1st Quarter 2017

We think that economic growth will surprise on the upside and that the consensus outlook is starting to converge with this viewpoint. Fourth quarter GDP was led by solid consumer spending and a pickup in business investment. Real consumer spending (70% of GDP) rose 3.5%. While overall real GDP increased 2.1%, final sales to domestic purchasers (excludes inventories and trade, the two most volatile components of GDP) rose 2.8% which is the fastest since the third quarter of 2015. The labor market has continued to strengthen. Job growth has averaged 218,000 per month over the last 39 months. Average hourly earnings have been rising (up 2.7% year-over-year) and should give the consumer more confidence to spend. Unemployment is at 4.5% which is the lowest level since May 2007. GDP strength is stronger than indicated because a contraction in government spending has been a headwind for the current recovery. Since 2009, real government spending has been reduced by $200 billion. This contrasts with prior recoveries when government spending increased. Government spending moves directly into the economy whereas monetary policy measures do not.

A more expansionary fiscal policy and a pickup in business investment will add to economic growth. A lowering of both corporate and personal tax rates, a simplification of the tax code and the repatriation of overseas corporate profits should prove stimulative. In addition, a 10 year infrastructure program of $1 trillion will be a stimulant for economic expansion by increasing jobs and having the potential to improve lagging productivity. In addition, President Trump has made rebuilding America's national defense a top priority. Areas of focus would include more ships and aircraft, enlarging the Army and modernizing our nuclear arsenal. Business investment should be helped by improved corporate profits, the possibility of immediate tax write-offs across a range of capital expenditures, a multiyear infrastructure program and improved business confidence. The Federal Reserve's program to normalize interest rates in a gradual manner with small increments should continue to encourage a low interest rate environment which should be conducive to financing capital expenditures.

From a policy point of view, there is no question there will be a host of pro-business policies that will have a positive impact, both short and medium term, on business activity and profits. Corporate tax reform could easily add 5%-8% to corporate profits assuming the lower end of the tax reduction proposals. Deregulation should increase the overall level of corporate activity and profitability particularly in the energy and financial services industries. The energy sector is in the middle of a significant renaissance in which the U.S. is becoming independent of foreign energy sources. Our potential supply of natural gas, the most abundant clean energy source, could lower consumer and industrial energy costs and at the same time be a cleaner source of fuel. Also, the variety of liquids that are produced along with oil and gas are a valuable source of exports given the lower cost of extraction versus the rest of the world. Regulations have been a significant impediment to our realizing the full value of these domestic assets. This will begin to change. One major uncertainty is the specifics regarding the policy proposals and their timing.

Trump's growth rate target of 4% versus historic growth of approximately 2% since 2008 faces major impediments. Long-term growth potential is determined by labor force growth and productivity growth. Demographic trends and business investment are critical variables to growth potential. Labor force growth has slowed significantly since 2000. The aging of the U.S. population and discouraged workers not entering the labor force (reflecting slow growth and up until recently subpar wage growth) have negatively impacted the labor force growth. Immigration can serve as a growth avenue for the labor force. However, policies from Washington lean to restricting immigration. The 1990s technology revolution was far reaching and transformed the business sector thereby significantly enhancing productivity. However, productivity growth has slowed significantly since 2008. Reasons cited for the slowdown include the demographic limitations that hinder demand and diminish productive investment.

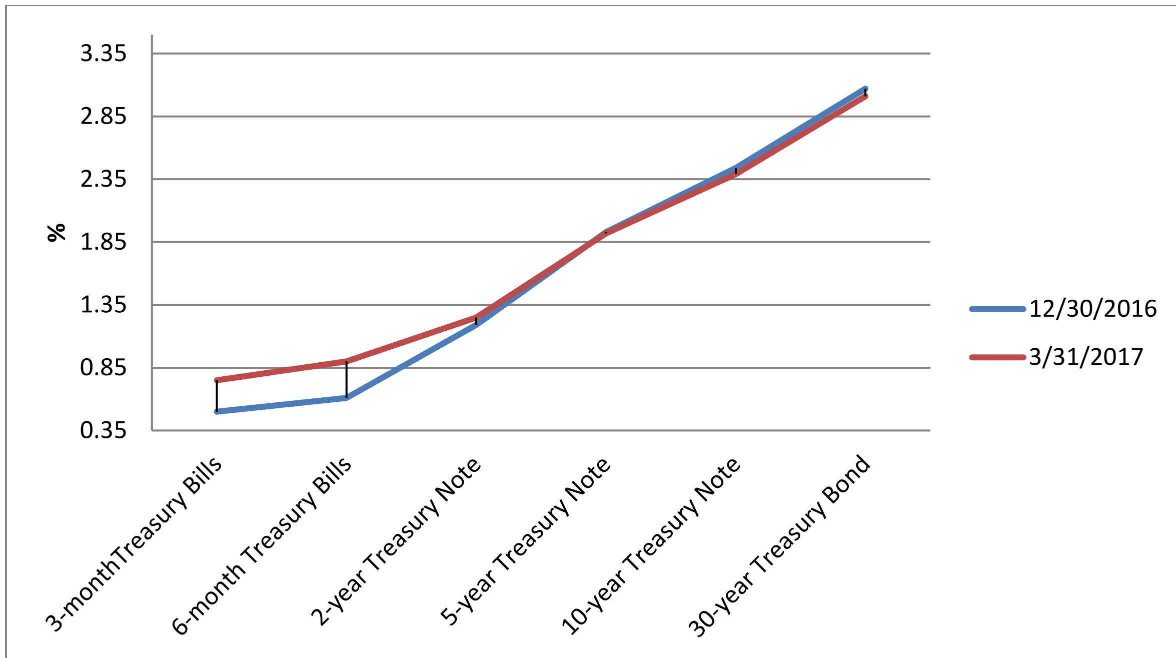
Inflation expectations as anticipated have begun to increase. The relationship between current and natural unemployment rates has narrowed considerably in recent quarters. During previous recoveries, this has led to steadily rising wages which leads to higher price levels across the economy. We are seeing evidence of this now (outlined in the charts below). The concern is that wage growth tends to be closely associated with services inflation which represents the largest percentage of U.S. consumption. The Federal Reserve's preferred measure of inflation (core PCE which excludes food and fuel) has risen to 1.8% over the past year versus their 2% inflation target. This level matches the highest levels touched since 2012.

We think the U.S. dollar will strengthen vis-à-vis other currencies. This is a reflection of a gradually tightening monetary policy (vs. a more expansive monetary policy for most other developed economies), greater fiscal stimulus (vs. continued fiscal austerity in other economies) and relatively stronger economic growth. We do not yet know the specifics of Trump's trade policies and this is an uncertainty for the USD outlook. Just because the U.S. runs a trade deficit doesn't necessarily mean it should penalize imports or run a trade surplus. Imports are important to prosperity both as a component for exports and as affordable goods for consumers. Imports enhance the standard of living. Policy should focus on economic growth and not necessarily the trade balance. What matters in the trade deficit is not whether it is rising or falling but why. Buying more imported consumer goods because you are making money is generally a good thing not a bad thing. If the deficit falls because sales of American goods and services boom, that will be good news. If it falls because U.S. spending collapses, it will be a bad thing. If it falls because of commodity price swings, it depends on which commodities and where they are produced.

At seven years and counting, this cycle has been one of the longest in recent history which leads historians and statisticians to wonder if a recession isn't just around the corner. Our position is that while the length of the recovery is stretched in terms of age, the character of the recovery is different and we can identify none of the typical excesses associated with the end of an economic cycle. Labor is still plentiful and while wages are increasing, a large untapped labor pool still exists. Industrial capacity remains slack and both corporate and consumer borrowing levels were quite low which is atypical at the end if a cycle. Finally, we also observe that the accommodative central bank policy outside the U.S. signaled that perhaps we were beginning a period of a global synchronized recovery. We conclude that there is a distinct probability that this apparently long in the tooth cycle can continue.

The yield curve flattened slightly during the first quarter, with short rates experiencing a rise in conjunction with Fed policy action. Longer rates finished the quarter mostly unchanged and the spread between 2 and 10 year rates dropped by 11 basis points. The table and graph below outlines the yield curve at the beginning and end of the first quarter.

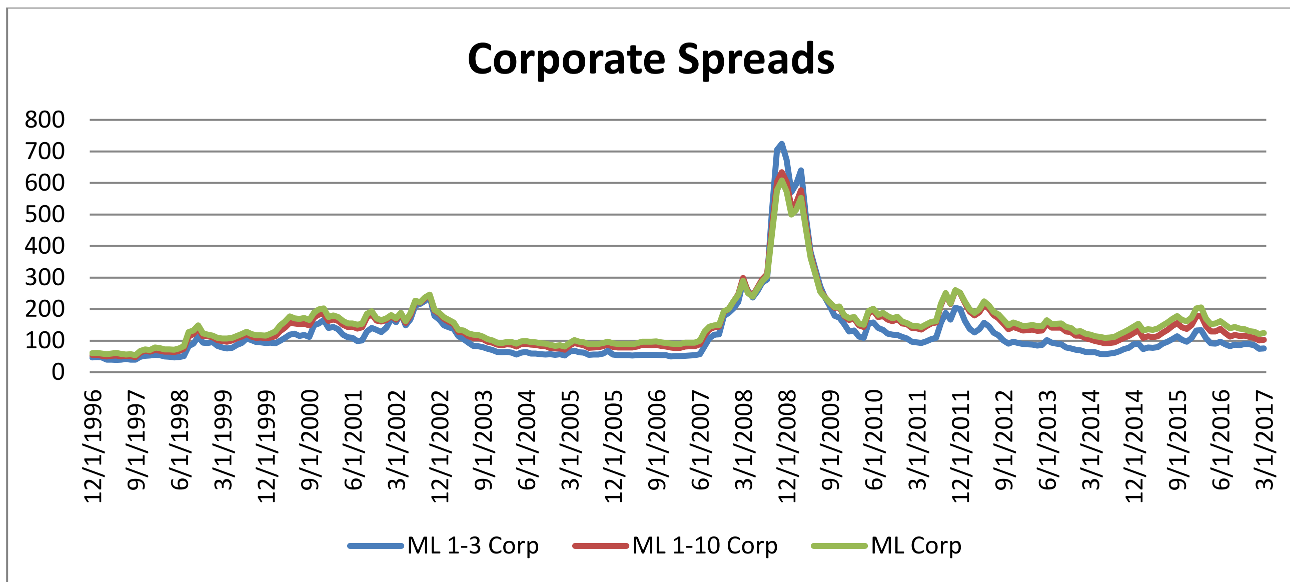
	31-Dec	31-Mar	Change
3-monthTreasury Bills	0.50	0.75	0.25
6-month Treasury Bills	0.61	0.90	0.29
2-year Treasury Note	1.19	1.25	0.06
5-year Treasury Note	1.93	1.92	-0.01
10-year Treasury Note	2.44	2.39	-0.05
30-year Treasury Bond	3.07	3.01	-0.06
10-year vs. 2-year	125	114	-11



Select US Treasury Yields Source: Bloomberg

Corporate Securities

Investor optimism over global growth and the ongoing search for incremental investment income resulted in a continuation of recent spread compression. Shorter maturity corporate bonds tightened by 0.13% versus comparable maturity U.S. Treasuries as measured by the Merrill Lynch 1-3 Corporate Index during the first quarter. Intermediate corporate bonds tightened by 0.09% based on the Merrill Lynch 1-10 Corporate Index during the same period. The move in spreads when combined with the higher income of the sector resulted in excess returns over Treasury bonds of 0.50% and 0.67% respectively for the two indices. Our overweight to the sector benefited overall return during the quarter.



Based on current spreads, quantitative measurements, and financial fundamentals, the corporate bond market is fairly valued assuming a continuing economic expansion. The current option adjusted spreads of Merrill Lynch Corporate Indices Index remain above the tight spreads of the last three economic expansions as shown in the table below. For instance, the 0.75% option adjusted spread for 1-3 year bonds in the Merrill Lynch Index as of quarter end versus the tightest spread since 12/31/1996 of 0.39% (month-end 5/31/1997).

Historical Corporate Spreads
12/31/1996-3/31/2017

	ML 1-3 Corporate Index	ML 1-10 Corporate Index	ML Corporate Index
LAST	75	103	124
Median	94	131	146
Minimum	39	48	54
Minimum 1990s	39	48	54
Minimum 2000s	50	71	81
Minimum 2010s	57	92	109

Current spreads, however, are trading through the median spread since 12/31/1996 and, therefore, provide only limited upside beyond the incremental income available in the sector as compared to U.S. Treasury bonds. The BAML Lighthouse Quantitative model (which incorporates equity prices, equity volatility and the level of debt to calculate fair value of the individual company's debt and compares this risk spread to the company's CDS to provide an excess spread estimate) has been relatively stable since year-end at 0.20% for U.S. corporate issuers. This level is at the low end of fair value. Corporate financial fundamentals are mixed. 74% of S&P 500 companies reported earnings that were in line with or exceeded expectations, which is within normal results and point to a stable credit environment. Interest coverage remains near prior cycle peaks at 10.3x but down from its high of above 12x during this economic expansion. The weakening coverage is driven by a rising level of corporate debt while the growth rate in EBITDA has not keep pace. The rising debt levels are most pronounced in the corporate sector gross leverage (Gross Debt/EBITDA), which stands at 2.3x (interest coverage and gross leverage are based on Morgan Stanley analyses). Similar leverage has historically only been seen during recessions. Though not an immediate concern, an economic slowdown would likely cause deterioration in corporate cash flow and place pressure on the credit quality of the sector. Therefore, our portfolios remain overweight but our focus is on less economically sensitive companies with track records of stable cash flow generation and financial flexibility.

During the first quarter, PACCAR and Anheuser Busch InBev were sold due to significant negative earnings surprises. A number of new issues were added to our portfolios. Several examples include, Abbott Laboratories, a diversified pharmaceutical company with diagnostics, medical devices, nutritional and branded pharmaceuticals. On January 4th, the Company completed the purchase of St. Jude Medical, a medical device leader. They had 10.4x EBITDA to Interest Coverage and a positive earnings surprise for their last earnings report. With the addition of their recent acquisition, excess cash flow is expected to reduce debt levels over the near term. Aetna, Inc. was also purchased during the quarter. Aetna is a healthcare benefits company serving 46.7 million people. On February 4th, the Company terminated its proposed acquisition of Humana due to anti-trust concerns. Subsequently, debt originally issued to finance the acquisition was repurchased. During the prior quarter, the Company had EBITDA/ Interest Expense ratio of 8.9x and a Net Debt (Gross Debt minus Cash) to EBITDA of just 0.36x. With the recent repayment of over $10 billion of debt, their leverage has been significantly reduced. In addition, Aetna had a significant positive earnings surprise. Amazon.com the leading internet retailer was added to our portfolios. The Company has strong and growing cash flow, providing both impressive EBITDA/Interest Expense coverage of over 25x and a cash position that fully offsets their debt. Amazon had a significant positive earnings surprise for their 2016 earnings.

Asset Backed Securities

Short ABS is continuing last year's solid performance into 2017. Despite a backup in short-term interest rates during the first quarter, short ABS generated 0.468% of total return, with 0.319% excess return relative to same duration U.S. Treasury issues. With interest rate uncertainty occupying the markets, the combination of stable prepays, low delinquencies and AAA-rating afford short ABS solid returns for another quarter.

Our portfolios remain over-weighted in ABS. We continue to invest in only the highest quality AAA rated ABS, collateralized by credit card receivables, auto loans/leases and equipment loans. We invest in prime auto loan securities, which offer lower yields, but significantly better credit stability than subprime loans. The short ABS securities in our portfolios continue to post low delinquency rates each month.

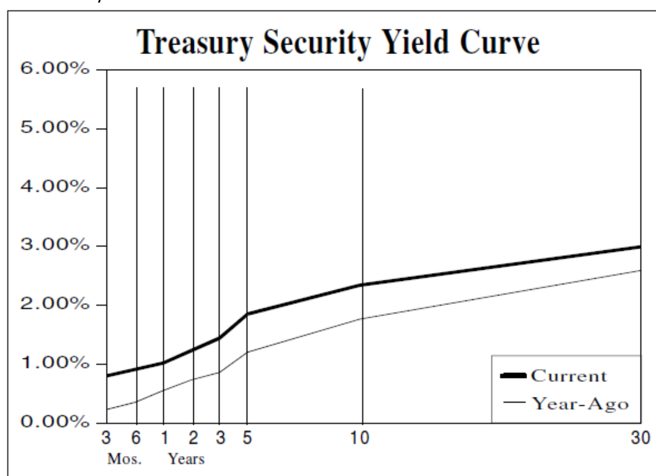
In recent months headlines have pointed to the increase in delinquencies within the auto loan market. Specifically, these delinquencies are permeating through the subprime auto market. While subprime auto loan delinquencies in general have

been increasing dramatically over the last several years, this is strongly driven by deep subprime loans. Since 2010, deep subprime auto loan origination has increased from 5% to 32% of the subprime market. As lenders lower their standards to borrowers with severely lower FICO scores (550 or below), delinquencies naturally rise.

In complete contrast to the above, our portfolios auto loans are generated by prime issuers with subprime collateral encompassing 0%–5% of their deals. Average FICO scores of deals we invest in are 700 at a minimum, and tend to average closer to 750 or greater. Given the high quality of the collateral supporting these loans, the delinquency rates we observe are well below 1% of the deals, with subordination levels typically ranging 15%-20% of the deal. These are well structured securities, with solid collateral, that offer a reasonable yield pickup to Treasuries, while maintaining a AAA rating. Despite the tighter spreads, these securities continue to add value to our portfolios on the short end of the yield curve.

Selected Yields

	Recent (4/16/17)	*3 Months Ago (1/4/17)*	*Year Ago (4/6/17)*
TAXABLE			
Market Rates			
Discount Rate	1.50	1.25	1.00
Federal Funds	0.75-1.00	0.50-0.75	0.25-0.50
Prime Rate	4.00	3.75	3.50
30-day CP (A1/P1)	0.73	0.66	0.38
3-month Libor	1.15	1.00	0.63
U.S. Treasury Securities			
3-month	0.80	0.53	0.23
6-month	0.91	0.62	0.35
1-year	1.02	0.86	0.55
5-year	1.85	1.93	1.20
10-year	2.34	2.44	1.76
10-year (inflation-protected)	0.33	0.44	0.22
30-year	2.99	3.04	2.59
30-year Zero	3.09	3.13	2.72



Source: Value Line, Inc.

	Recent (4/16/17)	*3 Months Ago (1/4/17)*	*Year Ago (4/6/17)*
Mortgage-Backed Securities			
GNMA 5.5%	2.37	1.99	1.75
FHLMC 5.5% (Gold)	2.42	2.43	1.84
FHLMC 5.5%	2.36	2.27	1.52
FHLMC ARM	1.75	1.76	1.83
Corporate Bonds			
Financial (10-year) A	3.50	3.59	3.24
Industrial (25/30-year) A	4.10	4.11	3.92
Utility (25/30-year) A	4.19	4.19	3.98
Utility (25/30-year) Baa/BBB	4.57	4.60	4.53
Foreign Bonds			
Canada	1.56	1.71	1.21
Germany	0.26	0.28	0.12
Japan	0.07	0.07	-0.06
United Kingdom	1.09	1.34	1.38
Preferred Stocks			
Utility A	5.76	5.96	5.93
Financial A	5.78	5.99	5.67
Financial Adjustable A	5.47	5.48	5.48

Federal Reserve Data

BANK RESERVES

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

	Recent Levels			Average Levels Over the Last...		
	03/29/17	**03/15/17**	**Change**	**12 Wks.**	**26 Wks.**	**52 Wks.**
Excess Reserves	2196433	2249709	-53276	2075108	2044633	2153992
Borrowed Reserves	10	8	2	19	57	93
Net Free/Borrowed Reserves	2196423	2249701	-53278	2075089	2044576	2153898

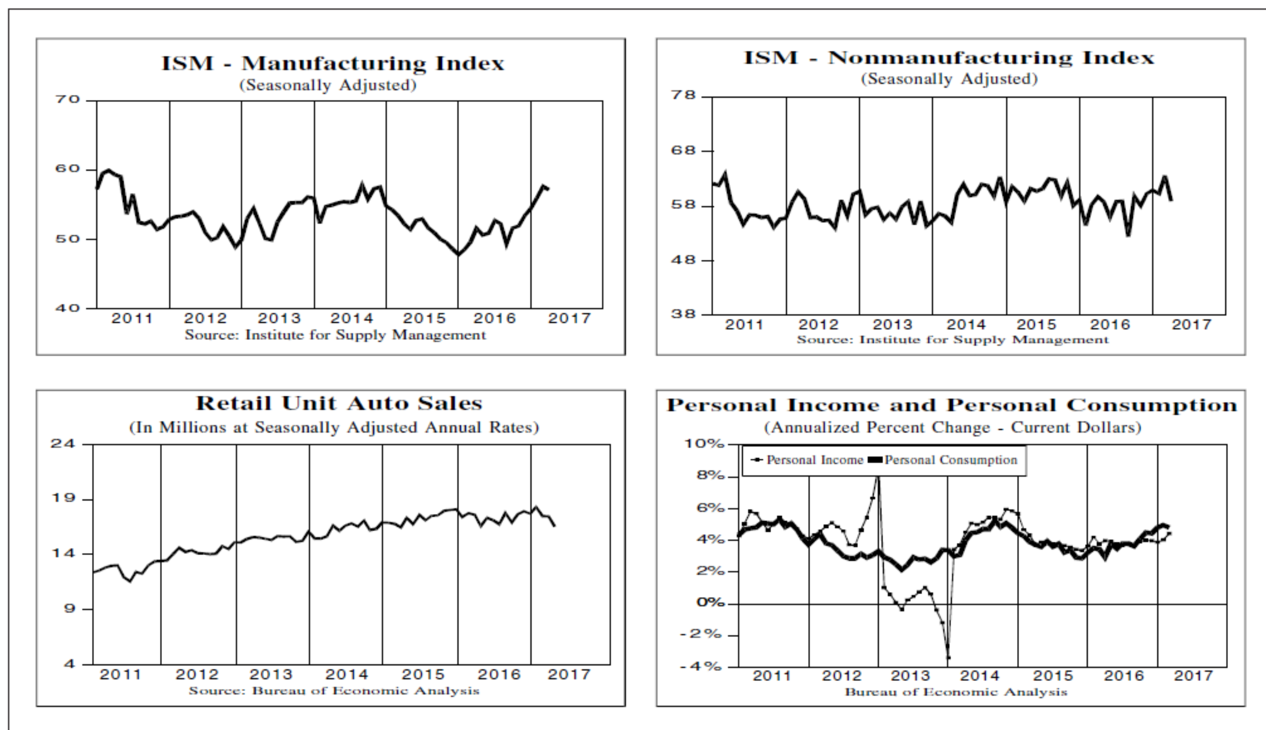
MONEY SUPPLY

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

	Recent Levels			Ann'l Growth Rates Over the Last...		
	03/20/17	**03/13/17**	**Change**	**3 Mos.**	**6 Mos.**	**12 Mos.**
M1 (Currency+demand deposits)	3417.9	3406.7	11.2	10.2%	5.9%	8.6%
M2 (M1+savings+small time deposits)	13405.4	13402.9	2.5	7.1%	6.0%	6.5%

Source: Unites States Federal Reserve Bank

Tracking the Economy



Source: Value Line, Inc.