Drexel Morgan Capital Advisers

McCabe Global Economic Commentary

Fourth Quarter 2014

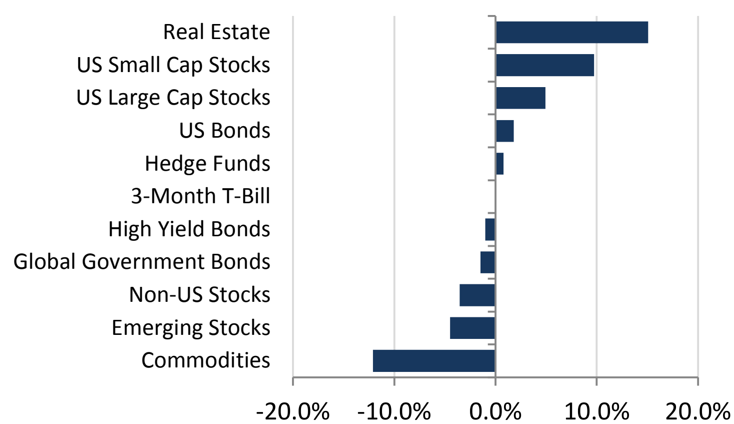
"In effect we have an incipient excess supply of savings, even at a zero interest rate. And that is our problem."

– Paul Krugman, May 2, 2009

As the opening quotation indicates, the main cause of weak global growth has been deleveraging, i.e., higher than normal savings to pay down excessive debt. The deleveraging process could last another four years. However, we believe that the real income gains associated with declining oil prices, combined with greater global fiscal and monetary expansion, will ultimately lead to higher aggregate demand growth in 2015. First, U.S. fiscal policy is likely to become more expansionary than it has been in the last three years, which have witnessed significant retrenchment associated with the sequester and reduced state and local spending. Second, we anticipate that there will be reduced austerity in the euro zone and that the European Central Bank (ECB) is likely to adopt a more expansionary policy. Third, the net effect of substantially lower oil prices should be positive for household real income and consumer demand. Fourth, although the Federal Reserve's balance sheet will cease to expand, this will be more than offset by higher bond purchases on the part of the Japanese Central Bank and the European Central Bank.[1]

Exhibit 1

Global Market Performance
For the Quarter Ended December 31, 2014



Source: Russell 1000, Russell 2000, MSCI EAFE Index, MSCI Emerging Markets Index, Barclays Capital U.S. Aggregate Index, Barclays Capital U.S. High Yield Index, Citigroup World Government Bond Index, Vanguard REIT Index Fund, Dow Jones UBS Commodity Index, HFRI Fund of Funds Composite Index, ML 3-Month T-Bill. All returns in U.S. Dollar terms

[1] JP Morgan Note to Investors as cited by Climateer Investing, January 7, 2015.

In our view, although 2015 could well mark a temporary pause in the advance, the end of the current bull market is substantially more than a year off. This bull market has outlasted the World War II average by a full year and the S&P 500 is more than three times its 2009 trough level. This run-up has produced a fully valued market, vulnerable to adverse shocks. However, a U.S. recession that would precipitate a protracted bear market does not seem imminent.

It is unlikely that price appreciation in the U.S. equity market in 2015 will come from valuation multiple expansion, as the main drivers should be earnings growth. If anything, price earnings (P/E) ratios are likely to contract. Such compression would be more the result of an increase in the Federal Funds target than an anticipated economic downturn. Reviewing the 32 rate hikes initiated in the developed markets since mid-1980s, the median price to earnings multiple fell 7% in the six months following the first rate hike.[2] Assuming that the Fed hikes rates by the midpoint of 2015, valuation multiples could be under pressure until year-end. We estimate that per-share corporate earnings of U.S. companies will rise 5.0% in 2015, partly through share repurchase and partly through sales growth, with margins remaining roughly constant. Most of the sales expansion should occur as a result of exposure to the domestic economy, with export sales and sales of overseas affiliates being relatively stagnant. The average return on U.S. equities, if positive, is likely to be in the low single digits, i.e., roughly comparable to that in 2011, and substantially below the 9% historic average. Obviously, the probability of a down year is close to 50%.

Even with the expected return this low, substantial equity risk is still justified in the U.S. market. The U.S. recovery is likely to be much longer than average. The slow rate of aggregate demand growth since mid-2009 has meant that the U.S. economy still has substantial slack, i.e., it is not yet supply constrained. Under these conditions, a flat or down year would not necessarily portend the end of a bull market already 5½ years old. There could be a substantial opportunity cost in missing a sharp rebound in the subsequent year. There is also a significant probability that the market return will surprise on the upside in 2015. The current advance has room in both time and price to match other historical bull markets, the last two of which peaked at price to earnings multiples above today's level.[3] Moreover, even with the limitations on equity return mentioned above, U.S. equity returns are still likely to be positive in 2015 and exceed those of cash or bonds over the next five years. We need to emphasize that the cyclical excesses or inflationary pressures that traditionally accompany bull markets are not evident at

[2] Goldman Sachs Global Investment Research, "Let it Grow: Markets take policy rate hike cycles in stride", September 10, 2014
[3] Goldman Sachs, "Global Equity Macro Scope: Strategies for 2015," Exhibit 70, January 9, 2015

the present time. The current unemployment rate, bond yield and inflation rate are in sharp contrast to those at historical market highs.

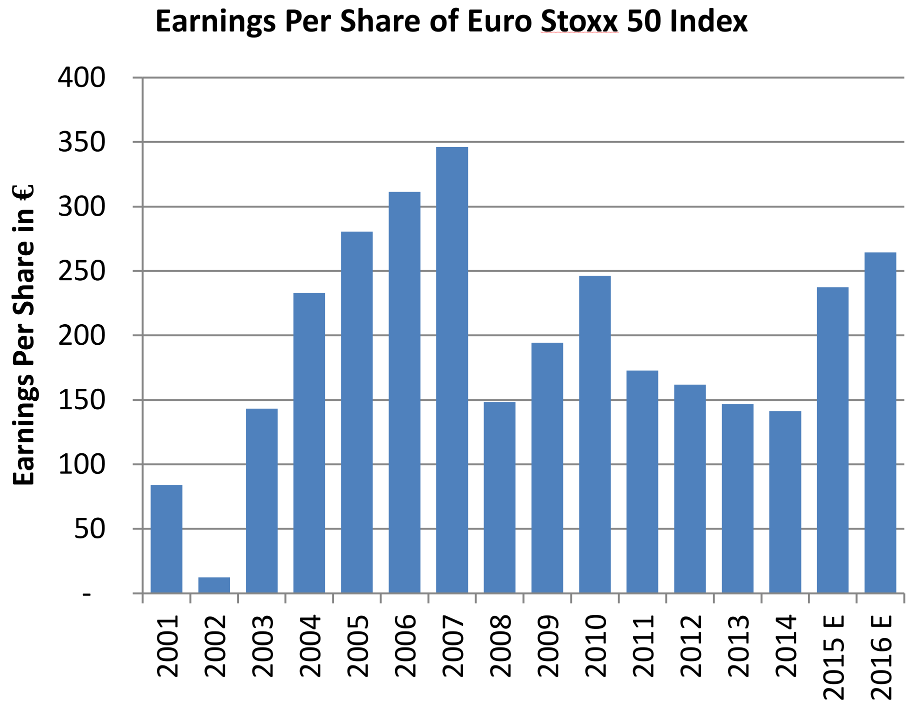
The highest weighted stocks in the Index, Exxon and Apple, partly account for why the average multiple on the S&P 500 Index is substantially below the median multiple. Such a disparity between mean and median reflects an overvaluation of stocks with relatively low capitalizations and undervaluation of stocks with relatively high capitalizations. The opposite was true at the end of 1999, which presaged a subsequent decade of small-cap outperformance; the opposite would tend to be the case now. A long-term earnings growth rate of 8.0% would be required to justify the forward earnings multiple for the Russell 2000 Index. If anything, this multiple is based on an overly optimistic projection of 12 month forward earnings. An 8.0% growth rate is substantially above the 4.4% per-share earnings growth rate achieved over the past 19 years in the small-cap universe.[4] We anticipate the beginning of a re-normalized, flatter yield curve. This, together with a stabilization of the Fed's balance sheet, will create a credit environment which is less favorable to small cap companies. Even though the U.S. GDP growth rate is likely to exceed that in other developed countries, which will hinder the earnings growth of many multinational corporations, the lack of foreign exposure of small-cap companies will not be enough to offset other factors including less available credit and a higher cost of capital.

Developed Market Stocks

We remain constructive on non-U.S. developed markets. This is largely because we anticipate that the worry about Japanese stocks is worth exploiting, not because we expect significant outperformance of Eurozone stocks. Deflationary forces may still have the upper hand in Europe. The combination of lower oil prices and sanctions has choked off euro zone exports to Russia. In addition, European banks held back credit expansion in order to maintain balance sheet strength during the recent stress tests. While we do not expect Greece to abandon the euro, the recently announced elections and the threat of a left-wing victory have produced less certainty about the euro zone holding together. Finally, as evidenced by the 0.2% decline in the euro zone CPI in December,[5] concerns about a deflation spiral are not baseless, although the market PMI readings indicate slight expansion in the fourth quarter. It is not yet clear that the euro zone has mounted a sustained recovery from the triple dip recession.

[4] Bloomberg, Russell 2000 Index
[5] Bloomberg

Exhibit 2



Source: Bloomberg

The case for retaining a market weight in euro zone equities rests on the following factors:

- Fiscal and monetary policy is likely to become more expansionary

- Weaker euro: euro zone growth in corporate profits is supported by the recent sharp decline in the euro which should improve the international competitiveness of European companies.

- Operational Leverage: Per-share earnings of euro zone companies are about 22% below 2008 levels.[6] European profit margins are still below their historic average and any significant pickup in nominal GDP growth could result in greater than 8% per annum earnings growth through the power of operational leverage.

[6] Bloomberg

- Valuation: At 7.8%, the equity risk premium, the spread between the forward earnings yield and the government bond yield, is very large in Europe. Even if 2015 is a very weak year in earnings, a small decline in the equity risk premium can cause a large increase in equity prices.[7]

- Lower oil prices: Although the sharp fall in the price of oil has reduced export demand from Russia, the net overall effect will probably be positive. The euro zone is a net importer of energy and the fall in oil prices acts like a tax cut.

In our view, the prospect for Japanese equities is good in 2015. Japan suffered a self-inflicted recession because of a value added tax increase in April. For the year as a whole GDP growth was slightly negative or zero as compared with an expected advance of 2%. To counteract last year's shortfall, Japanese authorities are making greater effort to induce growth. They are easing financial conditions and producing a highly stimulative monetary policy. On October 14, the Bank of Japan announced plans to increase the amount of monetary expansion from ¥60-¥70 trillion per year to ¥80 trillion. We expect it to increase the pace of monetary expansion even further this year. In addition, not only has the second scheduled consumption tax increase been postponed from its scheduled date this year, but consumption should be helped by a 2.5 percentage point reduction in the corporate tax rate and a ¥3.5 trillion supplementary budget which were recently announced.[8] Although we believe that Japan ultimately needs to raise taxes to reduce its chronic budget deficit, these measures will enable the economy to recover before the next tax increase. In the words of Keynes, "The boom, not the slump, is the right time for austerity."[9]

Other factors not directly related to policy, should cause Japanese growth to accelerate in 2015 these include:

1. Higher U.S. GDP growth which should benefit Japanese exporting sectors and more than offset an expected slowdown in China.
2. Support from a weaker yen and weaker oil prices.
3. Ongoing structural imbalances related to demographics as well as debt are still a threat to Japan's long-term fiscal stability. Nonetheless, they are unlikely to undercut our projection of modest GDP growth of about 1% in 2015.

[7] Goldman Sachs, "Global Equity Macro Scope: Strategies for 2015," Exhibit 31, January 9, 2015
[8] Financial Times, December26, 2014, Tokyo to cut corporate tax rate. December 27, Japanese cabinet approves ¥3.7 trillion stimulus. "Japan is boosting its economy with a simple idea. You won't believe we are not trying." VOX.com, January 4, 2015. The Tax Foundation, "Lessons from Japanese tax policy," November 18, 2014
[9] JM Keynes Collected Writings, 1937

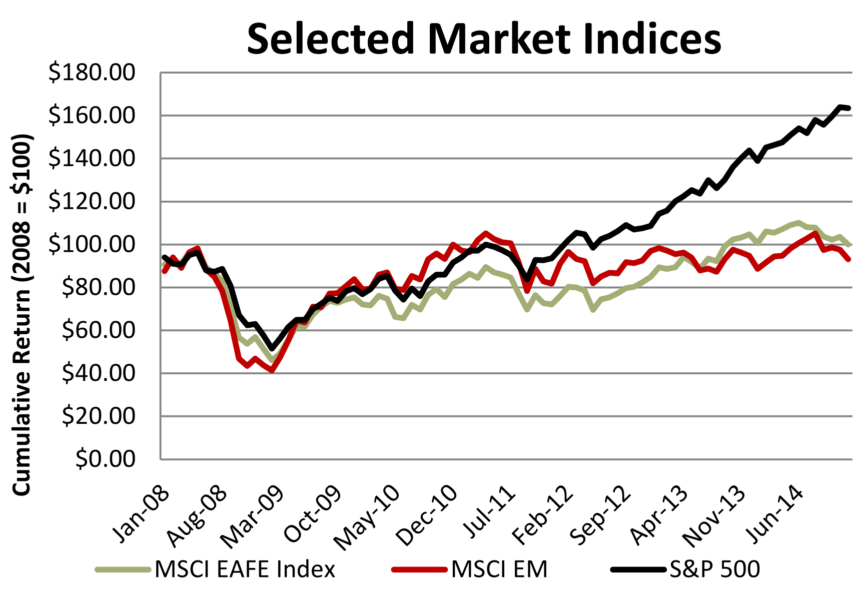
The outlook for Japanese equities is substantially improved, not so much by the domestic economic turnaround, as by higher U.S. growth and a substantially weaker currency. Export related companies account for 30% of the TOPIX (Tokyo Stock Price Index) market capitalization. Goldman Sachs has estimated that based on their assumption, the Yen (currently at 118 per dollar), will fall to 125 per dollar by the end of the year, the resulting increase in earnings growth should be nearly 8%.[10]

We expect that the Japanese equity risk premium will diminish and that the multiple on Japanese stocks will expand. There is evidence that the two forces that have resulted in a higher risk premium for Japanese equities in the past, deflation and capital return policies, are diminishing. Recent statistics indicate a positive inflation rate and Japanese firms have substantially increased their dividends and share buybacks. Within the MSCI EAFE Index we believe that Japanese equities will have a stronger performance than euro zone equities this year, with the European return being in the mid-single digits and the Japanese return being in the low double-digits.

Emerging Market Equities

The year 2014 represented the fourth consecutive year in which the EM stock index lagged the developed market stock index.

Exhibit 3



[10] Goldman Sachs Investment Strategy Group "Outlook: U.S. Preeminence", Page 59

This was attributable to factors such as disappointing earnings growth, unusual U.S. dollar strength, weak commodity prices, escalation of geopolitical risks, and a tightening of monetary and fiscal policies in the emerging market countries. Emerging market stock valuations look attractive on a price to cyclically adjusted earnings basis. However, there is justification for this valuation benchmark being lower than its historic norm. Declining profit margins and increased leverage have resulted in a lower quality as well as lower return on equity. Profit margins are unlikely to recover this year because of higher wages, higher input costs and excess capacity in many industries. Thus the positive return on EM equities is likely to result from earnings growth through sales expansion as opposed to margin improvement. For EM economies as a whole we anticipate that sales and per share earnings will expand in 2015 at rates of about 5% and 3%, respectively, despite an anticipated slowdown in the Chinese economy. This, combined with a 2.8% dividend yield, should result in a mid-single digit total return on emerging market stocks. Given the higher price volatility of emerging market stocks, this expected return is lower than that on developed market stocks, especially on a risk–adjusted basis.

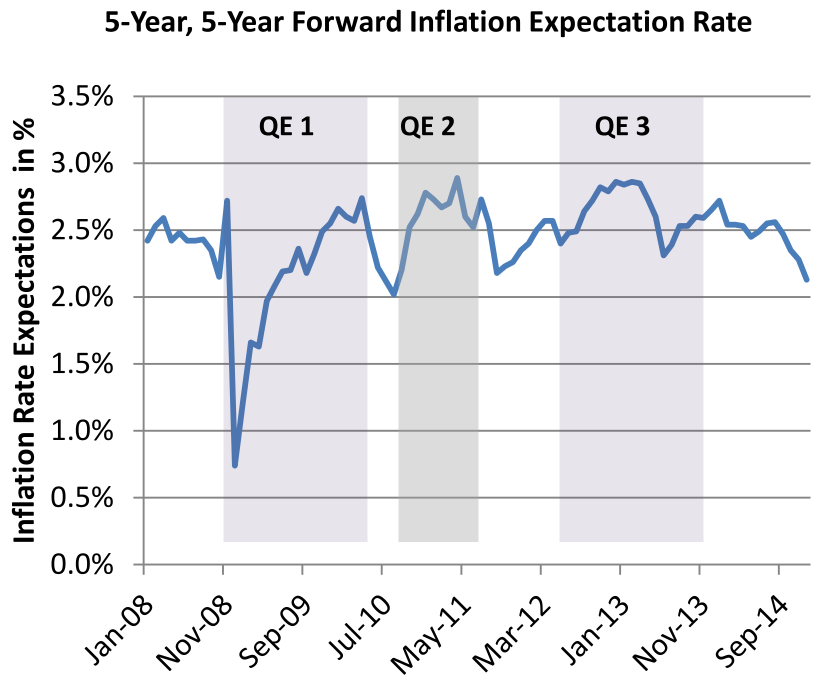
We must stress that country selection is extremely important and that the use of active managers is more prudent than relying on passive index funds. We also believe that government-owned companies should be avoided as much as possible. In Russia and possibly China there is the risk of outright seizure of private shareholder wealth associated with these companies. Even in Brazil such a problem may arise, as evidenced by the Petrobras situation. There are still significant opportunities for return in privately held companies.

Fixed income Outlook

We see 2015 as a transition year for fixed income markets, but we do not expect that it will be the beginning of a bear market for bonds. Even at low yields, longer duration, nominal bonds are a hedge against deflation, which is a greater threat today than normal. They are also negatively correlated with stocks in bear equity market periods and thus play an important diversification role in portfolios.

In 2015, we believe that the end of the Fed's bond buying program and the prospect of rate hikes in the U.S. will result in more volatility in fixed income markets, in other capital markets and in commodity prices.

Exhibit 4



Source: Federal Reserve Bank of St. Louis

In 2014, the ten-year Treasury yield fell from 3% to close to 2%, even as the Fed's bond buying program was being curtailed. This is not as paradoxical as it appears at first blush, in that bond yields also fell after the last two rounds of QE ended in 2010 and 2011. A possible reason for the rise in bond yields during periods of central bank purchase may be a link between quantitative easing and expected inflation, which has some empirical support.[11] It can be argued that when the Fed is pursuing QE, it increases inflation expectations causing nominal bond yields to increase. Its ending QE when there are not yet signs of accelerating inflation, let alone a very strong real economic growth, has the opposite effect: falling inflation expectations and lower bond yields. Witness the recent decline in the ten-year breakeven inflation rate from about 2.2% to 1.5%.[12]

A stronger dollar and falling commodity prices are contributing to lower inflation, but are also boosting real disposable incomes and consumer spending. Since household consumption is about 70% of aggregate demand, a rebound in U.S. growth is occurring. Unless this trend is reversed or the disinflation gets out of hand, we expect the Fed to start to raise rates in the

[11] Event Studies have established that announcements of QE 1 and QE 2 had a positive impact on inflation expectations within a two day window. See haas.berkeley.edu, Oct 28, 2011. PDF.
[12] Falling commodity prices in this case probably played a bigger role than the termination of QE 3.

middle of the year, earlier than we had previously anticipated. By this time, the unemployment rate should have fallen to the Fed's 5.2% target given it is already at 5.6% as a result of the recent large employment gains. Long-term yields are still below their equilibrium level, i.e., the nominal GDP growth rate, but we do not expect a substantial upward spike in Treasury yields. These yields are well above comparable ones in the rest of the developed world and the global market determines U.S. Treasury yields. More than half of all Treasury bondholders are outside the U.S. Given this, and the prospect of Fed rate hikes, the U.S. yield curve should flatten further in 2015.

Despite our expectation for continuing low long-term yields, we expect credit market volatility to rise reversing the trend of the past five years. The Fed should no longer be encouraging investors to move into higher risk bonds. It should cease encouraging the reach for yield by holding short-term rates near zero and buying long-dated bonds with an open-ended timeframe. Thus the gradual reversal of Fed policy, together with reduced dealer inventory, should cause credit spreads, already at the 20 year average, to rise further. In particular, the cessation of quantitative easing in December 2014 will force corporate bonds to compete more with Treasury bonds through a higher credit spread in order to induce investors to purchase them. The high-yield bond market is especially vulnerable since in addition to tighter monetary policy, the percentage of energy companies issuing high-yield debt has risen recently and falling oil prices have increased the probability of these issuers defaulting. At some point the risk/reward tradeoff for lower credit bonds should improve, but we believe that U.S. Treasuries, investment grade corporates, and municipal bonds, which are more liquid than high yield paper, will better withstand the likely increase in bond market volatility associated with less expansionary U.S. monetary policy. They should also hold up better given the greater issuance of long-dated paper by the Treasury to the private sector and the greater duration risk that must be borne by that sector.

In our view, maintaining duration close to that of the U.S. bond benchmarks, at about 5 1/2 years in the case of taxable issues and at four to eight years in the case of municipals, offers the best risk-adjusted expected return. The impact of Fed rate hikes tends to be larger on short duration bonds than on intermediate term issues. Caution is warranted in exposure to non-U.S. bonds, especially those of emerging market issuers. About 75% of the $2.8 trillion in EM bonds outstanding are denominated in U.S. dollars and the reduced value of EM currencies puts pressure on dollar reserves and makes it harder to service this debt.[13] As evidenced by the consequences of the Russian ruble collapse, the inflationary effect of a falling currency may cause emerging market central banks to hike short-term interest rates, which will further reduce emerging market bond prices.

[13] Charles Schwab Bond Market Outlook: Brace for Volatility, December 18, 2014

Conclusion

Lower oil prices and a more favorable fiscal/monetary policy mix should produce greater global demand growth. For example, the 36% decline in the oil price since mid-2014 has significantly reduced price inflation in the developed countries with wages roughly unchanged. This is increasing retail sales growth in the U.S. and the Eurozone as well as elsewhere. Global real GDP growth should exceed 3.0% in 2015, which is about half a percentage point higher than last year, but well below the long term average.

This pick-up in aggregate demand growth should be favorable to global equity return without significantly raising long term bond yields in developed countries. Although they have started off badly in early January, non-U.S. developed market equities should have the strongest performance this year and over the next five years, with expected returns in the low double digits in both cases. The U.S. equity outlook is less uncertain, but is likely to be in the low single digits in both the one-year and five-year cases. The expected return on emerging market equities is not compelling given the risk involved. The return on U.S. Treasuries should be slightly positive in 2015 and close to zero over the next five years. The return on high yield bonds should be higher but less compelling on a risk-adjusted basis. Emerging market debt is likely to provide returns only slightly above those of high quality developed market bonds, but will experience much greater volatility.

In short, as in 2014, the U.S. should make greater financial and economic progress than the euro zone or Japan but the relative return on U.S. stocks should be lower than that on the MSCI EAFE Index in 2015. The return on credit in all developed regions is likely to be lower than that in 2014 when bond yields fell substantially.

One must assume the usual market risk on long dated assets to obtain adequate returns. This is especially true in an environment in which the yield on high quality bonds is well below the historic norm. The asset class returns projected above along with our outlook for global growth are also subject to major non-market risks. These include:

- Bad deflation in the Eurozone. Medium term inflation expectations in the Eurozone remain unhinged below the ECB target of close to 2.0% and the Eurozone fails to recover from its latest recession partly because the ECB is not allowed to undertake sovereign QE on a large enough scale and partly because the sharp decline in oil prices has further reduced price expectations.

- A Chinese hard landing. Excess capacity in the construction and manufacturing sectors combined with excessive leverage in the non-bank sector in China are not offset by mini-stimulus and thus threaten global economic stability.

- Geopolitical hotspots and terrorist networks in the Middle East are not adequately dealt with and a terrorist attack of September 11 magnitude occurs.

- Russia invades former Soviet satellite nations in addition to the Ukraine.

- The current oil shock not only persists, but has major destabilizing effects on Russia and other oil producers in the emerging world with dangerous political and Eurozone consequences. This is similar to what occurred in 1998 (the year of the Russian default) during which credit risk became globally contagious and credit spreads exploded in developed country capital markets.

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