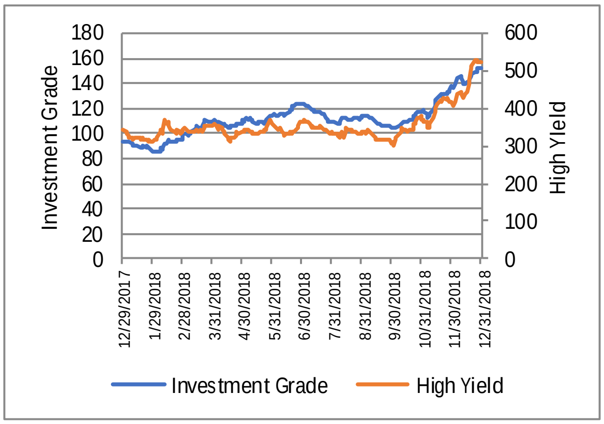
GLOBAL MARKET POSITIONING

January 2019

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 January 1, 2019)

Spreads Widening

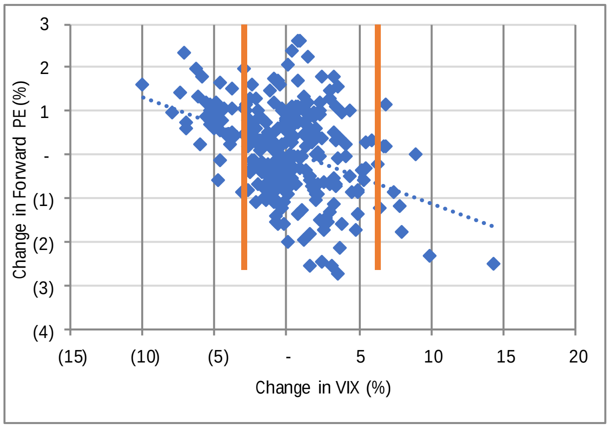


Source: Bloomberg, JP Morgan
As of December 31, 2018

CREDIT SPREADS RISING—IS A RECESSION COMING?

- High Yield and Investment Grade credit spreads widened significantly in the 4th quarter and for all of 2018 as equity markets declined and investors became more concerned about weaker economic growth in 2019.
- Investment Grade spreads widened by 58 basis points (bps) in 2018 while High Yield widened by over 170 bps. The large decline in oil prices in the 4th quarter impacted spreads with energy companies widening much more than other sectors.
- U.S. Dollar Emerging Market Debt spreads widened by 80 bps during the quarter, but local currency EMD rebounded slightly due to the weaker dollar. EMD held in better than High Yield in the 4th quarter partly due to the rise in U.S. Treasury prices.
- The Fed continued on its gradual tightening path in the 4th quarter with a 25 bps hike in December despite protests from President Trump. This was its seventh hike over the past two years and they are forecasting two more in 2019.
- We believe economic growth in the U.S. will slow in 2019, but a recession will most likely not occur. Slower growth and moderate inflation will result in no more than one additional hike in 2019. Don't be surprised if growth is close to 0% for one quarter, possibly early in 2019.

VIX Versus S&P 500 Forward PE



Source: Bloomberg, DCM; Monthly Data from 9/96 to 10/18

UNCERTAINTY PRINCIPAL

- In the abstract, risk aversion is driven technically by the number of uncertainties, the severity of their impact, and their estimated probability. What, then, is the diagnosis of recent volatility spikes and the prognosis for continued bearish sentiment and further market drawdowns?
- Systemic financial risks seem benign, but a panoply of near-term economic uncertainties have gained influence. Chinese growth dynamics, slower earnings growth and post-peak leading indicators in the U.S., the Brexit endgame, and softer Eurozone exports have amplified cyclical fears and dented confidence.
- The implications of unprecedented structural shifts and policy reversals add to the uncertainty mix. The end of quantitative easing, the reconfiguration of international trade norms, and the rise of the intangible economy require careful evaluation at both sector level and company level.
- Outside of recessions, twelve-month equity returns tend to be positive following a pronounced volatility uptick. However, a general valuation re-rating is unlikely while volatility persists or, at least, rebases at longer-term averages. For now, the contrarian Value mantra of "being greedy when others are fearful" is best supplemented by a preference for Quality characteristics.

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Current Positioning (as of January 1, 2019)

Global Equity

- Under the most likely economic scenarios – which range between (i) a demographic- and policy-driven adjustment of growth back toward sustainable long-term trends and (ii) a cyclical downturn becoming more undeniably evident – we would expect U.S. markets to fare relatively resiliently. Valuations remain at a premium to other regions, but they no longer look quite so stretched on a long-term investment horizon and reflect certain structural advantages and better exposure to the intangible economy.
- Compositionally, Europe and Japan are tethered more closely to the cyclical dynamics of global GDP, industrial production, and trade. Selective value opportunities exist in these regions and we continue to add to companies that are at the forefront of, or insulated from, digital penetration of traditional industries and changes in consumer behavior. However, patience may be required if key tail risks (Breality, cohesion and debt concentrations in the Eurozone, spillover effects from China) intensify.
- As detailed previously, the myriad uncertainties besetting equity markets are unlikely to be resolved imminently. In physics, the original uncertainty principle essentially states that there is a trade-off between the precision with which a particle's two properties – its position and momentum – can be determined. From a market perspective, we aim to hedge these two characteristics – by gaining exposure to under-appreciated or sustainable growth at a discount to long-term valuations, while also acknowledging that exact inflections are difficult to pinpoint.
- As such, we are looking to add opportunistically but selectively to cyclical stocks which combine mean reversal potential with embedded or strategic advantages. Given the prevailing structural winds, the emphasis is on gaining exposure to idiosyncratic drivers of return rather than mere beta contrarianism. This holds true across all asset classes, including Emerging Markets and Small Caps.

Fixed Income

- U.S. economic growth remains healthy, but inflation has eased after briefly exceeding the Fed's 2% target. We believe the Federal Reserve may only make one more hike in 2019 and possibly none. The duration of our portfolios is currently shorter than the benchmark to protect against rates rising slightly from current levels.
- Emerging Markets Debt (EMD) declined significantly in 2018, both for hard and local currency, and were the worst performing fixed income asset classes. The volatility in EMD may continue in the short-term, but we believe valuations are more attractive than other fixed income sectors. We have been slowly adding positions, mostly in hard currency, and methodically reducing cash. We moved to an overweight position to Turkey in the 2nd half of 2018 after the significant decline in the country's bonds earlier in the year. 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 widened significantly this year and are over 50 bps wider from the beginning of 2018. Corporate bonds are the best valued segment within investment grade fixed income. Accordingly, we have an overweight to corporates in our Core and Core Plus portfolios. We favor the basic industry, insurance, and the consumer sectors, but are underweight longer duration bonds to reduce interest rate and spread duration.
- High yield spreads widened significantly in the 4th quarter. Spreads may widen further, but the market is not as expensive as earlier in the year. 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.

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