2nd Quarter 2019

Vanderbilt conducts economic research to see how our outlook differs from the consensus to estimate what has or has not been discounted in the investment markets. For example, in 2018 we had a robust economic outlook which was different from the consensus. It was an outlook that proved correct. For 2019, VAAM has had a lower growth outlook than the consensus before the consensus also changed to this viewpoint. Analysts felt the strong labor market would provide the momentum for robust economic growth. However, final private sales rose 1.3% in the first quarter down from 2.6% in the fourth quarter 2018 and the weakest showing since 2013. The most important component of the economy, consumer spending, was weak in the first quarter and the housing market contracted for the fifth consecutive quarter. Consumer spending, which accounts for two-thirds of U.S. economic output, grew at a 0.9% annual rate. That was a sharp slowdown from the fourth quarter. In addition, lower corporate taxes, which were expected to be a stimulant for capex spending, instead resulted in $728 billion in stock buybacks. This was a 34% increase over 2017 and set a new record. In addition, should the economy become more stressed, fiscal policy is in a weaker position to help through either spending and/or tax cuts due to the current large federal budget deficit.

During the second quarter, the yield curve experienced a “bull/steepener” move with interest rates declining across the curve and more so in the 2 to 10-year area of the curve. The yield curve inverted from the 3-month bill rate out to the 10-year maturity.

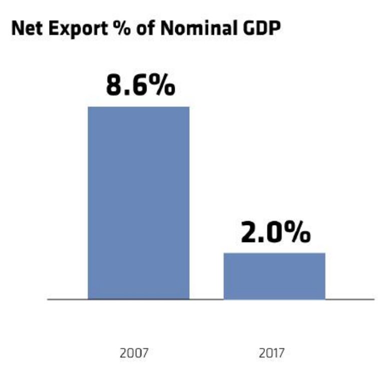
	3/31/19	6/30/19	Change
1-month Treasury Bills	2.42	2.13	-0.29
3-monthTreasury Bills	2.38	2.09	-0.29
2-year Treasury Note	2.26	1.76	-0.50
5-year Treasury Note	2.23	1.77	-0.46
7-year Treasury Note	2.31	1.88	-0.43
10-year Treasury Note	2.40	2.00	-0.40
30-year Treasury Bond	2.81	2.53	-0.28
10-year vs. 2-year	14	24	10

Since the 1970’s, an inversion has preceded every recession. However, from a longer-term perspective, an inversion does not always signal that a recession is imminent. A recession can occur in the absence of an inversion and there have been four instances. The average length of time between the onset of an inverted yield curve and the beginning of a recession has been 14 months. The current market cycle could be different due to the effects of global quantitative easing. At its most recent meeting, the Federal Reserve was split on its interpretation of the yield curve inversion-with three officials placing strong weight on the inversion and four officials downplaying a signal from a. inverting yield curve.

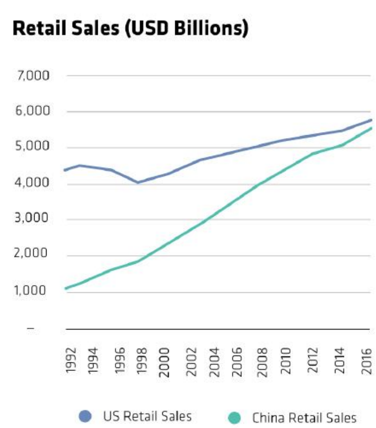
The Federal Reserve is currently reviewing inflation targeting and there is an expectation that they could adopt an average inflation target. By raising the target above the current threshold of 2% during periods of expansion, it would offset lower inflation during periods of slow growth and recessions. By adopting average inflation targeting, it would be less likely that rate hikes would occur during economic expansions until inflation reached a higher level. VAAM is of the opinion that if there is a surprise on inflation it will be negative due to the tight labor market and year-over-year wage growth of 3.1%. In addition, regardless of what happens to the ACA, Medicare costs are likely to accelerate. The year-over-year rate for the core CPI Index rose to 2.1% in June. The composition was fairly firm as well, with strength in shelter and medical services and only a modest boost from tariffs that may suggest more is in the pipeline.

Global trade policies continue to create uncertainty thereby threatening a brake on economic growth. The main impact of tariffs will be increased uncertainty about the business and trade environment along with the risk of future escalations which could negatively impact consumer, business and investor confidence. In general, trade tariffs are viewed as inflationary as import price increases are reflected in higher domestic prices. U.S. consumers are paying for the tariff disputes as importers are likely to pass on the increased tariff costs to consumers. Trade wars will hobble American economic growth and put upward pressure on U.S. prices if the current dialogue does not change.

President Trump has weaponized the U.S. economy through tariffs and sanctions in order to accomplish other policy goals. For example, he threatened higher tariffs on Mexico if they did not tighten immigration flows into the U.S. The threat alone prompted policy changes from the Mexican government and preserved the status quo. China is not without some leverage in the trade war; however, there could be unknown ramifications in future years if current negotiations do not result in a suitable trade agreement. China is reorienting its economy to be more consumer based. As China's domestic retail industry grows, its exports as a percent of future growth will become less important as outlined on the chart below. Chinese consumers drove 65% of growth in the first quarter. Exports were 18% of GDP in 2018 down from 35% in 2006. China is also avoiding tariffs by transshipping through other countries (e.g. Vietnam) rather than direct shipment to the U.S. Globalization is probably irreversible. Our view is that global supply chains are so complex, involving companies from multiple regions across continents, that tariffs will not prompt companies to swiftly close factories in China and Mexico and replace them with plants in Ohio and/or Indiana. If the China/U.S. feud escalates, it has the potential to fracture the foundations of globalization that have contributed to prosperity and relative peace. We believe that the U.S. should be mobilizing our allies to achieve a fair and reciprocal trade agreement with China. Imposing, or threatening to impose, tariffs on our allies does not result in cooperation to confront China. At the recent G-20 meeting, the U.S. and China agreed to hold off on any further tariffs while they restart trade negotiations. VAAM's outlook is there will be some sort of trade agreement because it is in both countries' interest. The U.S. will ultimately back away from increasing tariffs on China and look for an agreement. The U.S. economy's performance is too important for the reelection prospects of the current administration.



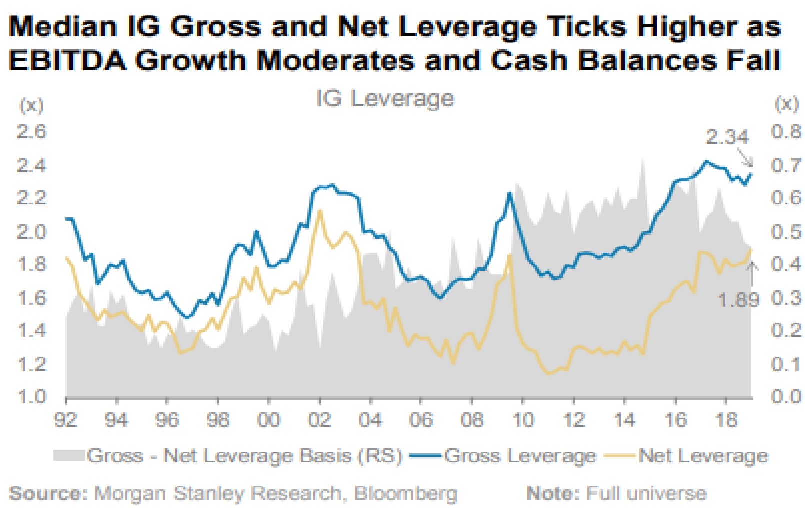
Source: CEIC, NBS, AB



Corporate securities

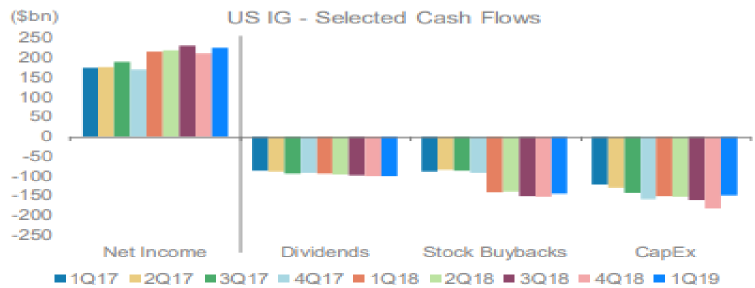
The corporate bond market environment faced several headwinds during the second quarter. A global slowdown in growth, uncertainty created by the trade wars, weaker CAPEX and the inversion of the U.S. yield curve were several factors that could have derailed the recovery in corporate spreads. Despite these potentially negative factors, corporate spreads, the incremental yield over comparable U.S. Treasury securities, were well-behaved during the past three months. For instance, 1-3-year corporate spreads rose 0.02% to 0.66% during the quarter, but due to their higher income, the sector provided 0.16% of excess return over Treasuries as measured by the 1-3 Corporate Index. Longer maturity corporate bonds fared even better as spreads contracted by 0.03% to 1.00% at quarter end. The combination of higher income and price appreciation from the tightening in spreads provided an excess return of 0.56% during the quarter. The historical median spread of the two indices compared to current spread levels indicate the sector as overvalued. The 1-3 Index at a current spread of 0.66% is 0.25% tighter than the historical median level of 0.91% and the 1-10 Index spread of 1.00% is 0.21% over the historical median of 1.21%. The corporate sector can remain overvalued in the near term but any significant slowdown in the U.S. growth rate would place pressure on spreads and impact relative performance.

The key financial fundamentals that impact credit quality of corporate securities have been relatively stable over the past quarter. However, they remain weaker than prior economic cycles. Cash flow growth, as measured by the growth of Earnings Before Interest Depreciation & Amortization (EBITDA), slowed during the quarter as compared to the increase in debt and the decline in cash. The combination of these factors resulted in a modest rise in both gross and net leverage. As shown in the graph below, these elevated levels have only been reached during a recession. Our view is that any decline in EBITDA would drive these leverage numbers significantly above any historical comparison.



One of the goals of the U.S. corporate tax cut was to free up existing cash balances and increase cash flow from operations that would then be available for higher CAPEX investment. Improved productivity and higher growth would extend the economic recovery and improve the credit quality of corporate bond market. As shown in the graph below, CAPEX rose in 2018 but dropped during the first quarter of 2019.

Elevated Buybacks Have Driven Lower Cash Levels, While Capex Fell in the First Quarter



Source: Morgan Stanley Research, Bloomberg

Ultimately, CAPEX will be driven by increased demand, cost savings derived from the investments, and/or competitive pressures not the level of cash held by a company or its cash flow generation. In addition to the rise in investments in 2018, stock buybacks rose dramatically. An underpinning of corporate credit quality throughout the expansion has been the significant level of cash on corporate balance sheets. Unfortunately, this no longer the case as buybacks have consumed increasing amounts of cash.

Cash-to-Debt Continues to Drop for the Broad Market, Hitting the Lowest Level since 2003

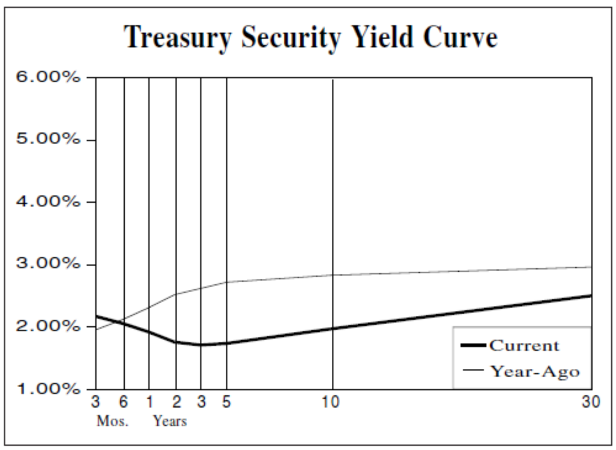
Source: Morgan Stanley Research, Bloomberg

It has been our recent investment position that corporate credit quality does not support corporate spread levels below the historical average. Financial performance during the past quarter has not altered this view. Leverage remains elevated and EBITDA/Interest expense are near the lows of the cycle while stock buybacks are depleting cash without the benefit of improved operational efficiencies. Therefore, your portfolio's corporate credit allocation is at significantly lower levels than previously held during this economic cycle. For instance, short duration portfolios are targeting a 40% allocation with a higher average credit quality and lower spread duration than the appropriate index. Intermediate portfolios have an exposure slightly below the Intermediate Index allocation and a higher average credit quality. This positioning will be maintained until valuations improve, corporate credit quality changes or the path of economic growth changes dramatically.

During the past quarter, several new investments were made in your portfolio. JPM Chase & Co., the premier money center bank in the country, was purchased. The company has solid financial fundamentals with a 1.23% return on equity, a Tier 1 Capital ratio of 13.8% and a significant positive earnings surprise during the past quarter. They are rated A2/A-. Honeywell International Inc. was also added. Honeywell is a diversified technology and manufacturing company with operations in aerospace (35% of revenue), performance materials & technologies (25%), building technologies (25%) and safety & productivity solutions (15%). The A2/A rated company has strong financial fundamentals. EBITDA/Interest expense was 21.5x, total leverage is a reasonable 2.12x and net leverage just 0.26x. Honeywell had a significant positive earnings surprise in the first quarter. Wells Fargo matured during the quarter and we did not reinvest due to a significant negative earnings surprise during the quarter.

Selected Yields

	Recent (7/2/19)	***3 Months Ago (4/3/19)***	***Year Ago (7/3/18)***		***Recent (7/2/19)***	***3 Months Ago (4/3/19)***	***Year Ago (7/3/18)***
TAXABLE							
Market Rates				**Mortgage-Backed Securities**			
Discount Rate	3.00	3.00	2.25	GNMA 5.5%	3.63	4.05	3.50
Federal Funds	2.25-2.50	2.25-2.50	1.75-2.00	FHLMC 5.5% (Gold)	3.55	3.57	3.66
Prime Rate	5.50	5.50	5.00	FHLMC 5.5%	3.49	3.55	3.51
30-day CP (A1/P1)	2.34	2.48	2.06	**Corporate Bonds**			
3-month Libor	2.33	2.60	2.34	Financial (10-year) A	2.87	3.45	4.00
U.S. Treasury Securities				Industrial (25/30-year) A	3.58	4.05	4.24
3-month	2.17	2.42	1.96	Utility (25/30-year) A	3.67	4.14	4.21
6-month	2.06	2.45	2.12	Utility (25/30-year) Baa/BBB	4.00	4.51	4.56
1-year	1.92	2.41	2.31	S&P 500 High Yield Corp. Bond Index	4.38	4.85	5.32
5-year	1.74	2.33	2.72	**Foreign Bonds**			
10-year	1.97	2.52	2.83	Canada	1.47	1.71	2.16
10-year (inflation-protected)	0.34	0.64	0.72	Germany	-0.38	0.01	0.31
30-year	2.50	2.93	2.96	Japan	-0.15	-0.05	0.03
30-year Zero	2.57	2.99	2.97	United Kingdom	0.70	1.10	1.28
				Preferred Stocks			
				Utility A	6.00	6.00	5.93
				Financial A	5.47	5.97	5.81
				Financial Adjustable A	5.47	5.47	5.47



Source: Value Line, Inc.

Federal Reserve Data

BANK RESERVES

(Two-Week Period; in Millions, Not Seasonally Adjusted)

	Recent Levels			Average Levels Over the Last...		
	06/19/19	06/05/19	Change	12 Wks.	26 Wks.	52 Wks.
Excess Reserves	1451037	1403240	47797	1426821	1481026	1611805
Borrowed Reserves	61	87	-26	43	40	119
Net Free/Borrowed Reserves	1450976	1403153	47823	1426777	1480986	1611686

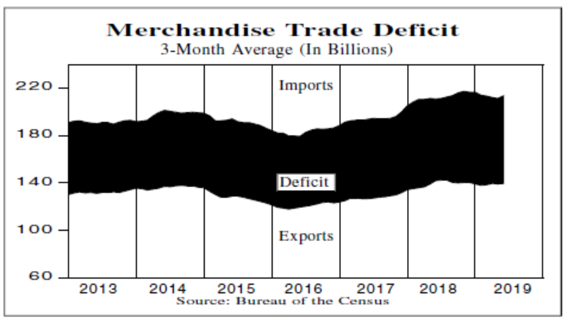
MONEY SUPPLY

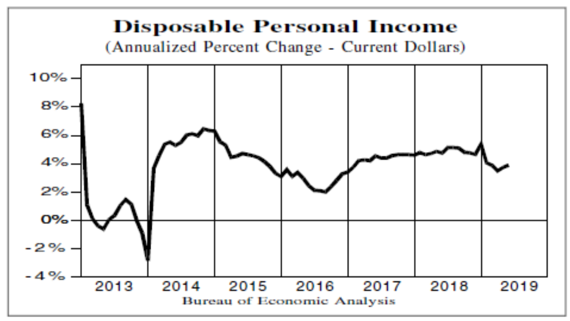
(One-Week Period; in Billions, Not Seasonally Adjusted)

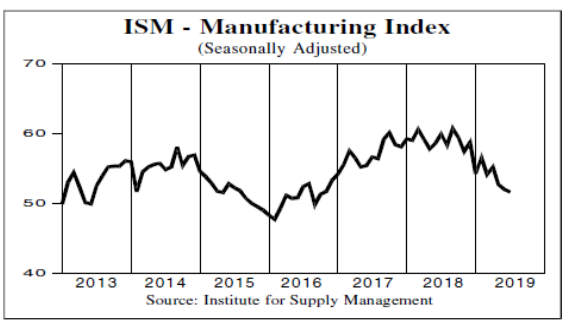
	Recent Levels			Ann'l Growth Rates Over the Last...		
	06/17/19	06/10/19	Change	3 Mos.	6 Mos.	12 Mos.
M1 (Currency+demand deposits)	3850.5	3836.2	14.3	12.8%	6.1%	5.1%
M2 (M1+savings+small time deposits)	14756.4	14729.4	27.0	8.8%	5.9%	4.6%

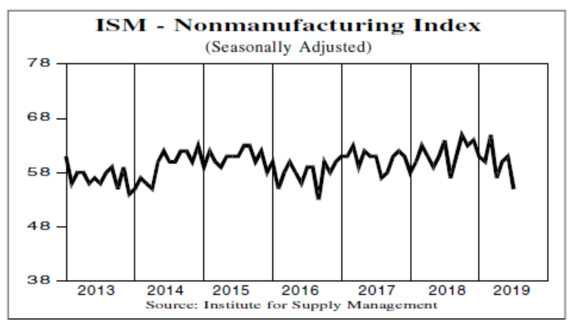
Source: Unites States Federal Reserve Bank

Tracking the Economy









Source: Value Line, Inc.