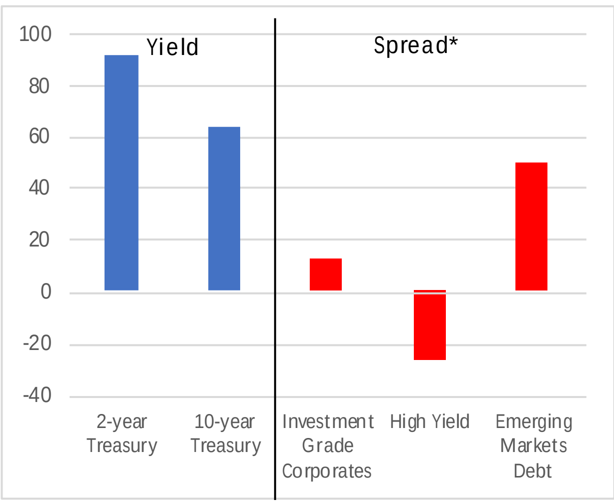
DuPont Capital

Global Market Positioning
October 2018

Real-time insight on how DuPont Capital has positioned its portfolios as a function of key factors driving the markets.

Key Market Factors (as of October 1, 2018)

2018 Changes in Yield and Spreads

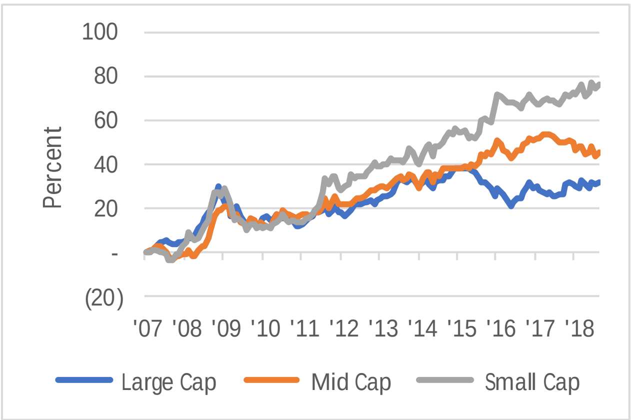


Source: Bloomberg, JP Morgan
As of September 30, 2018
*Option Adjusted Spread

U.S. Rates Rising

- Although U.S. interest rates have risen significantly in 2018, corporate bond spreads, both Investment Grade and High Yield, are not indicating any fear of weaker growth in the near future or of much impact from the trade war.
- Investment Grade spreads have widened by only 13 basis points (bps) in 2018 while High Yield has tightened by 27 bps.
- Emerging Market Debt has experienced difficulties with much wider spreads due to the stronger dollar, the trade war, idiosyncratic problems (Turkey, Argentina, and Venezuela), and a fear of "Who could be next"?
- The Fed continued on its gradual tightening path in the third quarter with a 25 bps hike in September. This was its sixth hike in twenty-one months, with one more expected this year.
- The future path of rate hikes is much more uncertain with the Fed projecting three more in 2019. We believe only one or two more moves is likely before slower economic growth in 2019 causes the Fed to pause.

U.S. Share Buybacks—Cumulative Factor Spread by Asset Class



Source: DCM. Universes: Large = S&P 500, Mid = S&P 400, Small = Russell 2000. Spreads calculated using sector neutral methodology.

Constraints on Growth

- U.S. companies' share repurchases have become turbocharged in the wake of corporate tax cuts. Year-to-date aggregate buybacks among S&P 500 members is approaching $800 billion in value, already comfortably surpassing total activity levels for both last year and the previous record from 2013.
- Although buyback expenditure relative to operating earnings remains reasonable, investors have shown a more balanced appetite for cash returns versus capital deployment. In effect, historically low interest rates fueled or enabled equity-for-debt swaps within many large caps.
- As a factor return, repurchases have fared better in small caps of late, where domestic exposure and tax windfalls are typically higher. In mid and large cap categories, we endorse greater market discrimination on longer term corporate capital allocation and discipline, which for long-term investors should be a cornerstone of sustainable value creation.
- Outside of the U.S., buyback activity remains much more muted due to structural norms. However, those companies that exhibit capital flexibility, rather than hoarding excess cash, tend to be rewarded for their shareholder-friendliness and have outperformed steadily over the last two years.

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Current Positioning (as of October 1, 2018)

Global Equity

- Intensifying trade wars remain squarely in focus for equity markets as tariff measures expand in scope. Associated risks to growth and inflation are well-documented, but the impacts are unlikely to be felt uniformly. We have initiated positions in targeted companies that we believe should be able to protect their margins, via brand- or innovation-related pricing power within their product categories. We remain wary of the potential duration rather than severity of trade tensions; political hegemony factors may exert as much of an influence as near-term economic ones.
- The slope of the yield curve in the U.S. continues to preoccupy many investors, with the fears of inversion present but possibly premature. From a company perspective we are more focused on debt levels, as interest rates remain on an upward path. As alluded to in the buyback overview, U.S. corporate indebtedness has risen through this cycle. Any cyclical deterioration in median profit margins will likely increase scrutiny on leverage.
- Emerging Markets have been beset by volatility due to thematic and global uncertainties. Developed international equities tend to be export-dependent and have also experienced sharp outflows in recent months. Within the price/earnings de-rating process, Value (cheapness) has not provided relative defensiveness. However, even some structurally advantaged firms are starting to appear attractively valued based on longer horizon earnings power.

Fixed Income

- U.S. economic growth remains strong and inflation has picked up to meet or slightly exceed the Fed's 2% target. We believe interest rates will rise slightly over the next six months as the Federal Reserve continues to tighten; we expect another 0.25% hike in December. The duration of our portfolios is currently shorter than the benchmark to protect against rising rates.
- Emerging markets debt (EMD) has declined significantly in 2018, and is currently underperforming all other fixed income asset classes year-to-date. The decline in EMD may continue in the short-term, but we believe valuations in both U.S. Dollar and local currency are more attractive than other fixed income sectors. We have been gradually reducing cash and adding positions in both hard and local currencies. In U.S. Dollar sovereigns, we are overweight Ukraine, Turkey, and Argentina, as well as Mexico and Brazil. In local currency, our main exposures are to Brazil, Mexico, Poland, and Russia.
- Investment grade corporate spreads have tightened this quarter, but are still wider than at the beginning of 2018. Although corporates are not very attractive, they are the best valued segment within investment grade fixed income. Accordingly, we have a small overweight to corporates in our Core portfolio. We favor the basic industry, insurance, and capital goods sectors, but are underweight longer duration bonds to reduce interest rate and spread duration.
- We are maintaining a slightly higher than normal cash position in our high yield portfolios due to tight spreads within the asset class. We are deploying capital in select restructuring situations as well as in more liquid investments that we believe have an attractive long-term risk-reward profile.