Drexel Morgan Capital Advisers

Global Economic and Market Commentary

Second Quarter 2016

"It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning."
– Henry Ford

"Despite brutal and widespread asset overpricing, there are no signs of an equity market about to break, indeed cash reserves and other signs or bearishness are weirdly high. In my opinion the economy has some spare capacity to grow for a while."
- Jeremy Grantham, GMO Commentary July 2016

Summary

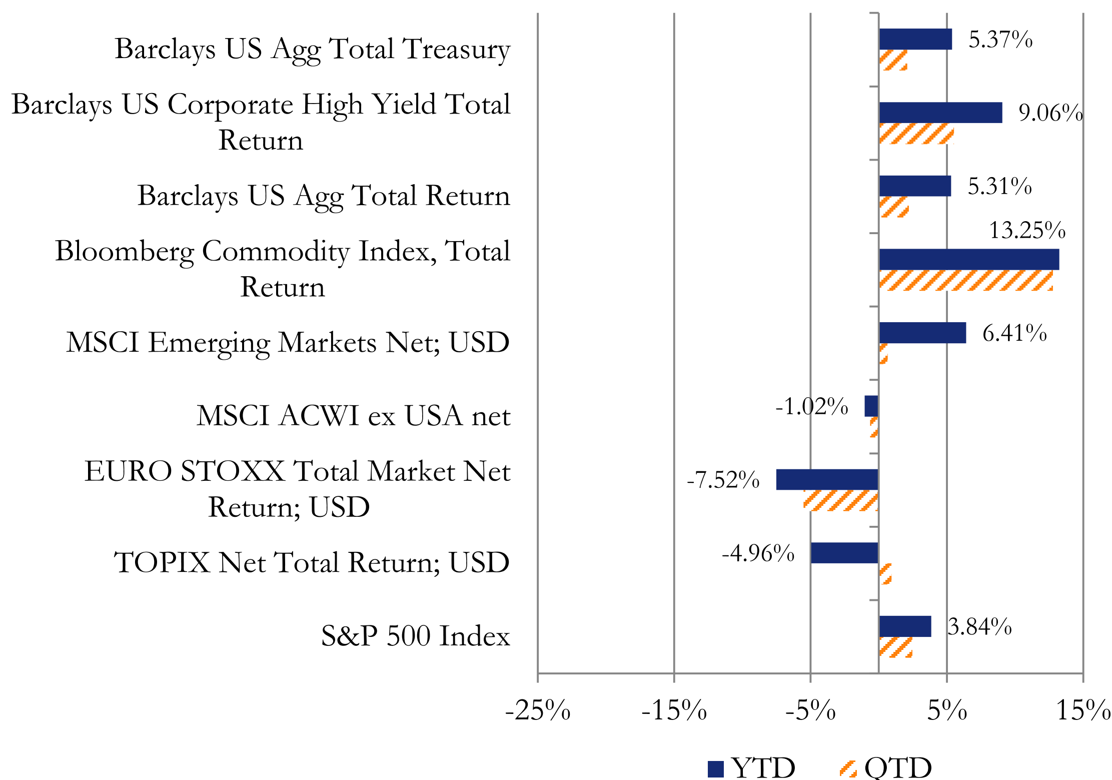
- The UK's vote to leave the EU has escorted in what could be a long period of uncertainty.
- We are skeptical about the recent, liquidity-driven bounce in risky assets.
- Overall, global equities and bonds should be range bound during the remainder of 2016, although both are at the higher end of their prospective ranges.
- Volatility will persist due to global uncertainty.
- We are recommending a slight underweight to global equities. Expected upside is less than expected downside risk.
- The likelihood of a shift toward more fiscal stimulus and consequently higher inflation has increased.

Economic and Stock Market Outlook

There were three factors that affected regional stock performance in much of the second quarter:
1) a slight weakening of the trade-weighted dollar 2) stronger than expected growth in China as a result of a new mini stimulus package and; 3) vacillating policy pronouncements by Fed officials; from dovish in mid-March through April, hawkish until mid-May and then dovish again. These factors held back US growth, but led to higher than expected European and Japanese growth and a strengthening of commodity and oil prices, which contributed to better performance in the EM economies.

While the US and EM equities had modest positive returns, non-US advanced country equities had negative returns due to the unexpected leave vote of the UK. In mid-May, some of the markets were anticipating a Fed rate hike at the beginning of the quarter which did not materialize, and lower than anticipated US short term rates kept the trade-weighted dollar from appreciating through most of the quarter helping EM equities and commodities. High quality corporate bonds delivered returns of more than 2% as a consequence of lower than anticipated US short-term rates. High yield bonds also benefited from a lower probability of default in the energy sector (see Exhibit 1).

<u>Exhibit 1</u>: Global Capital Market Returns YTD and QTD through June 30, 2016



In our earlier letters we mentioned Brexit as a potential risk, which was partially priced into the market. We did not, however, expect the UK to vote to leave the EU. The surprise Brexit vote just adds another layer of uncertainty to an already tenuous landscape and should contribute to even slower global growth and more challenges to corporate profits and more doubts about the effectiveness of central bank policies. The global economy was already in a precarious state, with negative interest rates in roughly one third of government bonds, rising geopolitical tensions and staggering amounts of bad debt on the books of Europe's banks.

The Brexit vote led to a two day decline in equity markets of about 4% to 18%, while high quality bonds and the US dollar rose sharply. Declines in equities of this magnitude are shocking, but often reflect an overreaction by investors which is not supported by actual changes in business or economic conditions. What surprised us was that markets turned on a dime rather than continuing to decline.

In the week following the Brexit vote, all country equity markets experienced a recovery of 5% to 7% and significant further appreciation is continuing into the current quarter. Of all the post

Brexit outcomes we have considered, "a buying frenzy" seemed to be the least likely. It appears that the negative growth implications of Brexit are offset by expectations for easier monetary policy, mostly in the UK, Europe and Japan, but to some extent in the US. US Treasury yields have plunged even as stock markets have more than recovered, an unusual phenomenon. Recently the ten-year Treasury hit a record low of 1.32%, down 43 basis points since the vote.[1] While the S&P 500 was only 1% below its close on the eve of the referendum at quarter end, it is now into fresh record territory. The market implied probability of a Fed rate cut in 2016 has declined from 50% on the eve of the vote to 10% right after. Eventually, the UK vote is likely to have a negative effect on financial conditions since we believe that the odds that the Fed will raise rates this year are well above the current market implied probability of at least one rate hike (29%).[2]

We believe that some of the factors affecting the market's perception of a likely rate hike are only temporary. Both groups in the FOMC, those for prompt and those for delayed normalization, realize that unconventional policies have become highly ineffective or even counterproductive as evidenced by the ECB and Bank of Japan struggles. Thus, they are concerned that if rates are hiked prematurely and the economy falls back into recession, they will have little to no ammo available. However, the capital market distortions, the zombie loans, savings problems and the asset price bubbles created by a long period of short term rates being held at emergency levels can be very destructive in the long run. While postponement of a rate hike may be the best alternative for both hawks and doves at this time, a significant stabilization of global economic and market conditions is likely to prompt a rate rise by the end of the year.

For this reason and because we are concerned about overvaluation of the global equity market, the presidential election uncertainty, the Italian referendum and a slowing global growth rate, we are trimming back our global equity exposure to slightly underweight. We are putting greater emphasis on asset classes with lower downside risk. Even with a benign outcome to the various sources of uncertainty, neutrality with respect to global equities is compelling given valuations and earnings prospects.

[1] "The Bull Market You Haven't Seen," Bloomberg, July 14, 2016.
[2] Goldman Sachs, US Daily: "Brexit and the Stock Bond Divergence." July 5, 2016.

United States Outlook

US recession risks have receded since the first quarter. The ISM Service and Manufacturing Activity Indices for June are consistent with moderate GDP growth (about 2.0%). The Citigroup Economic Surprise Index has risen to its highest level since late 2014 and payrolls recovered sharply in June.[3]

We are concerned that the US equity market is overpriced and that the negative global growth effects of the British vote to leave the EU have been outweighed by exaggerated positive interest rate effects, in particular, sharply lower Treasury bond yields which are unlikely to be sustained, and the questionable belief that the Fed will not hike rates at all this year. The S&P 500 Index was up more than 15% by the end of the quarter from its February lows. To some degree declining bond yields have caused stocks to shake off the increased probability of a global recession and fears of an oil price collapse and a Chinese currency devaluation. The US equity market has become a substitute for bond yield and the big gainers in the S&P 500 this year have been utilities and telecom which are mostly high dividend payers.[4]

Much of the run-up in share prices since early February has been prompted by corporate share buybacks in that mutual funds, foreign investors and pension funds have been net sellers.[5] Stock valuations are extremely elevated, hovering around a median percentile of 87 for six metrics, according to Goldman Sachs (see Exhibit 2). Still, the US equity market, at 2,168, is only 1.3% above the previous S&P 500 peak of 2,130 in May 2015. We expect the US economy and stock market to continue to produce mixed results for the following reasons:

- Corporate earnings for the second half are likely to disappoint since the translation effects of a stronger dollar have not been fully factored in.

- Cash flow yields are overstated because of abnormally low capital expenditure.

- The Brexit vote will have a significant effect on euro zone as well as UK earnings and growth rates which will be a burden to US multinationals. Although a strong Brexit supports a more dovish Fed in the near-term, it is likely that the Fed will become more hawkish toward the end of the year. This suggests a continuation of the frustrating range-bound and volatile stock market behavior, with the S&P 500 fluctuating between 1,800 and 2,200.

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[3] Lombard Street Research, July 20.
[4] Financial Times, "US Stocks and Bonds Delay Epic Reckoning," July 14, 2016.
[5] Wall Street Journal, "Buybacks Pump up Stock Rally," July 13, 2016.

- The US economy continues to register "slow, lumbering, and unstable growth."[6] Every time it grows above trend, it stalls. This phenomenon is not new; there has been a meaningful slowdown in growth every year since the economic expansion in June 2009.

- In a number of these years, recession risk appeared elevated. Yet, the US stock market has had an incredible run, with a total return of about 250% in the S&P 500 index from its March 2009 low. In terms of duration, it has exceeded 7.3 years. This has been the second longest bull market in US history, which suggests that the market may be beginning a topping out process.

- Although the rate of employment growth has declined, the rate of increase in wages has accelerated to 2.6% over the 12-month period ending in June.[7] With the economy close to full employment, this suggests that the labor market may be tightening to levels that precede higher unit labor cost increases. The inability to mark up costs and achieve revenue growth, when combined with such increases, suggests that margin pressure could result.

Exhibit 2: S&P 500 Valuation Metrics

Metric (Aggregate index)	Current	Long term average	Historical %ile
EV / Sales	2.1 x	1.3 x	94 %
P/E to growth (PEG)	1.4 x	1.1 x	90
EV / EBITDA	11.2 x	8.1 x	88
Forward P/E	17.3 x	12.7 x	87
Cyclically adjusted P/E (CAPE)	22.6 x	18.6 x	76
Price / Book	2.8 x	2.4 x	69
Free cash flow yield (FCF)	4.4 %	4.1 %	44
Median			87 %

Source: Haver Analytics, FactSet, and Goldman Sachs Global Investment Research as of July 8, 2016.

[6] Charles Schwab 2016 Mid-Year Economic Outlook, Page 1.
[7] Bureau of Labor Statistics, June Job Report.

In this context, we prefer companies with a leading market position, predictable earnings, cost discipline, low leverage and high profitability, known as quality stocks. Moreover, investors should consider how dividends are being generated. Dividend growth stocks generally provide lower notional yields than more cyclical dividend payers but can offer higher quality dividends likely to be more sustainable in an environment where growth is difficult to achieve. Finally, we like the stocks of companies whose revenues come predominantly from the home market and which are relatively immune to tariff increases. Since October 2010, firms with high US sales have been outperforming firms with high foreign sales. A strengthening US dollar indicates that this trend will continue.[8]

European Outlook

In a historic referendum on June 23rd, Great Britain voted to leave the European Union (EU). The next steps for Brexit will take some time and political risks will increase uncertainty which will dampen UK and even European growth prospects. (In the first quarter of 2016, Eurozone growth exceeded 2% per annum and was the highest of any advanced country region. According to Fulcrum Asset Management Nowcast estimates, it also exceeded advanced economies in the second quarter.) The UK will probably not invoke Article 50 of the EU Treaty, which provides the legal framework for withdrawal, until late in the year.[9] At this writing, Britain's leadership is not nearly in the disarray that it was on June 24th when the Brexit vote was announced. At that time, David Cameron announced that he would step down but that his resignation would not be tendered until October. Since then the Conservative Party has chosen a new Prime Minister, Theresa May, who took office on July 13th. She has gone ahead and named a negotiator for the talks with EU representatives about the terms of Britain's leaving. Article 50 of the EU Treaty provides for a two-year negotiation once it has been activated.

According to the Financial Times, Theresa May has "Neither the authority nor the legitimacy to negotiate a Brexit Agreement with the EU" by herself. She will need to bring people together to win parliamentary backing.[10] This is already apparent in her initial statement, after being selected Prime Minister, which focused on the broad British nation and not on a small elite. She clearly recognizes the public alienation with the establishment. The Financial Times recommends publication of a green paper setting out the time and dynamics which would be subject to public scrutiny. It would express the direct trade-off between passporting available

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[8] Goldman Sachs: "Where to Invest Now?" July 2016.
[9] According to the London Economist, there is good reason for this delay. For every month the British public incurs the cost of Brexit, the greater the probability of reconciliation. "Bremain," Economist,' July 2nd, page 10.
[10] Financial Times, A British model for Post Referendum European Future." July 7, 2016.

in the European Economic Area (EEA) and the control of immigration possible under a free trade agreement. Recognizing the cost of limiting immigration may cause many to rethink their decision not to leave and give the British government a compelling reason to call a second plebiscite. Hopefully, Britain will be able to preserve the flexible and open labor market, which has made it globally competitive.

The economic consequences of the Brexit vote are already being felt in Britain. Consumer confidence has fallen sharply. In addition, the pound sterling has declined by 20%, a 30-year low, property prices have collapsed, especially in the London area, and property funds have stopped allowing redemptions. There is likely to be an investment and hiring pause while uncertainty persists with regard to the UK's relationship with the EU.

Following Brexit, the IMF has downgraded its forecast for euro zone growth to 1.6% in in 2016 and 1.4% in 2017, as compared with its earlier estimates of a 1.75% expansion this year and next. However, this marginal reduction is based on an early assessment.[11] The IMF's estimated reduction relies on the scenario of the UK and the EU reaching a favorable deal close to the so-called Norway model, where the UK continues to have access to the European economic area and the single market. It would also provide passporting privileges for various UK based companies to undertake financial transactions into the EU. However, a Norway like arrangement in its present form would require unlimited immigration from the EU.[12] Even though the European economic area allows immigration restrictions under certain extreme circumstances, it is doubtful that other EU members would allow it.[13] The main question is whether Brussels and Berlin will allow the UK to limit EU migration.

While the uncertainty risk premium associated with these uncertain outcomes should constrain economic growth and portfolio returns, the political effect on the euro zone could be even more significant. The leave vote has underscored the fragility of the European Union and the rise of nationalist sentiment. Political hot air in the euro zone is likely to intensify with revived outcries by minority parties in some countries to pull out of the euro zone. At best, the leave vote will have a limiting effect on the progress toward uniform bank regulation or insurance arrangements across euro zone members and fiscal consolidation in the euro zone. At worst, it

[11] IMF Economic Outlook July 18, 2016.

[12] Financial Times, "Britain needs a plan to mitigate the Brexit shock." July 19, 2016

[13] Wolfgang Munchau says that the EEA option is totally rigid. Less free immigration cannot be exchanged for less market access. A sequence of deals going from the EEA option to the free trade agreement option may be desirable since it would allow British companies to develop enough EU presence such that the loss of the passporting privilege under a free trade agreement is tolerable. (See "Britain must pursue its EU Exit options," FT, July 3rd.)

may even lead to a breakup of the euro zone or cause countries outside the euro zone, such as Sweden, to rethink their EU membership.

Both the Bank of England and the European Central Bank are offsetting aggregate demand weakness brought on by the Brexit vote with greater quantitative easing. This has been a key stimulus behind positive equity market performance over the last few years and is likely to be extended. However, the ECB is combining QE with negative interest rate policy, which is squeezing bank profits. This is contributing to an already fragile European banking system, especially in Italy which is already on the brink of collapse. The need to recapitalize Italian banks may have a deflationary effect on the Italian economy since Italian investors may have to bear much of the burden.[14]

In the worst case, Brexit could reignite the euro crisis, causing market stress as bad, if not worse, than what we saw in 2011 to 2012. With ECB support in place, this can only really happen if Brexit encourages referenda in other EU countries, especially in marginal economies, such as Spain and Italy. If the UK economy recovers quickly without reconciliation, it is possible to see other systematically weak euro members vote to leave the EU under the circumstances. In a worst-case scenario, this could bring on a new euro crisis in the next two to three years.

However, this is not our base case outlook. We believe that the UK experience will encourage EU leaders to address politically contentious issues, such as immigration, with much greater effort. Alain Juppé, the front runner in the race for the French center right presidential nomination, has even proposed that limits on the free movement of people be negotiable. Donald Tusk, President of the European Council, has come to realize that the EU must secure sustainability, not through erosion of national independence, but through practical accomplishments, such as greater and more evenly distributed euro zone growth.[15] This will require fiscal stimulus, not austerity, and a reduction in the large German external surplus. While Germany's surplus with the other Eurozone countries has been halved since 2006, this has happened because domestic demand growth in these countries is being held down to very low rates. These countries would not have to subdue economic activity as much if Germany imported more from them and enabled them to be less dependent on German exports. This might be accomplished through a rapid increase in German wages that would reduce its trade competitiveness with the rest of the euro zone.[16]

[14] "The Crisis Facing European Banks is one of Earnings, not Solvency," Financial Times, July 18, 2016.
[15] Martin Wolf, How Europe should respond to Brexit," Financial Times, July 5.
[16] Gavyn Davies, "The German Balance of Payments Quandary," FT July 10, 2016.

The new British Prime Minister, Theresa May, took office on July 13th. She has appointed a number of prominent Brexit supporters to her cabinet. This is to her advantage since it shows she is committed to Brexit and, at the same time, sets the leave advocates up for failure if British public opinion changes.[17]

She is hopeful that the Brexit minister and Boris Johnson, the new Foreign Secretary, will be able to persuade Angela Merkel, Chancellor of Germany, and Christine Lagarde of the IMF that the EU needs to be pragmatic and not damage trading opportunities with the largest single export market and one with which it has a trade surplus. She should also be able to argue that a mutually satisfactory relationship is supported by the UK being, in the words of Martin Wolf, "a financial center, a security partner and a link to the wider world."[18] These considerations may outweigh concerns of the EU leadership about not wanting to be seen providing major concessions to the UK which would encourage other departures. The EU is already taking a conciliatory step by considering a migration "emergency brake" for the UK of up to seven years, according to the Guardian.

European multinationals will benefit from the strengthening of the US dollar and the weakening of the euro due to the flight to safety precipitated by the Brexit vote. Moreover, European companies are for the most part relatively insensitive to UK GDP growth. We are recommending a neutral weight in European equities other than those in the financial sector, down from our prior overweight. Here, as in the US case, we are stressing managers that invest in high quality companies. At the same time, we believe that the weak euro will make European multinationals more attractive than US multinationals.

Japan

Following surprisingly robust growth in Q1, negative growth in Japan in the coming quarters may be driven by exchange rate effects, i.e., an appreciating yen. In an environment of uncertainty, the Japanese yen has appreciated more than it otherwise would have. This should weigh further on export performance in an environment where global demand is soft. However, it is partly offset by the large fiscal spending package we expect as a result of the new supplementary budget of around 1% of GDP following the recently completed upper house elections. Moreover, the yen is now so overvalued on a purchasing power parity basis that it is more likely to depreciate than appreciate going forward.

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[17] As BCA notes, "Either way she remains above the fray and able to maneuver out of Brexit, if needed." BCA, "Brexit Update: Does Brexit really mean Brexit?" July 15, 2016, page 6.
[18] "How Europe should respond to Brexit," Financial Times, July 5, 2016.

We expect further easing measures at the Bank of Japan's next meeting in late July on the back of recent weak business survey results and still deteriorating core inflation measures. Japanese equities look more compelling than European equities on a valuation basis but additional overshoot of the yen on the upside is still a short term risk.

The demand for Japanese equities by Japanese households has been steadily increasing in the 21st century,[19] and we believe that this will continue, along with micro-driven improvements in corporate returns. At its present levels, the Japanese equity market appears to be aggressively oversold. The Japanese stock market seems to be assuming a yen of 100, against a 106 current level and last year's low of 125 to 128 and continued contraction of the price-earnings ratio. Believing this outlook to be too pessimistic, Citigroup is forecasting a Nikkei at 18,750 at the end of the year as compared with today's 16,620 level. For this reason we are maintaining a market weight in Japanese equities.

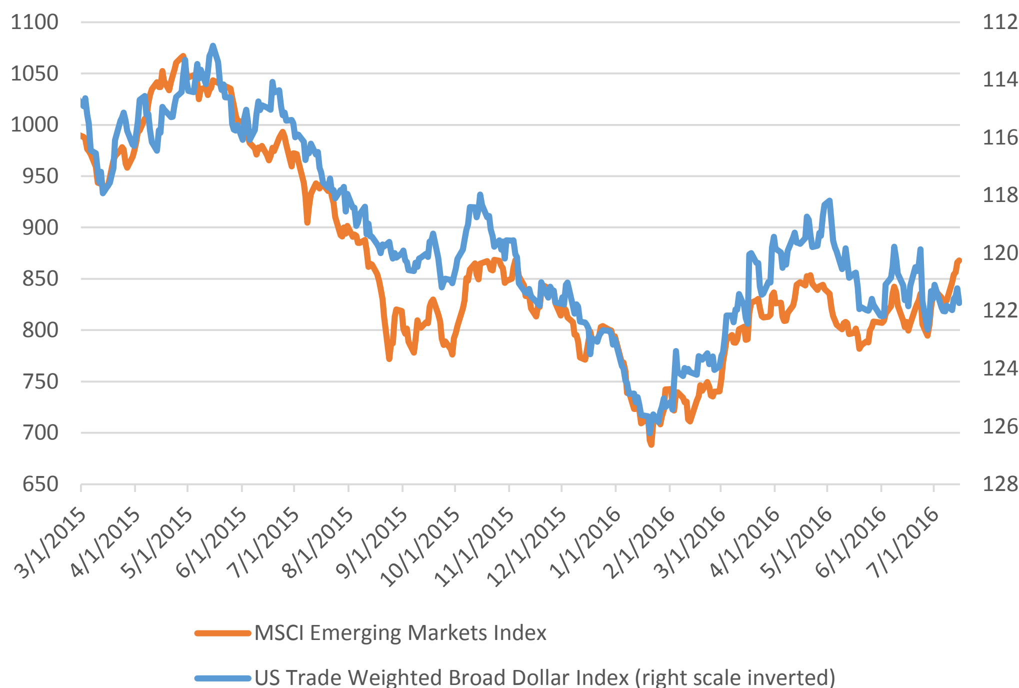
Emerging Markets

Emerging market (EM) performance has been dollar dependent, as shown in Exhibit 3. This is due in part to dollar-denominated debt owed by companies in emerging markets and capital flows into and out of EM economies from the United States. In the second half of the year, we do not see renewed weakness in the US dollar that would help emerging market stocks outperform as they did in much of the first half.

Latin American and EM Asia (ex-China) are evidencing stability or gradual improvement. In Latin America, governments are emphasizing growth and greater stability in China and suggest an underpinning for commodity prices, which are the main determinant of the Latin American terms of trade. The large domestic demand driven economies of EM Asia (ex-China) such as India and Indonesia will continue to benefit from a global environment of low interest rates and inexpensive energy, which will be reinforced by expansionary domestic policy. Substantial growth in these economies would at least partly offset the effects of deterioration in global manufacturing and trade on the export-dependent economies (Taiwan, Singapore and Korea). Most of the impact of the deterioration in the UK and euro area will be felt by EM Europe, including EU Poland and Turkey.

[19] Tokyo Stock Exchange, June 2016 as cited by Marathon Asset Management LLP Global Investment Review, June 30, 2016.

Exhibit 3: MSCI Emerging Markets Index vs US Trade Weighted Broad Dollar Index, March 1, 2015-July 22, 2016



The outlook for the EM economies is also crucially dependent on the outlook for the Chinese economy. Fear of a rapid drop in economic growth in China and what policymakers may do about it has disturbed global markets over the past year.

China faces a choice between supporting reform efforts focused on securing long term growth versus pursuing short-term growth initiatives that may undermine reform. China's overall debt as a percentage of GDP grew to 247% in 2015 from 164% in 2008. This severely limits China's ability to generate the degree of fiscal stimulus that enabled its economy to recover rapidly from the great recession in 2008 and 2009.

New leadership in 2013 unveiled reforms and a reducing reliance on debt-funded construction and favor consumer driven growth. The sharp economic slowdown over the past year, however, forced policymakers to choose stimulus over reform. The stimulus in early 2016 fueled construction, funded in part by $1 trillion in new credit and resulted in a 25% rise in residential construction starts in April and a 15% gain in infrastructure spending in April.

The impact was quickly felt, as seen with the rise of The Purchasing Managers Index, PMI, in Exhibit 4.

Exhibit 4: China PMI Jan 2014-June 2016

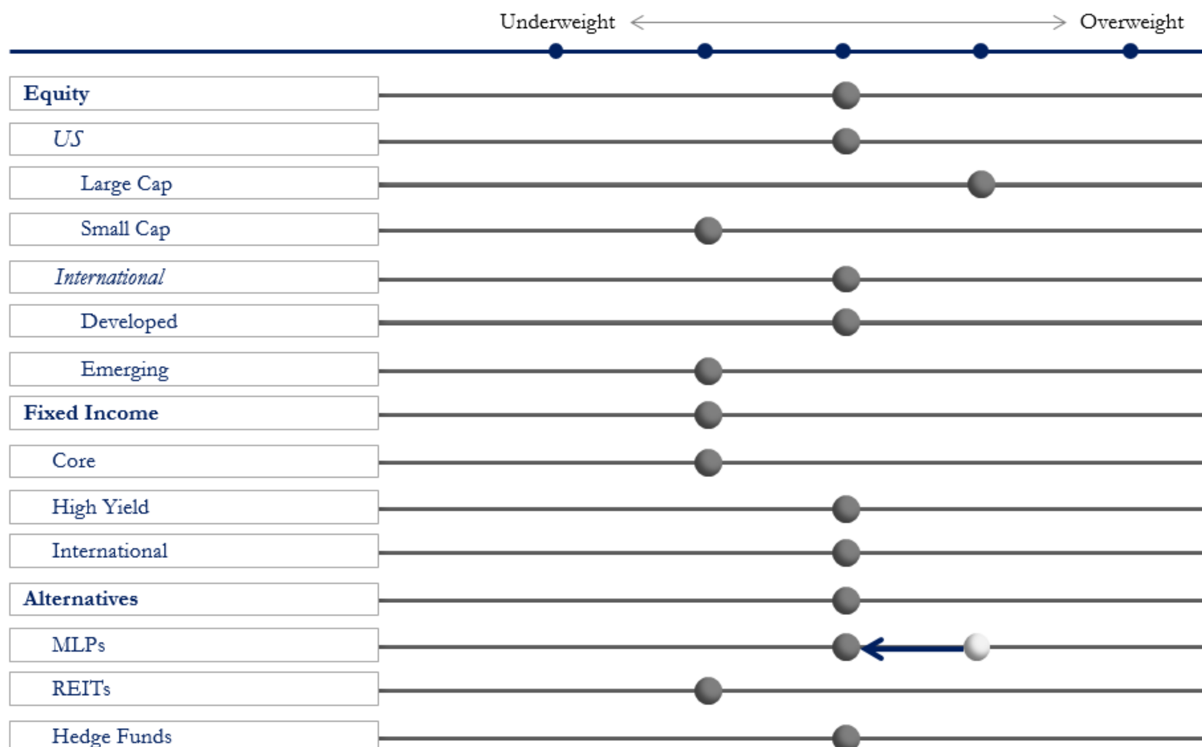
Source: Bloomberg, Chinese federation of Logistics and Purchasing

This boom does not appear to be sustainable. Signs indicate growth is slowing anew. Britain's vote to leave the European Union could result in slower export growth to Europe, China's largest customer. Yet we do not expect a hard landing. Rapid income growth for China's consumers and a sharp rise in retail spending can act as a buffer to a slowdown in exports, and China's government has the flexibility to continue investing in infrastructure.

China has been quietly depreciating its currency to restore its competitiveness. Lombard Street Research believes that China's growth stabilized at 6% in the second quarter, but should decline to 3% to 4% in the second half of the year.[20] Our view on China's economy supports underweighting emerging market stocks in relation to an investor's long-term asset allocation.

[20] "Chinese Growth Stabilized-Challenges Ahead," LSR, July 15, 2016.

Exhibit 5: DMCA Asset Class View as of June 30, 2016



Fixed Income

Federal Reserve policy took a back seat to the uncertainty surrounding the Brexit vote in the latter part of the second quarter leading to a significant decline in Treasury yields. Ahead of the vote, Chairwoman Yellen maintained her dovish stance at the June FOMC meeting; however, a poor May employment report in early June removed the likelihood of a rate increase at the June meeting. As of the writing of this letter, the ten-year Treasury yield is 1.54%, up 22 bps from the record low of 1.32%. Despite near record low yields, fixed income strategists now quip that US Treasuries are "high yielders" in the current developed sovereign bond market. As discussed later, the net result of this yield spread between the US Treasury yield and advanced economy sovereign yields is a strong dollar and artificially lower US Treasury yields.

The latest dot plots indicate FOMC members have kept their projections the same for 2016 - two rate increases - but have lowered projections for 2017 and the longer term by 25 – 50 bps. We see one to two rate increases through March 2017. If the core CPI reaches 2.5%, currently at 2.3% year over year, and/or employment data maintains a 200,000 jobs per month growth trajectory, the Fed will be pressured to increase rates as soon as September.

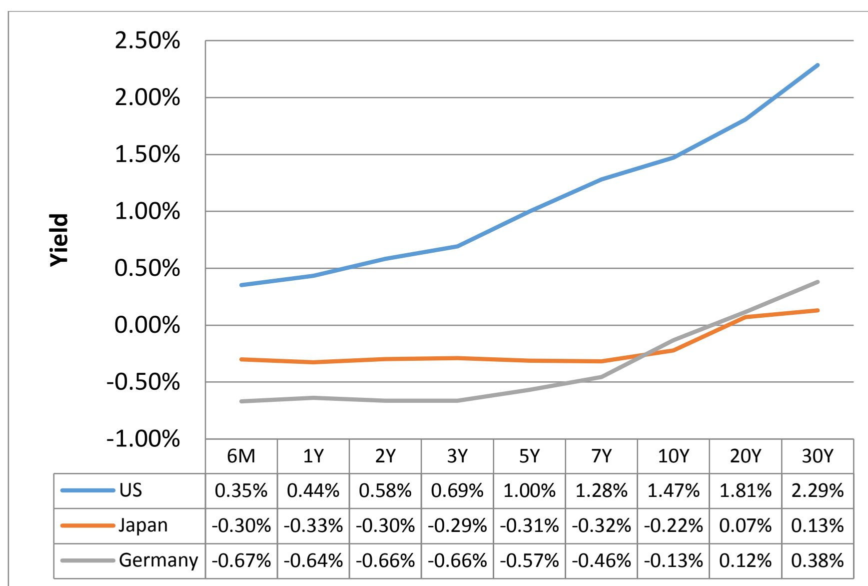
As seen in Exhibit 6, our estimate of the present equilibrium ten-year yield has decreased to 2.18% from our March estimate of 2.42%. Based on our model which uses the geometric mean forward Fed Funds rates, the ten-year zero coupon yield is expected to rise to 2.41% in 12 months. The model does not incorporate other global sovereign yield curves. As shown in Exhibit 7, both Japan and Germany have negative yields as of June 30, and we expect further easing from both regions. While we do not expect significant further declines in sovereign yields in Japan or Germany, prolonged easy monetary policy will keep non-US rates lower for longer. Attractive US yields, and additional factors such as declining Japanese corporate bond yields, possible purchases of Japanese government bonds in the primary markets, and ECB buying should keep demand high and cap US Treasury yields. Volatility surrounding Brexit and potential Chinese growth risks could lead to even lower yields in the near term, though we expect higher yields in 12 months. We are underweight duration in our fixed income allocations, and maintain a more diversified asset mix consisting of global bonds with positive yields, conservative high yield, and securitized credit to produce an expected total return similar to a diversified index with less interest rate sensitivity.

<u>Exhibit 6:</u> Estimated Equilibrium Yield for Five- and Ten-Year Treasuries Given Likely Hikes in the Policy Rate

	Now	**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 2026 Assuming 0 bp in 2026**
DMCA estimated Nominal Fed Funds rate*	0.42%	0.50%	1.25%	2.00%	2.75%	2.75%	2.75%
Subtract projected inflation	1.55%	1.70%	1.70%	1.90%	1.95%	1.95%	1.95%
Real Fed Funds Rate	-1.13%	-1.20%	-0.45%	0.10%	0.80%	0.80%	0.80%
Average short-term rate		0.46%	0.88%	1.63%	2.38%	2.75%	2.75%
Yields constructed using product of nominal Fed Fund rates for each year	5 yrs	1.61%					
	10 yrs	2.18%					
	10y 1y fwd	2.41%					
	5y 1y fwd	2.07%					
10 year Treasury strip (actual yield, Bloomberg):		**1.62%**					
Data as of June 30, 2016. Source: Bloomberg							

* This trajectory is slightly below that estimated by Curdia using real time estimates of the real equilibrium interest rate (natural weight). 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/

Exhibit 7: Developed Market Sovereign Yield Curves as of June 30, 2016



	6M	1Y	2Y	3Y	5Y	7Y	10Y	20Y	30Y
US	0.35%	0.44%	0.58%	0.69%	1.00%	1.28%	1.47%	1.81%	2.29%
Japan	-0.30%	-0.33%	-0.30%	-0.29%	-0.31%	-0.32%	-0.22%	0.07%	0.13%
Germany	-0.67%	-0.64%	-0.66%	-0.66%	-0.57%	-0.46%	-0.13%	0.12%	0.38%

Source: Bloomberg

We believe fiscal stimulus is needed globally, primarily because recent monetary policy has had a decreased impact on spurring growth. Near term, fiscal stimulus will likely have a modest upward impact on yields, but longer term we would expect inflation and consequently higher long and short term rates. Under these conditions, TIPS would outperform Treasuries and should be considered with the ten-year breakeven inflation rate below 1.50%. In other words, if inflation exceeds 1.5% for 10 years, TIPS would outperform a comparable maturity treasury bond. We have not added TIPS to our portfolios to date.

US municipal bonds continue to perform well with lower US Treasury yields as a tailwind. Strong foreign demand in the quarter contributed to AAA yields declining to multi-decade lows. Looking forward, municipal yields are vulnerable due to increased issuance to lock in low borrowing rates, and we maintain our stance that coupon income will contribute to the majority of returns in 2016 and 2017. Credit conditions have been stable, absent Puerto Rico, so lower rated issuers (BB-A) should outperform.

Spread Product

The US investment grade corporate bonds index option-adjusted spread (OAS) declined modestly in the second quarter leading to a 3.5% total return for quarter and 7.56% year to date. Energy and lower rated credits (BBB) outperformed year to date due to stabilized oil

prices and investors moving into higher yielding assets. Investment grade credit spreads should remain in their recent narrow range. While total return may be impacted by increased US Treasury yields, domestic corporate bond spreads benefit from benign credit conditions and ECB purchases of European credits. We expect issuance to remain robust to take advantage of low long term yields and investor demand.

High Yield

Slow growth may leave equity investors wary, but it is an attractive environment for high yield corporate bonds. High yield corporate bonds have returned over 9% year to date with CCC credits outpacing BB credits by a large margin (16.03% to 7.60%). The energy and materials sectors have both returned over 20% year to date due to stabilizing oil and commodity prices.[21] It appears contagion associated with energy defaults has subsided, though the default rate will increase through the end of 2016 and 2017. With an OAS of 594, high yield corporates are neither rich nor cheap, but we maintain a more defensive stance following the recent recovery. As we have cited previously, liquidity can disappear quickly, particularly in lower rate credits, so we will wait for a more attractive entry point to take on more credit risk.

Conclusions

To summarize, while our baseline remains slow global growth and lower long-term interest rates, the downside risks have increased. For this reason, we are recommending a more defensive stance, with a lower exposure to global equities and selective fixed income exposure, which is consistent with greater portfolio risk generating a smaller increase in expected portfolio return. We expect stocks to remain in a trading range from 1800 to 2200 on the S&P 500 and stocks in other advanced economies not to breach their 52 week lows and highs. Markets could move above these trading ranges if investors get carried away using equities as a proxy for bonds and bond yields continue to decline even more, with P/E multiples moving even higher. Highly unlikely, but interest rates are at unprecedented lows. We believe we can achieve a better risk return tradeoff with a higher than strategic weight in selected fixed income securities such as inflation protected bonds, securitized credit and possibly high yield issues in appropriate sectors. We prefer large cap US equities to small cap or stocks in foreign markets. Currently, the US economy has a better macro story with consumer and housing demand remaining strong and is little effect by growth declines in other countries or China.

[21] Barclays: "Daily Credit Call." July 4, 2016.

In our prior letters, we mentioned a number of left tail risks such as a British vote to leave the EU, a disorderly devaluation of the Chinese Yuan, the rise of populist politics and its negative effect on efficient markets and geopolitical risks. Our revised views on these risks as well as additional risks are as follows:

- *Brexit*: Despite the favorable leave vote, Bremain is a possible alternative; however if Brexit occurs it would lead to a weakened or collapsing EU.
- *Populism*: Populism is gaining momentum in both Europe and the US with immigration, income disparity and job loss being the main catalysts. To counter it, advanced countries may have to adopt aggressive fiscal policy.
- *Disorderly depreciation of the Yuan*: The Chinese seem to be depreciating their currency in an orderly fashion. Reuters has noted that the PBOC is willing to let the CNY depreciate as much as the 4.1% decline in 2015; however, a more sudden and larger currency adjustment cannot be ruled out if the Chinese economy slows more than expected in the second half. Since April, it has been losing foreign exchange reserves at an increasing rate after adjusting for bond appreciation.
- *Geopolitical Risks*: With increased terrorism in Europe, particularly in France, and an attempted coup in Turkey, geopolitical risks are at an abnormally elevated level. Geopolitical problems may impact the outcome of the US presidential election and destabilize the EU even further.
- *Non-performing Italian Bank Loans*: These loans are about 20% of total Italian bank loans and represent a sizeable portion of Italian GDP. There are political impediments to the recapitalization of Italian banks because of “bail in” provisions. If the problem is not corrected soon, there could be a bank run.[22]

Concern about these risks and the outcome of the US presidential election is holding back investment and hiring decisions and is adversely affecting global growth. Until there is some resolution, we are forced to take a more defensive stance.

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] LSR, “Macro Picture: Roman Ruins.” July 21, 2016.

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