THE MCCABE PERSPECTIVE

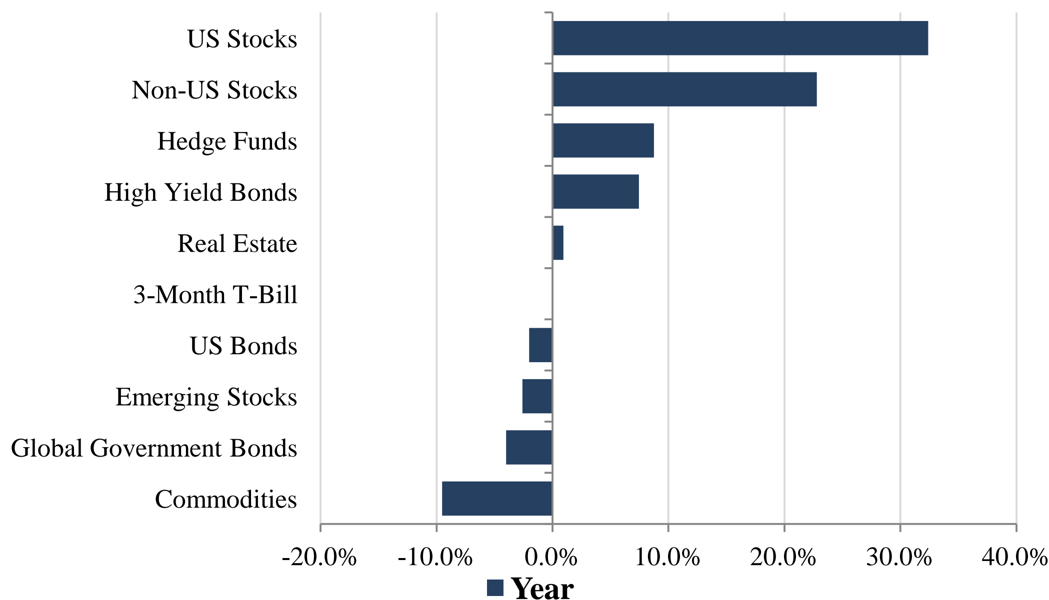
Fourth Quarter 2013

"It is better for reputation to fail conventionally than to succeed unconventionally"

– John Maynard Keynes

There is almost uniform agreement among economists regarding the global outlook for 2014, and the lack of contrarian views is a bit concerning. Most expect stronger global economic growth, the continuation of highly accommodative monetary policy by developed countries' central banks, further global equity market appreciation and more headwinds for global bond markets as interest rates normalize.[1] Five years after the Great Recession, developed economies are slowly recovering, interest rates and inflation remain low and many global companies have significant cash holdings on their balance sheets. While there are many areas of the economy that are not at capacity, improvements in growth, employment, housing, and consumer confidence were evident in 2013 and we expect these trends to continue next year.

Exhibit 1



Source: S&P 500 Index, MSCI EAFE Index, MSCI Emerging Markets Index, Barclays Capital US Aggregate Index, Barclays Capital US High Yield Index, Citigroup World Government Bond Index, Dow Jones REIT, Dow Jones UBS Commodity Index, HFRI Fund of Funds Composite Index, ML 3-Month T-Bill. All returns in US Dollar terms.

[1] Almost identical forecasts suggest that they are not made independently. Such a herd mentality is motivated by career risk and creates biases well recognized in behavioral finance.

In 2013 global equities performed strongly while global bond markets lost value. The MSCI All Country World Index, a broad measure of global developed and emerging markets, returned 22.8% while the Citigroup World Government Bond Index, a broad measure of global developed bond markets, returned -4.0%. Within equities, developed markets outperformed emerging markets and within fixed income, corporate bonds outperformed government bonds. Liquid alternative asset classes, such as commodities and REITS, underperformed developed market stocks and high yield bonds.

US Economy and Markets

Economic growth in the US is expected to increase next year to approximately 3.0% to 3.5% on an annualized basis.[2] An improving employment picture should support increased consumer spending and business investment should also pick up. If non-US economies stabilize as expected, exports could also improve from current levels. These factors, combined with the fact that there will be fewer fiscal headwinds in 2014, should result in a better growth environment going forward. The fact that the Federal deficit is shrinking faster than anticipated and Congress agreed to a budget deal in December should limit the uncertainty that has plagued consumers and business leaders alike.

According to the December Institute for Supply Management's Manufacturing Purchasing Managers Index (PMI), conditions in the US manufacturing sector continue to improve. The December reading of 57.0 was the second highest reading of the year (after November's 57.3) and the underlying components point to positive momentum. For example, inventories contracted in December while new orders picked up pace.

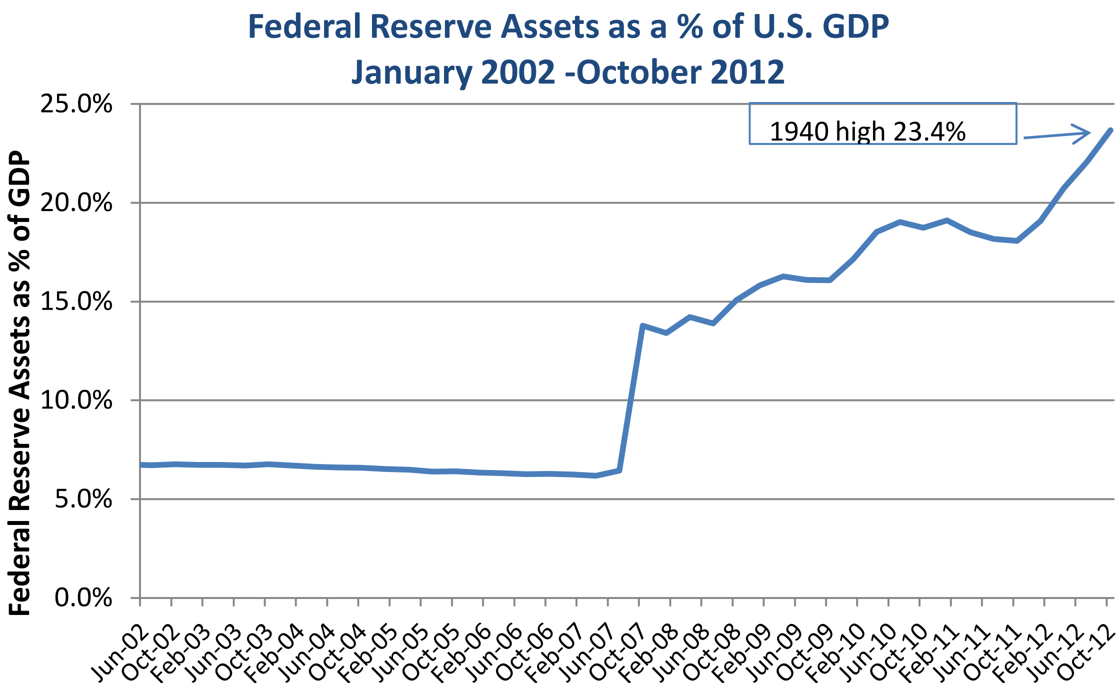
The US housing market has turned a corner and is no longer a drag on growth. While single family housing starts are well below where they were between 2000 and 2006, they are improving and now stand at their highest point since the financial crisis. Despite a slight increase in mortgage rates during the summer of 2013, homes remain quite affordable relative to history. In addition, house prices are rising and there has been a steady decline in the inventory of existing and new homes for sale which bodes well for future demand and construction.

Of course the big story of 2013 was whether the US Federal Reserve would start to taper its bond purchases and begin to exit its controversial quantitative easing program. While there were expectations of such action in the summer, the economic conditions to warrant such a shift were not strong enough until later in the year. In December the FOMC announced that it would reduce its Mortgage Backed Securities (MBS) and Treasury bond purchases by $5 billion each in January but that it would only consider raising the short term policy rate if the unemployment rate fell substantially below 6.5%. In contrast to the reaction in the summer, the positive response in December was due to the fact that there was an effort made to separate the forward guidance on short term rates from the decision to taper. This separation principle was evident in the bond market reaction as two-year Treasury rates remained at their low levels while longer term bond yields drifted higher. Even though the unemployment threshold

[2] Bank Credit Analyst, Outlook 2014, "Riding the Liquidity Wave", page 23.

for conventional tightening has been lowered, there is less incentive for the Federal Reserve to hold down long term rates than there would have been if the level of bond purchases were maintained at the previous level. The more long term obligations the Fed has on its balance sheet, the more the Fed is exposed to loss if long term rates rise. Markets are well aware of this difference and yield curves are more likely to steepen when a greater commitment to hold the zero bound is substituted for direct bond purchases.

Exhibit 2: Federal Reserve Assets as % of GDP



Source: Federal Reserve, FRED

Quantitative Easing (QE) in the form of bond purchases achieved some of its goals, missed others completely and may have created a bubble in some financial markets. It kept long term interest rates low enough to stimulate the housing market and it may have increased capital spending by encouraging REIT and MLP equity issuance but probably did not have a significant effect on corporate investment in other areas. It did not achieve the Fed's goal of making more credit available since banks sat on the cash that it gave them. It may have created asset inflation in certain equities and low quality bonds as investors were faced with reduced yields on high quality paper. Lower long term bond yields made it easier for companies to finance share repurchase programs and dividend increases. Per share earnings could also be increased through refinancing of long term debt and the resulting decline in interest expense.

While accommodative monetary policy has provided strong support for the US equity market over the last few years, it has not been the only factor. Reduced credit spreads, increased productivity, limited wage pressure and modest tax costs have allowed US profit margins to

return to historically high levels (9% operating profit as a percentage of sales)3 despite an underwhelming economic recovery since 2008. However, if margins are to remain strong, top line growth must pick up over the next few years in order to mitigate the likelihood of higher interest costs and higher wages in the future.

US Equity

US equities have become more expensive on a price to earnings basis. In addition, sentiment indicators have improved considerably and capital flows into the equity market have started to accelerate. While these technical factors are generally negative signs, we believe the US stock market still has room to rise and remains more attractive relative to the US bond market at this point provided the anticipated improvement in corporate fundamentals occurs.

The twelve-month forward earnings consensus estimate for the S&P 500 of $120 for 2014 may be too ambitious. For one thing it is approximately 14% higher than the estimate for the prior 12 months even though per share earnings growth in 2013 was only about 5.0% year over year. The long term per share earnings growth rate for the S&P 500 has been about 6.0% per year since 1926 based on our estimates. For another, Reuters recently calculated that 103 companies in the S&P 500 had issued negative guidance for the fourth quarter 2013 as opposed to nine which issued positive guidance. This is the worst ratio of negative to positive guidance ratio on record.[4] It may be unreasonable to extrapolate from these adjustments since they partly reflect weaker than expected non-US earnings which could well be reversed in 2014. However they should not be completely ignored. Based on the $120 projection, the price to forward operating earnings for the S&P 500 Index stands at 15.[5]

Using this measure as our basis, US equity markets are trading near their long term average. However the Goldman Sachs Valuation Index, based on several metrics, is in the ninth decile of historical observations[6] and the S&P 500 Index is trading at its highest level in six years compared to expected earnings.[7] The Shiller Cyclically Adjusted PE ratio (CAPE) is 25.4,[8] which is well above its historical average of about 16.5 over all time periods but close to its historical average of 22.3 during low inflation periods.[9] While they are no longer statistically cheap, equity markets in the US have further to run in our view although a double digit return this year seems unlikely. This is contingent upon profit and economic growth rates catching up to what the markets are anticipating.

[3] Bank Credit Analyst, Outlook 2014, “Riding the Liquidity Wave,” Chart 5.
[4] Bloomberg
[5] Standard & Poors, Bloomberg
[6] Goldman Sachs, “Within Sight of the Summit”, page 14, January 2014
[7] Bloomberg, Factset Research
[8] Online data, Robert J. Shiller, CAPE has only traded below its long run average for 9 months in the past 20 years according to UBS. The probability of almost perpetual overvaluation which this suggests is low. Comparing valuations to a mean based on 132 years of history is misleading because it omits structural changes that influence the fundamental value of stocks.
[9] Goldman Sachs, “Within Sight of the Summit,” page 22, January 2014

Exhibit 3: Valuation and subsequent return (table reproduced from Goldman Sachs research)

Region	Valuation Decile	Subsequent 5-Year Equity Returns	Share of outcomes with Positive Returns
US	9	5%	63%
Eurozone	4	12%	94%
EAFE	3	14%	92%

Source: Goldman Sachs, "Within View of the Summit", December 31, 2013. Note: Each decile contains five valuation metrics, beginning in September 1945. The current decile is based on an average difference from each decile's threshold across the following five valuation metrics: price/trend earnings, price/peak earnings, price/trailing 12m earnings, Shiller CAPE, and price/10-yr average earnings.

US Bonds

US bond markets suffered their first down year since 1994 as measured by the Barclays US Aggregate Index. Accommodative US Federal Reserve monetary policy has supported bond markets over the last few years but as growth improves and extraordinary measures begin to be removed, bond markets should continue to face headwinds. The consensus for 2014 is that government bonds will continue to underperform equities as they did last year. However, the US headline inflation rate has declined to just 1.2%. This means that the real yield on ten-year US Treasuries is about 1.7%, which is close to its post war average since 1945. Thus, by this criterion ten-year Treasury yields have almost renormalized.

Although we still believe that the nominal ten-year Treasury yield has about 40 basis points to rise to the midpoint of a 3.0% to 3.8% range, Treasuries of this duration are not seriously overvalued, are likely to be uncorrelated or negatively correlated with equities and serve as a deflation hedge in client portfolios. High Yield bonds performed better on a relative basis despite the record setting year of bond issuance in the sector. Companies have taken advantage of the generally low interest rate environment by either extending their current debt obligations or issuing new debt to raise capital at attractive rates. While investment grade corporate bonds and high yield bonds still offer better return prospects than government bonds, we remain cautious in our implementation in order to avoid the risks associated with rising rates and credit spreads that are close to historic lows, less discriminating investors and deteriorating covenant quality of lower quality issuers.

Non-US Developed Economies and Markets

Economic growth is expected to pick up in Europe, the UK and Japan in 2014 although each region has its own unique dynamics to consider. The UK stock market is dominated by global companies with revenue sources and profit potential largely unrelated to the underlying UK economy. For example, large oil companies, global banks and telecommunications companies represent nearly 50% of the market capitalization of the FTSE All Share Index. As global economic conditions improve, the UK stock market may also improve – although this is not necessarily representative of the underlying economy.

Europe

According to the Organization for Economic Co-operation and Development (OECD), European growth is expected to increase to 1.3% by the end of 2014 and 1.8% by the end of 2015. While this is not strong growth, it is quite an improvement over the last few years of double dip recession. The challenge in Europe remains the banking system. The highly anticipated Asset Quality Review and stress tests that will be carried out in 2014 will highlight the need for banks to build their balance sheets and improve their capital ratios. This will ultimately limit credit growth and overall economic growth as a result. While the late 2013 agreement on a Single Resolution Mechanism (SRM) represents progress toward banking union, it is only a limited step. One of its defects is that a single Europe-wide bailout fund will not be available for ten years and even then its total funds will be limited to about 55 billion Euros. Without sufficient funds in the early years, sovereign governments will be forced to seek assistance from the European Stabilization Mechanism (ESM) as Spain was forced to do in 2012. Thus, the vicious circle between banks and sovereigns still remains.[10]

Another concern in the Eurozone is the possibility of deflation, especially in the weaker countries. Inflation over the past year has declined from 2.0% to below 1.0%, which is substantially less than target. The main source of pricing weakness has been forced downward adjustment of wages on the periphery. The weaker countries are closer and more vulnerable to deflation, which makes it harder for them to reduce their high debt loads.

As a result, the European Central Bank has been accommodative thus far and will likely remain so going forward. The question is whether the ECB will be authorized or bold enough to try unconventional measures such as unsterilized bond purchases or negative interest rates, which would probably be opposed by the Germans with the possible exception of extremely weak economic conditions. Against this backdrop it is important to note that the peripheral countries in Europe have made substantial progress since 2011. This is particularly true of the smaller ones, such as Greece and Ireland, which have been able to offload their foreign debt on the European Central Bank, IMF and European Union in exchange for stringent austerity requirements and forced structural reform measures such as more flexible labor markets and major reductions in pension obligations. However, Spain and Italy have made less progress but received some relief in the form of lower borrowing costs as sovereign bond yields have declined.

It is our expectation that while the focus of the investing world was on the European peripheral countries in 2012 and 2013, the focus may very well shift to core European markets such as France and Germany as they seek to shore up their banking systems and simultaneously generate growth.

[10] Financial Times

Japan

Janet Yellen, the new Fed Chairman, and the architect of QE III, and Koichi Hamada, Special Advisor to Prime Minister Abe, are protégés of James Tobin,[11] a staunch advocate of central bank intervention in Treasury bond markets. Hamada was a major proponent of the reflationary monetary policy known as "Abenomics" and played an important role in choosing his former student at Yale, Harukiko Kuroda, to be governor of the Bank of Japan. Under Kuroda, the BOJ is buying more than $71.3 billion in bonds per month. Thus Japan's quantitative easing program has a distinct American flavor and is likely to be more successful as a real economic stimulus given Japan's long period of deflation since 1990. History has shown that once inflation expectations are increased, they tend to be self sustaining.

On the back of the monetary stimulus, Japan's equity market was among the best performing in 2013, particularly in local currency terms, but its currency return among the worst. The Yen weakened against most major currencies in 2013 as a result of aggressive monetary policy by the Bank of Japan. This policy has effectively kick-started the economy and as a result, export growth, business expenditure and consumer spending have all picked up. Importantly key inflation measures are beginning to rise as a result of the economic growth strategy implemented thus far. However, Japan still suffers from a large public debt to GDP problem and planned tax increases in 2014 and 2015 are necessary to address this particular issue, at least in part.

Exhibit 4: Relative Equity Valuations (table reproduced from Goldman Sachs research)

Global Equity Valuations Relative to the US

Region	Historical Average	As of December 31, 2013
Eurozone	-24%	-47%
Japan	-15%	-34%
Emerging Markets	-30%	-39%

Source: Goldman Sachs, "Within View of the Summit," December 31, 2013. Note: Historical valuations are calculated beginning in: Eurozone: 1980, Emerging Markets: 1995, Japan: 1999 (beginning of deflationary period), using US valuation history according to the corresponding region's history. Valuations are calculated across the following metrics: price/peak cash flow, price/peak earnings, price/book, price/10-yr average earnings (DM only), price/10-yr average cash flow (DM only), price/12-month trailing earnings (EM only), price/12-month trailing cash flow (EM only).

From a valuation perspective, non-US developed equity markets (i.e., UK, Europe and Japan) are trading at forward earnings multiples below that of the US. However, economic conditions in Europe are far from clear and growth rates are expected to be much lower than that of the US. In Japan much depends on the ability of government to implement structural reforms and while there is positive momentum thus far, the more difficult aspects of the reform such as labor market restructuring still lie ahead.

[11] Janet Yellen was James Tobin's teaching assistant at Yale and Koichi Hamada was James Tobin's dissertation advisee and a 27 year member of the Yale Faculty. Yellen laid out what she called the Yale Macroeconomic paradigm in a speech to the reunion of the Yale Economics department in April 1999 which advocates the use of aggressive monetary policy to offset the tendency of capitalist economies to run at less than full employment.

The Bank Credit Analyst highlights their concerns with commodity-related developed equity markets such as Canada and Australia. Both avoided the housing related crisis in 2008 but house prices continued to rise and household debt levels are well above those in the US. Given the fact that both economies rely heavily on commodity-related income, growth in these markets may be at risk. We remain cautious on both markets going forward and for this reason we have underweighted these markets.

Emerging Economies and Markets

Emerging markets were among the worst performers in 2013 led primarily by the poor performance of Latin American countries such as Brazil and Argentina. China managed a small positive return during the year despite economic growth slowing to 7.5% and deteriorating credit conditions. India, Indonesia and Turkey were among the worst performing markets for the year given their large foreign debt burdens and the capital flow out of the country following the tapering announcement by the Federal Reserve in June of 2013. India's market has since recovered on the hopes that a new Prime Minister will bring much needed leadership to a political system in chaos. In general Emerging Market Bonds have been a poor performing asset class as currencies in key markets such as India, Brazil and Indonesia have declined. With deteriorating commodity fundamentals and the potential for an improving US dollar, Emerging Market Bonds remain an asset class under pressure. In addition, capital outflow has put pressure on central banks to raise interest rates to prevent further capital flight. Brazil and India were two good examples of this.

We maintain an underweight to Emerging Markets relative to the MSCI AC World Index, but within Emerging Markets we favor countries with external surpluses or only small external deficits, especially within Asia, and are underweight Latin America. The relatively large difference in return between the two regions in 2013 is likely to continue. Asia is a commodity consumer while Latin America depends heavily on commodity exports. The trends in the commodity market remain weak and we believe this will continue throughout next year. We also believe that countries with external deficits are likely to be under pressure since long term developed market interest rates are likely to rise and the US is likely to strengthen. Even emerging market economies with external surpluses will be adversely affected by the weakness of the Japanese Yen and the increase in the Japanese share of world exports.

The Chinese economy is a key driver of economic growth for the emerging markets and the world. Last year was a year of transition within the Chinese economy and the new leadership is re-orienting the economy from an export-led economy to one that is driven more by domestic consumption. While this is likely to be a very long term trend, there is some evidence that structural reform is starting to occur. We also observe that the Chinese government is willing to step in to address any market stress – evidenced by their actions in June and again in December to mitigate the impact of rising short-term overnight banking rates. China has the resources to address any immediate slowdown or unanticipated credit crisis. This has emboldened the new government to crack down on the shadow banking system.

Debt levels of emerging markets have increased substantially. Thus, even a small capital outflow and increase in borrowing costs will have an adverse impact on the capital funding of governments and companies. This situation somewhat resembles that of the 1997-1998 Asian debt crisis. We are at the mature end of the credit cycle in emerging markets which suggests we may see increased defaults.

Summary

Our outlook calls for a moderate increase in global growth in 2014. We expect the GDP growth rate in advanced economies to double to 2.1% per year while the emerging market growth rate should increase only slightly from 4.7% to 5.3%, in line with the consensus projection.[12]

This base case growth projection is subject to certain downside risks. These risks are particularly important given the narrower margin of safety that investors now face. The strong recovery in asset values since the global financial crisis has compressed the once large risk premiums available to investors. We begin 2014 with less of a buffer to absorb adverse developments and errors in our outlook. Major downside risks include:

- A reappearance of the Eurozone sovereign debt crisis and a failure of Eurozone GDP growth to exceed stall speed.
- Withdrawal from quantitative easing in the US has more of a disruptive effect on financial markets than expected.
- The Federal Reserve's new tool, enhanced forward guidance, does not enable short term rates to have more influence over long term rates in the way that it was intended. In particular, restricting the conditions (e.g., reducing the unemployment threshold) under which the policy rate can be raised above zero will not significantly offset economic weakness.
- With higher than estimated capital destruction and permanent loss of labor skills due to extended unemployment, there is an outside chance that GDP growth in the G4 economies is strong enough to hit the full capacity constraint within two years which would derail further expansion as well as the equity bull market.[13]
- The Japanese experiment involving quantitative easing, currency depreciation and structural reform, fails and their economy reverts to its deflationary spiral.
- China's growth rate falls to nearly 6.0% against the expected 7.5%, causing a collapse in commodity prices and a hard landing in other major emerging economies (e.g., Brazil).
- Full scale revolution breaks out in Iraq and the Iranian nuclear threat reappears causing an upward spike in world oil prices.

We should not ignore the possibility of upside risks such as unexpected catch up growth in the US similar to the 5.0% GDP growth rate recently experienced by the UK.

James L. McCabe, Ph.D.
President

Mark E. McCarron, CFA
Chief Investment Strategist

[12] Bloomberg
[13] Financial Times, Gavyn Davies, "Will the Bull Market Continue?"

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