeptical and optimistic phases of the global bull market for equities and are retaining our long position in the asset class. Last year, market volatility was caused by a deteriorating Eurozone economy and by an emerging market currency crisis as investor concern was centered on the end of the Fed's quantitative easing and what its consequences would be for many emerging market (EM) countries' debt service requirements and cost of capital. This year, attention has been focused more on the unyielding decline in commodity prices and the sharp US dollar appreciation and their impact on US corporate earnings and those of certain EM companies.[1] In 2014, the top line, not the bottom line, was the main drag on market gains. In 2015, the drag is on earnings with sharp declines in S&P 500 earnings estimates and earnings estimates for companies in commodity exporting countries. However, we believe that the global equity market will continue to climb a wall of worry and that these concerns will prove to be overblown.

Despite a weaker than expected first quarter in the US, we still believe that global economic growth will rise in 2015, with stronger activity in most developed countries counteracting deteriorating prospects in some emerging market countries. The most pronounced growth improvement during the remainder of the year should occur in the eurozone and Japan. Both are relatively open economies and should benefit from currency weakness and reduced oil prices. They also should be stimulated by expansionary monetary policies. Despite negative economic releases in the fourth quarter and the negative effect of the stronger dollar on non-oil exports, the US economy should be able to grow at an average annual rate above 2%.

We are underwhelmed by the economic outlook for most emerging markets with the exception of China. Chinese policymakers are trying to make the economy less dependent on debt and rid it of corruption. These reform measures should reduce concerns over a "hard landing risk," but will produce at best higher quality growth in the next year. Stretched balance sheets, weak

[1] See Morgan Stanley, Michael Wilson, "On the Markets," April 2015.

productivity gains and declining commodity prices are wreaking havoc in some other EM countries, such as Brazil and Russia, and the outlook for commodity importers is still much more favorable than it is for commodity exporters.

There has been some concern that the downward momentum in the US may be beginning to dominate the world economy as global growth proxies, used for flash economic estimates, fell slightly in March, following some significant weakness in the first two months of the year. We do not expect a collapse in global growth momentum at the end of a very long global recovery. The "Nowcast" estimates[2] of slowing global growth are driven mainly by the apparent temporary weakness in the US. However, we are monitoring global economic indicators very carefully.

I. World Economies

United States Economy: Some of the slowdown in first-quarter US economic activity is due to temporary factors such as the especially cold winter and above normal snowfall across much of the Northeast and a labor dispute at west coast ports. However, the strong dollar and reductions in energy capital expenditure are also playing a role and these are likely to be less temporary.

Indices of macroeconomic disappointment for the US have risen sharply for most of the first quarter of the year. As evidenced by a rising household savings rate, the increase in real income due to lower gasoline and fuel oil prices is not being spent on other goods. Consistent with weakness in both household and business demand, durable goods orders and manufacturing output, housing starts and retail sales have all fallen short of expectations. The consensus forecast for growth in the first quarter is 1.4%.[3] A sophisticated, econometric model developed by the Federal Reserve Bank of Atlanta estimates GDP growth at a mere 0.2%.

Despite the weaker than expected economic backdrop, Janet Yellen and other key FOMC members continue to signal their intention to raise rates later this year. The timing of the first rate hike as well as the pace of any future rate increases will depend on how well the economy performs. As Janet Yellen put it in a recent speech, "The actual path of policy will evolve as economic conditions evolve and policy tightening could speed up, slow down, pause or even

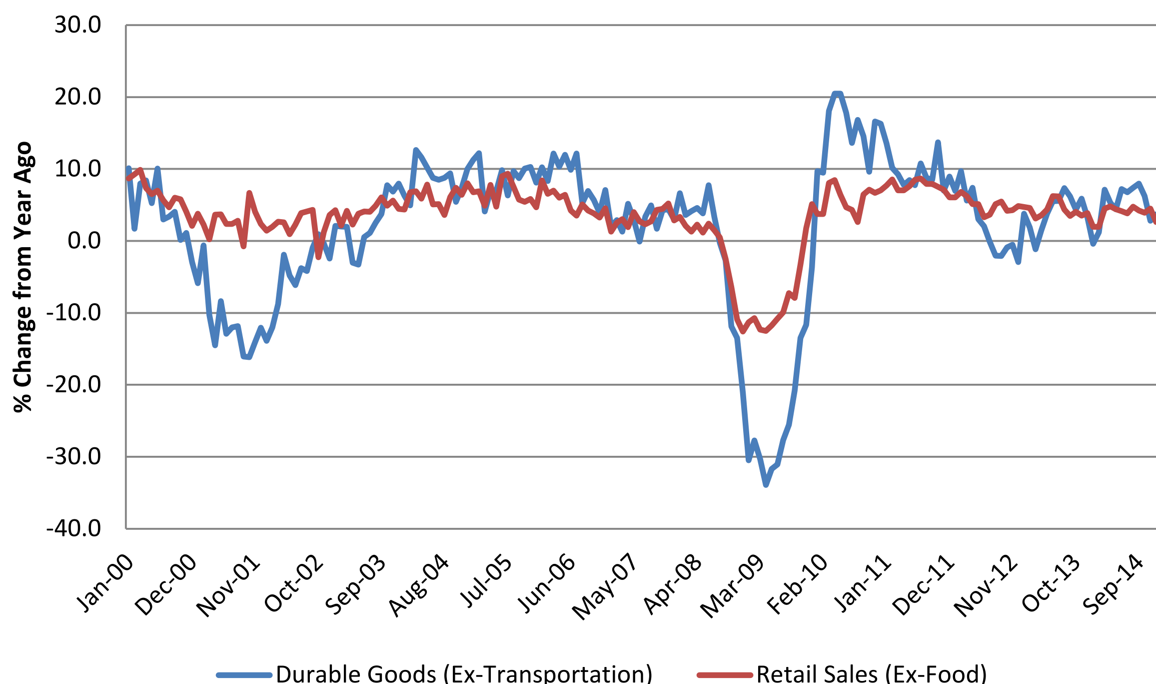
[2] "Nowcast" are estimates of economic growth from models using all relevant published data in developed economies. See Gavyn Davies, Global Growth Report Card, Financial Times, April 5, 2015.
[3] The Economist U.S. Edition, April 4, 2015, page 66.

reverse course depending on actual and expected developments in real activity and inflation." Though such pronounced flexibility has theoretical appeal, the Fed will not want to be in the embarrassing position of having to cut rates after having just raised them. Ray Dalio, founder of Bridgewater recently commented, "We do not know – nor does the Fed know, how much tightening will knock over the apple cart." For these reasons, we are skeptical of assurances from the Fed that it will raise rates even if inflation remains subdued. In this regard, commentators have noted that the Fed's new forecasts imply that inflation rates will remain low for the remainder of the year.

The Fed expects the unemployment rate to fall to a range of 5.0% to 5.2% by the end of the year, in line with its estimate of full employment. At the same time, recent trends suggest that the U6 unemployment rate[4] is likely to only reach 10.2% by this time. This is well short of the employment goals, above the rate of 9.5% that coincided with the first hike in June 2004. In addition, according to the Bank Credit Analyst (BCA), wage inflation had reached 3.8% back then, well above the current 2.3% rate.

Absent much greater progress toward fulfilling inflation and employment mandates, the Fed is likely to postpone raising its policy rate from the September date it has been hinting at to December or early next year. Many investors are complacent about the Fed dilemma; they reason that if the economy is strong enough to allow the Fed to raise rates, then that would be good news. If the economy is not strong enough, the benefits of low interest rates will persist. Despite this, investors are becoming increasingly concerned about the weakness in corporate profits.

[4] The percentage of the labor force that does not have a job, or is part-time employed and would like full-time employment. Unlike the U3 rate, the U6 unemployment rate expands the definition of the labor force to include "discouraged workers," or people without jobs who have given up looking for work (marginally attached workers) or people without jobs who would like to work but have not sought employment recently; and part-time workers who would like to be employed full-time (http://www.theopportunetime.com/).

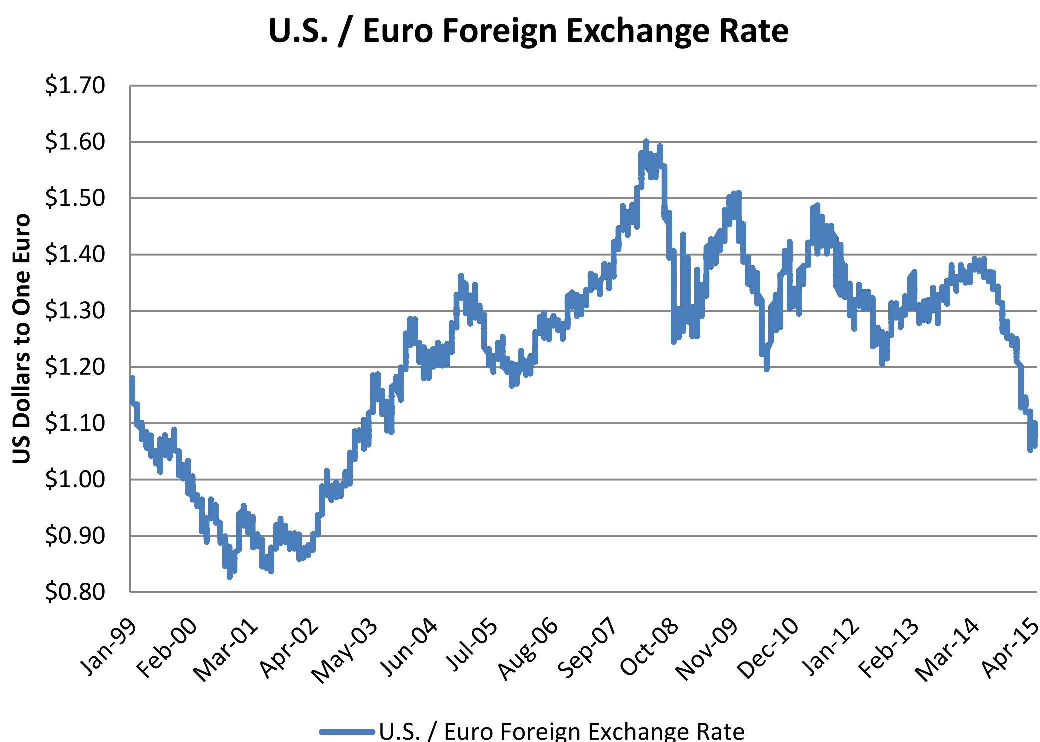


Source: St. Louis Federal Reserve (FRED)

The slowdown in the first quarter may be the beginning of a trend that started in the fourth quarter of 2014. US corporate profits fell by 1.6% in 2014 Q4, according to the Bureau of Economic Analysis, and were 6.4% lower than in the same quarter in 2014. Year on year GDP growth fell from 2.7% in the third quarter of 2014 to 2.4% in the fourth. In the first quarter of this year it is likely to be barely positive.

The dollar surge in 2014 is dragging down the earnings forecast for the current year. Earnings per share for S&P 500 firms are expected to rise by only 2.6%[5] even if real GDP growth is above trend for the year as a whole, as we expect. The reason for this earnings weakness is threefold, according to the Economist. First, the strong dollar is reducing the dollar value of profits earned on other currencies and reducing the competitiveness of US products sold abroad. Second, some of those foreign profits are being squeezed by slowdowns in developing economies. Third, the dollar is inversely related to oil prices and the fall in oil prices is dragging down profits and investment in the energy sector.

[5] The Economist, op. cit.



Source: St. Louis Federal Reserve (FRED)

The Eurozone and Japanese Economies: We are more positive on the Eurozone than we were in our last letter. It is estimated that eurozone growth will continue to strengthen, reaching 1.7% in March 2015, according to "Nowcast." Four factors are contributing to this increase: First, the euro has fallen 8.4% on a real trade-weighted basis which has improved the competitiveness of Eurozone companies. Second, oil prices have declined sharply, raising real discretionary income and lowering business input costs. Third, the easing of deleveraging by banks subsequent to the November stress tests is stimulating credit growth. Fourth, after several years of fiscal restraint, austerity measures are being relaxed.

We believe that the Grexit (the withdrawal of Greece from the eurozone) risk is minimal. Now that the April payment of one half billion dollars has been made to the IMF by the Greek government, there is a short window of opportunity to initiate a necessary new approach. This would consist of actual implementation of a few core actions; short-term financing to remove

the threat of default in the next three months and a new program to provide a blueprint for reform and financing for the next two to three years.[6]

The new Syriza government in Greece consists of outsiders who have little stake in upholding the established agenda. This does introduce a significant amount of uncertainty about the outcome of any future negotiations between the Greek government and the three institutions formally known as the Troika.

Still, according to BCA, a number of factors mitigate the risk of a disorderly departure of Greece from the euro area. The firewall around Greece is stronger. Most Greek debt is currently held by the EU, the ECB and the IMF, limiting the impact of any potential default in the private sector. Moreover, the incentive for Greece to leave the euro is less compelling than it was five years ago. The 15% decline in Greek unit labor costs has completely eliminated the competitiveness gap between Greece and the rest of the eurozone that developed between 2000 and 2009. For this reason, Greek exports have significantly outpaced the 40% export growth increase observed in the rest of the euro area since late 2009.

In Japan the strong growth recorded in indicators published during February now seems to have been an aberration and underlying growth activity slowed from an estimated 2.0% to 0.4% during March, according to Nowcast. This, along with the slowdown in core inflation reported recently, suggests that another round of monetary easing may be on Japan's agenda.

While productivity, poor demographics and a weakening fiscal position cloud Japan's long-term outlook, some positive developments are becoming apparent. Two major causes of past deflation, falling land prices and weak corporate balance sheets, are no longer present. Progress is also being made on structural reforms. For example, the employment to population ratio for working age women is now above the US average. In addition, corporate tax rates are set to come down over the next two years and the Companies Act has been revised to encourage the appointment of both outside and independent directors.

Export growth is starting to pick up as a result of the weak yen. In the fourth quarter of 2014, export volumes rose 11% above the prior year's level.[7] Together with falling commodity prices, this helped push the current account balance back into surplus. Preliminary data suggest that the current account surplus improved further in the first quarter of 2015.

[6] Bank Credit Analyst, Global Investment Strategy Outlook 2Q 2015, pages 18-19.
[7] Bloomberg Business, "Japan Export Growth Accelerates on Stronger Asia Demand "Economy", February 10, 2015.

Emerging Market Economies: There were substantial capital withdrawals from emerging markets in the second half of 2015. This, together with falling commodity prices and rising domestic and ex-euro interest rates, are tending to dampen EM growth. Moreover, EM currencies are weakening and foreign exchange reserves are being depleted.

What is likely to occur in the remainder of this year varies across EM economies depending on the magnitude of their imbalance. One group, including Mexico, Columbia, the Philippines and Indonesia, has implemented a number of productivity enhancing structural reforms. However, their prospects are limited by volatile political and socioeconomic conditions and low levels of educational attainment. Another group, including Brazil, Russia and South Africa, has squandered prior years of rising commodity prices by not implementing necessary structural reforms.

Still, emerging economies are in much better shape than they were in the late 1990s. This currency crisis period was characterized by a collapse in commodity prices, devaluation of pegged currencies, major sovereign debt service issues and rescheduling, all of which came to a head in the Russian default. The probability of such a crisis and the vulnerability of EMs to it have fallen substantially. For one thing, the share of debt denominated in local currency has risen significantly and much foreign-currency debt is now hedged with export revenues or through financial instruments. EM exchange rates are now flexible, whereas the 1990s EM economies maintained fixed exchange rates which were falsely assumed to be unvoidable and which had to be adjusted by an excessive amount in order to correct a fundamental disequilibrium. The flexible exchange rate system is relatively immune from destabilizing speculation capital flows, does not involve large forced devaluations and results in currency exchange rate volatility which makes the risk of mismatch between dollar liabilities and revenues denominated in local currency more tangible.

We believe that, unlike many other emerging markets, the risk of GDP estimated cuts in China are low and that room for further earnings downgrades is limited given where we think China's potential growth rate is. We believe that Chinese growth will be maintained in the 6.5% to 7.0% range through countercyclical measures taken by the government. Unlike many other EMs, China remains on the stable though slightly declining GDP growth trajectory. Morgan Stanley's bottom up analysis indicates that, "Progress is more advanced than official GDP statistics suggest."[8]

[8] Morgan Stanley, op. cit.

II. **Financial Markets**

Developed Market Equities: We remain overweight global equities. While valuations are not as compelling as they were, equities still offer more upside than most other asset classes in the world of negative real interest rates. At the same time, we have adjusted our outlook for different equity groups. We upgraded non-US developed market equities earlier this year and within that group we are further upgrading euro zone equities. The pickup in economic activity and the weakness in the euro have been greater than we expected. Both of these factors should lead to a substantial increase in dollar earnings growth.

The reasons for further underweighting US equities are twofold. First, while the US is preparing to raise rates, other central banks continue to ease monetary policy and in the immediate aftermath of the first rate hike in every Fed tightening since 1965 the Price Earnings ratio has declined.[9] Second, as already indicated, earnings growth is slowing. The S&P 500 EPS estimates for 2015 have fallen from $136 in October to $119 today, the sharpest decline since the financial crisis. Earnings estimates have fallen in every sector, not just the energy sector. The Bank Credit Analyst is concerned that even these analysts' forecasts may still be too optimistic. We disagree. History indicates that large positive moves in the US dollar and sharp declines in oil prices tend to have disproportionately depressing effects on S&P 500 earnings estimates, but that these estimates are subsequently reversed. We expect S&P 500 profits to be significantly above the $119 figure currently forecasted for this year. We believe that earnings in the non-energy sectors are likely to exceed analysts' estimates. Current earnings estimates do not adequately reflect the impact of lower energy costs on the bottom line.[10]

However, we have some doubts about whether the US market is priced cheaply enough to look over the valley of temporary earnings growth weakness. The market's trailing price to earnings ratio has historically been 15 to 16 times S&P 500 earnings post 1960. **Currently**, it is 18.5 times. The median price to sales ratio is also at a post-1960 high. Finally, the ratio of price to earnings, cyclically adjusted over the past ten years, is 27. This is 34% above the post-1960 median. For this reason, we favor active managers that purchase quality US equities only at reasonable prices and who focus on business values independent of market levels or short term noise.

[9] James Paulsen as cited in Jonathan Lang, "Is the Economy running too hot." Barron's December 27, 2014
[10] Bank Credit Analyst, op. cit., pp 31-33

Rising per share earnings, combined with depressed valuations, make non-US equities attractive even after a more than 4.4% advance in the first quarter of this year. The decline in the euro and the yen, together with the fall in energy prices and expansionary policies of the ECB, form a good backdrop for European and Japanese markets, irrespective of dysfunctional structural problems in their economies.

Take, for example, the euro area. Earnings per share are projected to increase by 14.5% in 2015 against an estimated EPS growth rate of 1.8% in the US. Yet the forward P/E of 16.0 in the Eurozone is substantially below the 17.4 forward P/E for the US. The eurozone's valuation discount is even greater if one looks at other measures. For example, the dividend yield is 90 basis points higher in the Eurozone than it is in the US. At 1.8 and 1.1, the price-to-book and price to sales ratios are well below those for US stocks, which are 2.9 and 1.8, respectively. Some of these disparities exist because US equity indices have larger weights in highly valued sectors such as technology and healthcare.[11]

The valuation case for Japanese equities is also compelling if one uses the price to cash flow ratio, rather than the price to forward earnings ratio as the benchmark. Japanese companies traded only 8.8 times trailing 12-month cash flow as compared with 9.8 for eurozone firms and 12.6 times for US firms.[12]

Two other factors buttress the case for Japanese stocks. First, the government pension investment fund and the Bank of Japan are stepping up their direct buying of Japanese equities. Second, Japanese companies are increasing their return cash to shareholders, with a number of companies announcing dividend increases.

China and Other Emerging-Market Equities: The MSCI China equity index has returned 15.8% over the past six months, which is substantially ahead of equity indices from most other countries. There is a good case that can be made that Chinese equities are at the beginning of a major bull run. Three out of four conditions for such a continued expansion of equity prices, which usually lasts three to six years, are being met. These include easy monetary policy, low starting valuation, and progress on structural transition and reform. Accelerating GDP is not a necessary condition for a sustainable market. This is especially true given China's GDP growth which is already above the average for its size and stage of development and which is stable or

[11] Bank Credit Analyst, op. cit., p 39
[12] Ibid, p. 42

at most slowly declining. In Morgan Stanley's view, "With slower GDP growth and a rising share of consumption/service activity, China's economy is starting to look like the Japan of 40 years ago and the Korea of 20 years ago". The MSCI Equity Index is being changed to give a greater weighting to the healthcare, information technology and consumer sectors ("the new China") and to give a lower weight to other sectors ("the old China"). Since 2008, new China's earnings per share have grown 8.2% per year against -2.3% for old China.

The risk of this view is that we are experiencing just another short-term false rally. Even so, significant downside from recent levels is unlikely. Equity valuations, especially for H-shares (which are shares of a company incorporated in the Chinese mainland that are listed on the Hong Kong Stock Exchange or other exchanges) are still low. The liquidity backdrop is supportive and a substantial growth downturn is unlikely. In addition, 2015 may also be a year that is conducive to re-rating structural reforms, which have been substantial this year. In short, we see a favorable risk/reward of overweighting China since the foregoing return of not participating in a sustained bull market run could well exceed the downside exposure of investing after another false rally.[13]

China aside, there is no near-term catalyst for a broad-based rally in other emerging market equities. A bounce in the Chinese market alone will not be enough since currency weakness in other EMs is expected to persist, particularly as the prospect of a Fed rate hike looms nearer. One has to be highly selective when investing in the EM universe and the benefit of active management in this area is significant.

Fixed Income: From the end of 2014 to the end of March of this year, the ten-year US Treasury yield has fallen from 2.11% to 1.99% according to data from Bloomberg. Thus the ten-year Treasury rates are just equal to the 2.0% inflation target and have at best a zero real rate of return. Even though such assets are expensive, we still believe that investors need to buy high quality fixed income assets to gain diversification. High-yield bonds or EM debt offer much more attractive yields than US treasuries and German Bunds. However, they do not offer diversification since higher-yielding bonds tend to be more correlated to the equity market than to US Treasuries.

[13] Goldman Sachs; China Strategy, "The Case for Re-Rating"(Parts 1 and 2), March 4 and March 11, 2015

Source: Bloomberg

In our view, the best way to construct a portfolio that mitigates equity risk is to buy global sovereign bonds on a hedged basis rather than just investing in ten-year US Treasuries. The decision to buy fixed income securities should be separated from the decision to limit or increase currency risk. The downside risk of high quality bonds, especially those with higher than normal yields, such as hedged Australian and New Zealand sovereigns, is less than commonly believed. The equilibrium Fed funds rate is closer to 2.0% than the 3.5% that the FOMC dot charts are calling for. Moreover, even though Fed officials continue to signal that a September rate hike remains likely, it is almost equally likely that the lift-off will occur in December or early 2016. The Federal Open Market Committee's median projection in its dot chart is 0.62% for the December Fed Funds rate. However, the Fed Funds futures market is predicting only 0.34%. Finally, the trajectory of increases in the Fed Funds target is likely to be flat given uncertainty about the strength of the US economy.[14]

[14] BCA, "Seven Structural Reasons for a Lower Neutral Rate in the U.S.", March 13, 2015

While the term premium (the excess of the yields to maturity of long-term bonds over those of short-term bonds) is very low on a historical basis, it is unlikely to rise significantly. The main reason for this is the global savings glut and the aging population in advanced countries. Though we are avoiding high-yielding credits which we believe are vulnerable to interest rate increases and bond market volatility, we are attracted to municipals in taxable accounts. Since December, global bond markets have fluctuated with primary drivers being the thrust of a lift-off in the US Fed's policy rate and subpar growth inducing rate cuts or unconventional expansion almost everywhere else. In this setting, the relative value ratio for ten-year tax-free municipals has remained elevated in the range of 95% to 100% of the ten-year Treasury benchmark. In other words, investors can purchase comparable quality tax-exempt bonds at essentially the same interest rate as a taxable Treasury bond. We favor investment grade obligations and essential service bonds, emphasizing bonds with coupons above today's market rates.

III. Conclusion

To summarize, we expect Chinese and non-US advanced country stock markets to remain strong during the remainder of the year, the US stock market to remain lackluster, having been virtually flat in the first quarter, and EM equities outside of China to have a high disparity of performance. Developed market bonds are likely to remain in a trading range, particularly if the lift-off in the US policy rate is delayed. Global GDP growth should increase during the remainder of the year.

As indicated in our year end letter, there are several risks to this outlook which are not fully discounted in market prices. The following are ones which we have not stressed before:

- The large debt overhang, both inside and outside the US. Globally, the total debt to GDP ratio is about 300% which is substantially above its historic norm and may have a strong dampening effect on aggregate demand growth.

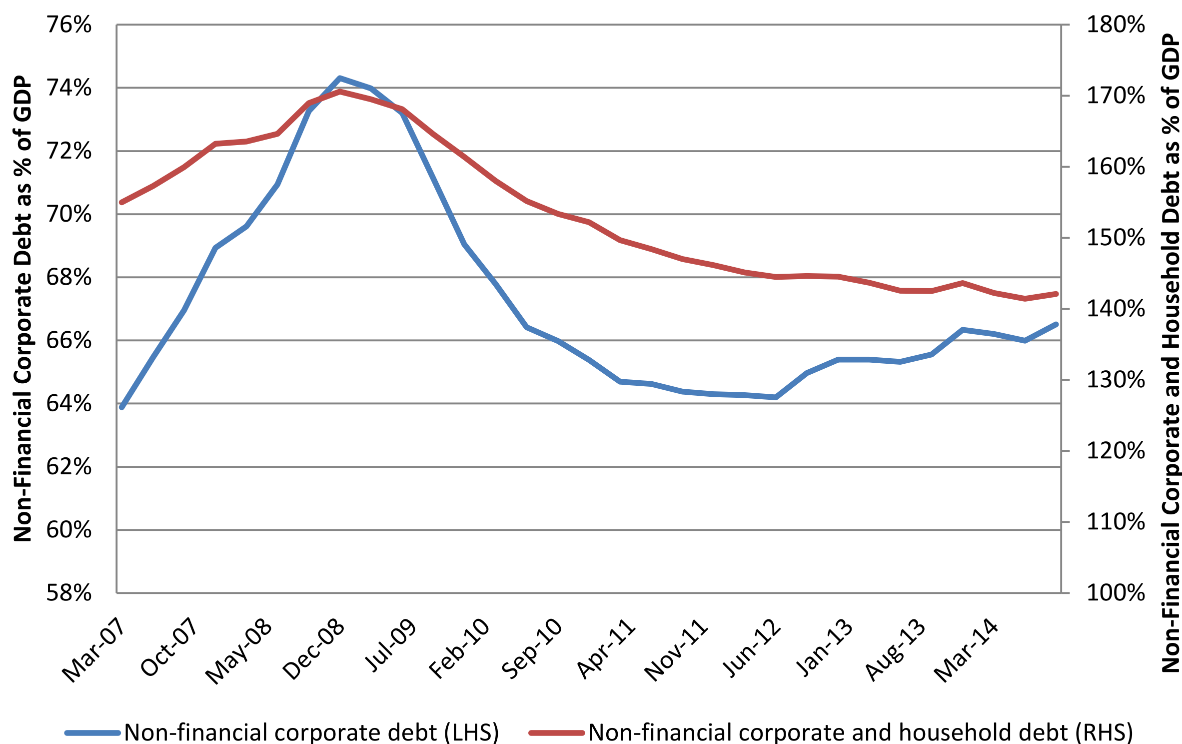
- Excessive increases in the Fed Funds rate or mistiming of the lift-off could plunge the global economy, as well as the US economy, into a crisis similar to that of 2008 to 2009 from which escape would be more difficult. The underpinnings for sustained global growth may be in place, but they are not so firmly anchored that the FOMC can attempt anything but small and cautious increases in the target rate. We expect that the FOMC will act prudently, but we are in unchartered waters.

- There have been previous episodes, such as those in 1982 and 1994, when even a responsible Fed policy tightening after an extended period of negative real rates precipitated a financial crisis in developing countries. For example, even if dollar denominated interest rates eventually rise at a measured pace, it may be impossible to prevent the Chinese private sector from having great difficulties. Its recent borrowings defied the wisdom of past crises; they have been oversized, foreign exchange denominated, short term, shadow bank-intermediated and housing-backed.[15]

- The lack of normal economic resiliency has made a tightening delay unavoidable but has produced an unrealistically low risk premium in financial markets priced to a "low for long" base line. As a result, there has been an excessive rise in net lending to nonfinancial corporate sectors, whose debt to GDP ratio has been rising since 2012. Loans to this sector have been used to finance dividends, levered buyout, share repurchases and acquisitions at above replacement cost and thus have eroded balance sheets.

- A greater sense of thrift among US households, along with stricter consumer lending standards, may dampen one key driver of increased global spending since 1982.

[15] Jeffrey Frankel, "Will Fed tightening Choke Emerging Markets", Project Syndicate, March 23, 2015



Source: Bank of International Settlements

James L. McCabe, Ph.D.	Mark E. McCarron, CFA
President	Chief Investment Strategist

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.

Investment in alternative investment products requires that the investor meet certain suitability standards, and therefore, investment in these alternative investment products may not be suitable for all investors.

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.

For further disclosures and information, please see our ADV, Part 2A:

http://www.adviserinfo.sec.gov/iapd/content/viewform/adv/Sections/iapd_Adv2Brochures.aspx?ORG_PK=110339&RGLTR_PK=50000&STATE_CD=&FLNG_PK=00C55AA80008017501E2A2B004F8769D056C8CC0