DREXEL MORGAN CAPITAL ADVISERS

THE MCCABE PERSPECTIVE

First Quarter 2014

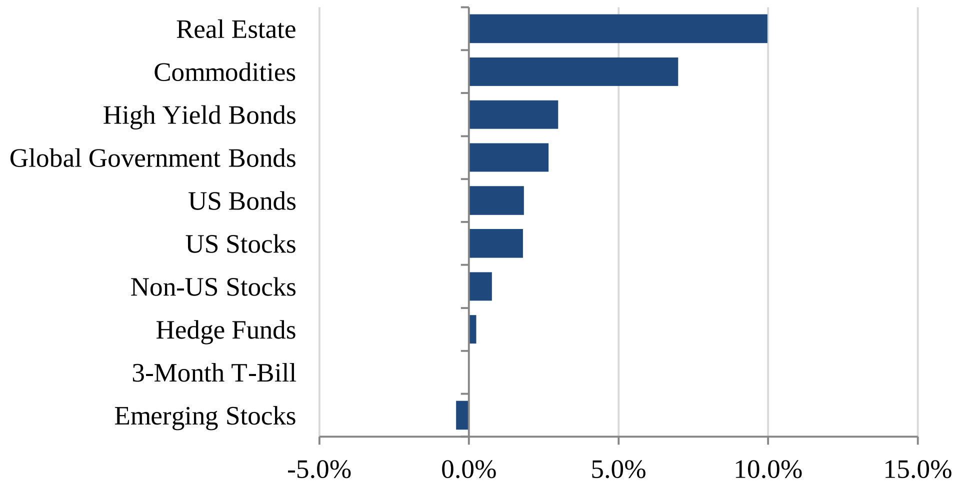
"Bull Markets do not die from old age; they die from excesses."

– Leon Cooperman, President of Omega Advisors

As we highlighted in our fourth quarter letter, there was almost uniform agreement among economists at the start of the year regarding the global outlook for 2014, as well as the likelihood of continued strength in global equity markets and weakness in bond markets. At the time, the lack of a contrarian view was concerning to us and it turns out that the economy and the market did not behave as well as many had anticipated. After such a strong year in 2013, there are signs that the global market in risky assets is starting to mature. For example, U.S. stock prices have broken out of their decade-long trading range and equity risk premia in developed markets, having been excessively high, are returning to normal levels. There are indications of bubble like conditions in some sectors, such as biotechnology and social networking. For example, Twitter's Initial Public Offering (IPO) was 30 times oversubscribed and electric car manufacturer Tesla's stock is more than half of the capitalization of General Motors, although its annual sales amount to the number of cars GM sells in a single day.[1]

Exhibit 1

Global Capital Markets Performance
For the Quarter Ended 2014



Source: S&P 500 Index, 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, Dow Jones UBS Commodity Index, HFRI Fund of Funds Composite Index, ML 3-Month T-Bill. All returns in U.S. Dollar terms.

[1] Bank of America Merrill Lynch, "Bubble Troubles", March 31, 2014, page 3.

According to Bank of America Merrill Lynch research ("Bubble Troubles"), the average valuation level for IPOs as measured by Enterprise Value to Sales is approaching 10, which is close to where it was at the market peak at the end of the 1990s. However, Merrill Lynch estimates that the overvalued segments of the market account for approximately 8.0% of the total market capitalization[2] and in the last few weeks the markets have already begun to correct from these lofty levels. This is evidenced by the sharp decline in the biotech and social networking stocks. In our view, such an adjustment should be viewed as a normal shift in leadership during a continuing bull market and is not the beginning of a bear market selloff, which could take the market down more than 20%.

It is argued that the present bull market in U.S. equities is long in the tooth since it is five years old. Since 1926 the average life expectancy of an S&P 500 bull market has been less than 60 months, however, age alone does not kill bull markets. Most of the major bear markets of the past 115 years were accompanied by recessions and were preceded by policy actions such as monetary tightening that were designed to control excesses that lead to recessions. These excesses include inflation, high capacity utilization rates, and speculative pricing of equities, commodities and real estate. Exhibits 2 and 3 show the higher inflation rates and short-term interest rates that are precursors of recessions and bear markets. None of the excesses that predict bear markets are currently present except for a small portion of the market which is temporarily overpriced and in the process of correcting.

The first quarter showed a much more even return pattern across asset classes than did calendar year 2013, when U.S. equities dominated the global market for risky assets. Real estate and commodities, which did poorly in 2013, were among the strongest asset classes in the first quarter of 2014. Bonds and emerging market equities, which significantly declined in the prior calendar year, also posted positive or flat returns in the first quarter of 2014. While the return to large cap U.S. equities was positive, it was far weaker than that in the first quarter of 2013 and led by value stocks this time around.

U.S. Economy and Markets

Our outlook for the U.S. economy calls for below consensus GDP growth in the first quarter of 2014 of 2.0%, due to unusually cold weather, to be followed by above average growth in the range of 3.4% to 3.8% in the last three quarters of the year. Supporting our view is the pick-up in the Institute for Supply Management's Manufacturing and Non-Manufacturing surveys in March which suggest that growth has already started to recover. In addition, labor markets appear to be strengthening as indicated by significant private sector employment growth and a higher labor force participation rate in March.

[2] Bank of America Merrill Lynch, "Bubble Troubles", March 31, 2014, page 3.

Exhibit 2: Consumer Price Index and Recessions

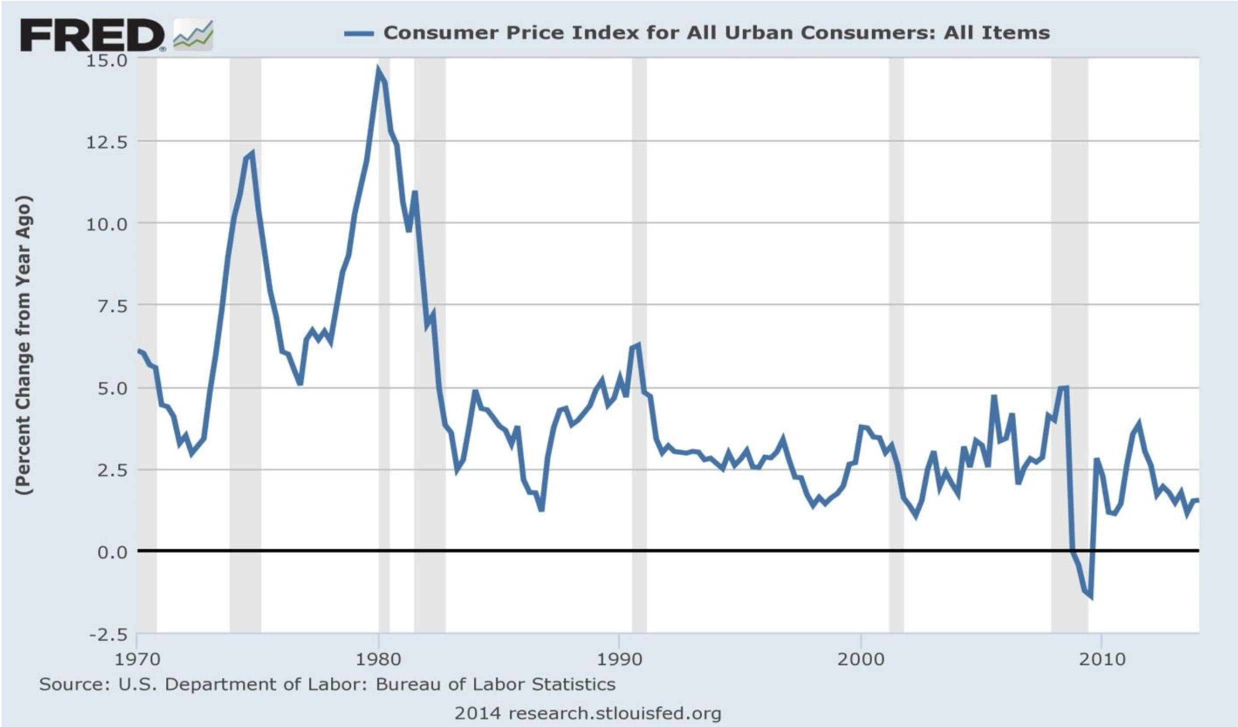
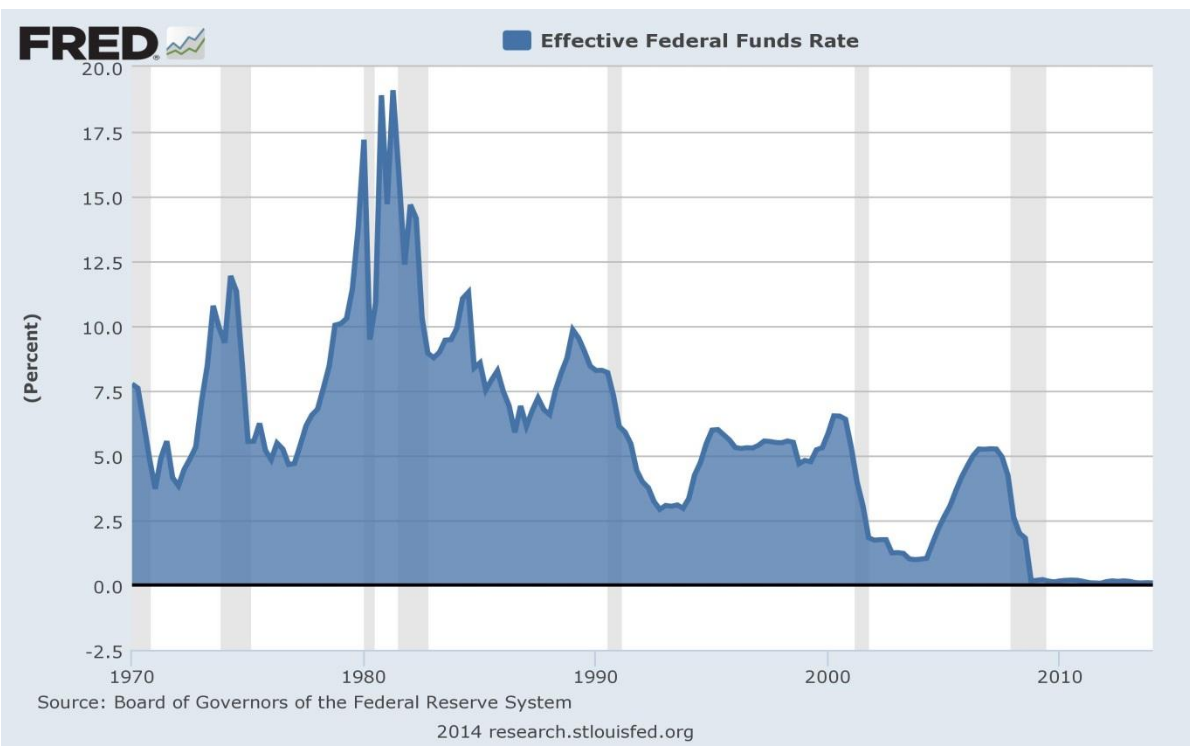


Exhibit 3: Effective Federal Funds Rate and Recessions



Source: St. Louis Federal Reserve Bank (FRED), U.S. Department of Labor: Bureau of Labor Statistics, shaded areas indicate recession periods.

We expect a decline in unemployment, rising inflation expectations and increasing costs associated with expanding the Federal Reserve balance sheet to keep the Open Market Committee (OMC) tapering its bond purchases at a measured pace of $10 billion per meeting. The OMC should stop its bond purchasing program in the fourth quarter of 2014 and we anticipate the first increases in the Fed funds rate will start around the middle of 2015, subject to labor market conditions. Despite this outlook, long-term bond yields have actually fallen since December 31, 2013.

We expect substantially less drag this year. The fiscal deficit should narrow by only 1.0% against 3.0% in fiscal year 2013. This will have a negligible depressing effect on GDP growth of about 0.1%. Another factor contributing to higher GDP growth in 2014 will be a significant rise in business capital expenditure. Capacity utilization rates are approaching 78.8%[3] and it is difficult to see how U.S. businesses can meet rising demand without substantially increasing plant and equipment. In addition to rising consumer spending and less fiscal drag, Goldman Sachs points out that the market value of assets relative to replacement value may also support further capital spending in 2014.[4] We estimate that real business equipment spending growth will rise from 5.0% to 7.5%. Accelerating commercial and industrial loan activity over the past six months support this view.

Against this economic backdrop, it is reasonable to expect that U.S. equities will continue to advance largely in line with S&P 500 earnings growth, which we forecast to be approximately 8.0% this year.[5] However, leadership within the market is likely to shift. U.S. equity market returns over the last few years have been driven by secular growth stocks that benefit from the low cost of capital (since investors receive their cash flow later), as well as high yield stocks which, being bond substitutes, benefit from the low interest rate environment.

If the economy accelerates and interest rates pick up, investors will be more likely to invest in stocks that are in the middle ground, with average cash flow maturity, such as energy stocks and industrials, and less inclined to own stocks at the extremes, such as low cash flow maturity utilities (interest rate risk) or high cash flow maturity biotechnology (cost of capital risk). Stocks with average cash flow maturity are generally inexpensive and trade at lower earnings and cash flow multiples relative to history. In addition, they tend to have good fundamentals and visible earnings growth. While it may be too early in the business cycle to give up on the secular growth (high cash flow maturity) story entirely, we would expect investors to start to shift their exposure into companies that have better valuation support and less exposure to rising interest rates.

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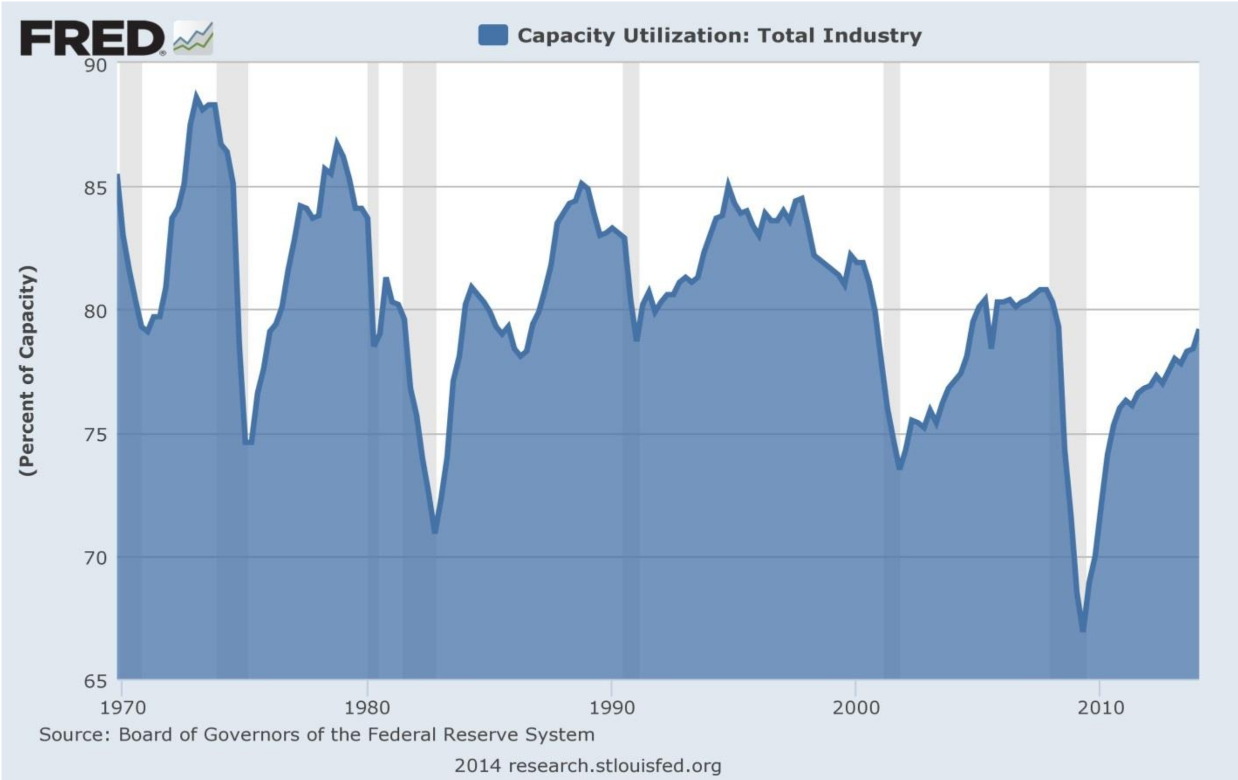
[3] St. Louis Federal Reserve System (FRED).
[4] Goldman Sachs, “U.S. Economics Analyst”, Issue No: 14/10, March 7, 2014.
[5] UBS, “House View”, April 2014, page 22.

Exhibit 4: Capacity Utilization and Recessions



Source: St. Louis Federal Reserve (FRED), shaded areas indicate recession periods.

Over the past several years the equity risk premium (the expected return on stocks less the 10-Year Treasury Yield) has declined by over 200 basis points (or 2.0%) and this has been a major tailwind behind the stock market. With some important exceptions, much of the future profits of the secular growth stocks are many years away from realization and because of this uncertainty, these stocks tend to have higher volatility associated with them, particularly as the cost of capital increases. Bank of America Merrill Lynch has estimated that a 300 basis point increase in the cost of equity capital could lower the discounted cash flow values of the highest multiple stocks by as much as 80 to 90%.[6]

Despite this particular segment, valuations for the overall market generally appear to be quite reasonable with most metrics at levels in line with or below historical averages. This is particularly true for metrics that reflect the significant buildup of corporate cash levels, e.g., enterprise value multiples as opposed to stock price multiples with the same denominator. For example, the Enterprise Value to Sales ratio is much closer to its historic average than is the Price to Sales ratio. The current S&P 500 valuation level is about 10% below the average valuation level at the end of past bull markets (see Exhibit 5). We remain positive on the long term outlook for U.S. stocks relative to other asset classes, but we are monitoring valuation levels relative to earnings power quite carefully.

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[6] Bank of America Merrill Lynch, "Bubble Troubles", March 31, 2014, page 4.

Exhibit 5: Market Valuation

S&P 500 Valuation Metrics	Current (April 16, 2014)	Average*	Minimum*	Maximum*	% Above (below) Average
Price/Earnings	17.18	19.70	12.76	29.30	**-13%**
Price/Cash Flow	9.20	10.89	5.75	16.95	**-16%**
Price/Sales	1.68	1.39	0.69	2.26	21%
Price/EBITDA	8.69	7.09	4.18	10.76	23%
Price/Book Value	2.60	2.88	1.86	5.00	**-10%**
EV/Sales	2.01	2.03	1.10	3.05	-1%
EV/EBITDA	10.35	10.31	6.65	14.53	0%
Dividend Yield	1.97	2.07	1.11	3.65	**-5%**
Free Cash Flow Yield	6.94	4.93	2.24	10.15	41%

*Average, Minimum and Maximum from Dec 1990 through Dec 2013. Source: Bloomberg

Fixed Income

The combination of easy monetary policy and the demand for yield has driven down expected returns on most fixed income assets. This partly reversed last year's increase in yields as a consequence of the initial tapering discussions. The recent rush for income-producing securities encompasses safe assets, as well as credit products such as corporate bonds and mortgages. It even extends to U.S. municipal securities, where investors have driven prices back up following a mass exit in the summer of 2013 which was prompted by the noise about Federal Reserve tightening, the negative headlines surrounding the Detroit bankruptcy, as well as difficulties with Puerto Rican debt (which just enjoyed a very successful public offering). Improving economic growth in 2014, a tightening of labor markets and a gradual rise in inflation should put upward pressure on U.S. bond yields. Even now real bond yields are still high enough to cause bonds to be negatively correlated with equities and to act as diversifiers in balanced portfolios.[7]

Non-U.S. Developed Economies and Markets

Eurozone equities present an attractive opportunity to participate in the European region's economic recovery. According to the International Monetary Fund (IMF), the Eurozone economy is poised to grow between 0.3% and 0.5% per quarter in 2014.[8] Industrial production is recovering, according to the most recent purchasing managers' data for the manufacturing and non-manufacturing sectors. Less fiscal austerity, stabilization of labor markets, rising

[7] UBS, "House View", April 2014, pp. 16-17 and Barclays Global Outlook, "A Balanced Portfolio Still Makes Sense", March 2014.

[8] www.IMF.org

business confidence and low inflation should support further improvement in domestic demand. Market conditions are improving and corporate profit margins are recovering. European bond markets have rebounded substantially, as evidenced by yields in Spain and Ireland falling to levels equal to that of the U.S. This reflects a dramatic decline in interest costs in peripheral Europe which, along with lower unit labor costs, should improve competitiveness and result in export-led growth.

Strong headwinds that sent the Eurozone economies back into recession in 2011-2012 have diminished due to progress made in repairing the financial sector and support from the European Central Bank. However, the IMF does not expect domestic demand to grow substantially above trend in the next two years. It will likely take time for the debt overhang and the bad debt exposure of banks that were at the root of the crisis to unwind. Public and private sector deleveraging will likely remain a drag on growth and fiscal consolidation. Private sector debt is still historically high and financial fragmentation persists, although it is improving. A key concern of investors during the European recession was the health and stability of the European banking sector. One of the key objectives of the solution was to create a stronger and more integrated financial system. With the establishment of a single banking regulator (Single Supervisory Mechanism or SSM), deposit insurance and a banking resolution mechanism, much of the reform has been completed. However, the fourth and final hurdle of bank recapitalizations needs to be completed following stress tests in October of this year. This will limit credit expansion in the short run and will likely prevent the European economy from enjoying the breakout growth that normally occurs in the early stage of recovery.[9]

By announcing on April 3, 2014 that the governing Council is now unanimously willing to adopt quantitative easing in order to prevent the Eurozone from sliding into prolonged low inflation (or deflation), the European Central Bank substantially reduced the risk that had been worrying investors for some time. The Eurozone inflation rate of 0.5% is now at the lowest level in four years and is about a quarter of the ECB's 2.0% target. In addition, the European Central Bank President Mario Draghi's emphasis on the exchange rate as a key component in the ECB's assessment of medium term inflation makes it less likely that the euro will be allowed to rise further without a policy response from the ECB. According to Gavyn Davies, there are three lingering concerns: the ECB might midjudge the severity of the deflationary threat; it might be too slow to act or; it may not be able to find suitable private assets to buy in sufficient scale.[10] In the words of Richard Barwell, Economist at the Royal Bank of Scotland, "The Council did not act in response to weak inflation and despite all the positive tone in the Introductory Statement and the press conference, it is not clear that the Council will act in the future."[11] All the same,

[9] Barclays Global Outlook, "A Balanced Portfolio Still Makes Sense", March 2014.
[10] Gavyn Davies, FT Blog, "ECB Addresses the Zero Lower Bound", April 3, 2014.
[11] Focus Economics, Euro Area – Monetary Policy, April 3, 2014.

we are reassured that the ECB will go to great lengths to prevent a Japanese style deflationary trap.

Japan

In Japan we believe corporate earnings growth will start slowing as the effect of the yen's weakness peters out. Over the coming 12 months, corporate earnings growth should slow to 10.0% year-over-year. This compares to 55% growth in fiscal year 2013. A serious risk for the next six months is a negative impact from the consumption tax hike in April. We expect the Bank of Japan to react in the second quarter by providing more quantitative easing. We are waiting to see how the Abe administration stimulates Japan's corporate investments and clears the uncertainty about 2014 growth.

One of the key themes in Japan in recent months is that, against most expectations, inflation has risen markedly and continues to surprise on the upside. A shift from deflation to inflation should provide long-term support for Japanese equities. At the same time, it is negative for Japanese government bonds or JGBs, especially since shorting these bonds is relatively cheap in the current market. At the margin, this will likely shift the optimal portfolio for Japanese investors away from fixed income and more towards equity. As higher inflation expectations become more permanent, the Bank of Japan may not provide as much stimulus via its quantitative easing program, which has been a major contributor to the weakness in the yen against the dollar. As a result, the negative correlation between the Japanese yen and the Japanese equity market that has persisted for some time may begin to break down.

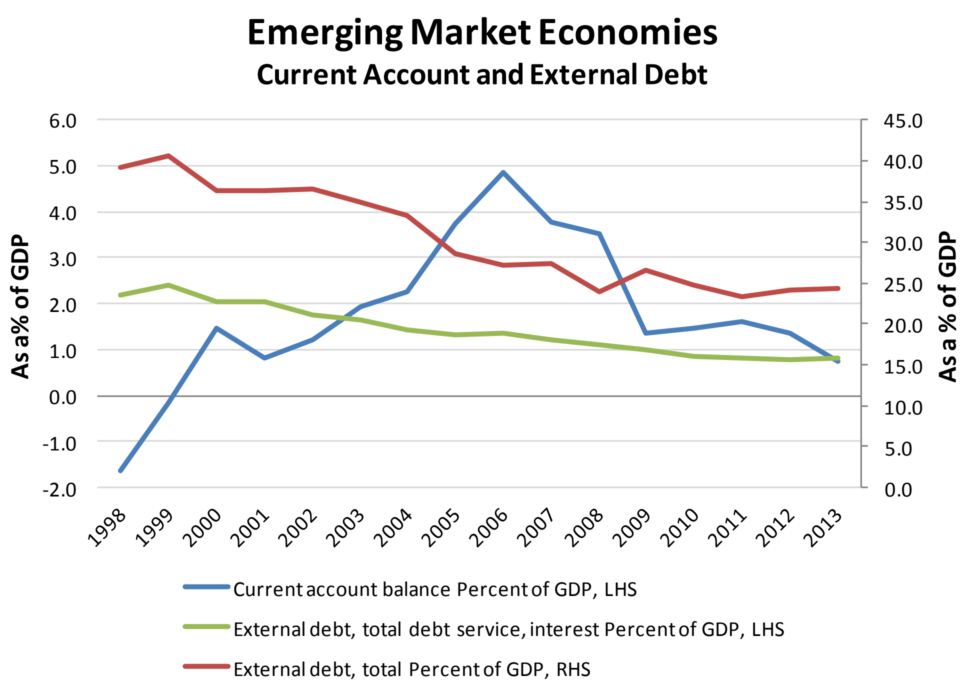
Developed market bonds are not particularly attractive at this stage. The ten-year U.S. Treasury Yield of 2.6% as of April 15, 2014 is about 0.7% or lower in real terms, compared with an expected GDP growth rate in excess of 2.5%. Nominal European bond yields are even lower. For example, the 10-Year German Bund is trading at 1.47% as of April 15, 2014. As already noted, peripheral country bond yields are in some cases nearly equal to those in the U.S. It is true that the real rate of interest on comparable high-quality Eurozone bonds is about equal to that of U.S. Treasuries, even though Eurozone growth is likely to be substantially lower.

Emerging Market Economies and Markets

Investors were concerned about a new emerging market crisis which would spread systematic risk across the global economies. Large amounts of capital have flowed out of emerging markets over the past year, which caused their currencies and financial asset prices to fall. In a way, this was similar to the 1998 Asian financial crisis, the main difference being that exchange rates are more flexible now than they were then and much of emerging market debt is denominated in local currency as opposed to hard currency. Thus, the widening of external deficits has been diminished as well as the level of destabilizing speculative capital flows. Moreover, external debt to GDP ratios are significantly lower for most emerging markets (see Exhibit 6).

Therefore, we do not believe that large capital outflows signal a general collapse of their economies at this time. By contrast, recent capital outflows are the result of normal business cycle changes and a more realistic expectation of global monetary policy, i.e., that quantitative easing and zero interest rates are only temporary. Following Barclays argument in its March 2014 Global Outlook, unlike previous business cycles, the current global recovery was initiated by emerging market countries, such as China. Consequently, these countries encountered capacity constraints before the developed economies and started to tighten policy to prevent overheating. Such restrictive policies brought on an economic slowdown and slower credit growth, which reduced investment prospects in many emerging markets.

Exhibit 6: Emerging Market Economic Fundamentals



Source: IMF Outlook Database, 2014 of GSP.

The present policy adjustments in emerging markets are salutary and have prevented a more precipitous decline in asset prices. Early signs of economic and market adjustment are taking place in certain countries which leads us to believe the stabilization may already be taking place and recovery may even be underway. Examples of such improvement are evident in data from Brazil, India and Indonesia, where inflation seems to be falling and external deficits are narrowing.

Among the emerging markets, China presents the greatest risks to global growth and financial stability. China has the highest ratio of corporate debt to GDP of any country and most of this debt is held by state-owned enterprises with negligible or non-existent profitability. This debt was accumulated over the last ten years at negative real interest rates. The Chinese economy slowed much more than expected and the first onshore corporate default occurred in the first quarter of this year. The large amount of corporate debt that has to be rolled over in 2014, in addition to the government's attempts to reform financial markets, suggests that more defaults are likely. The recent reversal of the long trend of appreciation in the Chinese currency against the U.S. dollar caught investors off guard and provided additional fuel for uncertainty.

For nearly three years, growth deceleration has been engineered by Chinese policymakers in an effort to reform the economy and financial markets and avoid a more precipitous slowdown later. During this process, there have been periods in which growth slowed more than expected for a few months, only to rebound thereafter as a result of policy intervention (see Barclays Global Outlook, March 2014). We are hopeful, but by no means certain, that a similar rebound will occur in the next few months and the high-speed rail project, among other things, suggests that measures have already been adopted to stimulate activity. Stronger U.S. and European economies should also increase the demand for Chinese exports. The likelihood of improved economic performance has started to be reflected in Chinese equity prices which, though still very low, have rallied since the beginning of the year. Their current price earnings ratio at 8.6 is below that of every other country in the MSCI All Country World Index save for Russia and Turkey.[12]

Credit policy in China will likely maintain a tightening bias in 2014. At the same time, liquidity should continue to be accommodative in the short run absent improvement in growth momentum. Nonetheless, we still anticipate a substantial uptrend in interbank rates in line with China's intention to continue liberalizing interest rates and limiting shadow banking activity. We believe that the government will selectively allow small-scale credit events to change investors' perception of the so-called "implied guarantees." This should be viewed as a long-term positive as the fall in the shadow banking credit will reduce moral hazard. It encourages effective risk pricing and leads to more mature financial markets. Although we should closely monitor whether limited defaults are being accompanied by a wider range of credit events, the probability of uncontrollable systematic risk in the economy seems low given that China is a capital exporter, that it has extensive foreign exchange reserves and that all of its corporate debt is held domestically.[13]

Emerging market equities have held up well in the first quarter and may be anticipating a growth recovery later in the year. In some cases, valuation levels are so low that they imply a negative earnings growth, which we believe is highly unlikely. We do not believe that monetary

[12] JP Morgan, "Eye on the Market", March 31, 2014
[13] JP Morgan, "Eye on the Market", March 31, 2014

tightening in the U.S. will occur until well into 2015 and that capital flight out of emerging markets of the magnitude seen in May and June of 2012 and in the early part of this year is unlikely to recur in 2014. China remains the dominant emerging market, but we believe that the economic setbacks that occurred in the first quarter of 2014 were only temporary and that China will surprise on the upside during the remainder of the year. This should improve investor sentiment.

We believe that emerging market debt in the present environment may be attractive, at least relative to developed country bonds. The sovereign debt of countries such as Indonesia, Brazil and India has yields which more than compensate for the susceptibility of these countries to external capital outflow. At 225 basis points, emerging bond spreads should tighten during the next year as the recovery continues. This may be partly offset by rising U.S. Treasury yields.

Geopolitical and Economic Risks

One of the key risks to the global economy is geopolitical in nature. The situation in the Ukraine is uncertain and the pro-Russian groups that are currently occupying important facilities in the eastern part of the country are not encountering much resistance from the weakened and poorly funded Ukrainian army. While it is difficult to predict the actions of one country versus another, it seems as though Russia will have some success in taking more control within the country. However, as the situation progresses it becomes more critical for the West to begin to devise a strategy to limit the infiltration. This would include broader sanctions against Russia as well as a build-up of NATO forces in Eastern Europe and the Baltic states. While the costs associated with such actions may be high, The Economist article entitled “Insatiable” published on April 19, 2014 suggests that if the West were to wait longer, the costs could be much higher. Other risks in the market revolve around monetary policy and excess leverage in most developed economies. With central banks maintaining their accommodative monetary policies for the foreseeable future, the risk of more speculative bubbles (such as the social networking sector) and misallocation of capital remain. There is evidence of excessive leverage which could create instability in equity markets. Some examples include the fact that margin debt in the U.S. is at an all-time high and leverage loans to shaky companies and covenant light bond issues have returned. In addition stock and bond prices are giving divergent predictions. For example, low long term interest rates in the developed countries suggest subpar economic growth and a risk of deflation. Such a scenario does not auger well for strong future earnings growth, which justifies the current bullishness in stocks.

Conclusion

The behavior of the markets in the first quarter of 2014 reminds us again of the importance of a diversified portfolio and maintaining allocations to asset classes that may seem relatively unattractive compared to the consensus view. Many felt that the bond market was due for a sell-off as growth picked up and yet the opposite occurred. The consensus was for the U.S. equity market to continue to post new highs and while it managed a positive return during the quarter, it fell short of expectations. Commodity prices and emerging market equities were expected to continue to decline significantly, yet they rose or remained flat.

Aside from the aforementioned biotech and social networking sectors, valuations for the overall U.S. market generally appear to be quite reasonable with most metrics at levels in line with or below historical averages, particularly on an enterprise value basis. Eurozone equities present an attractive opportunity to participate in the European region's economic recovery in our view, particularly given the promised support of the European Central Bank. While emerging markets are slowing down, we do not believe that large capital outflows signal a general collapse of their economies at this time and valuations are becoming attractive. Finally, we remain cautious on developed market bonds and expect yields to increase as economic growth improves.

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