DREXEL MORGAN CAPITAL ADVISERS

THE MCCABE PERSPECTIVE

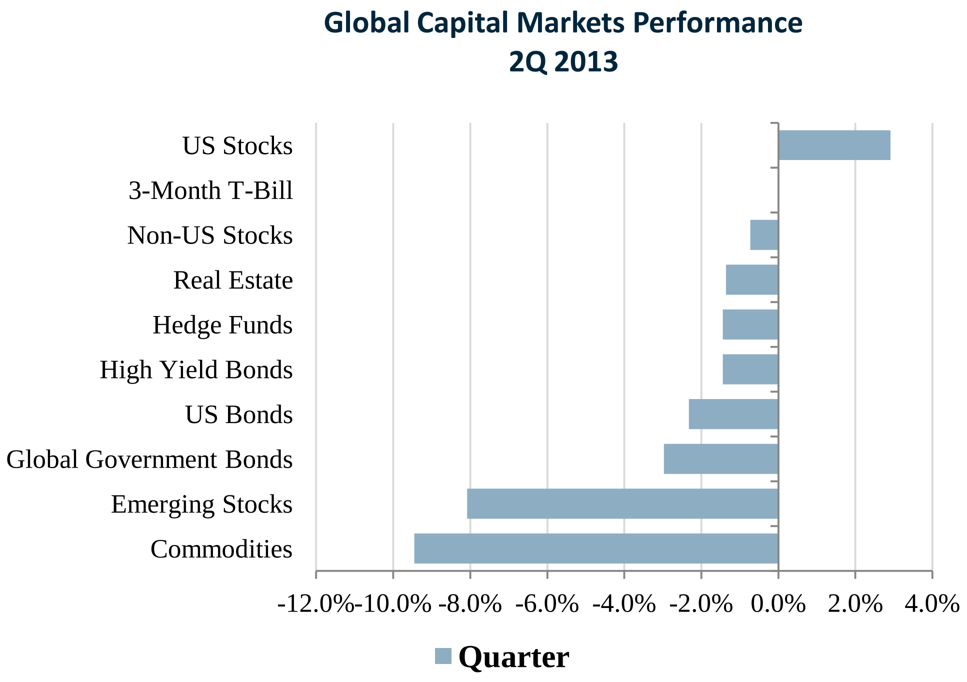
Second Quarter 2013

"The Fed can talk about tapering QE all it likes; it can't change the basic laws of economics and valuation."[1]

Volatility returned in the second quarter. Global markets reacted to mildly negative economic data and to the potential withdrawal of extraordinary monetary easing in the U.S., as well as slowing growth in the emerging economies during the second quarter. However, it was comments made by Federal Reserve Chairman, Ben Bernanke, on May 22 and again during his press conference following the FOMC meeting on June 19 that sent global bond and stock markets sharply lower. While the reason for less monetary stimulus is positive (i.e., a better economic outlook in the U.S.), market participants interpreted the statements as the first sign of future policy rate hikes, not just a tapering of bond purchases. They seemed to ignore the Chairman's point that any adjustment to the current timing or pace of security purchases will depend largely on improving the employment picture. While conditions in the U.S. economy are relatively stable and generally improving, economic growth outside the U.S. (with the exception of Japan) continues to slow.

[1] Jim O'Neill, former Chairman of Goldman Sachs Asset Management, now a Bloomberg View columnist.

Exhibit 1: Global Capital Markets Performance Overview



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, Dow Jones REIT, Dow Jones UBS Commodity Index, HFRI Fund of Funds Composite Index, ML 3-Month T-Bill. All returns in US Dollar terms.

Apart from U.S. stocks, most major asset categories posted negative returns for the quarter. Growth and interest-sensitive assets, such as U.S. Treasuries, real estate, commodities and emerging markets, were among the worst performers given the concerns over a downshift in China's growth rate and its impact on commodity producing economies around the world. As commodity prices fall so do inflation expectations and this had a negative impact on U.S. Treasury Inflation Protected Securities or TIPS, which were among the worst performing securities in the quarter. Currencies associated with commodity driven markets, such as Australia and Brazil, weakened considerably and the U.S. Dollar appreciated relative to most major currencies including the Yen, Euro and Sterling mainly because of the difference in monetary policy outlook.

US Economy

The U.S. Economy is expected to grow at a rather modest pace in 2013 (2.0%) and could even pick up some momentum by the end of the year and into 2014 (2.5%)[2] if employment continues to improve at the current or at a higher rate and the impact from the fiscal tightening related to the Sequester begins to wane. Further, it is our expectation that monetary policy will remain accommodative even if the Federal Reserve begins to taper its extraordinary bond

[2] Capital Economics

purchases in the coming months. In our view, the fundamentals in the U.S. are strong enough to power the economy and justify less artificial support by the Fed but are not strong enough to lead to higher short term interest rates.

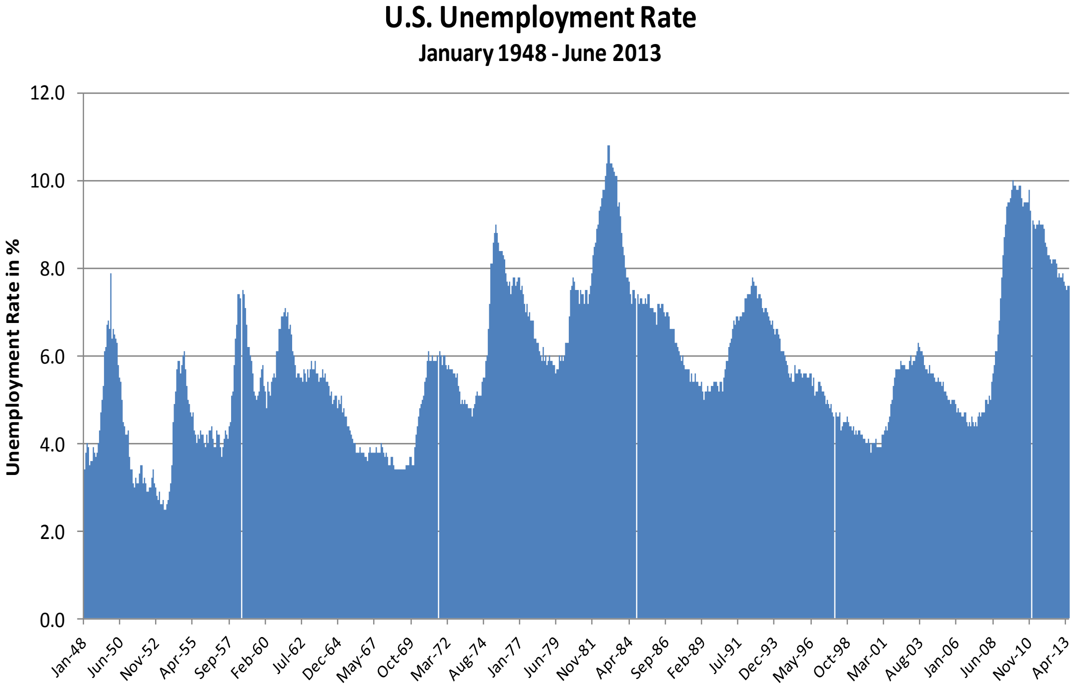
However, the areas that have been driving the recent growth in the U.S. include housing, autos and to a lesser extent business investment. According to research by Capital Economics, these rate-sensitive areas of the economy that have been driving growth may be negatively impacted by higher borrowing costs in the future.[3] While this is a valid concern, borrowing costs are still at historically low levels. Given the dislocation in the housing market that occurred as a result of the crisis in 2007 and 2008, housing starts have a long way to go to recover fully and house prices have been increasing nicely over the past year.

All eyes are on the Bureau of Labor Statistic's Employment Situation because this is the key economic data that the Fed is watching to determine when it will begin to wind down its bond purchase program. The latest report in June 2013 was encouraging. Not only did the report show continued non-farm payroll growth at a pace close to 200,000 per month, but the reports from April and May were revised upward. In addition, average hourly earnings over the past year have increased by 2.2% and the gains reached 4.5% in the latest monthly employment report. This bodes well for consumer spending in the future. Despite the payroll tax increase and the negative effect of Sequestration on employment, real disposable income grew by 1.1% during the twelve months ending May 31, 2013.[4]

[3] Capital Economics, Global Economic Outlook, Q3 2013, page 8.

[4] Bureau of Labor Statistics, The Employment Situation, June 2013

Exhibit 2: BLS U.S. Employment Situation



Source: Bureau of Labor Statistics

Developed International Economies

While there are some signs of stabilization in the Eurozone economy, as evidenced by improved business surveys across the region, risks remain. The Eurozone Composite Purchasing Managers Index, a survey of how thousands of European businesses view the current economic environment, increased to 48.7 in June from 47.7 in May.[5] A reading below 50.0 indicates contraction, although it should be noted that the decline is occurring at a slower pace than it did at the start of the year.

The reading for Germany, a major economy within the region, remains close to 50.0 and given their global exposure, particularly to China, we would expect that the potential for growth in the near term remains poor. European GDP growth remains in negative territory and the recession there has entered its seventh quarter. The contracting economic conditions and continued austerity have boosted the unemployment rate in the Eurozone to a record 12.1% in May.[6] These conditions are ripe for continued social unrest and protests. The U.K will follow its course of fiscal austerity until it achieves its economic and fiscal goals. Although its growth

[5] Markit, Eurozone Composite PMI June 2013.

[6] Organisation for Economic Co-operation and Development (OECD)

rate was an anemic 0.3% in the first quarter and its unemployment rate a relatively high 7.8% in May,[7] it compares well to the Eurozone.

It was Japan that ran counter to the global trend with strong results. These results were confirmed by The Bank of Japan's "Tankan" survey for June 2013 that showed that the index for major manufacturers rose to a four point positive score. It was the first positive reading since September 2011. Japan's seasonally adjusted Purchasing Managers' Index (PMI™) improved to 52.3 in June up from May's 51.5[8] indicating a strengthening in Japan's manufacturing sector. The latest reading was the best recorded for 28 months and was indicative of solid growth. The PMI has been posted above the 50.0 mark for four successive months. The election of a new government at the end of 2012 proved to be a turning point for Japan given its focus on addressing the deflationary trends that have plagued the economy for decades. While the economic growth recorded in the first quarter was strong (4.1% annualized GDP growth according to the Cabinet Office, Government of Japan), it may not persist at these high levels. There are plans to increase the consumption tax in the future and input costs in Japan have increased with the weakening Yen rate. Both trends may have a negative impact on growth going forward.

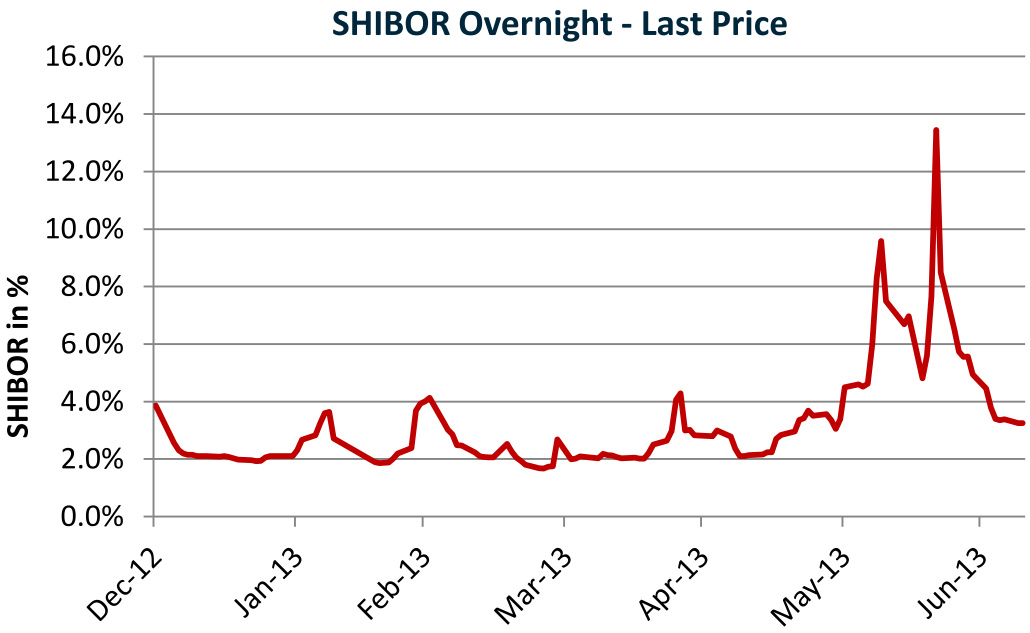
Emerging Market Economies

The potential withdrawal of extraordinarily accommodative monetary policy by the U.S. and the slowdown in China had a negative impact on emerging markets and emerging market currencies. The slowing in China is partially a result of government policy, and reflects in part a tightening in interbank lending. The tightening in lending policies began in March, as we discussed last quarter, and reached a peak in June as the People's Bank of China (PBOC) refused to intervene in a cash crunch that temporarily drove short term interest rates into double digits as the PBOC sought to reduce risky bank lending practices.

Chinese government measures implemented in March, which were designed to regulate the real estate market, have had little effect thus far. The National Bureau of Statistics survey of prices of residential buildings in 70 cities shows price increases on a year over year basis in all but one city for newly constructed buildings, and in all but three cities for existing properties. Year on year increases ranged from very small to over 15%, while monthly increases ranged up to 2.9%. On a monthly basis, 90% of the cities reported monthly price increases. These data may suggest why the People's Bank of China refused to provide liquidity to the banking system in mid June, and why banks will be required to tighten their lending going forward.

[7] Organisation for Economic Co-operation and Development (OECD)
[8] Markit, JMMA PMI

Exhibit 3: Shanghai Interbank Offered Rate



Source: Bloomberg. Shibor (Shanghai Interbank Offered Rate) is calculated, announced and named on the technological platform of the National Interbank Funding Center in Shanghai. It is a simple, no-guarantee, wholesale interest rate calculated by arithmetically averaging all the interbank RMB lending rates offered by the price quotation group of banks with a high credit rating. Currently, the Shibor consists of eight maturities: overnight, 1-week, 2-week, 1-month, 3-month, 6-month, 9-month and 1-year.

Importantly, all Chinese banks are either state-owned or state-controlled and according to research conducted by Bank Credit Analyst's (BCA) Chen Zhao, the Managing Editor of the Global Investment Strategy service, "There is no country sovereign constraint on the central bank [rescuing] any troubled financial institution."[9] In other words, the central bank has the authority and resources to bail out the banks but at the moment, does not have the willingness, and that is why this banking crisis is not as severe as the credit crisis that occurred in the developed economies in 2007 and 2008. In addition, the financial sector is not as interconnected as that of the U.S. or Europe. BCA points out that the liquidity crisis that occurred in June reveals a changing attitude of the new Chinese leadership and has indicated clearly that they are serious about addressing the "shadow banking" activities in China, such as high rate lending by off balance sheet entities of financial institutions.

[9] Bank Credit Analyst, "A Changing China….", Weekly Report, June 28, 2013

Global Equities

Most global equity markets reversed course during the second quarter of 2013 with the notable exception of the U.S. equity market as measured by the S&P 500 Index, which managed to post a positive return despite a few volatile days at the end of June. Market reaction was most severe within the emerging markets mainly due to the significant outflow of capital. When the U.S. started its Quantitative Easing program, capital inflows into emerging markets were significant. This inflow pushed emerging market currency values higher relative to developed currencies and the U.S. dollar in particular. Now that the Fed has signaled the potential end to the bond purchase program, capital flows out of emerging markets have started to accelerate. The potential shift in U.S. monetary policy, combined with slower growth in Asia (mainly China) and the likely impact on demand for commodities, contributed to the 8.0% decline for the emerging market equity index and the 9.45% decline in the commodity index for the quarter ended June.[10]

In the U.S. stock market, prices continue to rise while earnings remain relatively stable. As a result, the price earnings multiple for the S&P 500 Index has increased to approximately 16.25 as measured by current prices (as of July 11, 2013) divided by trailing 12 month earnings.[11] Schiller's cyclically-adjusted P/E ratio (which is based on average inflation-adjusted earnings from the previous ten years) is currently at 24.49 (as of July 11, 2013). While this measure is well below the maximum value of 44.20 reached during the market top of December 1999, it is higher than it has been since January 2008.

On a forward looking basis, the U.S. market is trading at a 14.5 price earnings multiple which translates into a 6.9% forward earnings yield for the S&P 500 Index as of July 12, 2013.[12] This observation is based on consensus earnings estimates. The forward earnings expectations for the S&P 500 Index, according to Bloomberg estimates, are for $115.49 per share versus the current $103.12 per share. In our view, these earnings expectations may be too high given that profit margins of U.S. companies are currently at or close to historic highs and there may be more headwinds to come. For example, profit margins for U.S. companies have been high mainly due to companies cutting costs, increasing productivity, the benefit of lower interest rates and a weaker dollar. Going forward, costs may increase due to increased employment and wages, increased interest burden and a stronger dollar (which impacts overseas earnings). While the economic environment is improving, the profit margins of U.S. companies are likely to decline from their current levels. If this were to occur, it would make the U.S. stock market more expensive in relation to fundamentals.

[10] MSCI Emerging Market Index, Dow Jones UBS Commodity Index
[11] Bloomberg SPX EEO
[12] Bloomberg

The contrast in valuation between the U.S. and European markets is exceptional. Capital Economics estimates that the cyclically-adjusted price earnings multiple is 9 points lower in Europe than in the U.S. for non-financial companies.[13] This presents a long term investment opportunity.

Japan's stock market has been among the strongest in the world over the past year. The main question going forward is whether the aggressive monetary stimulus will not only kick start the Japanese economy, but also lead to more sustainable growth from increased consumer spending and business investment. While the recent surveys have been relatively positive, it remains to be seen how resilient the real economy will be.

The decline in the emerging market indices has resulted in price earnings ratios that are relatively attractive compared to the developed markets as well as to their own history. As of July 11, 2013, the forward price to earnings ratio for the MSCI Emerging Markets Index was 10.2, which translates into a 9.8% forward earnings yield. While the emerging markets are cheaper on a relative price earnings basis, the trends in the underlying economies continue to be weak. The main risk within the emerging markets is the impact that the Chinese growth slump will persist (especially given the reduction in available credit) and that this slowdown will impact the rest of the global markets. In addition, prices of many commodities have broken down and the likelihood is that the declines will continue.

This has put stock price pressure on commodity producers while at the same time emerging market companies that are not leveraged to the commodity cycle have stock prices which are relatively expensive. In addition, capital flight is a major problem in emerging markets with a large basic balance (current account deficit minus long-term capital inflows). Among the larger countries this includes India, Turkey and to a lesser extent Brazil. Either for this reason or to correct policy excesses of the past, there is likely to be a shift in leadership within the emerging markets with the large BRIC countries (Brazil, Russia, India, and China) giving way to smaller economies such as Indonesia, Mexico and The Philippines. These trends are likely to continue in our opinion and while the stock markets are relatively cheap, we do not believe now is the time to overweight emerging market equities.

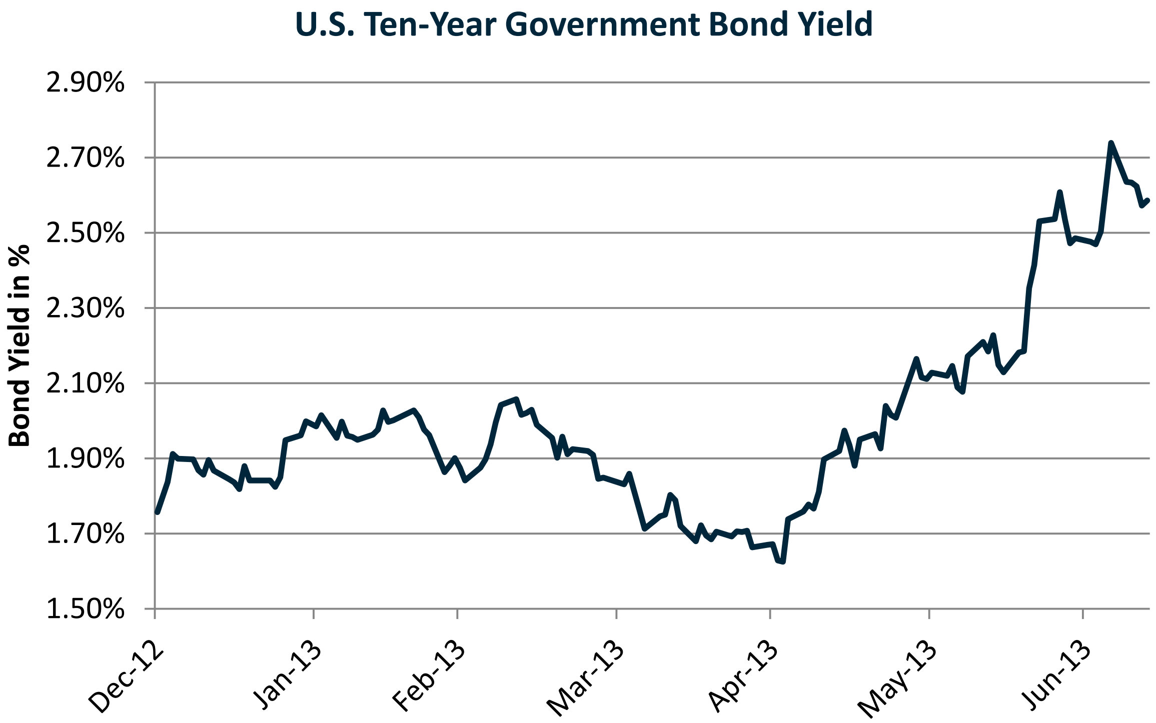
Global Fixed Income

Global bonds traded off significantly in the second quarter and especially in May and June on the back of the Federal Reserve comments regarding its Quantitative Easing program. Over the past one year U.S. Ten-Year Treasury yields have moved from 1.40% (July 25, 2012) to 2.73% (July 5, 2013) with the majority of this back up (nearly one percentage point) occurring in May

[13] Capital Economics, Developed Market Chartbook, July 2013

and June. This caused U.S. Treasury indices to fall across the maturity spectrum, with longer term bonds suffering the largest price declines. A one percentage point increase in the Treasury yield is comparable to that which occurred during the first two months of the 1994 tightening which represented the initial stage of the worst year for Treasury bonds on record. Even though the ten-year Treasury is still substantially below its long-term equilibrium rate of about 3.5%, an initial increase of over 100 basis points was excessive and, in our view, premature given the weakness in US labor markets, a low and declining inflation rate and a sub trend GDP growth rate. According to the futures market, the taper talk has brought the timetable for expected short-term rate hikes forward by 12 months, with the first one now anticipated to occur at the beginning of 2014, as opposed to the beginning of 2015.

Exhibit 4: U.S. Ten-Year Government Bond Yield



Source: Bloomberg

Yet the latest quarterly average increase in monthly employment, slightly fewer than 200,000 per month, if continued, is not enough to reduce the employment rate below 7.6% where it is currently. Much larger monthly increases will be required even to bring unemployment down to 6.5% by 2015, let alone 2014. According to statements made by Fed Chairman, Ben Bernanke, 6.5% is the trigger point which must be reached before there are Fed fund rate hikes. Even an unemployment rate in the vicinity of the 7% trigger, associated with the full termination of asset purchases and set in Ben Bernanke's June 19 press conference, is far away.

While the Fed may decrease asset purchases sooner than expected, it is unlikely that it will change the target Fed funds rate until mid 2015 at the earliest. Expected inflation rates now priced into the bond markets have fallen below the Fed's target of 2% which, together with a sticky unemployment rate, gives the Fed justification for postponement of the standard tightening measures, i.e., hikes in the Fed funds target rate.

Global developed bond markets sold off in sympathy with the U.S. bond market during the quarter. Interestingly, higher yielding bonds and bonds issued by below investment grade companies declined in value, but not by as much as Treasury and Inflation Protected Treasury bonds did. Emerging market bonds sold off and spreads over US Treasury yields widened as concerns over the potential for higher U.S. dollar denominated debt service costs caused capital flight out to accelerate. Given their reduction in dollar denominated debt, emerging economies are in a much better position than in the past to withstand policy tightening by the Fed and few are at risk of an immediate crisis.

U.S. municipal yields rose much more than comparable Treasury yields on a taxable equivalent basis because of large mutual fund redemptions and a lack of dealer inventory. In our view, this was an overreaction and creates a buying opportunity for bonds in the five to ten year maturity range.

Alternatives

Alternative asset classes, including commodities, hedge funds, Master Limited Partnerships (MLPs) and real estate, failed to offer too much diversification to the shift in market sentiment that began in May and intensified in June. Commodities and hedge fund strategies related to this particular asset class were among the worst performers for the quarter. Both the potential end to easy money in the US and the fear of slower growth in China meant that the deterioration in commodity prices picked up further momentum.

In addition, the dramatic sell off in the bond market caught many trend following strategies within the managed futures style off guard. Furthermore, many of these trend followers had built up long positions in the global equity markets and as both bonds and stocks declined in June, they were unable to adjust quickly enough. Event-driven and credit-oriented strategies in general also suffered declines in June which mitigated some of the positive returns generated so far in 2013. Equity long/short strategies were able to offset some of the equity risk in June via their hedging policies and short positions on stocks, particularly those related to the commodity sector.

Real estate securities or REITs fell marginally during the quarter while the higher yielding Master Limited Partnerships held up relatively well, posting a return of 1.7% according to the JP Morgan Alerian MLP Index ETN.

Despite the weakness in the varied categories of alternative investments, their role in portfolios is important. With markets moving in tandem, similar to the ones we experienced in the second quarter, the benefit is less obvious. However, the differentiated approaches and return characteristics of each can provide the portfolio with valuable alternative sources of return. Further, the flexibility of the mandate within the hedge fund category offers the opportunity to take advantage of quickly changing markets and these funds are often are well positioned to take advantage of unanticipated events.

In a rising bond yield environment, hedge funds offer investors an attractive opportunity to protect their portfolio against duration risk. Hedge funds displayed a negative correlation with high quality bonds during every market cycle from 2002 to 2012 and on an average annual basis from 1995 to 2009.[14]

Outlook

We are encouraged by the resilience of the U.S. economy thus far in 2013 although we are concerned about the slowdown occurring in the emerging markets and the impact this may have globally. On a positive note, the impact that tax increases and spending cuts related to the Sequester had on capital expenditure and consumer demand is largely behind us and we expect that these headwinds will begin to dissipate. While the U.S. economy is relatively stable, the non-U.S. economies are more mixed, with an improving Japan providing some relief from a slowing Europe and China.

We believe that moderate but below trend world growth will continue this year and next. The world economy has slowed slightly since the beginning of the year, according to business surveys, but we expect global growth to accelerate gradually for the second half of 2013 and during 2014. Fiscal drag in the advanced countries should diminish and monetary policy should become more accommodative in the U.K. and the Eurozone. The removal of monetary accommodation in the U.S. should be more gradual than the market expects.

[14] Financial Analysts Journal, January/February R. Ibbotson, P. Chen and K. Zhu, "The ABCs of Hedge Funds, Alphas, Betas and Costs, Citigroup 3rd Quarter Outlook.

There are three main risks to this outlook:

- First, while there is some improvement in the economic fundamentals in Europe, there are still major political and policy risks that remain in the Eurozone. The primary risks exist in the Spanish financial system and whether the Spanish Central Bank will allow their member banks to service existing loans with new loans to prevent a large bank failure. We still expect negative growth both this year and next in the Eurozone which may result in some sort of breakup.

- Second, the risk of policy errors continues to be a potential concern. Recent announcements have shown that there is an exceptional need to manage expectations when using unconventional monetary policy. Japanese policymakers are trying to balance the difficult objectives of increasing inflation expectations and managing the impact of increased interest rates if they are successful. In China, the government is seeking to gain more control over the financial sector, while at the same time trying not to cause a major liquidity crisis that could severely disrupt economic growth.

- Finally, employment is the third risk. If the U.S. recovery is to continue and the Eurozone recovery is to begin, there must be greater employment in both regions. This will require greater private sector growth, higher investment, and in the case of the Eurozone, lower barriers to entry within product categories. All eyes will be focused on the progress that the U.S. economy is making and ultimately the impact on the unemployment rate which will determine the future of U.S. Federal Reserve policy.

Summary

Despite these risks, we remain cautiously optimistic on the prospects for growth in the global economy, albeit at a lower rate than in previous years. In our view, stock market valuations (still 30% below the top valuation quintile) are not yet at extreme levels in the U.S. On a risk-adjusted basis, they are still attractive compared to other investment alternatives although multiples in the non-financial European sector are unusually low. The behavior of the U.S. bond market during the second quarter was a clear warning that the long bull market in bonds may be coming to an end.

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