Drexel Morgan Capital Advisers

Global Economic and Market Commentary
Third Quarter 2015

"In the EM equity space, whatever has a low valuation multiple is cheap for a reason … meanwhile stocks in healthy countries and sectors are expensive."

– Bank Credit Analyst

The third quarter was a formidable one for equities, commodities and spread product, as concerns about a lower than expected global growth rate led by indications of Chinese weakness and fear of a premature tightening by the Fed dominated world financial markets. In the quarter, global equity markets lost $11 trillion. More specifically: [1]

- Equity markets in five regions, China, Hong Kong, Brazil, Singapore and Spain, all entered bear market territories, being down more than 20% from their recent highs, with the lion's share of the decline coming in the July through September period.

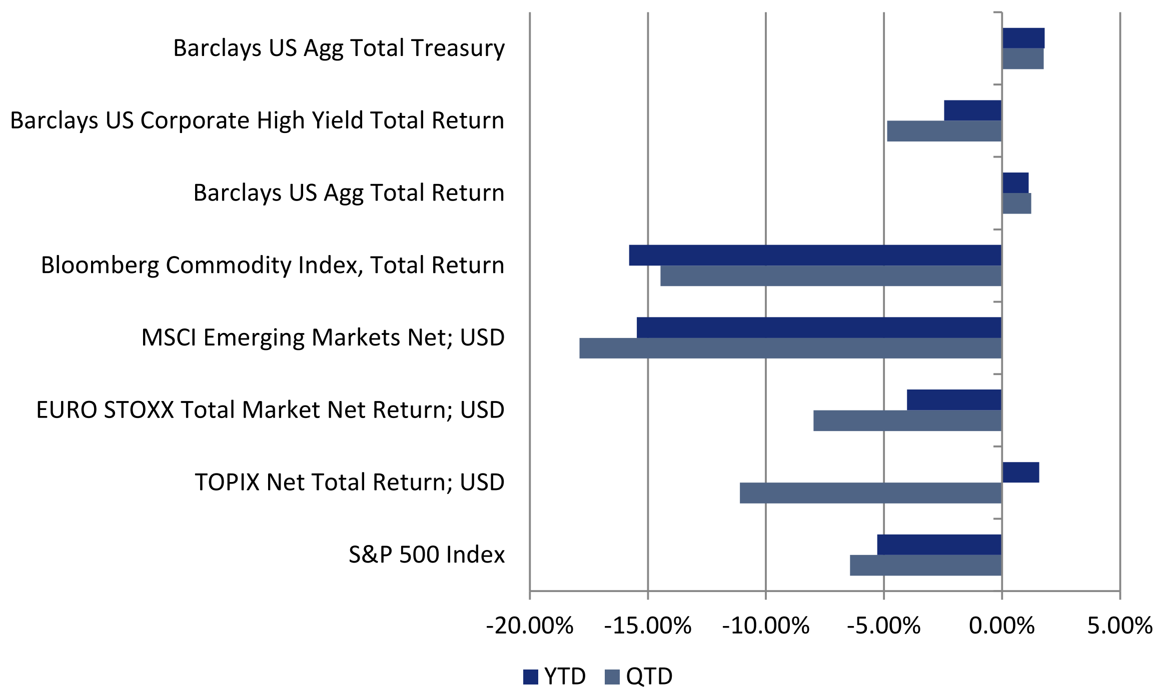
- Even though the US market's 12% decline made it a relative outperformer, over 50% of the companies in the S&P 500 finished the quarter 20% or more below their 52-week highs.

- While the Wilshire REIT Index rose 2.9%, the Alerian MLP Index fell 22.1%. Next to the MLPs, Emerging markets (EMs) suffered the most.

- In the third quarter, EMs underperformed developed markets (DMs) by 900 basis points, their worst underperformance in the 17 years since the peak of the Asian crisis. The selloff in EM equities was exacerbated by a sharp decline in commodity prices, with the CRB Index falling 14.78% in the quarter.

[1] Return Source Information from Zephyr, Bloomberg, MSCI Zephyr, Bloomberg, MSCI.

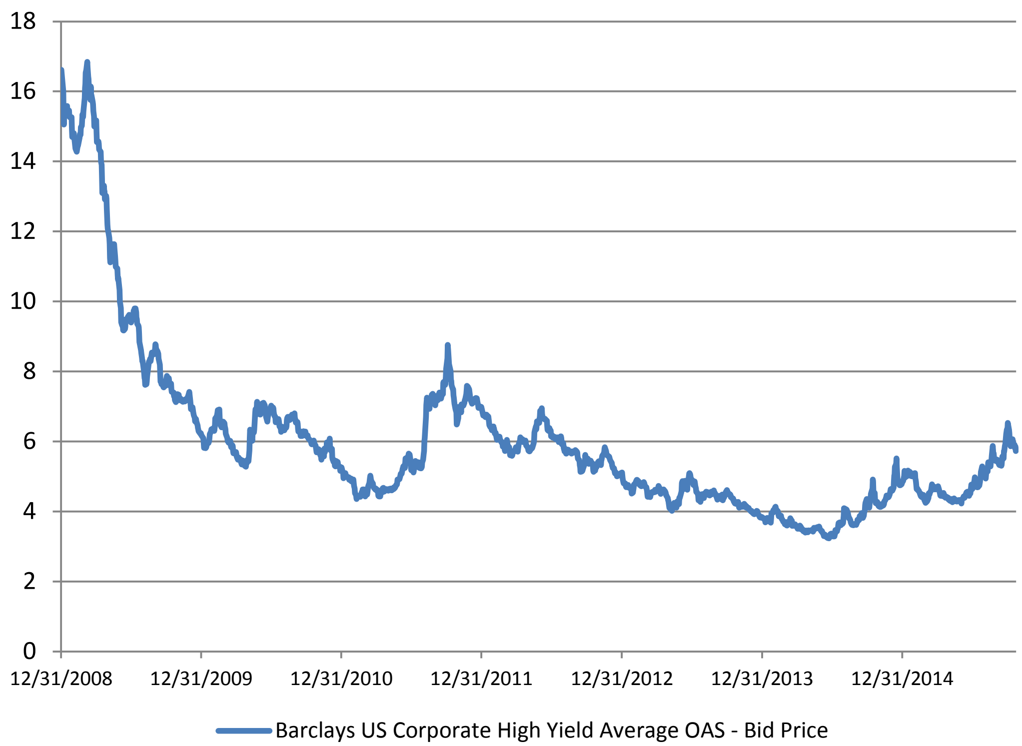
Exhibit 1
Global Capital Market Returns
QTD and YTD through September 30, 2015



Source: Bloomberg. The Barclays US Agg Total Treasury is a subset of the Barclays Aggregate US Bond Index and consists of most US Treasury bonds with a maturity of one year or more. It excludes TIPS and STRIPS. The Barclays Corporate U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. The Barclays Capital Aggregate US Bond Index, which used to be called the "Lehman Aggregate Bond Index," is a broad base index, maintained by Barclays Capital, represents investment grade bonds being traded in United States. The MSCI Emerging Markets Index is a stock market index that is designed to measure the equity market performance of emerging markets outside developed markets, markets such as Brazil, China, Russia, etc. The Euro Stoxx Total Market Index covers 95% of the free-float market cap of the stocks in Europe. The TOPIX Net Total Return index includes the stocks traded on the Tokyo Stock Exchange. It has approximately 1700 companies. S&P 500 Index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Fixed income markets were also severely affected. While sovereigns appreciated somewhat, lower quality US high-yield bonds (as proxied by the Barclays US Corp HY index) and EM debt (as proxied by the JPM EMBI Global Bond index) had negative total returns of 4.86% and 2.04% in the third quarter, which represented a 1.54% and 0.82% percentage point spread widening. In mid-2015, the Barclays average option adjusted spread (OAS) for high yield corporates returned to its early 2012 level, associated with the Eurozone debt crisis. This was a healthy change in that it brought credit spreads back to their historic average levels and to a post-crisis level more in line with the credit risk being assumed (see Exhibit 2).

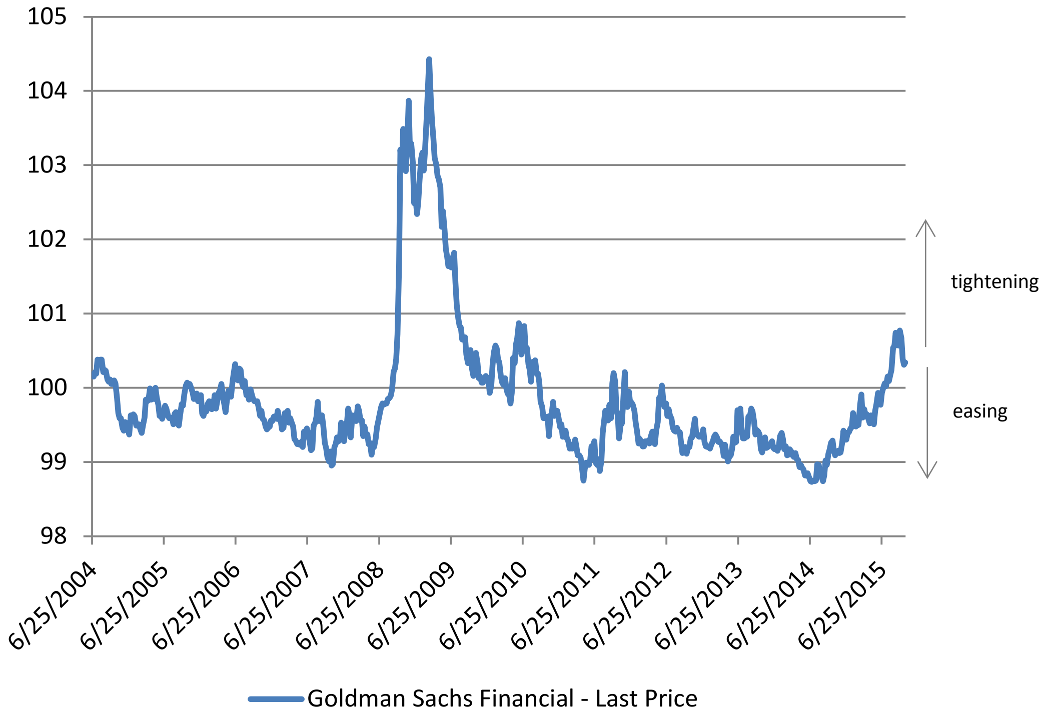
Exhibit 2:
Barclays US Corporate High Yield Average OAS - Bid Price



Source: Bloomberg

This was a classic “risk off” situation, brought on by a confluence of factors, in particular, the combination of a tightening of financial conditions and disquieting news from China. As shown in Exhibit 3, the Goldman Sachs Conditions Index had indicated an overall tightening since the beginning of the year in the US, driven initially by a stronger dollar and then by a decline in equity prices and a widening of credit spreads.

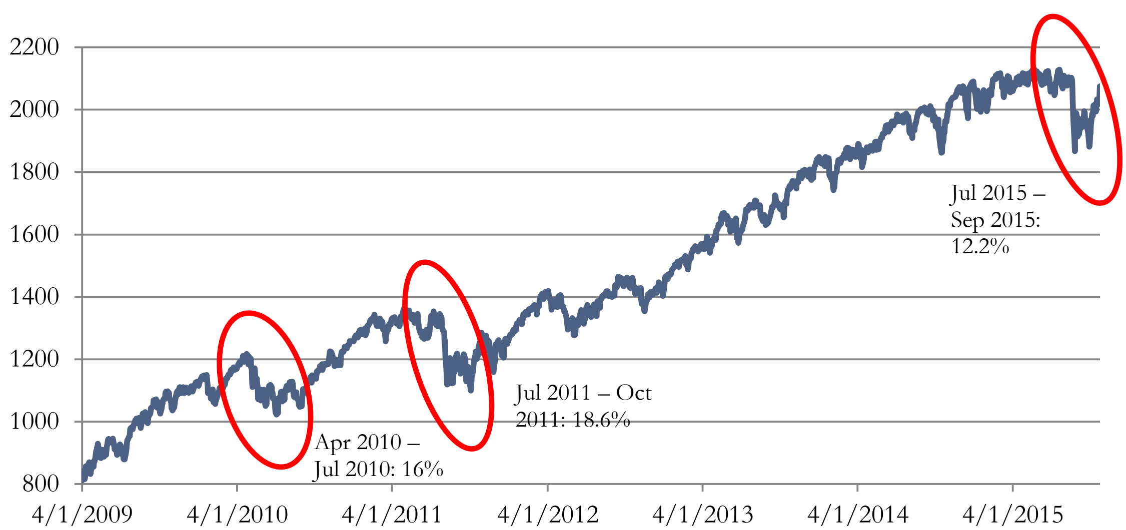
Exhibit 3
Goldman Sachs Financial Conditions Index June 2004- September 30, 2015



Source: Bloomberg

US markets had experienced a period of four years without a 10% correction and had become highly complacent as shown in Exhibit 4. This caused investors to be hypersensitive to unexpected macro issues, in particular, to evidence that China, the world's second-largest economy, was slowing much more than expected.

Exhibit 4
S&P 500 Corrections Since April 2009 to October 2015



Source: Bloomberg

Initially, there was a renewed collapse in industrial commodity prices, such as copper, zinc and aluminum in May, which was erroneously linked to a major slowdown in China's manufacturing construction and housing sectors, even though it was mainly a commodity market event associated with panic sales of inventories and a final unwinding of carry trades.[2] In July, there was China's collapsing stock market and the government's maladroit attempt to contain the damage. The historic currency devaluation followed on August 11 and was accompanied by data that the growth rate had fallen again after rebounding slightly in the second quarter. The decline was not substantial but much of it occurred in those sectors that are most important for commodities. This led to fears of a currency war and inaccurate linking of the May commodity price collapse with a major recession in Chinese manufacturing and the increased probability of a Chinese hard landing. Then a number of companies reported tougher conditions in China, which only deepened fears of a worldwide recession.

The Chinese stock market crash and subsequent currency devaluation should have been expected and did not represent a major deterioration in fundamentals or competitiveness. The equity selloff occurred after a boom in the A shares – up 60% between January and June and 150% on a year-over-year basis. The major selloff left the A shares still ahead for the year and 50% ahead on a trailing 12-month basis. The 3% devaluation of the RMB which had been closely tied to the US Dollar and thus increasingly overvalued in relation to other currencies, was clearly justified. Still, the poorly explained policy measures created doubt as to what was really going on and global market participants became highly concerned about the Chinese outlook.

MACROECONOMIC OVERVIEW

We will now examine economic conditions and prospects in each of the world's major economic regions. We will provide a more detailed analysis of the outlook for major emerging markets especially China, since we are highly focused on determining whether the selloff in these regions in the third quarter was an overreaction, and whether declining EM growth is creating a significant threat to sustained global growth.

China

In our previous report, we noted that a major risk to our outlook was a Chinese hard landing, i.e., a 4% or lower growth rate, according to the official data. There is no question that the Chinese industrial sector has become stagnant and is impaired by excess capacity due to years

[2] Gavyn Davies, "China Policy Failings Challenge The Fed," Financial Times, August 27, 2015.

of overinvestment. The after effects of the property boom have dampened the demand for raw materials and land. The bungling attempts to stabilize the stock market in July after encouraging the initial bubble caused questioning of Chinese policymakers' commitment to market reforms. Other policy moves, including the abrupt devaluation of the exchange rate, caused concern about their overall competence. Meanwhile, the unintended consequence of the government's anticorruption campaign was to cripple much needed capital expenditure.

These policy errors have contributed to a further slowdown in Chinese growth which has been falling for several years, as we have noted in prior commentaries. A major contributing factor to this slowdown has been the slowing of global trade. China has offset the slower growth of final export demand by increasing its share of global exports from 10% to 12% over the last four years, but the size of its economy alone means that exports are no longer a primary source of growth in the way they once were.

Global investors are well aware of these problems. However, their preoccupation with China's industrial growth neglects the transformation taking place from an export-driven economy to a consumer-driven economy, which is a positive development. Services now account for over half of China's GDP and roughly two thirds of its economic growth last year.[3] According to 13D Research, foreign direct investment (FDI) in China grew 9.5% during the first eight months of 2015, with the service sector representing 55% of it, 22 percentage points higher than manufacturing. A continued strong demand growth from Chinese consumers is inducing this investment. For example, express delivery volumes, a proxy for e-commerce activity, in China surpassed the US last year, reaching 13 billion items. In the first eight months of this year, express delivery volumes have gained another 45%. According to Bernstein Research, in the 12 months to July, consumer metrics improved substantially. For instance, movie box office receipts were up 45% and the volume of airline passengers were up 10%. Smart phone sales rose 37% in July and overall retail sales have grown 10.5% in real terms thus far this year.

A recovery in the property market and a continued rise in incomes have supported this increase in consumer spending. Despite the slowdown in economic growth in recent years, household disposable income per capita has risen at a steady pace, increasing 9% in the first half of 2015, according to the National Bureau of Statistics of China. While workers are being displaced as manufacturers cut costs and state economic enterprise reforms continue, new jobs are being created in the service sector which account for 41% of employment, up from 35% just five years ago.[4] There is plenty of room for household consumption to continue to rise in China. Today, it accounts for just one third of GDP, compared with 70% in the advanced countries.

[3] "China Services Sector Shows Strength," Wall Street Journal, August 5 2015.
[4] Holowesko Global Fund, September 2015 Quarterly Report, Page 11.

Although Chinese demand for construction materials and energy should decline further, the sales of multinational affiliates producing smartphones for 4G telephone equipment and internet equipment should increase substantially. The recently released Apple earnings report revealed substantial year over year iPhone sales in China. Moreover, the sales of consumer product companies in China are rising and should continue to increase. For example, as a recent earnings report of Nike indicates, sales of its Chinese affiliate are up substantially. General Motors has stated that monthly automobile sales rose in September. In short, we believe that China is making a successful, albeit bumpy, transition from an export- and investment-led economy to a consumer-led economy. Chinese real GDP growth should stabilize in the 5% to 6% range, although it could fall below that range in 2016 and 2017 due to the usual bottlenecks an economy of that size will encounter in making such a difficult transition and the large excess capacity in the industrial construction and housing sectors which could impede investment demand.

Emerging Market Economies as a Group

Emerging markets should close 2015 with five consecutive years of declining growth, from 7.4% in 2010 to an estimated 3.8% in 2015. The healthy and the unhealthy are separated by a dependence on commodity exports. Take, for example, the normally fast growing countries known as the BRICs, Brazil, Russia, India and China. The top commodity exporters, Brazil and Russia, are in recession while China and India have decreased growth rates from 10% to a still healthy level near 6%. Structural constraints have hampered growth in many EM economies in the post financial crisis. These obstructions arise from barriers to open markets, obstacles to business operations and constraints to access to finance.

Growth has slowed in EM economies partly because of external factors such as sluggish growth in the advanced economies and partly because of domestic structural impediments. EM economies are also exposed to the risk of the so called “middle income trap” as they exhaust the potential for low hanging productivity gains from such factors as reallocation out of agriculture to urban industry and technological catchup. Managing the risk associated with the “new normal” of the post crisis global environment and avoiding “middle income traps” would require reform to effect resource allocation to more productive and higher value added sectors and the production of more innovative goods and services. According to the World Bank, a sample of 30 middle income emerging economies shows that the barriers to open markets and the availability of finance are significantly correlated to post crisis total factor productivity growth. The finding suggests that reforms in these two bottleneck areas could take the level of policy in low growth countries up to that of the best ranking countries. These reforms could more than offset the slowdown in the post crisis period but are unlikely to be implemented soon.[5]

[5] World Bank: Z Quereshi, J. Diaz-Sanchez and A. Varondakis, “The Post-Crisis Growth Slowdown In Emerging Economies and the Role Of Structural Reforms.” World Bank Policy Research Working Paper November 2014.

According to the Bank Credit Analyst, most EM companies have to restructure to reduce excessive debt and raise returns on equity, which have fallen below their 2008 lows. However, these company level adjustments result in capital spending cutbacks and layoffs that tend to reduce economic growth.[6]

Europe

Economic conditions continued to improve in Europe, albeit at a slow pace, and headlines have shifted from the probability of a "Grexit" to the fundamental improvements in the region and the attractiveness of European equity markets. Virtually all the data released in the third quarter from the Eurozone has been positive, and the ECB has kept its stimulative policies intact through purchases of sovereign and asset-backed debt. Manufacturing PMI remains expansionary and unemployment is down to 11% in the Eurozone and in countries such as Germany, the unemployment rate is under 4.5%. Consumer confidence and retail sales have increased year over year and demand for consumer and business loans has increased materially. Low Eurozone interest rates - the German Bund ten-year yield is approximately .50% as of the writing of this letter - and the improvement of Eurozone bank balance sheets have enabled banks to meet the growing demand. In aggregate, Eurozone GDP is expected to grow 1.5% in 2015 and 1.6% in 2016.

The debate on the attractiveness of Europe stems from opposing forces that will impact the economy in the coming quarters. The Eurozone benefits significantly from low commodity prices, specifically oil, as it is a major importer of energy and European companies can expand margins via decreased input costs. Additionally, the depressed Euro has helped exporters. On the contrary, the slowdown in Chinese industrial growth will have a direct impact on the Eurozone, particularly Germany, which sends more than 8% of its exports to China. While China will not cripple the Eurozone economies, uncertainty regarding the true impact of these headwinds on European companies and the perceived fragility of the economy and political issues in Greece have caused valuations in European equities to remain depressed. We do not see these issues abating anytime soon; however, we are confident that the positive momentum in the underlying fundamentals of the economy will continue and we see the Eurozone as one of the most attractive regions to which to allocate assets.

[6] The Bank Credit Analyst: "A Look at EM Corporate Health," October 28, 2015.

Japan

The Japanese economy unexpectedly contracted in the second quarter; however, GDP should be positive in the third quarter and finish the year at approximately 1-1.5%. We do not foresee a subdued growth outlook for Japan related to the slowdown in China and other emerging market economies. The Japanese consumer has been helped by positive wage gains in 2015 and additional forecasted gains in 2016, low inflation, and positive wealth effects. Additionally, the Bank of Japan and the government are both committed to easy monetary policy and structural reforms to generate growth and inflation. These stimulative policies coupled with low unemployment and well capitalized consumers, due to years of high savings rates, should lead to the continuation of a moderate recovery.

The impact relative to the magnitude of Japan's quantitative easing can be debated and in 2016 we expect to see additional targeted stimulus, specifically equity-linked ETF purchases and continued structural reform measures related to corporate governance and shareholder friendly actions. Traditional monetary action would be analogous to "pushing on a string" at this phase. While headline GDP and inflation figures have been underwhelming to date, policy success can be evidenced by a 15% growth in Japanese corporate profits on a trailing 12-month basis despite a slowing environment for much of Asia. The weaker yen contributed partially to this increase in profitability, but more importantly, Japanese companies are buying back stock, increasing dividends, and implementing a new governance code focused on the bottom line.

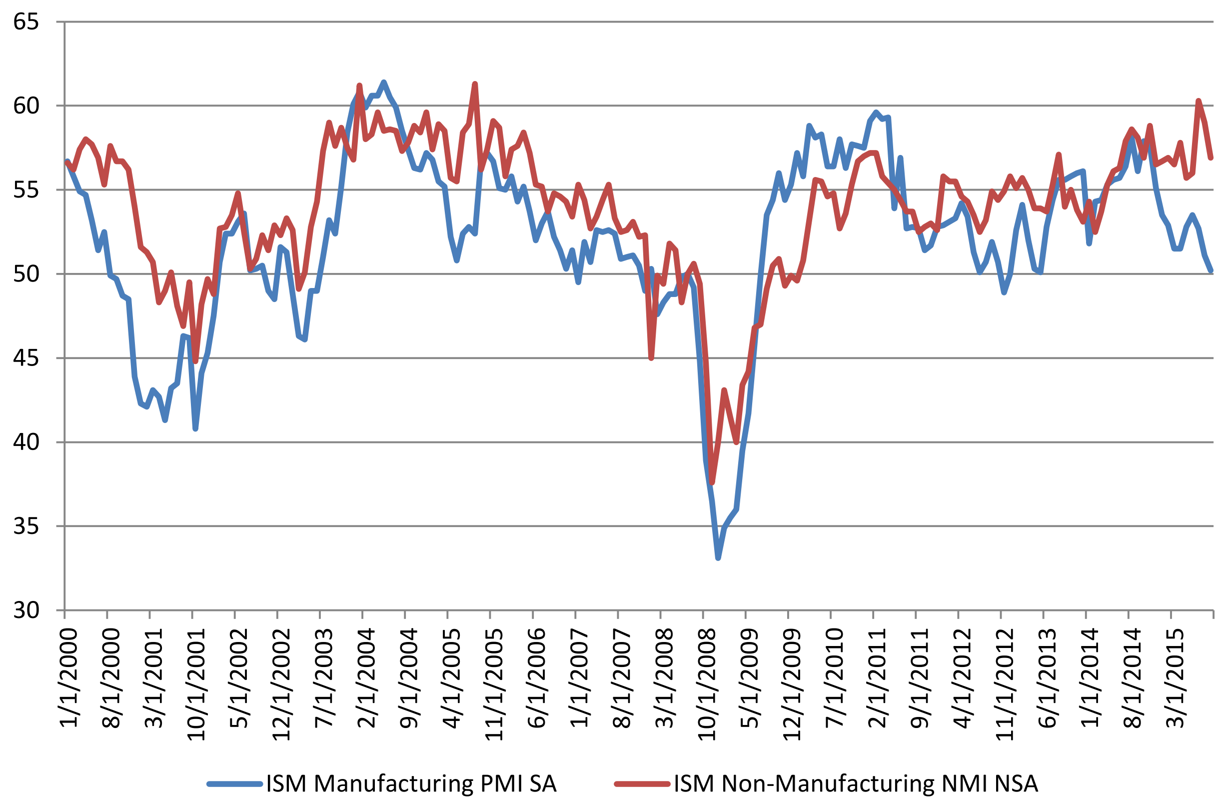
The US

Our estimate for the US growth rate in 2015 at 2.24% has become less positive. There are three reasons for this downward adjustment, all relating to the second half of the year. First, the Atlanta Fed GDP Nowcast calls for only a 1.1% GDP growth rate in 2015 Q3.[7] This is well below trend and implies that the US economy has been slowing since mid-year. The Atlanta Fed GDP Nowcast has significant credibility, since it proved quite accurate in Q1 and Q2. Second, we had expected a cyclical upswing in consumer spending in the second half of the year. However, such an upswing seems less certain given the recently released September payroll report, which showed deceleration in job growth and hours worked, as well as a continued lack of wage growth. Third, even though the Atlanta Fed may have overestimated the effect of inventory adjustment on GDP, it has made the reasonable prediction that the direct impact of the decline in net exports in the third quarter would be substantial, subtracting about 1% from real GDP in Q3. The August trade report indicates that exports are now declining on a year-over-year basis and the forces causing this weakness, falling non-US growth rates and an overvalued dollar, are unlikely to abate quickly. The recently released preliminary estimate for GDP in Q3 is 1.5%, with final demand growing at 3%.

[7] Gavyn Davies, "Is the US slowdown for real?" Financial Times, October 8, 2015.

Still, tailwinds will counteract headwinds enough to enable positive growth in 2015. These include: 3% or more consumption gains, well in excess of the long-term trend, real wage gains due to low inflation, significant employment growth for this stage of the business cycle, a strong housing market, and as seen in Exhibit 5, the service sector continues to expand.

Exhibit 5
Manufacturing vs. Non-Manufacturing (Service Sector) PMI



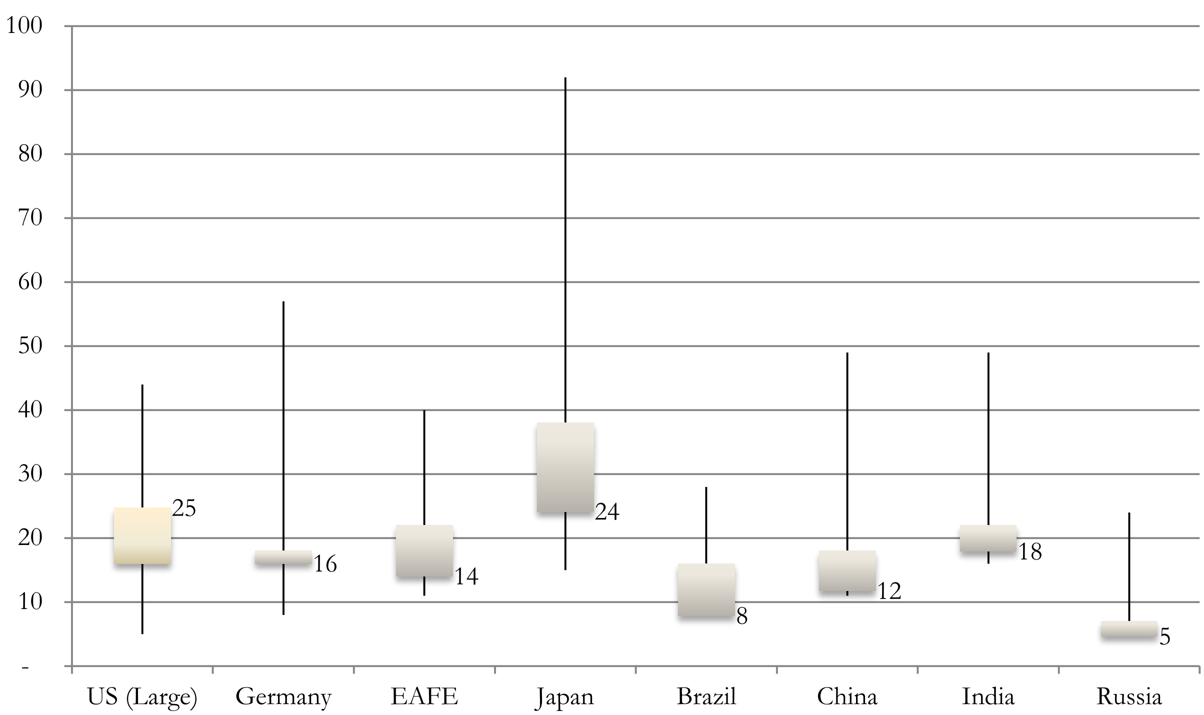
Source: Bloomberg

GLOBAL FINANCIAL MARKETS

Advanced Country Equities

We anticipate that EAFE and US equity markets will experience positive but single digit returns with higher than normal volatility over the next 12 months. This is roughly what has occurred over the year preceding October 31, with the S&P returning 5.2% and the EAFE Index returning -0.07% in dollars. The forward earnings multiple for the US equity market, at 17.1, is more than one standard deviation above its ten-year median, whereas that for the developed world is less than one standard deviation above its ten-year median. The cyclically-adjusted P/E ratio is substantially above its historic median in the US case, as well as being below that of EAFE, Germany and Japan as shown in Exhibit 6. With long-term government bonds yielding only 2.1%, the US equity risk premium is well above its ten-year median, suggesting that US equities are cheap in relation to its sovereign bonds. A similar relative undervaluation is present in the Eurozone and Japanese equity markets. Although estimated per share earnings gains for the year are negative in the US, subpar in the Eurozone and only double digit in Japan, the subsequent year (2016) earnings gains are expected to be in the double digits, or slightly below, in all these regions because of stronger topline growth and a stabilization of oil prices. The largest percentage increase in estimated earnings from the end of 2014 to the end of 2016 is expected to take place in Japan and the Eurozone which are behind the US in the business cycle and have higher operating leverage (see Exhibit 7).

Exhibit 6
Shiller P/E Across Various Countries



Source: Research Affiliates; https://www.researchaffiliates.com/AssetAllocation/Pages/Equities.aspx as of 09/30/2015. These expected returns are calculated by Research Affiliates LLC using data provided by MSCI Inc. and Bloomberg. Data series have different start dates as indicated in each card above. US (Large) uses data from 1871 to September 2015, Germany from 1969 to September 2015, EAFE from 1972 to September 2015, Japan from 1969 to September 2015, Brazil from 1994 to September 2015, China from 1995 to September 2015, India from 1994 to September 2015, Russia from 1996 to September 2015.

Exhibit 7
Global Valuations
EPS Growth Estimates 2015 and 2016

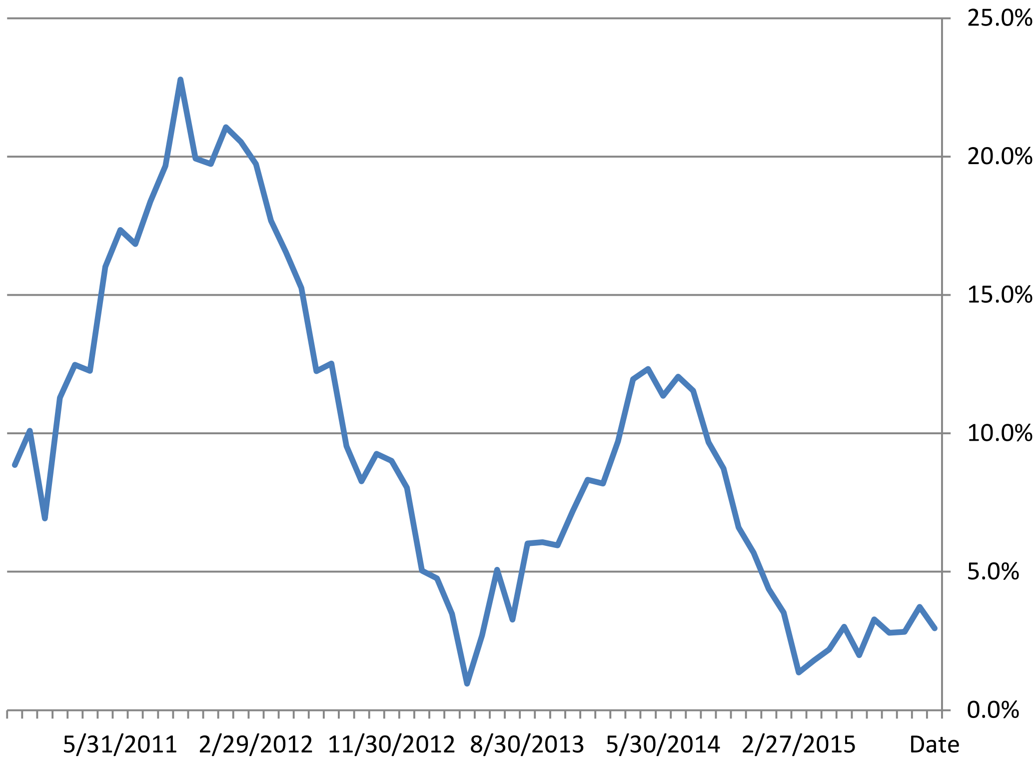
Region	2015 EPS Growth Estimates	2016 EPS Growth Estimates	Price/Book Ratio - Actual	Enterprise Value/EBITDA for Third Quarter 2016 - Estimate	Dividend Yield for Third Quarter 2016 - Estimate
Japan (FY)	17%	13%	1.26	8.0	1.9%
US	-3%	10%	2.71	10.4	2.1%
Europe	5%	8%	1.76	8.4	3.4%
Asia ex Japan	0%	5%	1.42	6.6	3.4%

Source: Toyo Keizai, I/B/E/S, Factset, Goldman Sachs Investment Research, Drexel Morgan Capital Advisers. Data as of October 2015.

We believe that that the slow absolute growth in the combined assets of the four major central banks, which was briefly below that of their nominal GDP, is now reversing (see Exhibit 8). This is important because the decline in asset growth, precipitated mainly by a significant loss of Chinese foreign exchange reserves, was a major cause of the selloff in equity prices in 2015 Q3. It amounted in fact to a global quantitative tightening.[8] The growth rate in combined central bank reserves is beginning to pick up for several reasons. At its September meeting the Federal Reserve decided to postpone any rate hikes that were under consideration. In fact, the FOMC even went so far as to cite the financial condition deterioration as the primary reason for this delay. In other words, they recognize that the global financial stress, evidenced by a stronger dollar, widening credit spreads and declining stock prices, brought on partly by Chinese Treasury bond sales, was creating a tightness in global financial markets that would be exacerbated by a Fed rate hike. Additionally, the drawdown in Chinese foreign exchange reserves appears to be changing course. They declined by only $43 billion in September, a major improvement from the August $94 billion decline.[9] At the same time, Europe and Japan are initiating more aggressive quantitative easing which, combined with the slower decline in Chinese foreign exchange reserves, should cause the combined balance sheets of the big four central banks to expand more rapidly. Obviously, further improvement is necessary, but the initial signs are favorable. Recent price stability in the Chinese stock and currency markets implies that China's intervention can be reduced and evidences a sounder currency situation and stabilizing financial conditions. Oil prices have recovered since August lows which should stabilize the oil exporters' outflow of currency reserves and enable them to reduce the decline in their central bank balance sheets.

[8] Gavyn Davies, "Will Emerging Market Economies Cause Quantitative Tightening?" Financial Times, September 2015.
[9] Morgan Stanley.

Exhibit 8
Year-Over-Year Growth in Central Bank Assets



Source: Drexel Morgan Capital Advisers, Bloomberg

The pickup in global quantitative easing associated with more expansionary policies in Japan and the Eurozone and less Chinese currency drain partially explain a significant rally in DM as well as EM equities that has taken place in October.

As already noted, we continue to find European and Japanese equities more attractive than US equities on a valuation basis. There is substantial room for margin improvement in Japanese and European companies with net margins at 7% as opposed to US companies with net margins close to 10%. In 2016 earnings growth in Europe and Japan is likely to exceed that in the US by at least 10 percentage points on a year-over-year basis. European companies have substantially more operating leverage than US companies and European and Japanese multinationals benefit from favorable currency translation resulting from continued dollar strengthening.

The expected return on Japanese equities is higher than that on European equities in 2016, but the macro uncertainty is higher because of Japan's greater exposure to Chinese import demand and its large debt burden.

As noted in prior commentaries, Japanese equities are benefiting from greater emphasis on shareholder returns and a new corporate governance code, which are for the most part already present in Europe. Unlike most European governments, the Abe regime has very strong popular support and is able to enact measures that will encourage business growth.

EM Equities

The case for EM equities is less compelling. As of October 16, the equal weighted price to cash flow and price to sales ratios for EMs were greater than those in in Japan and about equal to those in the Eurozone. Moreover, the MSCI EM Index traded only slightly below its fair value estimate of 882, according to Goldman Sachs. As noted earlier, EMs are suffering from a lack of structural reform and excess corporate capacity which will continue to stifle their growth in the post crisis period. Finally, while EMs have rallied substantially from their September 29 lows, this recovery does not represent a new bull market in that asset class. This is a momentum reversal, not a fundamental improvement. The markets hit hardest during the April - August decline have bounced back the hardest, and the best-performing EMs are those that stand to benefit from the Fed reprieve, such as Indonesia, Brazil, South Africa and Turkey. We believe that this upward move is unlikely to continue. As the opening quote indicates, these stocks are on balance either value traps or high quality issues that are fully priced.

Asia remains our preferred region. Restrained commodity prices and improving DM growth bode more positively for Asia than for Latin America which has more commodity exposure and less exposure to the US and Europe.

Fixed Income

The equilibrium real interest rate is the short-term real interest rate that in the long run is consistent with production potential and stable inflation. In determining the outlook for the ten-year Treasury rate, one must first determine the equilibrium real interest rate. This is a major determination of long term Treasury yields.

Work prior to the financial crisis estimated the real equilibrium interest rate from the trend real growth rate of the economy. More sophisticated analysis since the crisis shows that there are additional determinants of equilibrium real rate, which is time varying. This has a major implication for Fed policy and explains why the Fed has delayed the lift off of the Fed Funds rate.
In Exhibit 9, we show our projected real funds rate based on the equilibrium real rate of 1.25% at the end of 2014 which a Fed researcher has estimated.[10] We assume that the initial lift off occurs in December 2015 and that the real Fed funds rate is hiked to -1.2%. It then is increased in 25 basis point quarterly increments in 2016 and fewer increments later on until it reaches 1.22% at the end of

[10] Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C. Michael T. Kiley "What Can the Data Tell Us About the Equilibrium Real Interest Rate?" August 26, 2015.

2019 and remains at that level thereafter. This trajectory is consistent with a pure discount nominal 10 year treasury yield to maturity of 2.73% as compared to the current yield to maturity of 2.29%. The constant coupon treasury yield based on this trajectory would exceed that of the current 10 year bond by about the same magnitude. This difference in treasury yield should be regarded as an upper bound since there is only a 50% probability that lift off will occur in December and the trajectory is based on the assumption that the unemployment rate will remain at target for the entire projection horizon. Clearly markets will take into account the probability of an intervening recession in pricing the 10 year treasury after the initial Fed funds hike. Thus, the downside risk in treasury bonds at present prices is limited.

Exhibit 9
Implied Treasury Yields

	Current (Data as of 10/30/15)	**At End of 2016**	**End of 2017 Assuming 75 bps in 2017**	**End of 2018 Assuming 75 bps in 2018**	**End of 2019 Assuming 25 bps in 2019**	**End of 2020 Assuming 0 bp in 2020**	**End of 2025 Assuming 0 bp in 2025**
Nominal Fed Funds rate*	0.42%	1.42%	2.17%	2.92%	3.17%	3.17%	3.17%
Projected inflation	1.70%	1.70%	1.70%	1.90%	1.95%	1.95%	1.95%
Real Fed Funds rate	-1.28%	-0.28%	0.47%	1.02%	1.22%	1.22%	1.22%
Geometric average quarterly rate.		0.92%	1.80%	2.55%	3.05%	3.17%	3.17%
Estimated pure discount bond yields.**	Five years	2.29%					
	Ten years	2.73%					
Actual ten-year Treasury Pure Discount bond yield as of October 30, 2015.		2.33%					

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

**The geometric average of the one-year rate (0.92%) and expected one-year rates beginning one year from the end of 2016.

Source: Bloomberg

This is in sharp contrast to the predictions of the Bank Credit Analyst,[11] Bill Gross and the secular stagnationists that the equilibrium short-term interest rate will reach zero at the most and the core inflation rate will fall to 1.5%. In the Bank Credit Analyst case, these predictions imply a ten-year Treasury yield of 1.5% in two years, which represents a significant decline from present levels. By contrast, our fixed income strategy is based on the assumption that the ten-year bond yield will start rising, albeit modestly, as the initial Fed Funds lift off occurs.

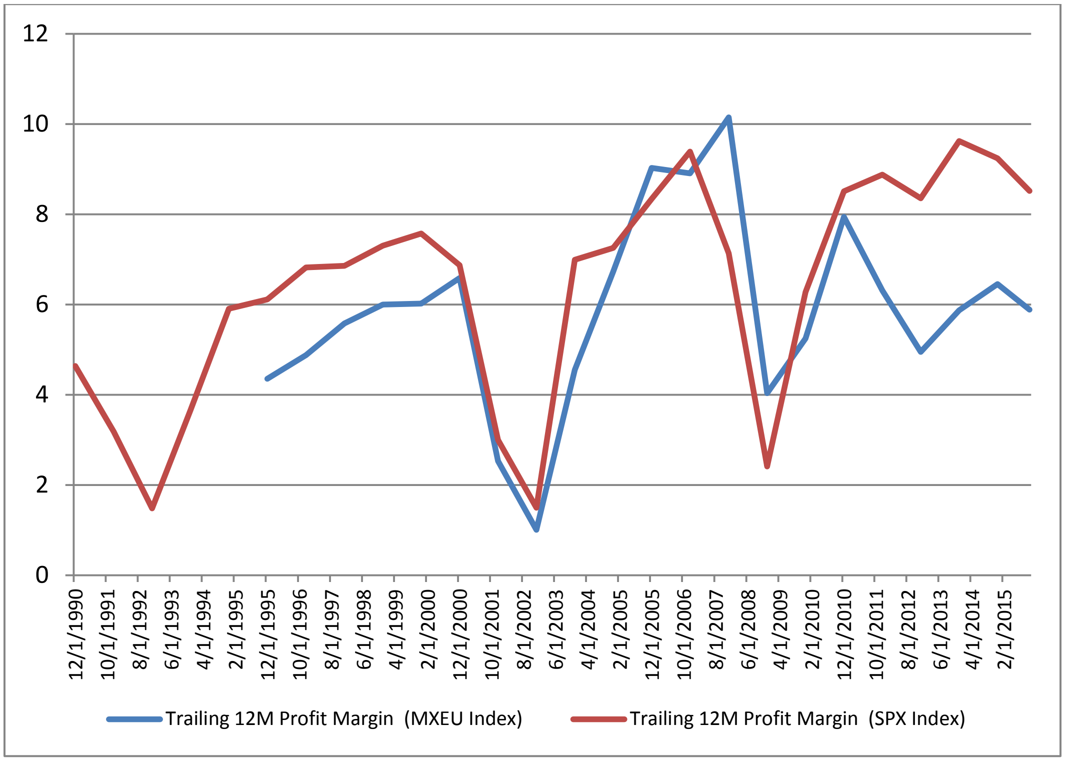
Non-US bond funds which hold credits, as well as sovereigns, have been under pressure as a result of the strengthening dollar. We believe that a properly hedged exposure to the UK, Canadian and Australian bonds can be profitable. All these economies are softening which should put downward pressure on long-term interest rates.

The outlook for credit is not entirely clear. Although economic conditions should remain favorable and robust enough to prevent a significant bankruptcy, they will not be sufficiently strong to prompt and aggressive tightening by central banks. However, a large increase in US corporate issuance due to firms' issuance of cheap new debt to finance share repurchases and acquisitions have weakened their balance sheets. This real leveraging of the balance sheet is leading to a decline in corporate credit quality, especially if record high profit margins start to decline sharply. High yield indices are heavily weighted in energy companies, which could undermine confidence if oil prices decline further and widen high yield spreads as they did in August and September.

Non-US bond funds, which hold credits as well as sovereigns, may have an advantage over US bond funds, not only because Europe has less exposure to energy producing companies, but also because accelerated ECB bond purchases are likely to induce investors to buy high yielding spread product. Moreover, profit margins have greater room to rise in the euro area which should improve corporate debt servicing capability. This again assumes proper hedging of the euro against the dollar, although the upside of the dollar is very limited from the current 1.10 level (see Exhibit 10).

[11] BCA Research "Strategy Outlook: Fourth Quarter 2015, September 25,2015

Exhibit 10
Profit Margins in the US and Europe



Source: Bloomberg

Conclusion

While we view the downside risk in high quality bonds as minimal, the outlook for advanced country equities is one of single digit returns and higher volatility. This assumes that a global recession is not imminent, i.e., that the global growth rate will not fall below trend by two standard deviations for two consecutive quarters. Such an occurrence could result in a meaningful, protracted and devastating downturn in equity markets, such as those that occurred in 2000–2002 and 2007–2009, during which global equities fell by more than 50% from peak to trough. We view a bear market of this magnitude as extremely unlikely in the next year, but a moderate global recession involving low growth for an extended period is beginning to be a growing concern. The global recovery which began in 2009 is long in the tooth. In order to partly hedge against this risk, we recommend longer duration, high quality bonds which tend to be inversely correlated to equities during market declines. We also recommend some exposure to low volatility US and EAFE equities which have lower downside capture than do the more broad-based S&P 500 and MSCI indices from which these equities are taken.

In the last year, we have experienced low returns with normal or above normal volatility, an advanced country equity pattern we expect to continue. At the same time, in line with the predictions of earlier commentaries, the current year to date performance of equity markets through October 31 in Europe and Japan (approximately 3.57% to 9.5%) is better than that in the US (approximately 2.89%). This is in line with the redistribution of growth within the advanced countries from the US to the euro zone and Japan. This redistribution is occurring partly as a result of a stronger US dollar, weaker oil prices and greater monetary ease outside the US. We expect the recent strong rebound in emerging markets to be unsustainable and the structural slowdown in EM earnings growth to continue. Hence, our investment strategy overweights European and Japanese equities and underweights US and EM equities, where possible. Despite the probability of a small increase in long-term yields, we are continuing to hold long-term Treasuries and other high quality sovereign bonds as a hedge against equity market downturns.

Our prediction that advanced country equities will have a single digit or slightly higher return over the next year, albeit with higher than normal volatility, is subject to the following downside risks:

- A major devaluation of the Chinese Yuan (CNY) and other EM currencies could result in a further appreciation of the trade-weighted dollar of more than 10% leading to weaker than expected earnings growth of US multinational corporations and even an absolute decline in US GDP. The main transmission mechanisms would be reduced US exports and lower investments by US multi-national corporations.

- China is unwilling to take the appropriate fiscal measures, financed by debt monetization, and/or use excess foreign exchange reserves to avoid its GDP growth falling significantly below 5% over the next two years. This could lead to a global recession in the form of two or more years of significantly below trend growth in the global economy.

- Another systemic debt crisis in the DMs or EMs or both cannot be ruled out. Debt to GDP levels in both areas are at historic highs. Economists do not know much about effective macroeconomic stabilization in such a highly levered environment.[12]

[12] Willem Buiter, Citi Research: Global Economic View September 8, 2015, page 13.

- The advanced economies may have reached a fragile stasis in which a stable GDP growth rate with a high debt ratio is only possible at very low interest rates. The equilibrium real interest rate in the past is not the one which ensures a zero output gap and any attempt to raise it to its once normal level, or even 50 basis points below it, such as that being contemplated by the Fed, may be perilous, as evidenced by the Swedish experience in 2010, i.e., an aborted rate hike.

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

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