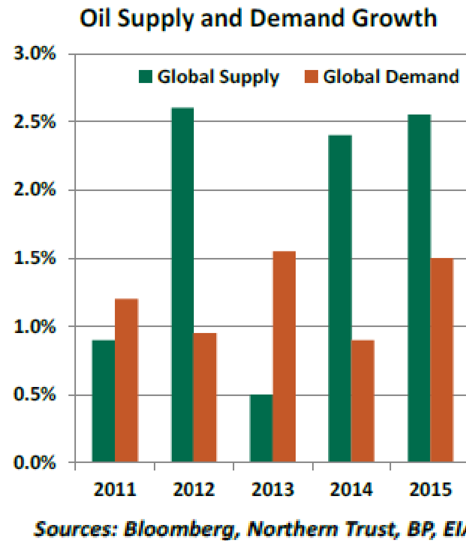
VANDERBILT Ave.
ASSET MANAGEMENT

1st Quarter 2016

Our economic outlook continues to forecast economic growth higher than the consensus outlook for 2016. Consumer spending (approximately 70% of GDP) was up 2.4% in the fourth quarter which represented the fastest pace in eight months. The consumer's propensity to spend has been boosted by a strong job market and recent wage gains. Total payroll employment is up more than 600,000 the past three months and the ratio of employment to population is gradually rising. Work force gains are at the fastest pace in more than a decade. The share of the population with a job is the highest since 2009 and the 5.0% unemployment rate, while up from 4.9% the previous month due to more people looking for jobs, is near an eight year low. Job growth has averaged 237,000 jobs per month over the last 27 months. March average hourly earnings rose 0.3% and are up 2.3% for the last 12 months.

Households are in good shape with real disposable income up 3.5% and the total value of homes is 7% higher than a year ago. Underlying inflation is beginning to rise which is reflective of greater economic momentum. Core (excludes food and energy) CPI grew at 2.3% for the 12 months through February. This is the largest increase since May '12. The personal consumption expenditures price index minus food and energy, the Fed's preferred gauge of inflation, rose 1.7% for the year ended February, the fastest pace in three years. The Fed estimates that lower import prices, the result of the strong dollar, depressed this measure by 0.5% last year. Removing this dollar effect suggests core inflation is at the Fed's 2% target.

Several questions have arisen with regard to economic momentum. First, why does employment seem so strong when the economy does not? Historically this is a rare occurrence and the two at some point will need to come back into alignment. There have been some suggestions that the recent slowdown in productivity has caused an increase in employment to compensate for the slowdown. Ideally economic growth would accelerate, closing the gap with employment growth. Second, if manufacturing is in recession, can the U.S. expansion survive? The U.S. Purchasing Managers' Index is in contraction territory and has declined over the last year. However, major developed economies have become heavily service oriented, allowing for expansion to continue in that sector while manufacturing is in retreat. Third, can the U.S. economy continue to gain momentum if other economies are retreating? Cumulative progress since the end of the last recession has been strongest in the U.S., and prospects for the year ahead remain solid. Reacting to this, the Federal Reserve took a first step away from its zero interest rate policy. In other markets however, sluggish conditions have prompted central banks to move in the opposite direction. Negative interest rates, larger quantitative easing programs and currency devaluations have all been employed to revive their economies. During the 1998 Asian financial crisis, the "knock on" effects to the U.S. economy remained limited while the U.S. economy continued to expand for an additional three years. The U.S. is not overly dependent on sales to other regions. Exports are 12.5% of U.S. GDP. Fourth, why are equities and oil prices in lockstep? Since the middle of 2014 (when crude oil prices began their decline), oil and equity price movements have been positively correlated. This is not behavior historically observed. Lower energy prices are normally seen as a boon to a wide number of industries and for consumers. This would generally translate into better equity returns in general and create an inverse relationship with energy prices. Investors are presently interpreting lower energy prices as a result of weakening demand, suggesting a weakening in economic activity. But since global production of oil has risen over the past year, lower prices are more likely due to oversupply and not a slowing of the economy as depicted in the following graph:



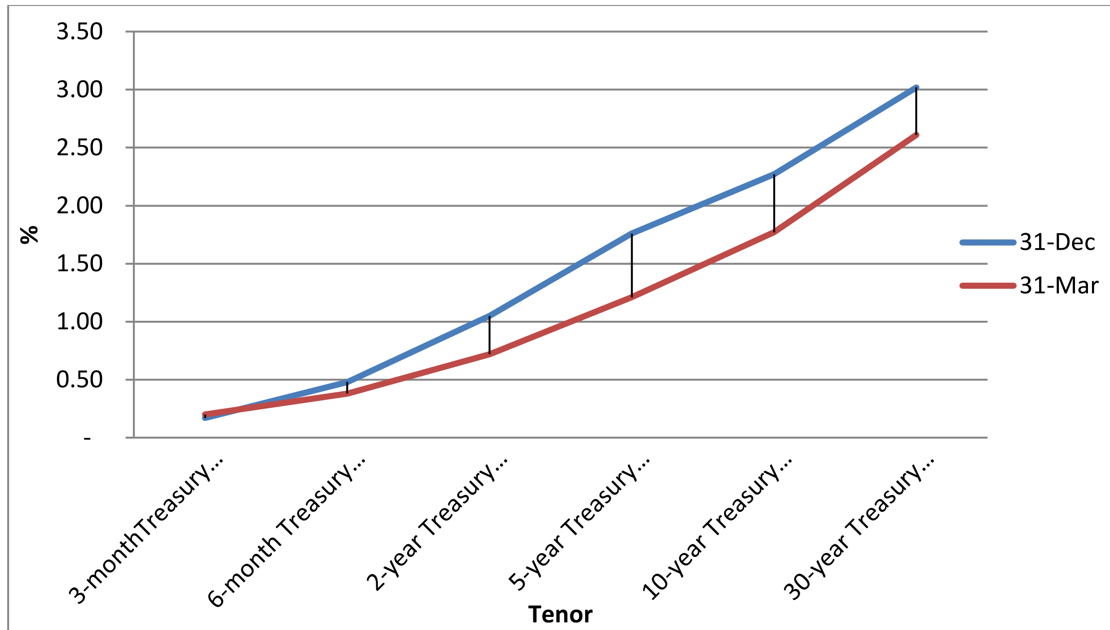
Sources: Bloomberg, Northern Trust, BP, EIA

At their recent meeting, the Federal Reserve pared plans for raising interest rates given the weakness of the global economy and recent financial market volatility. The Fed issued a relatively upbeat assessment of economic conditions and affirmed plans to raise rates gradually. They plan to raise rates only twice this year, instead of the previously planned four times, taking the fed funds rate from 0.375% to 0.875%.

The yield curve flattened slightly and shifted downwards by the end of the 1st quarter, as market expectations of the path of interest rates were revised downward as a result of dovish communications from the Fed. The spread between the 10-year and the 2-year Treasury notes tightened 17 basis points from the previous quarter end to 105bps. The table below shows the yield curve at the end of the fourth quarter 2015 and first quarter 2016.

	31-Dec	31-Mar	Change
3-monthTreasury Bills	0.17	0.20	0.03
6-month Treasury Bills	0.48	0.38	-0.10
2-year Treasury Note	1.05	0.72	-0.33
5-year Treasury Note	1.76	1.21	-0.55
10-year Treasury Note	2.27	1.77	-0.50
30-year Treasury Bond	3.02	2.61	-0.41
10-year vs. 2-year (bps)	122	105	-17.0

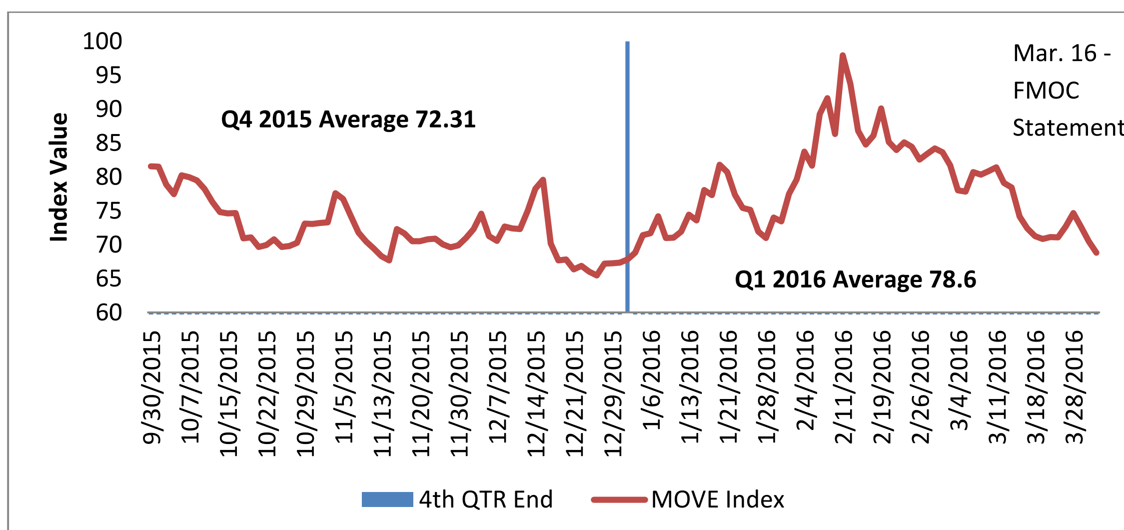
The curve shifted downwards by an average of 31bps. Effectively, the curve returned to levels similar to those seen in the third quarter of last year, albeit with a much flatter slope suggesting some degree of economic deterioration. The shift was concentrated in the intermediate-to-longer end of the curve, as suggested by the flattening. The 2 year note traded below 1% again at the end of the quarter (0.72%). The retreat in yields is consistent with the curve returning to levels last seen in the third quarter of the previous year. This is likely due to a diminished expectation of further policy tightening and a declining economic outlook. The graph below illustrates the move in yields from fourth quarter 2015 to first quarter 2016.



Select US Treasury Yields Source: Bloomberg

The first quarter was characterized by increased volatility, as market participants weigh a more dovish than expected Fed against a more delicate economic outlook. While employment has been strong, with payrolls growing an estimated 200 thousand per month, expectations for first quarter GDP have been lowered. The uncertainty surrounding the Fed's new path for normalization and the stability of the economic outlook have translated into increased volatility in financial markets. The graph below illustrates the apparent change in regime, as the average value over the quarter increased by about 9% relative to the previous quarter. The value reached a local peak of 97.9 towards the beginning of February, the highest level in over a year.

The MOVE Index stands for the Merrill Lynch Options Volatility Estimate index. It is a yield curve weighted index of the implied volatility on the 1-month Treasury options. This indicator is typically used to as a barometer for volatility in the bond market. It can be thought of as an analog to the VIX index used in the equity market.



Merrill Lynch Options Volatility Estimate (MOVE Index) Source: Bloomberg

The volatile environment may persist in the coming quarter if economic data surprises to the downside or the Fed reverses course. Expectations for policy tightening remain significantly low, as futures markets are only assigning a 3% probability to a hike at the next meeting.

Corporate Securities

Renewed worries over global growth in the Euro zone, China, and emerging markets drove volatility and financial markets during the quarter-including commodity and equity markets. Corporate bond spreads responded to lower valuations during the first half of the quarter before stabilizing and retracing the move as the quarter proceeded. Corporate spreads ended the period virtually unchanged though the sector did provide positive excess returns over comparable U.S. Treasury securities due to the higher income of the sector. For instance, intermediate corporate bonds enjoyed 0.18% outperformance, while shorter maturity corporate bonds had 0.24% of excess return over Treasuries.

Your portfolio remains overweight the corporate sector based on positive economic growth in the U.S. and attractive valuations. Financial fundamentals remain generally supportive but are beginning to show signs of deterioration. For instance, leverage has been increasing since the cyclical trough at the end of 2010 and is up 0.5 times over the past three quarters to 2.23 times. The increase in leverage is due to both an increase in total debt outstanding and a decline in EBITDA in part driven by the energy sector. As long as the economy continues to grow, EBITDA should again grow modestly and, coupled with fewer incentives to grow debt such as elevated market volatility, leverage should stabilize over the coming quarters. In addition, the Cash/Debt ratio is trending lower. The ratio peaked in the middle of 2010 at 21% and stands at 14.6% currently. Historically, however, this ratio remains well above the historical norm. On the positive side, due to the low cost of new debt and improved cash flow since the recession, the EBITDA to Interest Expense ratio remains well above historical levels at 10.8 times. Based on this fundamental back drop, your overweight to the sector is being maintained but with a focus on stable cash flow generating companies and away from more cyclical firms.

Financial companies underperformed the overall corporate market during the first quarter. This performance was driven by worries over the flattening yield curve, exposure to the energy sector, weaker trading/investment banking revenue and global growth concerns. Though operating results are likely to be weaker in the coming quarter, their strong capital position and asset quality should provide support to current valuations. The risk of bank losses due to the energy sector seems exaggerated. For instance, the six largest banks have current funded exposure of $80 billion to the energy sector and $130 billion of unfunded. Based on a stress level price of crude oil of between $30-35/bbl, losses are estimated to reach $17 billion. Though significant, this loss would comprise only 5% of pretax earnings over the next two years. A price of $20/bbl would increase the losses to $60 billion, still just 20% of pretax earnings over the next two years and just 4% of capital. Therefore, your portfolio continues to hold exposure in this sector.

During the past quarter, several new positions were added to your portfolio. Within the healthcare sector, UnitedHealth Group was purchased. The company is a leading provider of health insurance and managed care. They have a strong market presence and are a consistent financial performer. Net Debt/EBITDA was 1.5 times and EBITDA/Interest Expense was 16 times for their last earnings report. In addition, they had a positive earnings surprise. Within the financial sector, Morgan Stanley was purchased after their report of a significant positive earnings surprise. A strong capital position and a significant wealth management group that provides a relatively stable source of cash flow support this investment.

Asset Backed Securities

Interest rates in the first quarter of 2016 delivered an impressive rally, and short duration asset backed securities (“ABS”) kept pace both on a price and income return basis. The total return of short ABS was 0.705% in the first quarter, which was 0.043% greater on an excess return basis versus similar duration U.S. Treasury issues.

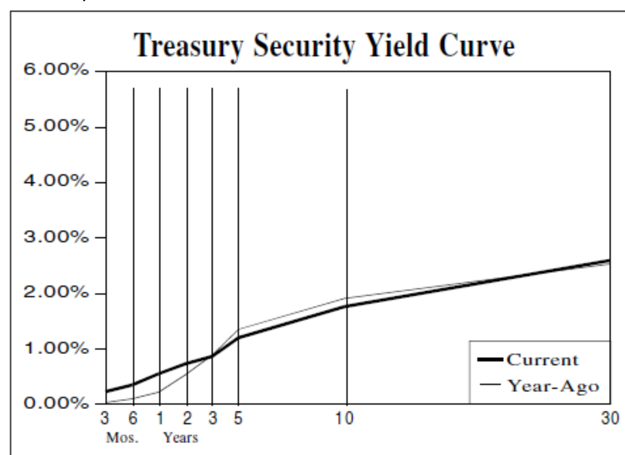
Your portfolio continues to be overweight in this asset class. We are focused on investing in only the highest quality AAA-rated short ABS that are collateralized by credit card receivables, auto loans/leases and equipment loans. We look for prime collateral in all of the securities that we buy and avoid securities that are collateralized by sub-prime collateral. This results in relatively lower yields, but since we invest in this asset class for its liquidity and price stability, choosing the best collateral insures that the securities we purchase remain free from credit crises.

These ABS offer stable cash flows with either locked out prepayment windows or gradual prepayments that do not fluctuate with interest rate movements. We buy both short fixed rate and floating rate securities. This combination leads to stable returns when interest rates rise and fall.

In the first quarter we added the security FORDF 2014-1 A1, collateralized by receivables on Ford cars to your account. This security is rated AAA, has a one year weighted average life, with a price just under 100.0 and a yield of 1.23%. It pays a fixed monthly interest at an annual rate of 1.2% and will pay off its principal in February 2017. This bond is collateralized by solid collateral and is structured to offer stable cash flows for the duration of the time your account holds it.

Selected Yields

	Recent (4/6/16)	*3 Months Ago (1/6/16)*	*Year Ago (4/8/15)*		*Recent (4/6/16)*	*3 Months Ago (1/6/16)*	*Year Ago (4/8/15)*
TAXABLE							
Market Rates				**Mortgage-Backed Securities**			
Discount Rate	1.00	1.00	0.75	GNMA 5.5%	1.75	2.16	1.10
Federal Funds	0.25-0.50	0.25-0.50	0.00-0.25	FHLMC 5.5% (Gold)	1.84	2.22	1.25
Prime Rate	3.50	3.25	3.25	FHLMC 5.5%	1.52	1.94	1.06
30-day CP (A1/P1)	0.38	0.36	0.11	FHLMC ARM	1.83	1.80	1.86
3-month Libor	0.63	0.62	0.27	**Corporate Bonds**			
Bank CD's				Financial (10-year) A	3.24	3.62	3.07
6-month	0.14	0.13	0.16	Industrial (25/30-year) A	3.92	4.24	3.72
1-year	0.22	0.22	0.27	Utility (25/30-year) A	3.98	4.33	3.66
5-year	0.80	0.81	0.87	Utility (25/30-year) Baa/BBB	4.53	4.84	4.08
U.S. Treasury Securities				**Foreign Bonds**			
3-month	0.23	0.20	0.03	Canada	1.21	1.33	1.34
6-month	0.35	0.46	0.10	Germany	0.12	0.50	0.16
1-year	0.55	0.66	0.22	Japan	-0.06	0.25	0.36
5-year	1.20	1.64	1.35	United Kingdom	1.38	1.79	1.58
10-year	1.76	2.17	1.91	**Preferred Stocks**			
10-year (inflation-protected)	0.22	0.70	0.09	Utility A	5.93	6.02	5.91
30-year	2.59	2.94	2.53	Financial BBB	5.67	5.89	5.99
30-year Zero	2.72	3.07	2.62	Financial Adjustable A	5.48	5.48	5.48



Source: Value Line, Inc.

Federal Reserve Data

BANK RESERVES

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

	Recent Levels			Average Levels Over the Last...		
	03/30/16	**03/16/16**	**Change**	**12 Wks.**	**26 Wks.**	**52 Wks.**
Excess Reserves	2317887	2419803	-101916	2317185	2409394	2467364
Borrowed Reserves	28	14	14	55	105	123
Net Free/Borrowed Reserves	2317859	2419789	-101930	2317130	2409289	2467241

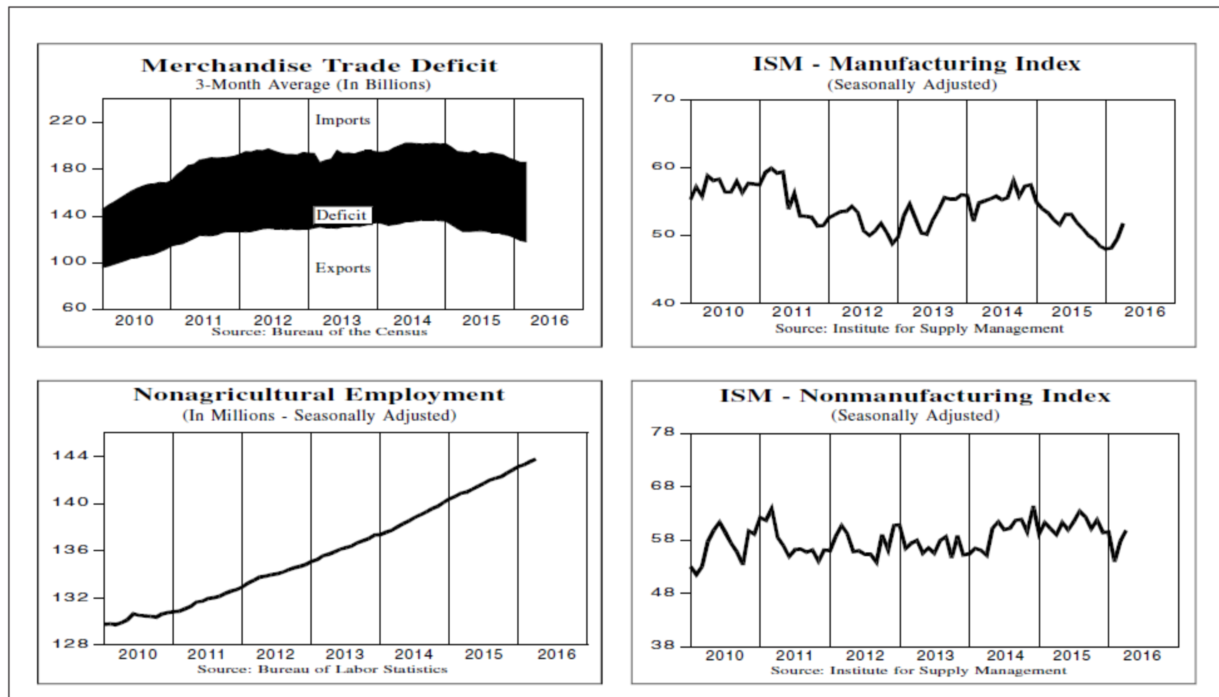
MONEY SUPPLY

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

	Recent Levels			Ann'l Growth Rates Over the Last...		
	03/21/16	**03/14/16**	**Change**	**3 Mos.**	**6 Mos.**	**12 Mos.**
M1 (Currency+demand deposits)	3136.1	3118.4	17.6	8.1%	5.7%	4.8%
M2 (M1+savings+small time deposits)	12571.8	12534.3	37.5	8.2%	6.6%	6.2%

Source: Unites States Federal Reserve Bank

Tracking the Economy



Source: Value Line, Inc.