VANDERBILT Ave.
ASSET MANAGEMENT

3rd Quarter 2016

The labor market has remained strong and continues to be a source of strength for consumer spending. Job growth has averaged 225,000 per month over the last 32 months. In addition, private sector growth gains are more than double those of the previous cycle. Wages have recently begun to climb with the 12-month increase since September up 2.6%. This has kept most workers ahead of inflation. Unemployment has held steady at or near 5.0% since the beginning of the year. The unemployment rate has held steady even though employers have added 180,000 jobs a month this year. That means potential workers are coming off the sidelines and preventing the labor market from overheating.

The strengthening labor market has allowed the consumer sector to be the leading growth component of real GDP. Unemployment, which was 10% after the recession, is 5% while hiring and pay gains have been healthier lately. Improved household balance sheets also have helped. Recent statistics show income gaps are narrowing, wages are rising and poverty is easing. This all argues for a stronger consumer sector. Indeed, household spending was the bright spot for second quarter real GDP rising at an annualized rate of 4.3%. Personal consumption accounts for approximately two-thirds of economic output.

Federal Reserve monetary policy has and will continue to foster a low interest rate environment. Interest rate normalization will be a pattern of small interest rate increments over a gradual period of time. The Fed has said that policy will be data dependent and, with slower than expected growth in both the domestic and foreign economies, there were fewer and smaller interest rate increases in 2016 than originally forecast by the Fed. While central banks have various tools at their disposal, there is only so much they can accomplish by themselves. Various central banks have made the case for greater fiscal stimulus in contrast to efforts by governments to cut their deficits that ballooned after the recession.

Real U.S. government spending has been reduced by $200 billion since 2009. This contrasts with prior recoveries when government spending increased in the hundreds of billions of dollars. However, fiscal policy is about to change. Fiscal policy across the developed world is collectively turning more stimulative for the first time since the end of the recession. With infrastructure maintenance lacking and interest rates low, the U.S. need for infrastructure is so great that it could increase its debt and still come out ahead. The U.S. investment in infrastructure would increase the productivity and efficiency of the economy. Infrastructure investment would invigorate the economy and raise overall living standards. Both Presidential candidates support a multi-year infrastructure program adding to optimism that some sort of big public works push is coming. Government spending moves directly into the economy whereas monetary policy measures do not.

While the length of the current economic expansion exceeds the duration of the average recovery, it is important to recognize there are no excesses that would argue the current expansion will imminently end. The chart below outlines several variables for the current cycle vis-à-vis previous cycles:

	Wages	Housing/GDP	Capex/Cash Flow	10-Yr Yield
1960s	**4.1%**	**5.0%**	**92%**	**4.6%**
1980s	**3.0%**	**5.5%**	**91%**	**9.1%**
1990s	**3.5%**	**5.0%**	**90%**	**6.6%**
Current	**2.6%**	**3.8%**	**83%**	**1.7%**

The year-over-year wage growth is lower, the ratio of housing/GDP is lower with the potential to go higher, business spending (capex/cash flow ratio) has room to grow and the 10-year U.S. Treasury yield is lower than previous cycles.

There are concerns on the horizon:

- **Real estate**: Conditions are more alarming today than during 2001-07 real estate bubble when prices rose 81% from trough-to-peak. The current environment has seen a 95% surge in commercial real estate prices since the trough in late 2009.

- **Productivity**: There has been a significant slowing in growth of this important metric. Productivity is a key ingredient in determining growth in wages, prices and overall economic output. This in turn has played a role in subdued capital investment and expenditures by the business sector.

- **Money market fund ramifications**: Trends in money market funds have caused increases in interest rates for corporate borrowers. Institutional prime funds are investing less in the commercial paper market as investors migrate to pure government money market funds to avoid restrictions implemented by the SEC that take effect in October. This is reflected in the 3-month Libor rate increasing from 0.33% a year ago to 0.87% currently which will have a direct impact upon floating rate notes that are Libor based.

- **Potential inflation**: The Fed's preferred measure of inflation is Personal Consumption Expenditures (PCE) whose core (excludes food and fuel) index is up 1.7% year-over-year versus the 2% target objective of the Fed. However, other measures of inflation are higher. Core PCE has a 20% weighting in healthcare versus 7% for the CPI. The CPI's gauge of medical costs has surged in recent months with an annualized growth rate of 4.9% in August. However, the increase in healthcare for the PCE has been hovering around 1% so far this year. The CPI tracks consumer out-of-pocket expenses while the PCE Index is heavily influenced by payments from government programs (Medicare and Medicaid) which have been held in check by law. Greater healthcare inflation will ultimately flow through to and be reflected in the PCE.

The yield curve flattened very modestly and shifted upwards by the end of the third-quarter. The spread between the 10-year and the 2-year U.S. Treasury note tightened 6 basis points, from the previous quarter end, to 83bps. The table below shows the yield curve at the end of the second and the third quarter of 2016.

	30-Jun	30-Sept	Change
3-monthTreasury Bills	0.26	0.27	0.01
6-month Treasury Bills	0.35	0.43	0.08
2-year Treasury Note	0.58	0.76	0.18
5-year Treasury Note	1.00	1.15	0.15
10-year Treasury Note	1.47	1.59	0.12
30-year Treasury Bond	2.61	2.29	0.03
10-year vs. 2-year (bps)	89	83	-6

The curve shifted upwards by an average of 10 basis points, as expectations for future rate hikes have strengthened. Relative to the third-quarter end of 2015, the curve has flattened significantly. The spread between the 10-year and 2-year notes dropped from 142 basis points in September 2015 to 83 basis points, the flattening was driven by rising short rates, which moved by an average of 24 basis points, and declining longer rates, which fell by 41basis points.

Market expectations of tightening monetary policy have shifted as Fed officials have revealed conflicting statements regarding the future path of interest rates. Nonetheless, expectations remain stable for the fourth- quarter, as futures markets have assigned a 69% probability of at least one hike by year-end.

Corporate Securities

Corporate bond spreads continued to tighten versus U.S. Treasury securities resulting in strong relative performance during the past quarter. Option adjusted spreads on shorter corporate bonds moved from 0.96% to 0.88% during the quarter.

Intermediate bonds benefited as the OAS fell to 1.18% from 1.35%. Year-to-date, corporate bonds have easily outperformed comparable U.S. Treasuries by 1.18% for shorter corporate bonds and 2.33% for Intermediate bonds as measured by the Merrill Lynch 1-3 Year Corporate Index and the Merrill Lynch 1-10 Year Corporate Index respectively. Our portfolios' overweight to the sector benefited performance during the quarter and year-to-date.

The sector's strong performance was driven by several factors. Corporate buying by foreign investors was robust during the quarter as higher yields, wider spreads and strong relative economic growth in the U.S. compared to the rest of developed world made U.S. bonds attractive. As of the end of the second quarter, foreign ownership had increased to over 27% of total corporate bonds and other non-government debt, which is up from approximately 24% in 2012. The beginning of the European Central Bank's corporate sector purchase program in June of around Euro 7.5 billion per month is likely to support European corporate spreads at relatively compressed levels and force yield buyers in Europe into the U.S. dollar denominated market. Partially offsetting the yield advantage of U.S. bonds is the rising cost of hedging the currency. Depending on the type hedge used by the buyer, either a cross-currency swap or a three-month rolling FX swap, investments in U.S. corporate bonds still provide 0.40% or 0.70% yield pickup for a European purchaser depending on the hedge utilized. A Japanese investor would enjoy a 0.40% or 0.90% fully hedged yield increase. (estimates provided by Barclays Research).

In addition to this demand technical for corporate bonds, financial fundamentals remain relatively supportive of investments in the sector though clearly weakening compared to prior quarters. Almost 80% of companies reported earnings that exceeded expectations during the second quarter. This number is on the high side historically. The sector was trading over 0.30% cheap during the quarter based on the BAML Lighthouse Quantitative model. This level is on the wider end of the range. By the end of the quarter, however, the model projected that the investment grade market had declined to 0.21% of excess spread due entirely to the move tighter of sector spreads as discussed above. The current level is now fairly valued. With regard to the financial fundamentals, corporate total debt has grown steadily since the middle of 2012, at approximately 10% year over year. EBITDA (earnings before interest, taxes, depreciation & amortization) growth has been less robust. As a result leverage, defined as gross debt/EBITDA, has reached 2.44 times. This level has never been reached over the period beginning in 1992 through today. The EBITDA to interest expense ratio has fallen from a high of over 11.5 times at its peak in the fourth quarter of 2014 to a current 9.9 times. The coverage is near the peak of the prior cycle in 2007 and significantly above the normal range. The recent decline is a result of both the increase in the amount of outstanding debt and the recent weakness in EBITDA growth. EBITDA is down 4% year over year in the latest quarter and up only 1.6% for the period if one excludes energy companies. The size of cash on balance sheets remains large but its growth lags the growth in debt. Cash to debt is 13.8%, which remains above historical levels since prior to the last recession. The current environment support corporate valuations as investors search for yield. Therefore, we remain overweight to the sector but have become more cautious in our security selection.

During the past quarter, several new issuers were added to our portfolios'. The key characteristics of the investments were stable cash flow generating capability and less economically sensitive industries. Stryker (Baa1/A) manufactures specialty surgical and medical products including implants, endoscopic and digital imaging. During the first quarter the company purchased Sage Products, Physio Control International and a subsidiary of Synergetics at a total cost of over $4.2 billion. $3.5 billion of debt has been issued to finance the purchases. Their financial fundamentals are solid with net debt/EBITDA at 1.59 times, interest coverage of just under 12 times and a positive earnings surprise for their second quarter results. General Dynamics (A2/A+) was also purchased during the quarter. This defense contractor has low leverage at just 0.33 times, interest coverage of over 40 times and a significant positive earnings surprise. A final illustration is Kroger Company (Baa1/BBB). The supermarket company has low leverage for its rating at 2.10 times and interest coverage of 11.8 times for the past 12 months. Second quarter earnings exceeded market expectations.

Asset Backed Securities

In the third quarter, short ABS reported a total return of 0.42%, with most of this return, 0.41%, coming from excess spread over U.S. Treasury issues. Short ABS has been in limited supply on many dealers' offering sheets and trading at higher prices when available. This strong performance can be attributed to stable prepayments accompanied with low delinquency rates.

Our portfolios' have an overweight allocation to 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 sub-prime loans. The short ABS securities in our portfolios' continue to post low delinquency rates each month.

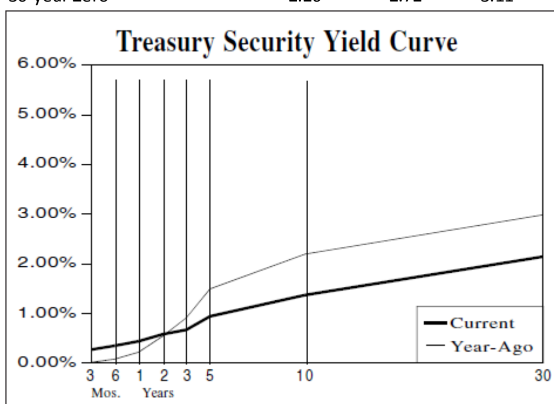
Additionally, the ABS in our portfolios' offer stable cash flows with either locked out prepayment windows or gradual prepayments that do not fluctuate with interest rate movements. We buy both short fixed rate and floating rate securities. This combination leads to stable returns when interest rates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

In the third quarter, we added several ABS, including credit card and auto, to our portfolios'. We purchased a 2.5 year average life floating rate credit card security: CHAIT 2014-A5 A5, backed by Chase bank credit card receivables. This security is exhibiting extremely stable monthly prepayments and very low 60+ day delinquencies rates of 0.80%. We also invested in a 1.8 year average life fixed rate security: GMALT 2016-2 A3, backed by leases on General Motors vehicles. This security has 22% in credit support and only 0.39% in 60+ day delinquencies.

This sector has exhibited strong relative performance and spreads are approaching levels where we would look to unwind some positions. Once these spreads meet our target levels, we would sell some of the shorter ABS positions and buy Agency securities.

Selected Yields

	Recent (7/06/16)	*3 Months Ago (4/06/16)*	*Year Ago (7/08/15)*		*Recent (7/06/16)*	*3 Months Ago (4/06/16)*	*Year Ago (7/08/15)*
TAXABLE							
Market Rates				**Mortgage-Backed Securities**			
Discount Rate	1.00	1.00	0.75	GNMA 5.5%	1.57	1.75	1.63
Federal Funds	0.25-0.50	0.25-0.50	0.00-0.25	FHLMC 5.5% (Gold)	1.68	1.84	1.88
Prime Rate	3.50	3.50	3.25	FHLMC 5.5%	1.33	1.52	1.64
30-day CP (A1/P1)	0.46	0.38	0.13	FHLMC ARM	1.85	1.83	1.65
3-month Libor	0.66	0.63	0.28	**Corporate Bonds**			
Bank CD's				Financial (10-year) A	2.83	3.24	3.62
6-month	0.14	0.14	0.17	Industrial (25/30-year) A	3.49	3.92	4.28
1-year	0.23	0.22	0.27	Utility (25/30-year) A	3.56	3.98	4.30
5-year	0.79	0.80	0.86	Utility (25/30-year) Baa/BBB	4.01	4.53	4.69
U.S. Treasury Securities				**Foreign Bonds**			
3-month	0.27	0.23	0.01	Canada	0.97	1.21	1.52
6-month	0.35	0.35	0.08	Germany	-0.18	0.12	0.67
1-year	0.44	0.55	0.22	Japan	-0.27	-0.06	0.42
5-year	0.94	1.20	1.49	United Kingdom	0.77	1.38	1.89
10-year	1.37	1.76	2.19	**Preferred Stocks**			
10-year (inflation-protected)	-0.03	0.22	0.37	Utility A	5.88	5.93	5.97
30-year	2.14	2.59	2.98	Financial A	5.77	6.16	6.17
30-year Zero	2.26	2.72	3.11	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...		
	06/22/16	**06/08/16**	**Change**	**12 Wks.**	**26 Wks.**	**52 Wks.**
Excess Reserves	2307518	2309182	-1664	2308899	2317880	2414601
Borrowed Reserves	126	89	37	74	69	126
Net Free/Borrowed Reserves	2307392	2309093	-1701	2308825	2317812	2414475

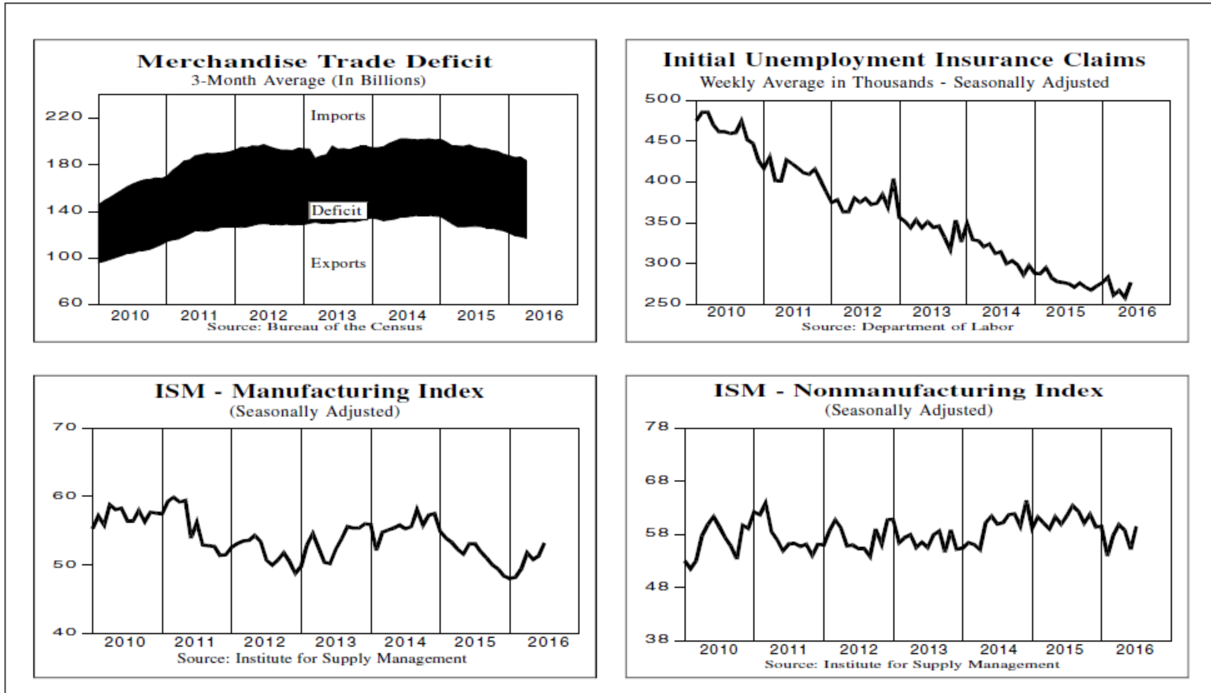
MONEY SUPPLY

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

	Recent Levels			Ann'l Growth Rates Over the Last...		
	06/20/16	**06/13/16**	**Change**	**3 Mos.**	**6 Mos.**	**12 Mos.**
M1 (Currency+demand deposits)	3233.8	3231.6	2.2	12.7%	10.2%	7.8%
M2 (M1+savings+small time deposits)	12816.7	12798.6	18.1	8.0%	7.8%	6.9%

Source: Unites States Federal Reserve Bank

Tracking the Economy



Source: Value Line, Inc.