OUTLOOK AND INSIGHTS

Mellon Capital's proprietary expectations for economic growth, leading economic indicators, and inflation expectations

EXECUTIVE SUMMARY

Jeff Zhang, CFA
Executive Vice President,
Chief Investment Officer

In this publication, we draw on the firm's expertise to share our current investment outlook on several key asset classes. A discussion of the key elements of our outlook follows.

Global equities made solid gains in the third quarter following June's Brexit shock, as risk appetite increased on expectations for continued stimulus from central banks, while record-low sovereign bond yields also boosted the attractiveness of stocks. The risks resulting from the British referendum, while still potentially significant, appear to have minimal impact in the short-run.

Central banks set the tone late in the quarter. The European Central Bank (ECB) kept monetary policy unchanged at its September meeting, with ECB president Draghi noting that there was no discussion of extending its QE program. The Bank of Japan (BoJ) and the Federal Reserve (Fed) issued policy decisions on the same day in September. Instead of increasing is current asset purchase program, the BoJ announced a goal of controlling the shape of the Japanese yield curve by maintaining the yield on 10-year Japanese governments bonds around 0.0%. Controlling the shape of the yield curve appears to reflect concerns over margin pressures in the banking sector due to negative bond yields, while also attempting to mitigate scarcity issues the BoJ has encountered in its asset purchase program. The Federal Reserve left rates unchanged, though the tone of its statement was more hawkish than expected, and was seen as setting the stage for a December >>

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

rate hike. The Fed acknowledged the recent pickup in the pace of economic activity compared to the first half of 2016 as well as the consistent strength seen in the U.S. labor market.

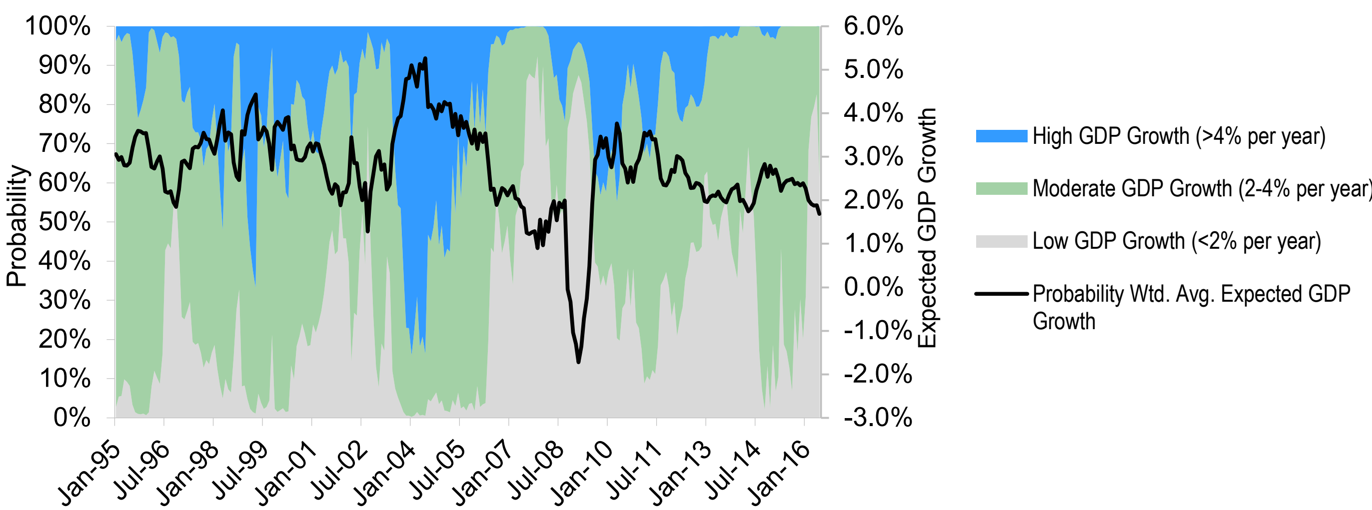
In our view, U.S. growth should continue on a slow but steady trajectory over the near term, with low risk of recession. Our proprietary measure of leading economic indicators (LEI) has shown resilience over the past quarter and remains in ex pansion territory, with healthy Purchasing Managers' Index (PMI) indicators and solid growth rates in the Eurozone. We continue to closely monitor the risks that may alter our view, particularly those that could arise as the U.K. implements its exit from the European Union.

THE GLOBAL ECONOMY

Karsten Jeske, Ph.D.,CFA,
Vice President,
Multi-Asset Research

In the U.S., economic growth has endured a soft spot recently. GDP grew at only 1.4% annualized in the second quarter of 2016, following two previous quarters of sub-1% economic growth. While personal consumption has been expanding at a very strong pace, the continued weakness of business investment subtracted from growth again, likely due to the effects from the energy sector. Moreover, weakness in inventory accumulation has been a major drag on growth over the last five quarters and especially so in the second quarter of 2016. If inventory accumulation were to come back to more normal levels again we should see some moderate upside risk to GDP growth. Hence, we revised up our fourth-quarter GDP forecast to 1.9%, which is still slightly below >>

FIGURE 1: U.S. GDP GROWTH EXPECTATIONS FOR ONE-YEAR AHEAD GDP



January 1995–September 2016

Data source: Proprietary calculations of Mellon Capital utilizing Thomson Reuters Datastream
Forecasts are based on Mellon Capital models, which are confidential and proprietary.

many of the other commercial forecasters, but an improvement from our forecast three months ago. We currently assign a probability of about 61% of below 2% growth, a 39% probability of 2-4% growth and essentially zero weight on above 4% growth.

At the September Federal Open Market Committee (FOMC) meeting, the U.S. Federal Reserve decided not to raise its target federal funds rate. But with three dissenting members who would have favored a rate hike by 0.25%, and the dot chart of committee member rate forecasts pointing to a likely federal funds rate hike before year end, we believe the FOMC came close to "broadcasting" a strong desire to fit in at least one more hike in 2016. We thus maintain our forecast of a rate hike at the December meeting, absent any significant deterioration in economic conditions before then.

GLOBAL LEADING ECONOMIC INDICATORS

At Mellon Capital, we generate our own proprietary measure of LEI. Our calculation is based on a number of high- and medium-frequency measures of the macro economy and financial markets that we believe are highly effective at estimating subsequent economic growth. A level slightly above 100 would indicate a significant probability of a mild economic recovery. The further the LEI measure is above 100, the faster the pace of economic growth. Conversely, a level approaching 99, and certainly below 99, would indicate a significant probability of a mild economic contraction.

The global weighted average LEI increased again to 100.7, as a result of a relatively broad-based recovery

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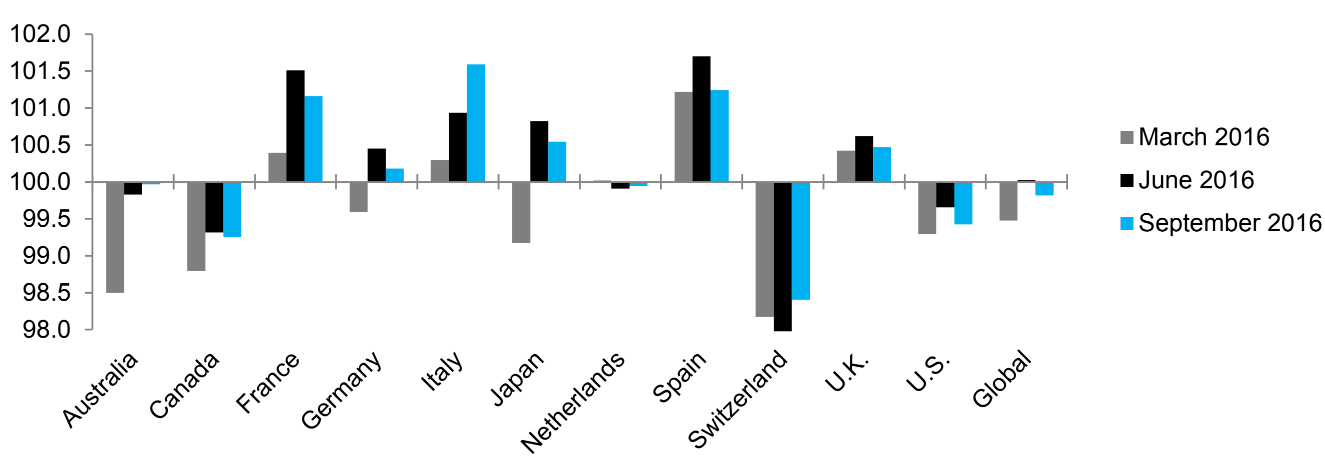
FIGURE 2: LEADING ECONOMIC INDICATORS



March 2016-September 2016

Data source: Mellon Capital
LEI outputs shown are based on Mellon Capital models, which are confidential and proprietary.

in our LEI measures. In most countries the strong recovery in equity markets since the first quarter helped lift the leading index. Much of Europe also experienced healthy PMI indicators and solid growth rates, actually higher than the recent growth rates in the U.S.

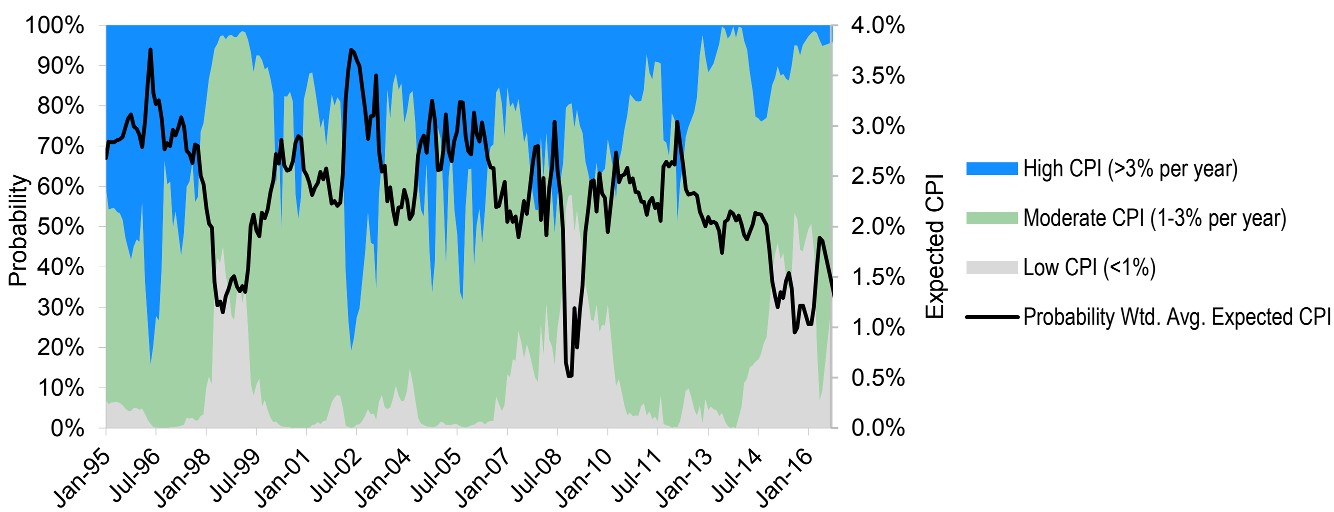
Great Britain and Italy were the only countries with noticeable drops in their LEI readings, the former due to the uncertainty about fallout from the Brexit vote and the latter due to the uncertainty about its financial sector. While neither country is in outright recession territory yet, the magnitude of the drop over the last quarter is a reason for concern.

U.S. CPI INFLATION

U.S. headline inflation remains very low at just 1.1% year over year (August 2016 over August 2015). Core Core Consumer Price Index (CPI) inflation firmed slightly to 2.3% over that same interval. With the stronger core inflation and a possible recovery in energy prices on a twelve month rolling basis, we expect headline inflation to come in higher over the next year. Specifically, our forecast for inflation over the next twelve months stands at 1.8%, which is a bit lower than the 2% to 2.2% among many other forecasters. In our view, the firming core inflation is more than offset by relatively weak growth going forward and disinflationary pressures from a stronger U.S. dollar once the Federal Reserve raises its target rate again at the December 2016 meeting. As for the distribution of likely inflation readings over the next twelve months, we predict an 11% probability of inflation below 1%, 87% probability of inflation falling into the 1-3% range and a very low 2% probability of above 3% inflation over the next year.

MUCH OF EUROPE ALSO EXPERIENCED HEALTHY PMI INDICATORS AND SOLID GROWTH RATES, ACTUALLY HIGHER THAN THE RECENT GROWTH RATES IN THE U.S.

FIGURE 3: U.S. CPI GROWTH EXPECTATIONS FOR ONE-YEAR AHEAD CPI GROWTH



January 1995–September 2016

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IMPLICATIONS FOR ASSET ALLOCATION

STOCKS/BONDS/CASH

We continue to favor global equities relative to global bonds based on our assessment of the global equity risk premium. However, we prefer to place less weight on directional positions as we favor relative value opportunities.

EQUITY MARKET ALLOCATION

We are devoting less risk to equity market allocation as expected returns between markets have narrowed. We continue to prefer Japanese and Eurozone stocks due to relatively strong earnings forecasts and attractive valuations. Expectations for continued looser monetary policy from the ECB and the BoJ should also be supportive. Further, as both regions are more cyclically oriented, we believe they will also benefit from improving global growth. Among Eurozone stocks we prefer Germany, France, and Spain. Negative earnings revisions and slower relative earnings growth make us relatively bearish on U.S. equities.

CURRENCIES

The U.S. dollar remains attractive based on relative economic fundamentals and expectations for the Fed to gradually raise interest rates. The Norwegian krone is also an attractive long position due to continued improvement in macro data. We are bearish on the euro and the British pound. Negative interest rates and an aggressive quantitative easing program make the euro an attractive short position. We dislike the British pound due to weak macro signals and an expanded quantitative easing program from the Bank of England.

FIXED INCOME: SOVEREIGNS

Among sovereign bonds, we prefer U.S. and Australian bonds as term premiums remain high relative to other global bond markets. Conversely, German and U.K. bonds are unattractive to us as term premiums are narrow. We closed our long Japanese bond position as we prefer to focus on bond markets where the yield curve is not explicitly manipulated. As noted, the Bank of Japan moved to control interest rates and the shape of the Japanese yield curve through the selective purchase and sale of various government maturities. We also expect both markets to benefit from demand for "risk-off" assets.

FIXED INCOME: U.S. TREASURIES

We maintain our neutral outlook on U.S. Treasuries. The Fed refrained from hiking at the September FOMC, despite an increasingly hawkish tone leading up to the meeting. According to the FOMC press release, "The stance of monetary policy remains accommodative, thereby supporting further improvement in labor market conditions and a return to 2% inflation." At the time of writing, markets are pricing in a 65% probability of a Fed rate hike by the end of 2016, but improving payroll reports will be closely followed. >>

Vassilis Dagioglu
Managing Director, Head of Asset Allocation Portfolio Management

Paul Benson, CFA, CAIA,
Managing Director, Head of Fixed Income Portfolio Management

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10-year Treasury yields fell to a low of 1.37% early in the quarter following the surprise Brexit vote at the end of Q2, but ended the quarter at 1.60%.

With the U.S. elections less than a month away, we expect market volatility will continue to be a concern. U.S. Treasuries remain an attractive safe-haven asset. We believe the distortions from quantitative easing efforts that global central banks continue to exert on government bonds will prevent long U.S. Treasury yields from rising significantly.

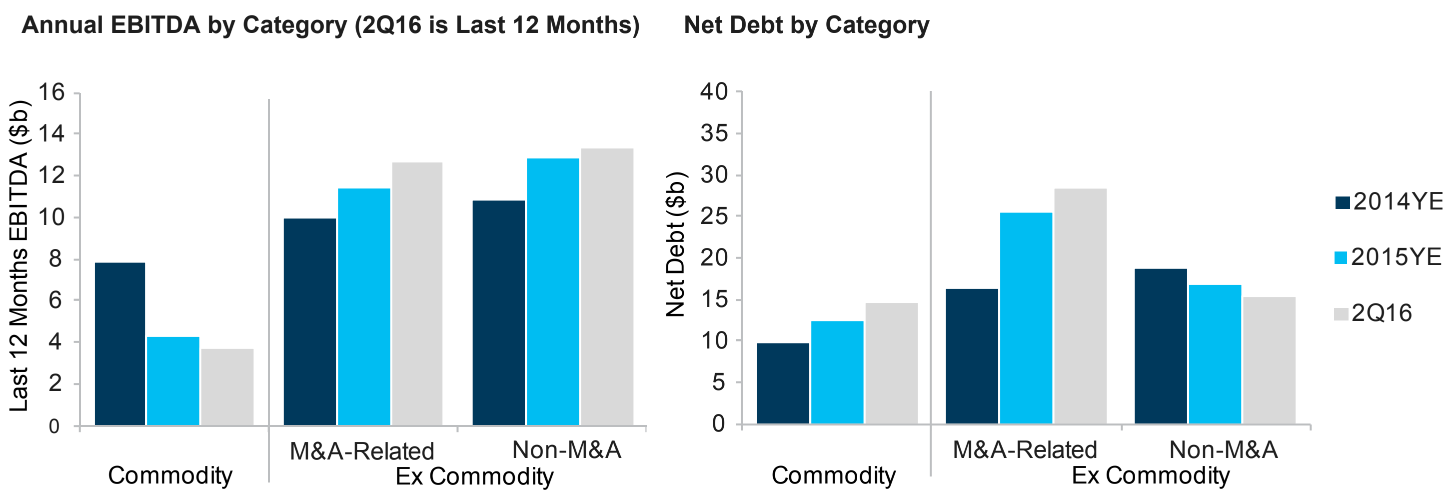
FIXED INCOME: CREDIT

We continue to be constructive on investment grade and higher quality, high yield bonds (BB/B), albeit with more caution. Over the third quarter, spreads continued to tighten and we view the case for further price appreciation as limited. This year, BBB spreads have recaptured more than two-thirds of the dramatic widening we witnessed from mid-2014 to early 2016. It is important to keep in mind, however, that even after this rally, BBB spreads are just slightly below their five-year average.

Issuance in U.S. investment grade continues apace, as 2016 looks to be another record-setting year. While the increase in corporate leverage continues to be a concern, corporate net leverage has moved lower during the second quarter and fundamentals excluding commodities, appear strong (see figure 4). >>

WITH THE U.S. ELECTIONS LESS THAN A MONTH AWAY, WE EXPECT MARKET VOLATILITY WILL CONTINUE TO BE A CONCERN.

FIGURE 4: U.S. ANNUAL U.S. INVESTMENT GRADE EBITDA[1] BY CATEGORY AND NET DEBT BY CATEGORY



As of September 30, 2016
Data sources: Factset, Barclays Research

1. Earnings Before Interest, Taxes, Depreciation and Amortization

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By contrast, high yield issuance is down significantly from last year. Defaults in the U.S. high yield space have been rising and are currently at an annualized rate of 5.4% (see figure 5).

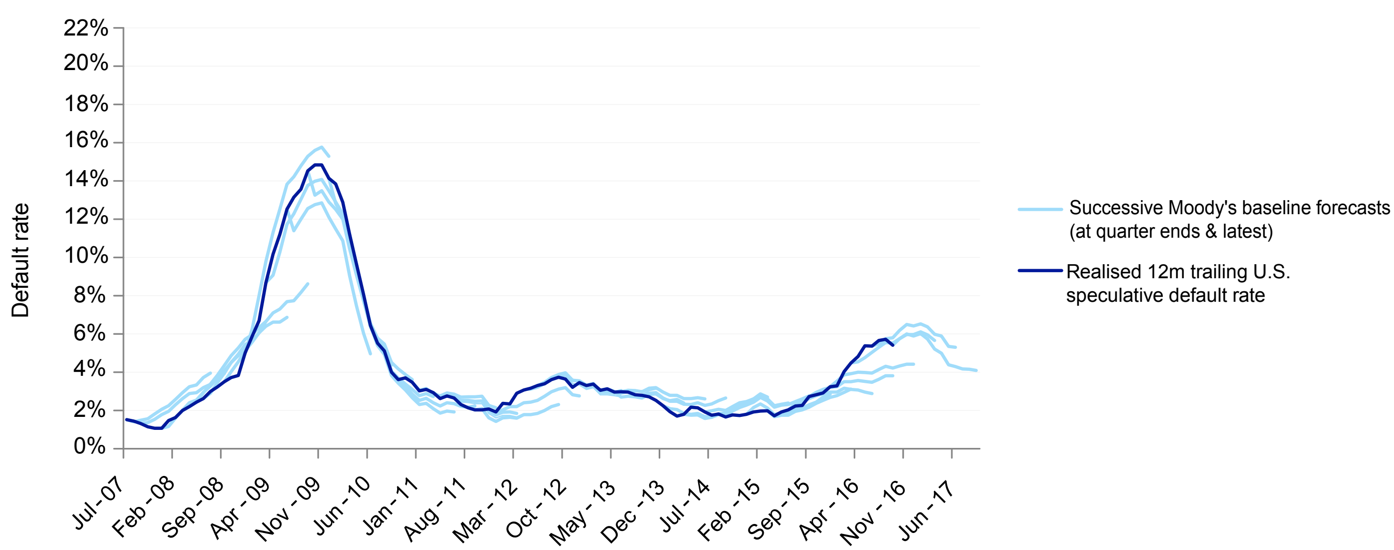
We expect the default rate will moderate going forward, with more concentration in the commodity-driven sectors. We continue to be watchful in the energy, metals, and mining sub-sectors and diversify our exposures to mitigate risk.

We maintain our constructive stance given the positive fundamentals coupled with the continuing global search for yield.

FIXED INCOME: TREASURY INFLATION-PROTECTED SECURITIES (TIPS)

We continue to prefer this asset class relative to nominal U.S. Treasuries. 10-year breakeven rates remain relatively low at 1.6%, but rose over the last quarter along with the rise in oil prices following the August OPEC supply deal and increasing expectations of a Fed hike by 2016 year end. U.S. wage growth continues to trend upward and unemployment remains low. August headline CPI was stronger than expected, rising 1.1% on a year-over-year basis, while core inflation rose 2.3% year over year. As noted above, headline inflation is expected to expand in early 2017: our expectation is a rise to 1.8% over the next twelve months. Given our continued expectation of an upward trend in inflation and the relatively low breakeven rates, we see an attractive relative value opportunity in U.S. TIPS. >>

FIGURE 5: U.S. REALIZED DEFAULT RATES VS. FORECASTS



As of September 30, 2016

Data sources: Deutsche Bank, Moody's

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COMMODITIES

We see attractive opportunities among commodities, particularly within the grain sector. In our view there is a divergence in the fundamentals and momentum signals within the grains sector. The soy complex (soybean and soybean oil) remains relatively favorable due to better fundamentals and less steep contango. Meanwhile corn and wheat show most unfavorable fundamentals in terms of inventories and roll yield. Within energy, we still see downward pressure on natural gas as the bearish curve shape dynamics persist. Positions in the petroleum sector are relatively small, with only a short position in WTI crude as the roll yield remains negative. We continue to moderately overweight metals through aluminum and nickel due to their relatively low levels of inventories. Divergences in the inventory is also the contributor to a long position in silver versus a short platinum position.

EQUITY INDEXING

Karen Q. Wong, CFA
Managing Director,
Head of Equity Portfolio Management

Net flows into U.S. and international index assets experienced strong momentum during the quarter as investors continued to exit active equity strategies and direct flows into both U.S. and international equity index exposures. July, in particular, was a strong month for index flows as equity assets rallied on relaxed post-Brexit concerns and continuing global central bank support.[1] During August and September, MSCI and S&P Dow Jones implemented the first new sector change to their shared Global Industry Classification Standard (GICS®) structure since 1999. Real estate securities, excepting mortgage REITs, were promoted out of the financial sector and into a standalone sector. Mortgage REITs, considered to be more similar to traditional financials, were given their own industry within the financial sector. This new eleventh sector reflects the unique attributes of real estate firms as well as their increased growth and specialization over time. As of the end of the quarter, the S&P 500® Index held 3.06% of its weight in the new real estate sector. [2] This change was also reflected in MSCI indexes, which made the switch during their standard August rebalance. As of the end of the quarter, the MSCI EAFE index held 3.99% weight in the new real estate sector. [3]

JULY, IN PARTICULAR, WAS A STRONG MONTH FOR INDEX FLOWS AS EQUITY ASSETS RALLIED ON RELAXED POST-BREXIT CONCERNS AND CONTINUING GLOBAL CENTRAL BANK SUPPORT.[1]

1. Source: Morningstar. Data through 8/31/16.

2. Source: S&P Dow Jones. Data based on the S&P 500® Index as of 9/30/16.
3. Source: MSCI. Data based on the MSCI EAFE index as of 9/30/16

ACTIVE EQUITY

William Cazalet, CAIA
Managing Director,
Head of Active Equity Strategies

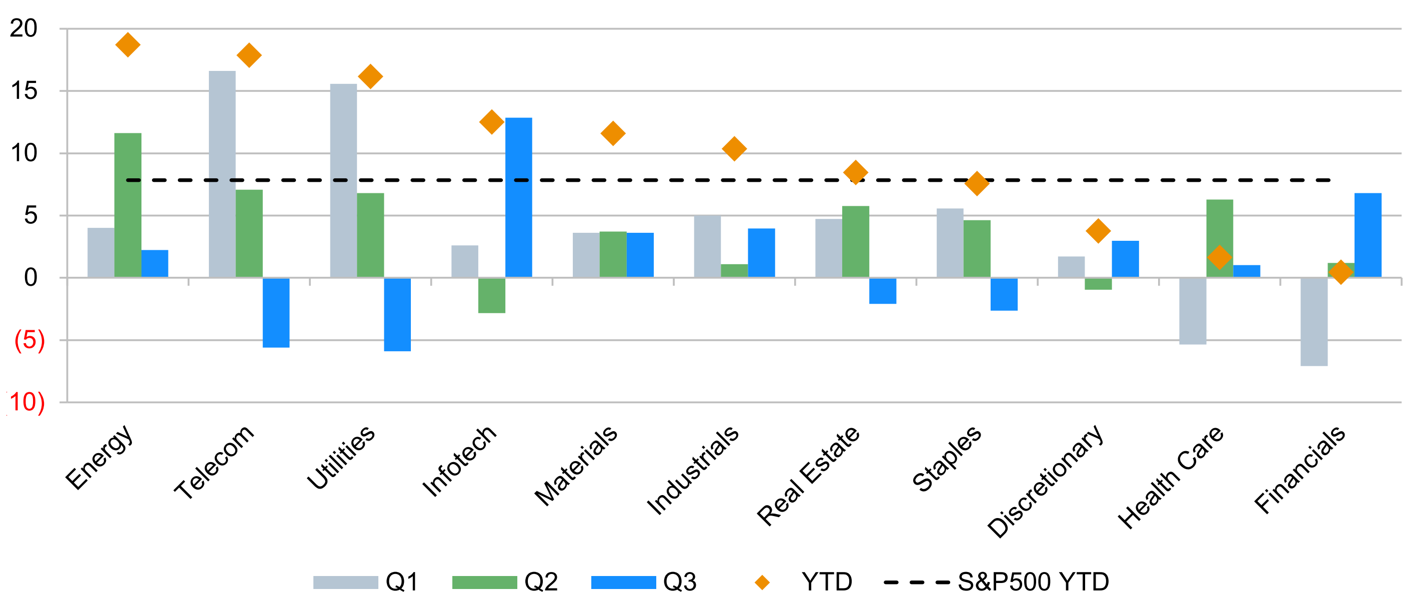
After a brief but precipitous drop following the result of the U.K. referendum on membership of Europe ('Brexit'), markets had managed to regain their footing by the end of the second quarter. While many major developed market indices made gains during July and the S&P 500® reached an all-time intra-day high of 2,193.81 in mid-August, many equity benchmarks marked time thereafter through the end of September.

In the U.S., the first half of the year saw significant interest in – and strong performance of – sectors such as consumer staples, telecoms and utilities that act more as bond proxies, both in terms of income generation and defensiveness.

But after the implications of the Brexit referendum result had been digested by global markets, the S&P 500 registered a marked shift away from defensive sectors into more cyclical ones, with strong rebounds in information technology and financials. The energy sector also advanced modestly after a strong second quarter: crude prices ended the quarter almost flat, which belied the volatile nature of the energy market during the quarter as prices sank to the low $40s in early August before recovering and receiving a final fillip from the OPEC deal on production at the end of September.

With the U.S. currently in the eighth year of a bull market, attention inevitably turned to the quarterly report card of U.S. corporate profitability as companies announced second quarter results. Year-on-year, second quarter S&P 500 earnings declined 3.48%; excluding energy, where earnings fell by almost 85% year-on-year, earnings were up 0.40% but earnings growth was negative >>

FIGURE 6: S&P 500® EARNINGS FORECASTS OVER TIME



January 2016-September 2016
Data source: FactSet

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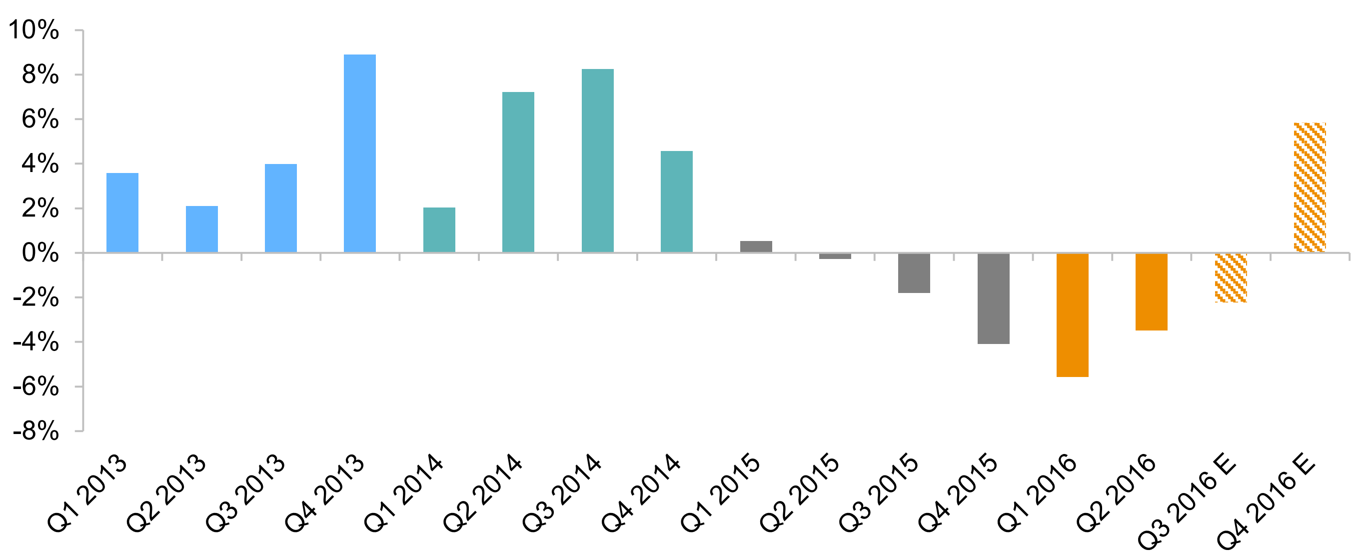
in five out of ten sectors and effectively flat in consumer staples. Consumer discretionary was the best performer, with 11.6% earnings growth year-on-year, helped by strong numbers from Amazon.com, General Motors, and Comcast.

The earnings season was even more challenging outside of the U.S., with second quarter earnings of the Stoxx Europe 600 declining by almost 10% year-on-year, and first quarter 2017 earnings of the TOPIX index in Japan declining by 12%. Both markets beat consensus estimates but in Europe, as in the U.S., only half the sectors enjoyed positive earnings growth, while in Japan just two out of ten sectors (healthcare and telecoms) posted positive growth in their earnings.

KEY RISKS TO OUR OUTLOOK

- S&P 500® earnings have now posted declines for five straight quarters in a row, and consensus estimates for S&P 500® third quarter earnings, which had been predicted in late June to rise by 1.5%, recently turned negative and currently stand at -2.2% year-on-year. (See figure 7). With the index trading at 18.2 x next year's earnings, investors will be looking not only to earnings but also to top-line growth for evidence that economic expansion is still underway.
- With the date of the U.S. presidential election less than five weeks away and polls indicating neither candidate with a significantly clear lead as yet, the potential impact of the eventual winner's policies on a sector-by-sector basis is uncertain.
- Finally, while the Federal Reserve elected not to raise interest rates at its September meeting, there was a more hawkish tone to the Fed's post-meeting release, such that most commentators agree that a rise in rates in December is more likely than not.

FIGURE 7: S&P 500® EARNINGS FORECASTS OVER TIME



January 2013-September 2016

Data source: FactSet

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Mellon Capital – Global. Insightful. Engaged. Mellon Capital has provided investors with distinct insights into complex capital markets since 1983. Our unique approach to fundamentals-based systematic investing drives our capabilities, which include multi-asset, active, smart beta, and indexing strategies. We're committed to helping our clients reach their investment goals. That's why we've been an innovative pioneer of dynamic multi-asset allocation for more than 30 years. Our intellectual curiosity, sophisticated research platform, global reach, and flexibility to transact in all liquid asset classes help us deliver powerful and unique investment solutions.

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