Drexel Morgan Capital Advisers

Global Economic and Market Commentary

Fourth Quarter 2015

"… the Committee decided to raise the target range for the Federal Funds Rate to one quarter to one half percent." - Janet Yellen, Fed Press Release December 2016.

"The risks of raising rates seem more likely to play out and much more serious than the risk of standing still on rates…an excessive delay in raising rates can be remedied eight weeks later at the next FOMC meeting. On the other hand, if rates are raised and it proves to be a mistake, there are likely to be substantial costs as inflation expectations move down, financial turbulence ensues and the economy possibly tips into recession."
- Lawrence Summers, Financial Times December 15, 2015.

Summary

- The range of investment quality stock and bond returns in 2015 was unusually narrow with a lackluster median. High yield bonds, emerging market stocks and master limited partnerships (MLPs) experienced sharp declines.
- The global economy continued to grow significantly below trend.
- Our base case outlook calls for developed market (DM) equity return to be higher by five percentage points in 2016 from -.32% in 2015 and with the balance of risks skewed to the downside.
- Some of the macro themes of 2015 (a strong dollar and monetary tightening in the US) will carry forward into 2016 but some will change and new themes will develop.
- We are advising an overweight in European and Japanese equities, a slight underweight in US equities and an underweight in global fixed income.
- US high yield bonds and MLPs provide significant investment opportunities with proper security selection.

For most financial assets 2015 was a challenging environment. Equities saw negative or muted performance as the S&P 500 returned 1.4% year to date, its worst yearly performance since 2008. Moreover, non-US developed market equities, with the MSCI EAFE (net) Index returning -0.8%, declined for the second consecutive year even though European and Japanese earnings recovered in local currency and central banks took aggressive actions.

Fixed income faced challenges as the Barclays Aggregate Bond Index, 0.6% for the year, had its worst year since 2013 as yields slowly moved higher in anticipation of the Fed rate hike in December. US high yield, down -4.5%, posted its worst annual decline since 2008 due to its oil related exposure. Although the dollar, up 9.2% on a trade-weighted basis, increased as a result of diverging monetary policies, it negatively impacted commodities, with the Bloomberg Commodity index down -24.7%, which posted its worst year since 2008. This, along with slowing Chinese growth, contributed to the -14.9% decline in emerging-market (EM) equities.

For reasons explained in the remainder of this commentary, we expect that developed market equities will deliver slightly better dollar-denominated returns in 2016, while EM equities should continue to languish and the unhedged performance of developed market government bonds will tend to be lackluster.

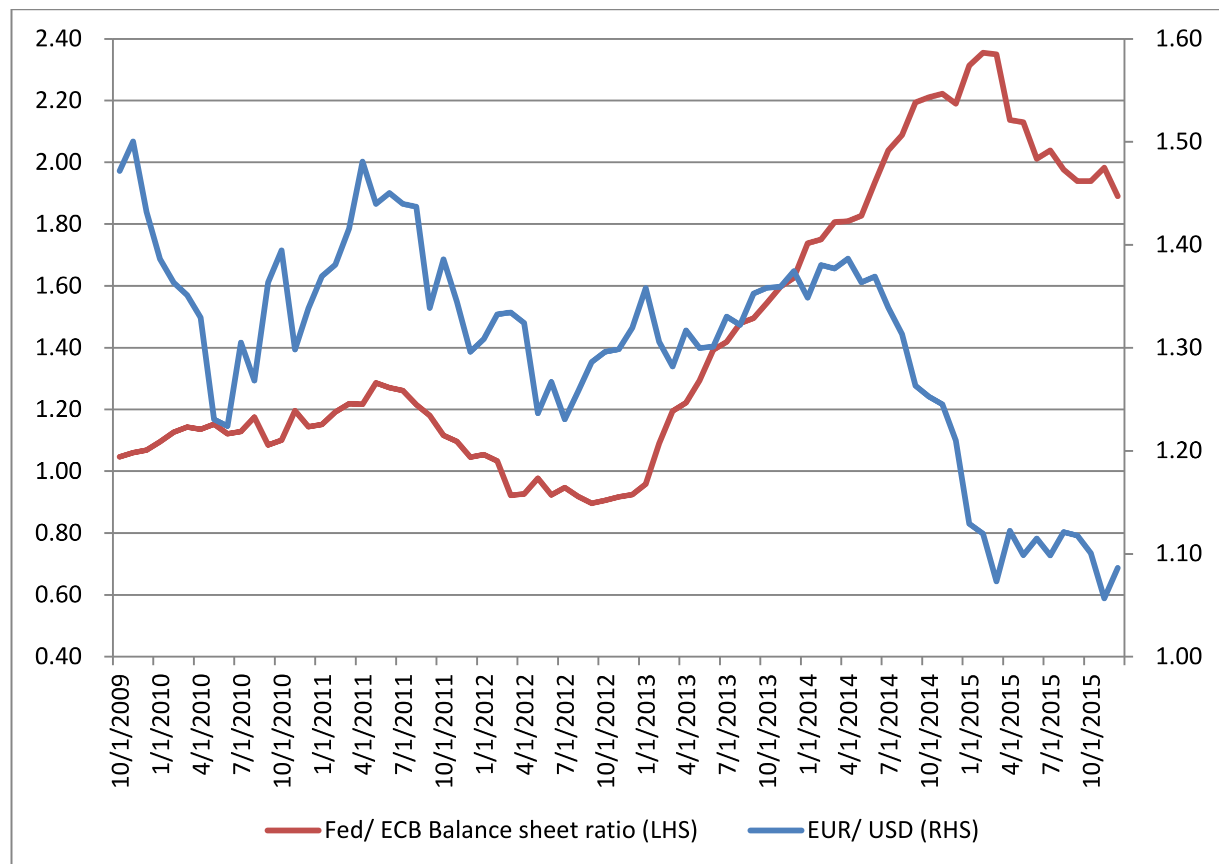
DEVELOPED MARKET ECONOMIES

United States: We expect US economic growth to come in at about 2% in 2015 and at about 2.5% in 2016, with purchasing manager indices indicating expansion in most of the economy (see Exhibit 1). The growth concerns that periodically appeared during 2015 have involved a less confident response of US consumers to higher real incomes. In the second half of 2015, the renewed decline in oil prices began to convince consumers that at least part of the downward adjustment in energy prices was sustainable and should only be partially saved. Hourly wage rates in December grew at 2.5% on a trailing 12-month basis, up from 2.3% in November.

Exhibit 1: ISM Manufacturing vs. Non-Manufacturing Indices

Source: St. Louis Federal Reserve

Exhibit 2: ECB Versus Fed Balance Sheet and Exchange Rate



Source: Bloomberg

This, combined with an average increase in employment of over 200,000 per month in the last year, has substantially increased consumer purchasing power. The final estimate of third quarter GDP showed that the gain in consumer demand accounted for more than 100% of the overall U.S. growth rate. The likely continuation of low energy prices, together with the improved housing equity position of many households, suggests that there will be a greater jump in consumption in 2016. It is estimated that the decline in the household savings rate, together with an improvement in the household net worth, will add the equivalent of 1.1% to US GDP.[1] This adjustment will not occur rapidly, but is likely to permeate the economy during the course of 2016.

There will be some additional fiscal stimulus in 2016 with the estimated budget deficit-to-GDP ratio rising to 3.1% from about 2.8% in 2015. This, together with positive developments at the

[1] Lombard Street Research, LSR Daily Note, December 3, 2015 Page 8.

state and local levels, should add 0.4 percentage points to GDP growth in 2016 according to Goldman Sachs.[2]

On the unfavorable side, vehicle sales will play a much reduced role in boosting growth given that the late 2015 level of more than 18 million units at an annual rate was at a high extreme and leaves little upside. Moreover, the rise in the US dollar suggests that the deterioration in net trade will continue to be a drag on growth over the coming year. This drag should be less than it was in 2005 because we expect a more subdued increase in the trade-weighted dollar. Finally, with relatively low topline growth, business investment will remain subdued although it is likely to increase at a higher rate than it did in 2015. This is because most of the fall in investment in the oil sector has already taken place, because of the investment tax credits incorporated into the latest tax legislation and because monetary policy will likely remain accommodative even after three additional rate hikes, with the difference between the neutral and actual policy rates exceeding 90 basis points.[3]

Putting all this together, the pace of growth should remain the same or accelerate slightly in 2016 as suggested by the Purchasing Managers Indices in Exhibit 1. This will leave the US as one of the better performing developed economies save possibly for some in the euro area.

The Euro Zone Recovery Gains Momentum in 2015: Fueled by cheap oil and aggressive monetary stimulus, 2016 could also witness better than expected expansion in GDP assuming decent global growth and thus far illusory, a long awaited increase in capital expenditures. Meanwhile, the European Central Bank (ECB) will do its best to keep the euro (down 20% in the last 2 years) depressed, since it believes that a competitive exchange rate is the most effective way for policy to stimulate exports (see Exhibit 2). It's actions to increase bank lending (which supplies 75% of corporate funding) and the willingness of banks to lend after six years of balance sheet repair should continue to open up the supply of credit to the European periphery.[4]

Assuming the world economy avoids a major downturn, we are confident that the euro area expansion will continue in 2016. We expect both net exports and business spending to improve, while consumers will become more challenged. Nominal wage growth remains weak, but this should be more than offset by higher job growth and a consequent higher increase in the wage bill. We expect that business investment should increase enough to sustain the growth in aggregate demand. According to LSR, "a range of indicators, including rising

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[2] Goldman Sachs 2016 Global Economic Outlook, page 38.
[3] An estimated neutral real rate of 0% is provided by the estimates shown in Lawrence Summers' Blog: Financial Times, December 15, 2015. The real policy rate is about -.95% currently.
[4] Goldman Sachs Op. Cit., Page 41.

corporate profits, bullish investment intentions and a recovery in corporate demand for loans all point to a revival in capital expenditure (CapEx) in 2016." [5] Absent another postponement of investment plans due to global economic uncertainty, a long expected rebound should lead to a year of above trend growth.

In the last six months, the eurozone has faced a major inflow of migrants from North Africa and the Middle East. While many of the working age migrants will be difficult to absorb into the labor force rapidly and will create some disruption, they should stimulate aggregate demand as a result of additional deficit spending by governments to provide them with adequate living facilities, food, and other necessities. In the longer-term they are, on average, substantially younger than the existing eurozone population and should reduce the age-dependency ratio and provide an additional, badly needed, pool of labor.

Japan: Early in the fourth quarter, third quarter Japanese GDP was released showing a 0.8% annualized decline in the economy and since the second quarter GDP had also been negative, the Japanese economy was technically in a recession. This announcement set off widespread news reports of Japanese economic contraction and questioned the effectiveness of the current economic reforms. The continued contraction was not consistent with the conversations we had with investors who visit Japan regularly and a few weeks later, third quarter GDP was revised up to 1.0% on an annualized basis. In addition, the Bank of Japan Tankan Survey of business sentiment in December was positive for manufacturers (versus negative expectations) as well as service and construction. Compared with September, Japanese companies raised forecasts for profit growth and capital investment for the fiscal year. While the health of the underlying economy is not essential to appreciation in the equity markets we, as investors, feel more comfortable when the underlying economic growth trajectory is positive.

Inflation registered approximately 0.3% year-over-year in October 2015, but the economic data support a healthier economy. First, the labor market is very tight with unemployment currently at 3.1%. Wage growth appears lower than it actually is owing to a large and growing temporary work force, a phenomenon which originally emerged in 1999 and grew through 2008 to over 30% of the work force. Women have also increased their place in the workforce. Second, tourism is booming in Japan; 2015 finished at 3.5 Trillion yen on an annualized basis versus 2.0T yen in 2014. [6] The largest source of tourists in 2015 was China. [7] Third, lower energy prices should boost consumption in the first quarter and the rest of 2016. Finally, stabilized growth in China and Asia ex-Japan should boost exports. These regions account for 54% of exports and will continue to grow, albeit at a lower rate than in the past.

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[5] LSR Daily Note, Op. Cit., Page 17.
[6] Morgan Stanley Global Macro Outlook.
[7] The Wall Street Journal, China Real Time, December 2, 2015.

We estimate that real GDP increased by 0.7% in 2015. However, there are indications that Japanese growth will pick up in 2016. Labor income should increase significantly owing in part to the 3% increase in the minimum wage rate and significant employment growth. In addition, Goldman Sachs[8] notes that there are four other factors which should benefit the economy this year: (1) the government has recently introduced a 3.3 trillion Yen stimulus package (0.6% of GDP);[9] (2) stronger external demand for Japanese products from its major trading partners other than China which are anticipating higher GDP growth; (3) lower commodity prices which benefit a major commodity importer; and (4) a competitive exchange rate. We expect Japanese real GDP growth rate to be in the 0.75% to 1.0% range.

CHINA

Chinese economic activity in the fourth quarter was not significantly lower than that of the first half of 2015, despite the recent stock market collapse and downward pressure on the Chinese exchange rate. Although we believe a hard landing will be averted, Chinese growth and policy will likely remain uncertain in 2016. We believe that overall GDP growth will maintain a slight downward trend. China's economy is facing major imbalances, unsustainably high investment and a potential deflationary spiral created by excess capacity and falling profits. However, policymakers will continue to defend against the downward trend in growth using monetary and fiscal tools. We expect China's growth to fall in 2016, but to remain well above 5%. Hence, the spillover effects from a slowdown in China will remain, but not increase in 2016.

It is not possible to have a stable exchange rate, free capital movement, and interest rate flexibility at the same time. Without capital controls, domestic speculators will view exchanging the yuan for the dollar as a one way bet as long as the currency is allowed to drift downward against the Greenback. This could occur even if a fixed trade-weighted exchange rate is maintained. Given that capital outflows exceeded $100 billion in December, more adequate capital controls need to be implemented. For this reason, Chinese authorities are eliminating Chinese households' ability to convert the yuan to dollars up to a $50,000 amount each calendar year. Much of the reserve decline in the last month has been due to such Chinese household conversions. Stabilization of the effective exchange rate would require a relatively minimal depletion of reserves if the People's Bank of China (PBOC) were able to obtain Fed assistance through a currency swap arrangement. This would clearly be in US interests since the threat of a yuan devaluation is a roadblock to further Fed tightening. The Fed would also want to prevent the massive offloading of Treasuries if China has to rely further on its reserves

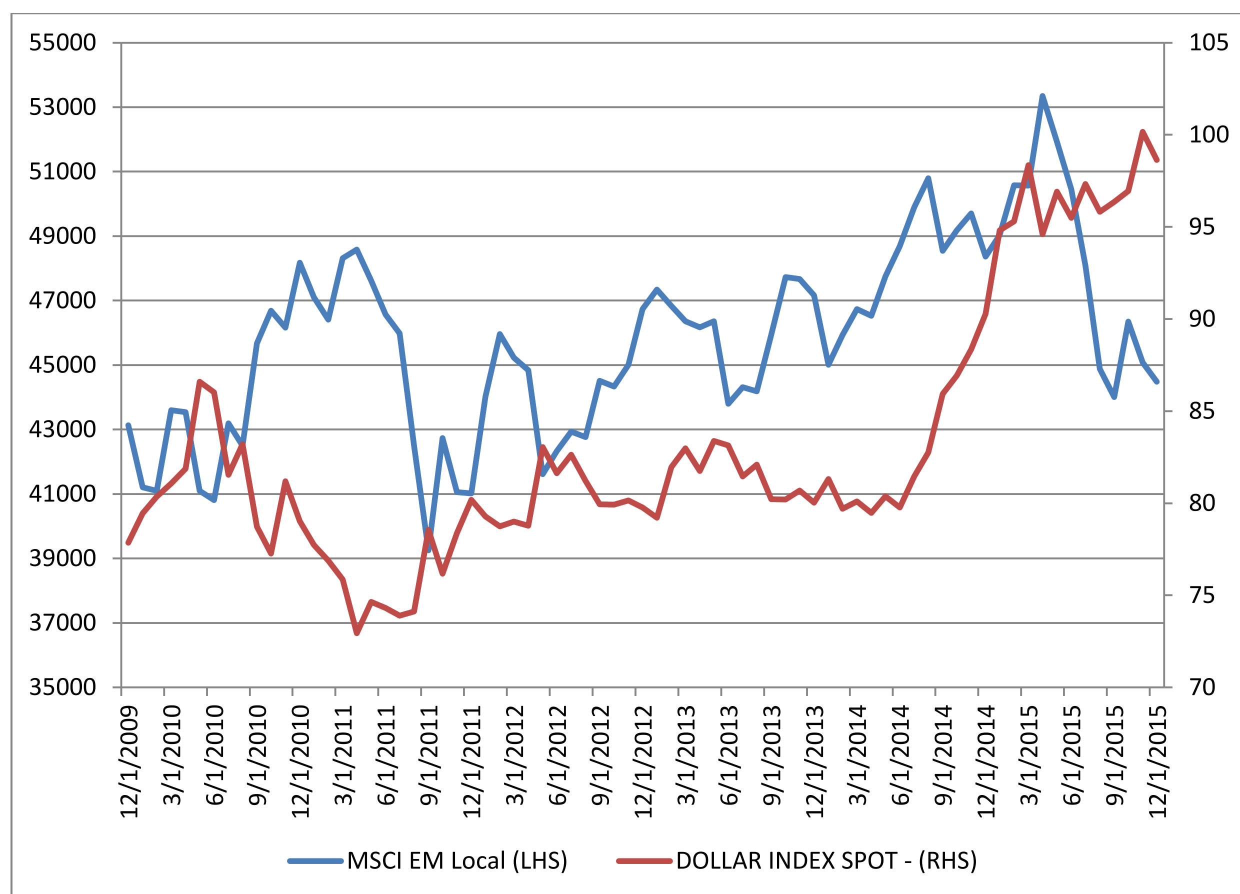
[8] Goldman Sachs, Op. Cit., Page 49.

[9] 3.3 Trillion Yen stimulus package (0.6% of GDP)." Barclay's Global Outlook November 2015, page 45.

to support its currency. Nonetheless, according to Reuters, there is pressure on the PBOC to undertake a major devaluation in the 10-15% range immediately and then draw the line.[10] Such a reactive policy would export Chinese deflation and bring the world economy to the brink of recession. We believe that an adjustment of this magnitude has a low probability of occurring given the Chinese government's commitment to making the Renminbi a major reserve currency.[11]

OTHER EMERGING MARKET COUNTRIES

Exhibit 3: Relationship Between Dollar Index and MSCI EM Index



[10] Kevin Yaq and Pete Sweeney: "Pressure on China central bank on bigger Yuan depreciation." Reuters Market Notes, January 7, 2016.

[11] Henderson Global Investors cites several other reasons why China would not undertake a major devaluation. See www.moneymovesmarkets.com, January 8, 2016. Still despite statements to the contrary by the PBOC, there is a significant probability that the State Council will force it to undertake modest devaluations of the effective exchange rate in 2H2016 and 2017 to restore some of the loss of export competitiveness incurred since 2004.

Source: Bloomberg

As noted in our previous commentaries, the outlook of other Emerging Markets (EMs) as a group is unlikely to improve in 2016 following almost half a decade of underperformance. This is true for four reasons: First, Lombard Street Research estimates that EMs ex-China are only half way through the structural adjustments needed to regain the competitive levels they enjoyed in the late 1990s.[12] Second, while the returns on assets and profit margins have fallen, nonperforming loans have increased, as has the magnitude of debt accumulation (see Exhibit 6). More of this debt is dollar-denominated than official statistics show because many corporations have turned to offshore subsidiaries to issue debt, much of which is denominated in foreign currency. Third, export demand is unlikely to regain pre-crisis levels, because of China's rebalancing and because the US trade deficit is likely to remain below its historic peak. In addition, competition for global export market share from Japan and the eurozone has become intense. Finally, EMs have become more vulnerable to increases in US short-term rates as 65% of ex-China debt is denominated in dollars and has increased (see Exhibit 6).[13] Thus, further Fed tightening may push up the dollar and add to the debt servicing burdens of the ex-China EMs.

GLOBAL FINANCIAL MARKETS

Developed Country Equities

Equity bull markets tend to go through four stages: accumulation, hope, fundamental improvement, and optimism. From 2010 to July 2014, we went through a period of improving fundamentals, during which the market was driven by per share earnings growth. Since then we have been going through a period of growing optimism in which multiple expansion has played a major role. In 2016 the fate of the market will be determined once again by earnings growth since little multiple expansion is expected. At the end of December 2015, the S&P 500, at 2044, traded at 16.6 times analysts' consensus estimates of 123.50 for 2016 compared with a forward P/E of 15.8 at the beginning of 2015.

Stocks are not cheap, nor are they rich given a long-term average forward P/E of 15 and today's low interest rates.[14] Our target value for the S&P 500 at the end of 2016 is 2113, which assumes a forward P/E of 16.3 and per share earnings growth of 5% in 2017. We expect some increase in the ten-year bond yield (about a 25 basis point increase in the equilibrium rate as

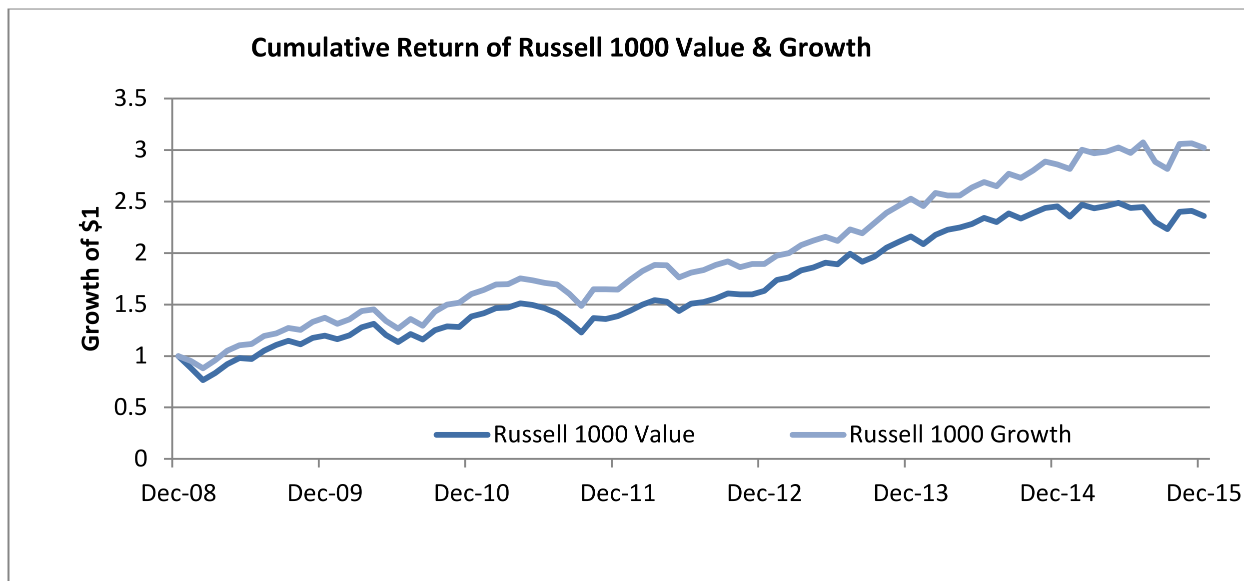
[12] Ibid., page 19.
[13] Ibid., page 19-22.
[14] Barrons, December 14, 2015 page 34

discussed below). A 2% decline in the P/E multiple is consistent with a duration of approximately 8 in line with empirical estimates for equity duration.

Growth stocks have outperformed value stocks for several years, but that gap was particularly large in 2015, with the Russell 1000 Growth Index outpacing the Russell 1000 Value Index by 9.5 percentage points (see Exhibit 4). Such a divergence is not unusual in the latter stages of a bull market.

This outperformance may not continue in 2016 since S&P 500 earnings growth is projected to be well above 5%. Historically, when S%P 500 earnings growth is either at 5% or exceeds it, value stocks outperform growth stocks.[15]

Exhibit 4: Cumulative Return of Russell 1000 Value and Growth Indices



Source: Drexel Morgan Capital Advisers and Zephyr

EUROPEAN AND JAPANESE EQUITIES

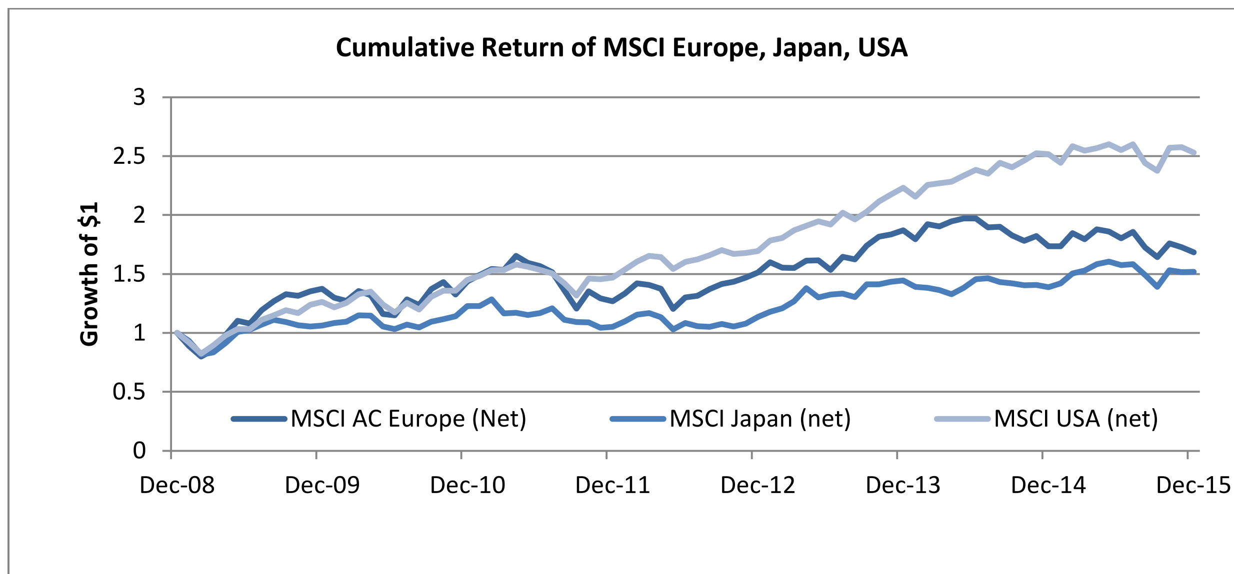
While the US has followed a traditional stock market cycle involving accumulation, hope, fundamental improvement, and optimistic stages, the two other major developed markets, Europe and Japan, had very different experiences. The European equity cycle started in a similar way as that of the US with the initial hope phase of the bull market which followed the despair phase associated with a market bottom. However, the growth phase was sidetracked

[15] Bloomberg.

by the euro area crisis and has disappointed due to a lack of earnings growth thus far. As a result, most of the European equity returns since 2011 have been due to multiple expansion.

Japan has had a more pronounced equity cycle with very negative earnings growth in the despair phase, a sharp earnings recovery in the hope phase and continued strong earnings growth since 2011 with very little multiple expansion thus far. The Japanese bull market has not yet entered the optimistic phase[16] (see Exhibit 5).

Exhibit 5: Cumulative Return of MSCI Europe, Japan, USA



Source: Drexel Morgan Capital Advisers and Zephyr

We have a preference for non-US Developed Markets (DMs) like Europe and Japan, which are earlier than the US in the equity cycle and which have a prospect for high single digit or even low double digit earnings growth. Moreover, easier monetary policy might expand equity valuations in contrast with those in the US, which are weighted down by probable Fed rate hikes. Historical cross asset performance around the first Fed rate hikes since the 1970s shows that the euro tends to weaken, but the US versus the German and Japan rate differential tend to widen, and European and Japanese equities tend to outperform US equities.[17]

Both European and Japanese forward earnings multiples, at 14.7 and 14.2, are below those of the US at 16 based on the Goldman Sachs forward earning consensus. Although the European forward price earnings multiple is at the upper end of its historic range, along with that for the US, the Japanese forward P/E is at the lower end. However, the European cyclically-adjusted P/E is below its historic median along with that of Japan. For this reason, we believe that the

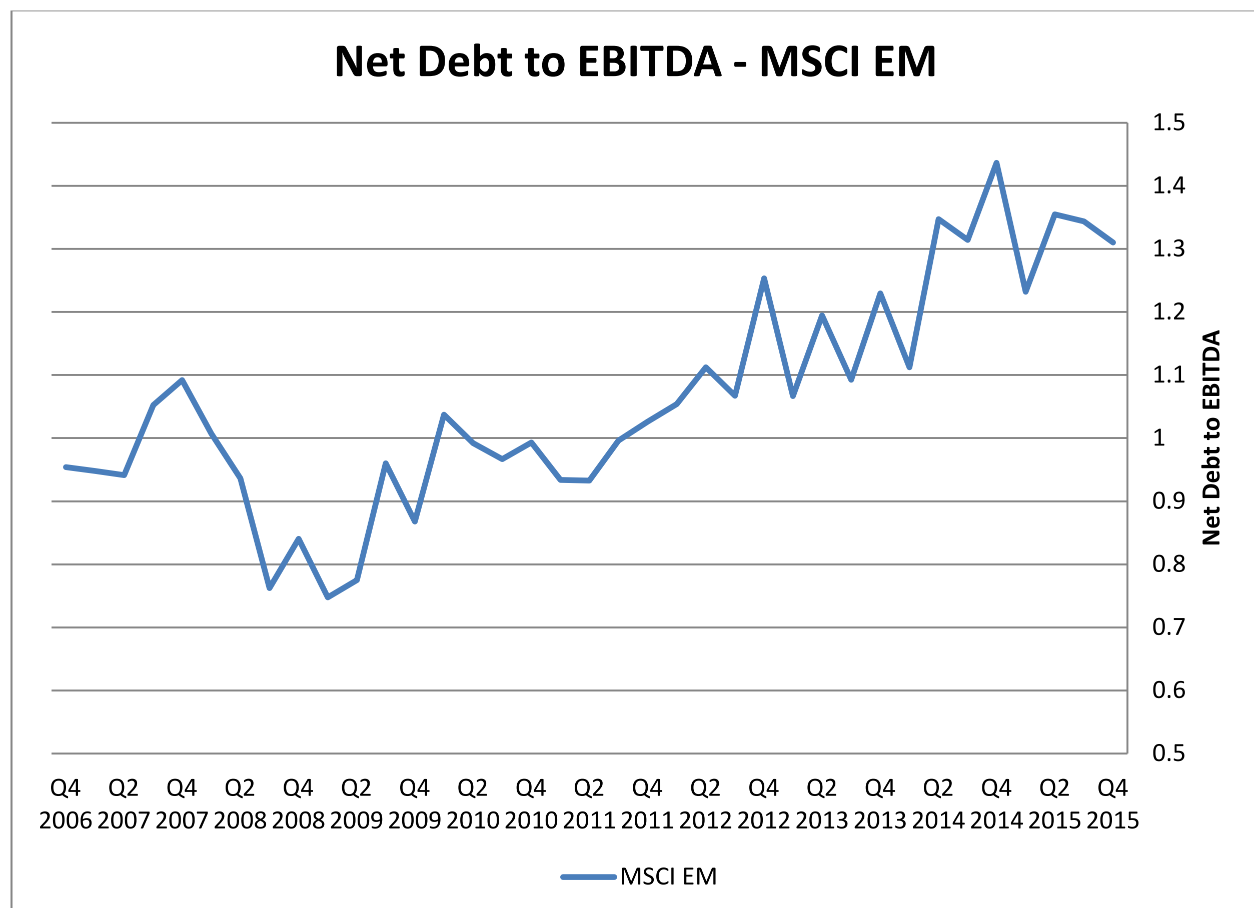
[16] Goldman Sachs, Portfolio Strategy Research: Global Opportunity Asset Locators, December 8, 2015, pp. 4 to 5.
[17] Goldman Sachs, December 18, pp. 8 – 9.

European and Japanese markets have greater appreciation potential than does the US market. We are forecasting low double-digit total returns for Europe and Japan over the next 12 months, against low single digit returns for the S&P 500.

EMERGING MARKET EQUITIES INCLUDING CHINA

Historically, EMs have underperformed DMs during periods of appreciation in the trade weighted dollar (see Exhibit 3).

Exhibit 6: Relationship Between Net Debt/EBITDA for Emerging Markets



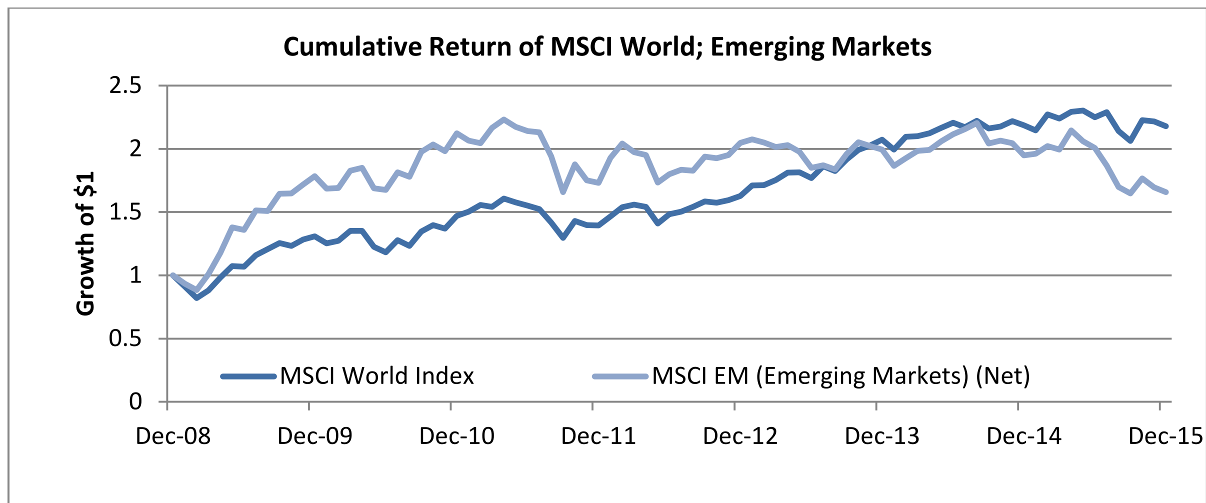
Source: Bloomberg

The P/E ratio for the MSCI EM Index is not more than one standard deviation below its historical average and is equal to its historical average when sectors are evenly weighted, according to the Bank Credit Analyst.[18] As already indicated, the outlook for per share earnings growth for EMs as a whole is not very promising, and 2016 is likely to be a continuation of the

[18] BCA Global Investment Strategy, September 26, 2015, Chart 29.

weak trend of prior years with an estimated US dollar earnings decline of 2%. We expect EMs to decline in 2016 (see Exhibit 7.) We prefer EMs that are commodity importers with low exposure to China and with comfortably low current account deficits and low overall debt.

Exhibit 7: Cumulative Return of the MSCI Emerging Markets Index



Source: Drexel Morgan Capital Advisers and Zephyr

In 2015, Chinese companies are expected to report only 1.9% earnings growth, the worst performance since 2010, with the MSCI EM China Index falling -7.8% on a dollar basis. Many Chinese stocks listed in Hong Kong, including Alibaba and Baidu, still have excessively high earnings multiples and deteriorating fundamentals. Service sector and consumer-oriented companies in general offer attractive opportunities. These companies make up half of China's GDP, compared with 80% in the US, leaving a lot of room for expansion[19].

Social networking stocks and issues of smartphone companies are especially attractive. Take for example a popular social network which has 650 million users in China is owned by a publicly listed company. Also, certain smartphone makers have taken off in China because of a distribution model that cuts out middlemen and allows rock-bottom prices. The state's strategy of effectively shutting out foreign competitors is helping fuel substantial results. Although these companies are nowhere close to expanding outside their home market, contrary to the view of many private equity and venture capital managers, they do provide significant upside for investors. Our EM managers have significant exposure to Chinese consumer tech companies.

[19] Fortune: Investor's Guide 2016, December 5, 2015 pages 125-133.

OIL

As we have mentioned in this letter, 2015 saw a precipitous decline in the price of oil which has impacted a variety of economies and currencies at the macro level, and at the micro level has impacted the equity and debt securities of companies on a global basis. We will discuss the broad macro impact as well as the impact on Master Limited Partnerships (MLPs.)

In the oil equilibrium pricing equation, demand growth has slowed, although it will have a positive trajectory for the foreseeable future. The supply side of the equation has been impacted by the shale revolution in the US, OPEC maintaining production, Iranian oil coming online in 2016, and global technological advancement which has lowered production costs. Oil ended 2015 down 39.7% from its peak in June and now trades at prices below $40 a barrel. We are not in the business of predicting oil prices; however, from our research we conclude that oil prices should remain under pressure through 2016 due to excess supply and moderate global growth. An upward trajectory in prices should emerge in late 2016 and/or 2017 as current excess supply is consumed, but we do not expect the price to exceed $53 a barrel in 2016, its level at the end of 2014.

The decline in energy prices has largely been viewed through a negative lens by the media, but a price of $35 per barrel oil that persists over a longer period of time can have longer term structural economic impacts which can benefit consumers and broader economies. As mentioned previously, consumer spending should increase as energy cost decreases are perceived as more permanent. Additionally, energy importing regions, such as Europe and Japan, will experience the benefits of lower input costs for manufacturing and transportation. Finally, global inflation expectations should remain low and decrease the likelihood of tighter monetary policy which could have negative impacts on global GDP.

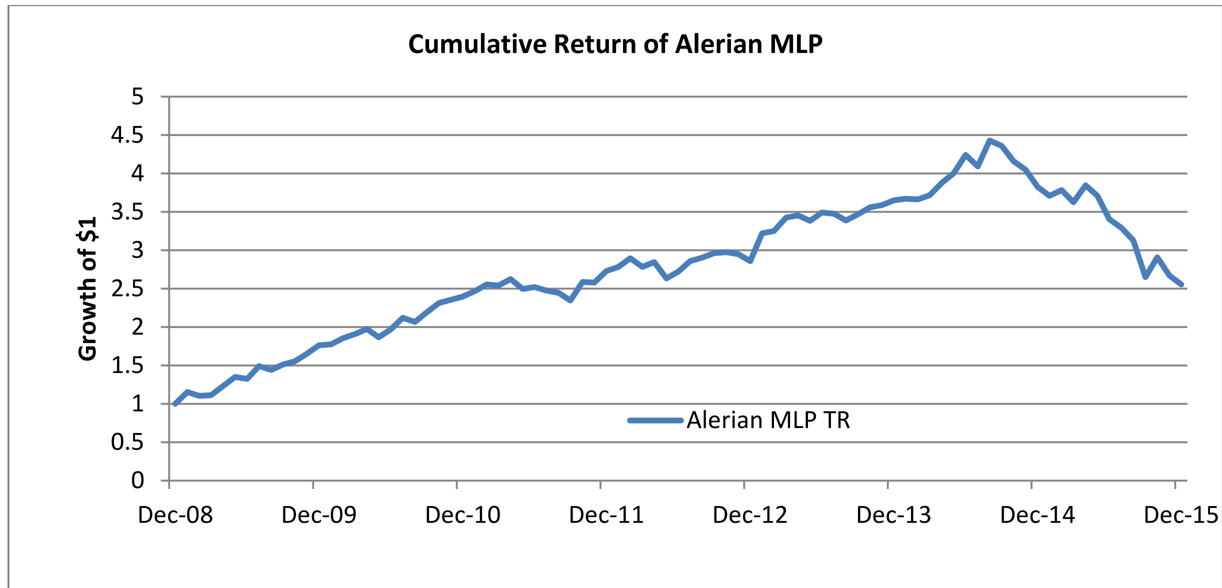
MASTER LIMITED PARTNERSHIPS (MLPs)

The universe of MLPs represents a variety of underlying assets, primarily related to energy, and for the purposes of this discussion, we will focus on the "midstream" segment of the market which includes pipelines, gathering and processing terminals and storage tanks for oil, natural gas and natural gas liquids (methane, propane, etc.). MLPs remain an asset class heavily owned by retail investors which can lead to exacerbated moves in pricing without corresponding fundamental data.

The Alerian MLP Index declined 32.6% in 2015, according to Bloomberg, which is the worst year of performance since 2008, a year in which MLPs declined 37.1%. The performance has been the result of the misguided perception that all MLP revenues and distributions are tied to

commodity prices. Some segments of the asset class are tied to commodity prices; however, midstream assets are largely independent of commodity price movements and rely more on volume of oil and gas flowing through pipelines and storage tanks.

Exhibit 8: Cumulative Return of Alerian MLP Index



Source: Drexel Morgan Capital Advisers and Zephyr

Midstream MLPs now face a financing problem, not a revenue problem. MLPs have historically been attractive due to distributions (yield) and forecasted growth in distributions from the construction or acquisition of new pipeline projects. In order to fund these projects, MLPs have issued debt or additional partnership units, but now financing costs are similar to the accretion value of new projects. As stated previously, the forecasted volumes on oil and gas will not subside in coming years, so demand for additional pipelines and storage remains intact and growing. We believe midstream MLPs will pursue these new projects through two avenues:
1) more creative financing instruments including convertible preferreds and hybrids; and
2) distribution cuts to finance projects from internal cash flow. The net result of these initiatives will be less dilution, especially in the case of distribution cuts, and higher expected distributions in the future once partnership prices recover or new projects come online. We expect more distribution cuts in midstream partnerships, but we believe this outcome has been priced into the market creating an attractive entry point for MLPs

FIXED INCOME

Global Sovereigns

In our prior commentary, we estimated that the equilibrium ten-year treasury yield after the December 25th basis point hike, would be about 2.73%. This projection was based on the assumption that there would be four hikes in the Federal Funds rate in 2016 and a real equilibrium rate of interest of 1.22%. However, the futures market is predicting two 25 basis point hikes in 2016, even though the median dot plots show four such hikes based on estimates provided by the Federal Open Market Committee (FOMC) members.

The Fed is starting to tighten under unusual conditions in which markets have been supported by over six years of excess monetary accommodation. Extremely measured hikes are needed to give markets time to learn to survive without the Fed's help. For this reason, and because the 30-year breakeven inflation rate is below 2%, we now believe that the two 25 basis point hikes predicted by the market are more likely to occur in 2016 and we have re-estimated our real equilibrium ten-year yield based on this assumption (see Exhibit 9). This estimate, based on the geometric mean Forward Fed Funds rates, puts the present equilibrium ten-year zero coupon yield at 2.58%, against the 2.2% yield presently observed in the market. Based on this model, we expect the ten-year zero coupon yield to rise to 2.83% by the end of 2016, which is about half the 50 basis point increase in the Fed Funds rate expected over the next year, which implies a flattening yield curve.

The global macro environment continues to be favorable to sovereign bonds and we are recommending that clients stay long duration in their government bond holdings outside the United States. The combination of excess global savings, stimulative monetary policy, low inflation and ongoing demand for low risk assets is keeping non-US sovereign yields at unusually low levels and this is not likely to change soon. In fact, the ECB's decision to extend the Quantitative Easing (QE) program will mean an even greater decline in European sovereign bond yields. The Bank of Japan's purchase of government bonds also exceeds net issuance, keeping yields at very low levels.

Inflation-indexed bonds may be more attractive in the US than in other developed countries since an upswing in inflation is much more likely in the US in the latter part of 2016 than it is outside the US. As the US unemployment rate continues to decline, wage increases are likely to accelerate resulting in higher rates of increase in the US Consumer Price Index. Thus, we would expect significant returns on short duration TIPS but not on comparable US Treasuries.

Exhibit 9: Estimated Equilibrium Yields for Five- and Ten-Year Treasuries Given Likely Hikes in the Policy Rate

	Current Yield	End of 2016	End of 2017 Assuming 75 bp in 2017	End of 2018 Assuming 75 bp in 2018	End of 2019 Assuming 25 bp in 2019	End of 2020 Assuming 0 bp in 2020	End of 2021 Assuming 0 bp in 2021	End of 2026 Assuming 0 bp in 2026
Nominal Fed Funds rate (based on increases from previous year indicated in header, based on DMCA assumptions)*	0.42%	0.92%	1.67%	2.42%	3.17%	3.17%	3.17%	3.17%
Subtract projected inflation	1.70%	1.70%	1.70%	1.90%	1.95%	1.95%	1.95%	1.95%
Real Fed Funds rate	-1.28%	-0.78%	-0.03%	0.52%	1.22%	1.22%	1.22%	1.22%
Average short-term rate (based on average of starting and ending nominal Fed Funds rates for a given year)		0.67%	1.30%	2.05%	2.80%	3.17%	3.17%	3.17%
Estimated Yields Based on the Product of the Nominal Fed Funds Rate for Each Year	**5 Years**	**1.99%**						
	10 Years	**2.58%**						
	10y 1-year forward	**2.83%**						
	5y 1-year forward	**2.49%**						
Ten-Year Treasury Strip (actual yield, Bloomberg):		**2.27%**						

Data as of December 31, 2015
Source: Bloomberg

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

Admittedly, global sovereign bonds are not going to be a high return investment from current levels. Eventually, we expect that the yields will shift higher, in the middle of 2016 in the US and later in Europe and Japan, and at some point it will be appropriate to shift to shorter maturities starting with US Treasuries. Meanwhile, benchmark duration sovereign bonds will be a good hedge against downside economic risks and will provide some stability to portfolios.

US municipals were one of the best-performing asset classes in 2015. We do not expect that 2016 will be as favorable to this asset class since Treasury yields are likely to rise, especially in the latter half of the year and municipal yields are closely related to Treasury yields. Still, municipals offer an after-tax return substantially higher than Treasuries for investors in high tax brackets. Municipals are trading at about 95% of the Treasury yield which makes their taxable equivalent yield substantially greater.

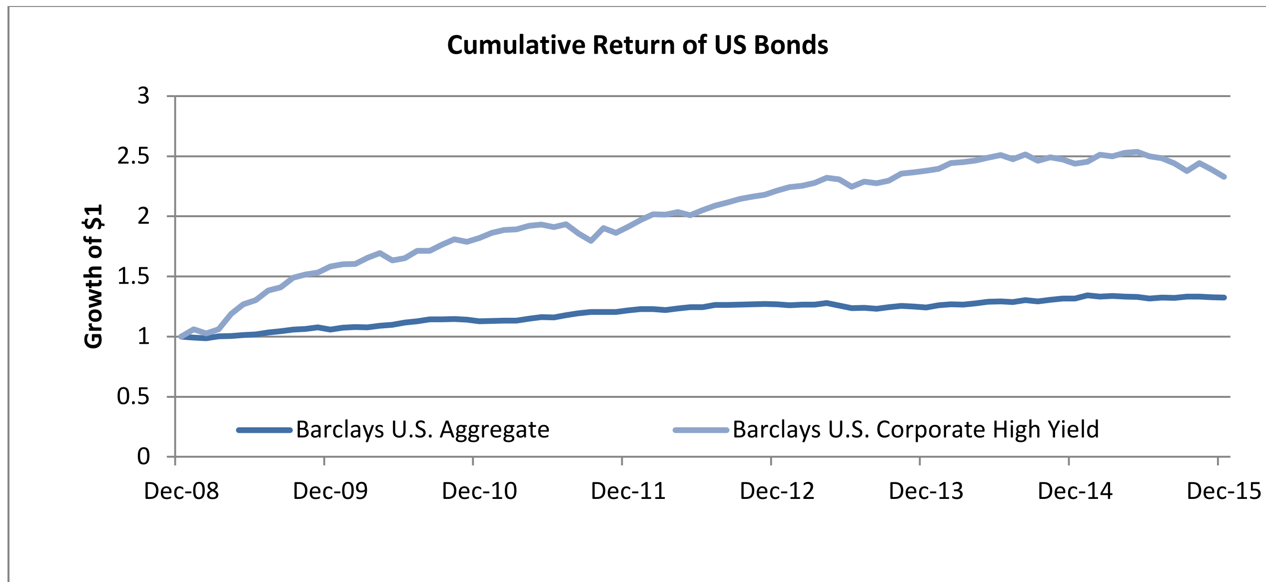
Spread Product

Investment grade (IG) corporate bonds have been under some pressure due to widening spreads. This has been mainly the result of a deterioration in corporate balance sheets associated with borrowing for share repurchase. In addition, per share earnings growth rates of corporations issuing investment quality bonds has slowed and in the case of IG energy companies, turned negative.

- We believe that high-quality corporates are still good investments but do not expect substantial spread tightening in the next year in aggregate.
- By contrast, European corporate bonds are more attractive since the balance sheets of European companies are improving and spreads on these issues are likely to narrow.

US high-yield spreads in most sectors are above long-term averages and coincide with what we think is a reasonable macroeconomic environment for spread products, with modest growth, gradual Fed tightening and accommodative monetary policy elsewhere. Above average spreads are the result of concerns about credit quality, but we believe that these concerns are overblown, especially outside the energy sector. For example, the majority of the underperformance in high yield issues year to date has come from CCC credits which have declined 12.1% vs 1.0% for BB. We expect default rates for high-yield issuers to rise in 2016 creating a "mini default cycle" in energy, but this must be weighed against what wider spreads already compensate for. Higher spreads more than offset the impact of higher default rates than we expect; however, we see an environment of yield capture as opposed to significant spread tightening due to elevated volatility and technical pressure from redemptions. US high-yield and leveraged loans should deliver mid-single digit returns in 2016.

Exhibit 10: Cumulative Return of US Bonds



Source: Drexel Morgan Capital Advisers and Zephyr

CONCLUSION

We believe that DM equity market returns denominated in dollars in 2016 will be low to mid-single digit, with a risk profile similar to 2015, with considerable variation across sectors and regions. Essentially, they should be nearly "flat" and "fat."[20] EM equity returns are likely to be negative in some but not all cases. This is a continuation of the increase in volatility in 2015 following the Fed's termination of quantitative easing at the end of 2014.

DMs have now moved from the repair stage to growth and recovery. The repair process remains underway in EMs, as economies have had to start deleveraging, rebalance their output mix, restore productivity growth, and loosen fiscal and monetary policies. They have also had to contend with less US monetary accommodation and less Chinese demand growth. Consequently 2015 will mark the fifth consecutive year that global growth is being held back by slowing EM growth.

We are overweight global equities on a 12-month horizon as they offer the best return prospects versus other asset classes. However, the return trajectory for equities is flattening. High valuations reduce the buffer for shocks and increase the risk of drawdowns. We see little hope for multiple expansion in 2016 and expect only moderate earnings growth with

[20] Goldman Sachs, European Equities: "'Fat' and 'flat' with a Resurgence of Divergence in 2016," December 30, 2015.

substantial variation across regions and sectors. We are equal weight US equities as we expect low earnings growth relative to other DMs in 2016 but view US equities as the DM most insulated against an EM downturn. We are also underweight EMs due to limited growth, rising rates, and a slowing China. We are overweight Europe and Japan. In Europe we expect that resilient growth, accommodative policy, and a weak euro should provide tailwinds. In Japan we expect higher earnings growth than the DM average as a result of margin expansion and topline growth. We are optimistic about the performance of US MLPs in the next 12 months whose prices have over-reacted to falling oil and high-yield bond prices. We maintain an underweight stance on fixed income with the exception of US high-yield issues. In 2016 we expect US treasuries to underperform relative to Bunds and Japanese Government bonds. We are concerned about medium- and long-run inflation, especially in the US, and higher nominal rates than forward curves are currently discounting.

This outlook is subject to a number of risks:

- The contemporary economic recovery in the US has been persistently sluggish despite massive and unprecedented policy stimulus. Thus, it is not easily explained by standard macroeconomic concepts. In this anomalous economic recovery, it is hard to determine the forces that are driving the expansion and the warning signs of a recession. Thus, as Summers suggested on December 15, 2015,[21] a recession could occur in the US even though the usual leading indicators, such as overheating, rapid short-term interest rate hikes, and high inflation, are not present.

- A hard landing in China could occur if the authorities get the mix of reform and economic stimulus wrong. One of the biggest surprises of 2015 was a decision to let the Renminbi decline in August creating a month of market turmoil around the world, which forced the Fed to delay raising rates.

- Larger than expected capital outflows from China cause foreign exchange reserves to fall to a threshold level where policy makers no longer have the substantial options they do now.

- A "Brexit" (exit of Britain from the European Union) resulting from a referendum vote in 2016; this could cause the EU to "unravel."

- An EM Debt Crisis: JP Morgan economists estimate that credit deleveraging may reach the point where it reduces EM GDP growth by two to three percentage points over the

[21] See quotation at the beginning of the present commentary.

next three years.[22] This could slow global growth to 1.5% and result in a global recession in the extreme case.

- The China turmoil of early January, which involved further A-share implosion, currency weakness and increased evidence of policy incompetence, has pushed the Goldman Sachs Financial Conditions Index into its tightest condition since 2009. If this tightness reduces US aggregate demand through negative wealth effect and diminished credit availability, US economic growth in 2016 may be lower than we expect.

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

Sincerely,

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

[22] JP Morgan as cited in Gavyn Davies article, "Macro Themes and Risk for 2016." Financial Times, January 1, 2016.

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