

Drexel Morgan Capital Advisers

McCabe Global Economic Commentary

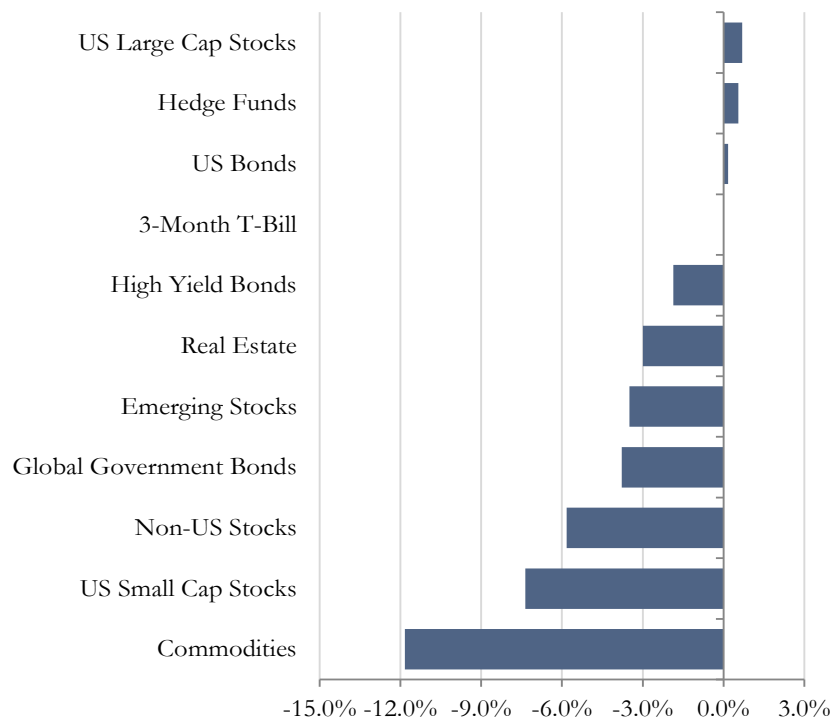
Third Quarter 2014

"Monetary policy ultimately must be conducted in a pragmatic manner that relies not on any particular indicator or model, but instead reflects an ongoing assessment of a wide range of information in the context of our ever-evolving understanding of the economy."

- Federal Reserve Chairwoman Janet Yellen, Jackson Hole Economic Policy Summit, August 22, 2014

Lackluster economic conditions in the developed world continue to support the easy monetary policy of the US Federal Reserve and the Bank of Japan and may even encourage the European Central Bank to consider further actions, including quantitative easing. While economic growth in the US and the UK remains positive, if not robust, European economies have stalled and emerging market growth is decelerating. The debate on when the US Federal Reserve will raise interest rates and to what level continues to dominate the headlines, although the bond market strength so far in 2014 seems to suggest that the market isn't expecting an interest rate spike any time soon. We continue to monitor the employment situation carefully for signs of the participation rate rising and the reservoir of underutilized employees falling, or whether wage pressures are increasing for other reasons. This in turn will be the catalyst for higher short-term interest rates in the US. However, there is little evidence of any such trend in the most recent reports from the Bureau of Labor Statistics.

Global Market Performance For the Quarter Ended September 30, 2014



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

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In our view, the main drag on global economic growth is the overall lack of demand for goods and services. Even six years following the credit crisis of 2008/2009, governments and households continue to pay down their debt rather than increase their spending, despite the record low interest-rate environment that exists today. US households are much farther along in the deleveraging process than those in other developed countries. The memory of the financial crisis is no longer a substantial drag on demand growth in the US. However, the upswing in demand does not match that of earlier expansions. Households are less willing to take risk and face higher than normal liquidity constraints when attempting to obtain or refinance home mortgages. Even though US corporations are issuing more debt, they are using much of it to buy back their own stock and pay out dividends or otherwise restructure their balance sheets, rather than expand their productive capacity.

This is not just a US phenomenon but an even more pronounced global one. The European economies have yet to recover from their recession in 2011 and are slowing down again, while Chinese growth is weakening due to the government-led clamp down on excessive borrowing related to the country's infrastructure build out. Japan is also having trouble inflating. While the healing process in developed economies has taken much longer than many participants would like, the slow recovery is consistent with previous credit induced recessions.

Key Global Economies

We shall now consider the economic situation in one country, China, and one region, the eurozone, which we believe are crucial to the recovery of global growth over the next 12 to 18 months.

Eurozone: In the first week of September, the President of the European Central Bank (ECB), Mario Draghi, surprised markets with another round of interest rate cuts and promises of more monetary stimulus to prevent deflation and stimulate growth. While he cut the ECB's main lending rate from 0.15% to 0.05%, he also increased the negative rate banks pay for holding deposits at the central bank from -0.1% to -0.2%.¹ In addition, Draghi announced that the ECB will buy asset-backed securities (ABS) and private debt securities called covered bonds. The ECB also indicated that it does not intend to raise the value of loans on its balance sheet by about \$1.2 trillion to bring them back to 2012 levels.

We do not believe that these measures are sufficient to significantly stimulate the eurozone economy. According to Bloomberg review.com, the interest rate cuts are “negligible” and the purchases under the bond buying program are less than they appear. An increase of \$1.2 trillion is equivalent to a 33% increase in the ECB balance sheet. Such an increase pales in comparison with measures taken by other developed country central banks. For example, since 2009 the Bank of England has increased its assets by 70%, the US Fed by 100% and the Bank of Japan even more since each began its quantitative easing programs, according to James McIntosh of the Financial Times.

¹ European Central Bank <https://www.ecb.europa.eu/home/html/index.en.html>

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By these standards, the proposed ECB increase does not measure up and more is needed if it is to raise overall confidence and expectations of higher inflation. The US, UK, and Japanese central banks' mass purchases of government bonds are politically contentious in the eurozone, since the Germans are apprehensive about large-scale money printing programs. Another problem is that European banks, unlike their US and UK counterparts, have yet to clear up their balance sheets and are thus reluctant to make new loans.

Still, economic stagnation and threats of deflation are fueling the fears of a Japanese-style malaise. For this reason, the ECB may have no other alternative than to take the plunge into a program of full-scale quantitative easing. This, combined with a substantially weaker euro, should fuel a modest rebound in eurozone growth. Since European businesses depend mainly on bank credit rather than traded bonds, quantitative easing may be relatively ineffective and fiscal stimulus in Germany recommended by the ECB and the IMF may be required.²

China: Chinese economic rebalancing has paused and will continue to pose major downside risk to global economic growth. Chinese growth is less than originally expected this year. For example, industrial production is expanding at its lowest annual rate since 2009, electricity production fell in August for the first time in four years and foreign direct investment is at a four-year low. In addition, property prices have been falling for four months. However, we do not expect the economy to fall far short of its 7.5% GDP growth target for 2014 let alone experience a major hard landing this year. The HSBC PMI survey of the manufacturing sector published on September 13 was higher than expected and indicated that the economy was still growing at close to its target rate.

In response to the property market correction, the People's Bank of China injected \$81 billion into the banking system in the form of three-month loans.³ This cash injection may prevent serious loan defaults since there is no other source of funding for many borrowers.

The Chinese government is walking a tightrope. It does not want to inflate the credit bubble any further and wants to wean the economy from dependence on a high investment rate by promoting consumption and deregulation. It has only used targeted stimulus. Still, if growth falls below a certain point, there is the danger of social unrest which will necessitate wider stimulus, such as interest rate cuts. The Chinese authorities have chosen long, drawn out economic rebalancing, not a greater correction that would take GDP growth significantly below the 7.5% target in 2014.⁴

² Jean-Claude Trichet, Bank Credit Analyst New York Investment Conference, September 15-16, 2014 Special Report

³ China Joins ECB in Adding Stimulus as Fed Scales Back, www.Bloomberg.com, September 17, 2014

⁴ Gavyn Davies, Financial Times, "No Hard Landing Yet in China," September 23, 2014

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Global Markets

Global equity and bond markets have produced strong returns over the course of the past few years against the backdrop of moderate economic growth, low interest rates and low inflation. However, in the third quarter of this year credit spreads widened and global equity markets were lackluster or registered poor performance. The performance of US equities was mixed. While the Russell 2000 Small-Cap Index declined, the Large-Cap S&P 500 Index registered a 1.13% return. In the third quarter, equities in non-US markets registered a negative return. Part of this is explained by disappointing European and Chinese economic data and the stretched US equity valuations discussed in our previous commentary. The price to 12-month forward earnings ratio of 15.9 is at the top end of its ten-year range according to Goldman Sachs.⁵ This does not seem to be justified by a sustainably high rate of earnings growth. The latest earnings report in the US showed corporate per share earnings growing strongly at a 10% per annum rate, but the quality of earnings growth was poor; a large portion of the earnings gain was accomplished through share repurchases not through topline growth. In addition, subsequent earnings reports are likely to indicate earnings growth in the 6-7% range because of the negative translation effect of a strengthening US dollar.

Disappointing economic data, especially in Europe, caused the non-US equity indices to decline. The MSCI EAFE Index, which includes the major developed country markets, fell by 5.8% in the third quarter. The MSCI Emerging Market Index returned -3.5% for the quarter. Sovereign bond yields fell across most of the developed world in the third quarter despite substantial differences in regional economic growth. This was particularly true in Germany where the ten-year Bund yield fell below 1.0%. While the buoyant US stock market suggested that good times were ahead, the strength of the Treasury bond market told a different story, with the ten-year bond yield ending the quarter just below 2.5%. Low interest rates imply an environment of weak growth. The diverging outlooks expressed by the markets can largely be explained by the role of the Fed's aggressive policies which have pushed down Treasury yields, squeezed volatility out of markets and compressed spreads in credit markets. At the same time, simmering crises around the world (Iraq, Ukraine, Syria) spurred a modest flight to quality, with high yield and investment grade corporate spreads widening slightly though still remaining abnormally depressed.

In the US, high-quality large-cap multi-national corporations (MNCs) lagged the averages, along with deep value stocks. Weak non-US growth and a strengthening US dollar penalized MNCs, while continued low interest rates made highly leveraged companies more attractive. Deep value plays are not generally exposed to the technology and healthcare sectors which led the market. They also tend to be smaller-cap rather than large-cap and were hurt by the underperformance of that size group. Since companies with high cash flow yields and low price-to-book ratios with improving fundamentals are usually sound, we view this underperformance as largely temporary.

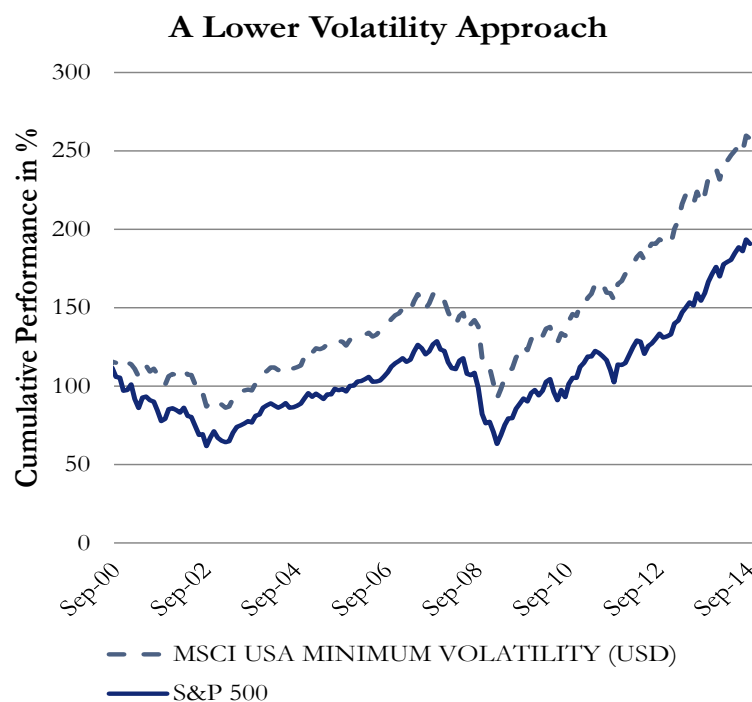
⁵ Goldman Sachs, "Global Weekly Kickstart", p 10

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The performance of high quality domestic issues has been held back by a persistently low cost of capital which has benefited low-quality stocks. The current yield spread on low-rated bonds at 4.1% is 0.7 percentage points below the historic 10-year median spread of 4.8% and 1.5 percentage points below the average spread of 5.6% over this same time period.⁶ This has flattered the earnings reports of lower quality but higher levered companies. Also, low quality companies have been able to substantially extend the maturities of their debt so that they will be under minimal pressure to roll over their bond obligations at low interest rates in the near term. We expect this advantage to be reversed once interest rates and credit spreads rise.

The US equity market in the third quarter had much lower than average price volatility and the performance of stocks with higher than normal volatility tended to exceed that of stocks with lower than normal volatility since low volatility was no longer scarce. For this reason, the MSCI USA Minimum Volatility Index (an Index composed of US equities that, in the aggregate, have lower volatility characteristics relative to the broader US equity market), which has good long-term performance, lagged the S&P 500 Index. As indicated in the graph below, exposure to this Index has provided attractive risk characteristics in the past; it has low downside capture which is exceeded by its upside capture.

Performance of Low Volatility Index Versus S&P 500 Index



Source: MSCI, S&P, Zephyr StyleAdvisor

The valuation of the US small-cap equities moderated in the third quarter due to a broad selloff in this asset class. There were similar losses across sectors and styles, whereas in the second quarter the selloff was dominated by the underperformance of small-cap growth in relation to value.

⁶ Bloomberg, Barclays Capital Live

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The enterprise value to EBITDA ratio for US small-cap equities was 12 versus 11 during the 2003-2007 expansion at the end of September.⁷ The recent rebound in small-cap earnings growth provides some limit on the decline in this multiple below 11. Limited multiple compression to the high single digits should have an increased probability of occurring if an improving domestic economy causes earnings growth to continue at its current rate.

Investment Strategy

At the end of September, the US equity market was on the cusp of the top decile of many valuation metrics.⁸ While overvaluation does not cause markets to collapse, it can limit long-term returns. At September 30 valuation levels, the overall return on US equities as a broad group probably has a no more than 50% chance of exceeding 5.0% per annum over the next five years. At the same time, there are still pockets of value in segments of the US equity market: High-quality large-cap US stocks and US equities with lower than average volatility. In our view, investment in those categories is likely to outperform the overall equity market.

As we move toward 2015, we expect the pace of earnings growth to increasingly favor non-US developed markets. Both Europe ex-UK and the Japanese markets should benefit from currency weakness vis-à-vis the US dollar. This, together with a benign cost environment, especially in Europe, should lead to healthy earnings growth, even in the absence of strong economic growth and while near-term risks remain high, other measures of investment behavior are not consistent with a major market top in the developed countries. In the US there is no indication that a recession is near and in Europe and Japan we expect that high operating leverage, improved international competitiveness and favorable currency translation will cause earnings to rise significantly. In addition, both the ECB policy framework and lower borrowing costs in the periphery support improved valuations and rising aggregate demand in the eurozone.

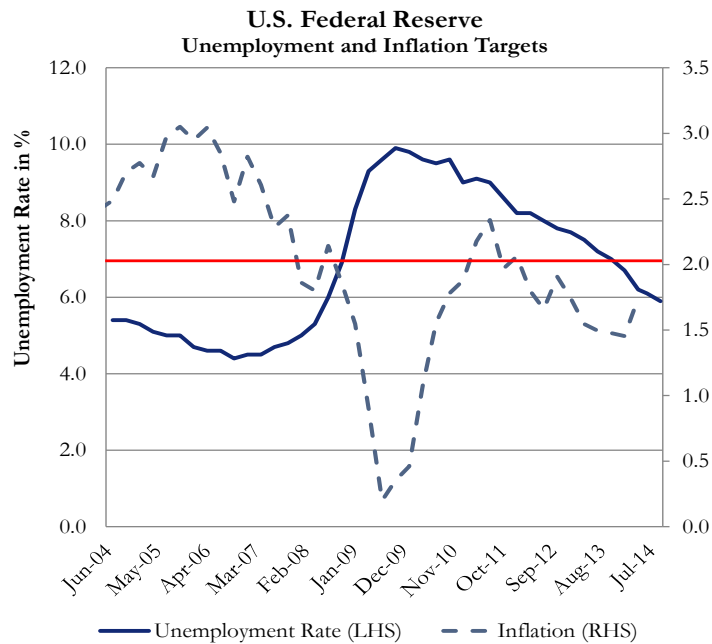
The case for emerging market equities is based on the following: First, commodity prices, which have been falling since the beginning of the year, are likely to bottom sooner than the market thinks, especially in the case of oil. Second, the rise in US short-term interest rates will be later than markets currently expect and thus will not likely attract capital away from emerging markets. Third, emerging market equities are still undervalued on a historical basis given a cyclically-adjusted price/earnings ratio which is substantially below that of the developed market average based on the historically normal discount.

⁷ Barclays Global Outlook, September 2014, p 107

⁸ Sharmin Massavar-Rahmani, Goldman Sachs, "A Summer Breeze, Not a Summer Squall", August 2014, p7

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As indicated by the graph below, the Fed's targets of no more than 2% inflation and unemployment below 6.5% have been attained or nearly reached.



Source: Federal Reserve Bank of St. Louis (FRED)

We believe that inflation is likely to accelerate to above 2.0% by late 2015. However, the Fed can tolerate a cyclical overshoot in its inflation target for two reasons: 1) inflationary expectations remain well anchored; and 2) the unemployment rate at which wage increases accelerate is now well below its historical level of 6.1%. The latter is true because there are many more part-time workers who want to work full-time than one usually sees at this stage of the business cycle. In addition, the labor force participation rate is unusually high. For these reasons, even though the observed unemployment rate is 5.9%, the full-time equivalent employment rate is much lower than 94.1% and the degree of tightness in the labor market is not great. Two half-time workers are equivalent to one full-time worker and the full-time equivalent employment rate is much lower than 94.1% and its complement, the adjusted unemployment rate, is much higher than 5.9%. We do not expect a significant rise in wage growth until the observed unemployment rate reaches 5.1% or less.⁹ Even then the unit labor cost increase may be neutralized by higher labor productivity growth. Thus, we do not expect the Fed to hike short-term interest rates until early 2016, and then to do so only in 20 basis point increments, even though the futures market is calling for an earlier, sharper increase.

With the end of Fed purchases of Treasury bonds to take place this month, we expect greater instability in the US Treasury market. However given the likely postponement of conventional Fed tightening (i.e. increases in policy rates) and the downward pressure created by lower sovereign yields in other developed areas, we believe that the Treasury yield curve is unlikely to flatten or rise as much as swap markets are predicting. Thus, the additional returns obtained by

⁹ Gavyn Davies, "Labour Under-Utilisation in America", Financial Times, September 28, 2014

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rolling down the existing steep yield curve should be realized. We prefer Treasuries in the five- to seven-year range to capture an additional roll down yield estimated at at least one percentage point.

Despite somewhat wider credit spreads in the third quarter, we believe that US credit remains expensive. Deteriorating underwriting and low yield compensation create an environment where investors need to be cautious about investing in corporate credits. The yield on below investment grade bonds is about 400 basis points above Treasuries as of the quarter end, which is below average. Moreover, many high-yield issues are covenant-light. Although high-yield spreads are still above their 2007 lows they are quite narrow and do not comport with the low ten-year Treasury bond yield of 2.5%, which implies an environment usually associated with high credit spreads, i.e., one of low growth, low inflation and general economic malaise. We believe that the Treasury market, though somewhat on the pessimistic side, is closer to reality than are the US credit markets. Since the credit markets are likely to weaken first, we are limiting our investment grade corporate and high-yield exposures.

The ratio of US municipal bond yields to comparable Treasury yields has fallen over the last 12 months which makes the current entry point less compelling. Nonetheless, high tax rates offer tax-adjusted yields for taxable investors which are high relative to similarly rated corporates.

Sovereign yields in other developed markets, except for Australia and New Zealand, are comparable to or lower than US Treasuries on a nominal basis but not necessarily in real terms. Certain dollar-denominated emerging market bonds are attractive, especially those from countries with comparatively strong fundamentals and substantial foreign exchange reserves. Credit spreads for these issues have not retreated to their June lows, whereas those for US high-yield corporates have.

Conclusion

The present global recovery, though slow, may turn out to be the longest one since information on global activity was first gathered in the early 1970s. The Global Equity Index has been declining recently as a result of concerns about slowing global growth. In our view, these concerns are ill founded and global growth is close to an inflection point. The slowdown in global activity gains in the first half of the year was partly due to one-off factors, such as an unusually cold winter in North America, the Japanese value-added tax and the threat to Europe posed by Russian interference in Ukraine. The uneven growth pattern across developed regions, which has been holding back overall global growth, is about to be reduced. The pace of global expansion should be higher in the second half of 2015 and even higher in 2016, though in both cases it will be low by historical standards (i.e., below 4% per annum).¹⁰

¹⁰ IMF Estimates

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Although they have corrected sharply, global equities are becoming more reasonably valued, since fundamentals have remained intact since September 30.¹¹ Our anticipated re-acceleration of global growth, combined with our expectation of a longer recovery, is favorable to global equities in the medium term and is based on the following observations:¹²

- An easing of the one-off factors that slowed growth in the first half of 2014.
- Stabilization in German exports and Confidence. These trade flows and consumer and business confidence have been impacted by sanctions on Russia which we do not expect to escalate significantly. Improvements in German competitiveness should increase exports to non-eurozone trading partners.
- A reduction in growth disparity across regions. While growth in the US may be rising above the 2% range it has been at since the beginning of the great recession, growth in other parts of the developed world has been diminishing. This is partly attributable to an overvalued US dollar; the dollar has begun and should continue to depreciate against the euro and the yen, enhancing the global competitiveness of both the euro zone and Japan. Central bankers are now orchestrating a transition in monetary policy that will enable the global recovery to be more balanced and less likely to suffer a permanent demise.
- Ample Global Liquidity. Though it has largely abandoned quantitative easing, we do not expect the US Fed to start raising short-term rates until early 2016. The Bank of Japan has just announced additional quantitative easing measures and the probability of European quantitative easing has increased substantially. Emerging market central banks are starting to be much more accommodative as their overheating problems have abated.
- Low probability of joint overheating. There is still a lot of slack in world economies. With wage growth and inflation below central bank targets in most countries, overheating will not occur soon. Moreover, countries are at different stages of the business cycle, so the probability of a joint overheating and central bank tightening that usually ends a global expansion is still especially low.

There are several downside risks in this outlook:

- While we expect “lower for longer policy rates” which will support average asset class valuations, there are definite pockets of over valuation. These presently include equities of low quality, over-levered companies and high-yield bonds.

¹¹ Neither “now-cast” estimates of global GDP, nor purchase managers surveys from Markit and JP Morgan have shown a decline in global economic activity thus far. See Gavyn Davies, “It’s the ‘new mediocre’ not a global recession,” Financial Times, October 12, 2014.

¹² These observations include some of Michael Wilson’s points made in “On the Markets,” Morgan Stanley, October 2014.

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- Global growth may fail to accelerate to the degree we expect. Additional accommodative monetary policy and a weak currency may fail to stimulate the eurozone and to prevent a triple dip recession. In Japan, yen depreciation may not be sufficient to maintain growth. Liquidity-constrained US households may reduce spending as a result of continued sluggish wage growth, while policy uncertainty may cause US businesses to limit capital expenditure. The structured transition in the Chinese economy may not go smoothly and real GDP growth may fall below 5.0%. One or a combination of these developments could cause global equity prices to fall significantly below current levels. For this reason, we are monitoring leading and coincident economic indicators carefully.
- Our expectation of a record period of moderate global expansion is based on the questionable assumption that normal economic and policy conditions are returning. As Robert J. Samuelson points out, this may result in overly optimistic growth projections (see *Investor's Business Daily*, October 10, 2014). Secular stagnation tendencies which occurred since 2008-2009 and which are difficult to quantify or reverse have become evident in the advanced economies for the first time since World War II. The level of demand at given safe interest rates seems to have fallen significantly. Increasing and consecutive doses of monetary expansion have been required to prevent serial recessions in the eurozone and Japan, as well as in other developed economies. Such unsustainable policies may cause speculative bubbles in asset prices and prematurely end economic expansion when these bubbles burst.

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