Carret Credit Insight

Reverse QE?

Portfolio Managers

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Firm AUM

$2.4 Billion

As the 1st quarter came to a conclusion, we started to hear some chatter from the Federal Reserve Board (FED) about normalizing their balance sheet. Recall that the 1st round of Quantitative Easing (QE) was initiated in November of 2008, QE2 was announced in November of 2010, and QE3 was launched in September of 2012. At the conclusion of the third round in October of 2014, the FED's balance sheet had ballooned from $750 million in assets to $4.5 trillion. The impact of the QE programs was lower interest rates. The FED purchased bonds, thus increasing demand and lowering market supply, which in turn had the effect of increasing bond prices and decreasing rates. The FED's aggressive QE actions were coupled with an equally aggressive decline in the FED Funds Rate to 0.0%.

Since December of 2015, the FED has hiked the FED Funds Rate three times to a range of 0.75% to 1.0%; however, the FED has left the balance sheet intact. In fact, via Operation Twist, the FED has kept the balance sheet stable by reinvesting maturing bonds. During this fifteen month time frame, intermediate to long rates have not moved in tandem with short rates – the 10 Yr U.S. Treasury bond ended 2015 at 2.27% and as of mid April, yielded 2.20% (see chart on page 2). The FED continues to suggest two additional rate hikes this year. We find that a stretch, especially given the balance sheet normalization chatter - the markets seem to agree. So what will the FED do? Raise the FED Funds Rate, normalize the FED's balance sheet or both… our vote - BOTH!

As the economy has continued to expand at a tepid pace, we believe the FED is quietly becoming more concerned about normalizing monetary policy. They appear to be interested in shrinking the balance sheet through tapering and increasing the FED Funds rate to 1.0%+. This concern rises from the anticipation of needing both of these economic stimulus weapons for the next recession. We are in the midst of one of the longest running economic expansion on record – which will not last forever. The economy is on strong enough footing to SLOWLY implement this normalization process.

Key Interest Rates	3.31.17	12.31.16	12.31.15
Prime Rate	4.00%	3.75%	3.50%
Fed Funds Rate	0.75% – 1.00%	0.50% – 0.75%	0.25% – 0.50%
3 Month U.S. T-Bill	0.75%	0.50%	0.18%
5 Yr U.S. Treasury Note	1.92%	1.92%	1.76%
10 Yr U.S. Treasury Bond	2.39%	2.44%	2.27%
10 Yr AAA Municipal Bond	2.24%	2.33%	1.93%
10 Yr A Corporate Bond	3.46%	3.49%	4.05%

Source: Bloomberg, Wall Street Journal, Reuters, Municipal Market Data (MMD), FactSet

Fed Balance Sheet

Source: Federal Reserve, Haver

The FED's chatter of initiating tapering gained momentum in March when New York FED Chair William Dudley said, "normalizing the balance sheet is a substitute for a rate hike." We see a scenario where the FED could possibly raise rates again or alternatively eliminate the bottom end of the range (which we would count as a hike) before moving to a tapering series in the 2nd half of 2017. This would enable the FED to start winding down the portfolio of U.S. Treasury and Mortgage Backed Securities on the balance sheet. Any such move needs to be gradual, measured, and telegraphed. There are several ways for the FED to enact a tapering, the simplest of which is to let the existing portfolio simply run off (mature). Approximately $1.5 trillion of securities are set to mature by 2022. FED officials have already discussed this scenario at the March meeting. We agree with Dudley that a tapering series has a similar impact as a rate hike – increasing interest rates. Think of it as reverse QE, which simply would remove stimulus from the system.

Regardless of the FED's path, we believe they need to be patient and move gradually. While inflation is creeping higher globally, we remain concerned that louder "war mongering tensions", an unpredictable French election and potential Euro exit, forward movement of Brexit, and the increasing uncertainty of the Trump Administration's ability to push tax reform and infrastructure bills forward at a rapid clip (we told you so) creates an environment where the FED could and should be patient.

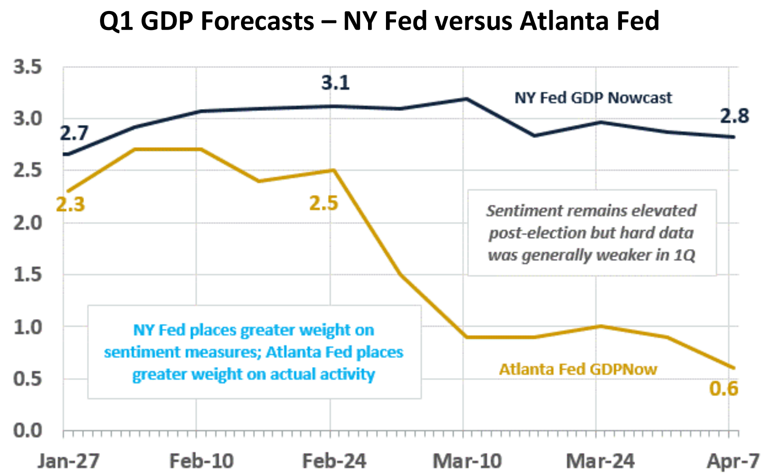
The FED's preferred inflation gauge, the Personal Consumption Expenditure Price index (PCE) topped 2% in February - the strongest gain since March of 2012 (Core PCE rose 1.8% YoY - below the FED's 2% target rate). We believe the FED would let the inflation rate float above 2% for a period of time to "guarantee" a more sustained recovery. As previously discussed, we believe they will let the economy run hotter for longer – if they can. Neil Kashkari, Minneapolis FED Chair, recently commented on the inflation front, saying, "for the last five or six years, the FED keeps predicting inflation is around the corner and those predictions end up being wrong". The market's flattening yield curve (2/10 spreads), while not a pure predictor, is indicating early signs of slowing economic growth – another reason the FED will be cautious in its normalization process.

We remain focused on the new Administration's tax reform and infrastructure policy as we view these items as potential game changers that could prolong and accelerate this economic expansion. An example is the 1st Q 2017 GDP forecasts (see chart below). Estimates rose after the election on increased business confidence; however, the Atlanta FED forecast has declined through the quarter as the excitement of rapid change has dissipated. Economists are forecasting 1stQ GDP growth in the 1% to 2% range, although, many are now in the sub 1% range.

U.S. Treasury Yields & Federal Funds Rate

Source: Bloomberg

The Big Picture: We expect U.S. economic growth to continue to progress at a 1% to 2% pace during 2017, inflation to hover around the FED's



Source: NY Federal Reserve, Atlanta Federal Reserve, Vining Sparks

target of 2%, and unemployment to stay at low levels. The Fed's desire/need to normalize monetary policy will push them to increase the FED Funds Rate to 1.0%+ and initiate a tapering program to slowly reduce the size of the FED's balance sheet – the FED needs to "get prepared" for the next recession. The FED is not inclined to discuss this; but it is clear to us that normalization is paramount before the next down-turn. We continue to expect intermediate rates to slowly trend higher.

Investment Grade Taxable Bonds

The general realization that the Trump administration may not be able to stoke the low growth embers of the current economy as quickly as promised had investors rushing back into bonds late in the 1stQ. This movement has kept yields of intermediate and long maturity bonds from rising in tandem with the short end of the yield curve. If the low growth environment we have endured since the financial crisis continues, interest rates in general should remain low.

Investment Grade (IG) companies had a record quarter of new debt issuance eclipsing $414 billion of debt issued. Despite this, corporate bond spreads have tightened across the yield curve as demand for corporate debt continues to outweigh supply. Companies are holding more debt now than in recent memory. The ratio of net debt to operating cash flow is over 21% higher than the 5 year historical average for the S&P 500. Overall, we continue to invest in companies with strong balance sheets and less sensitivity to sweeping economic challenges.

As of March 31st, we remain over-weight corporate bonds with an emphasis on A and BBB credits. The 5 Yr U.S. Treasury note started the quarter at 1.92% and ended the quarter at 1.92% - an amazing lack of change given all the movement in yield levels throughout the beginning of 2017. Relative to 5 Yr U.S. Treasuries, A rated spreads remain at +65 basis points which is tighter than historical averages. We are watching spread levels closely as we determine broad sector allocations. BBB rated spreads of +106 basis points remain an attractive investment relative to U.S. Treasury bonds. Despite tight spreads, we see opportunities in the lower tier of IG bonds as the U.S. economy maintains momentum and corporate earnings are expected to hit record levels in 2017.

Our ***Taxable Bond Strategy*** is focused on high quality IG, intermediate maturity bonds. Our taxable portfolios are structured to generate an average yield to maturity (YTM) of 2.52% with a duration of 3.4 and an average credit rating of A-.

The ***American Independence Carret Core Plus Fund***, at quarter end, has 84% of its assets invested in IG bonds and 13% invested in high yield (HY) bonds (the maximum permitted exposure to HY is 20%). At quarter end, the Fund had a YTM of 2.65%, a duration of 3.8, and an average credit rating of A-.

High Yield Bonds

The HY bond market picked up 2017 right where it left off in 2016. During the 1st quarter, HY rates declined by 28 basis points to 5.84% as measured by the Barclays U.S. HY Index. While many consider HY market valuations to be stretched, the hunt for yield continues as investors struggle to find value in other sectors of the investment landscape. HY companies are more than willing to meet this demand having issued nearly $80 billion in debt to begin 2017, double that of 2016, according to Dealogic. Strong issuance and strengthening corporate earnings make HY bonds more attractive in an absolute basis. We believe in getting paid to take on risk. As such, we shifted to a shorter duration bias to reduce both interest rate and credit risk while diligently researching companies from a credit perspective in an attempt to dig up overlooked opportunities in an otherwise crowded market.

At quarter end, our ***Opportunity Strategy***, on average**,** had a YTM of 5.04%, a duration of 4.6 and an average credit rating of BB-. Our ***Leveraged Opportunity Strategy***, on average, had a YTM of 5.25%, a duration of 4.2, and an average credit rating of BB-. As high yield spreads have tightened, we have unwound our margin position as we focus on patiently waiting for an advantageous move in yields.

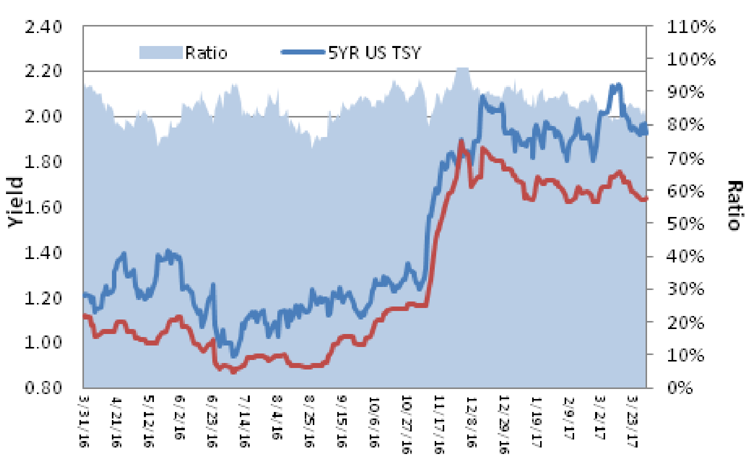
Investment Grade Municipal Bonds

After a very challenging end to 2016, the municipal market demonstrated its resilience once again. Against the backdrop of broad based uncertainty, the municipal market shook off a tough quarter and got back on track during the first few months of 2017. More specifically, the forces that have driven the market for the past several years took center stage once again. These factors include supply and demand, yield ratios, and credit considerations. Additionally, we continue to focus on the direct and indirect impact of forthcoming policy changes in the quarters ahead.

As we projected in our 2017 model, new issue supply volume was modest during the first quarter. Visible supply ended the quarter at $10.2 billion which remains below the 52 week average of $12.3 billion. The potential for higher yields, FED activity, and uncertain political policy appear to have directly impacted the level of new issue supply. Higher rates can dampen refinancing activity while political uncertainty can surely limit new project initiatives. Demand, on the other hand, continues to be quite vibrant. Mutual fund inflows returned to positive levels in early 2017 after sizable outflows following the Presidential election. Separately Managed Account (SMA) portfolio flows did not experience the same degree of asset flow volatility during the 4thQ of 2016 through the 1stQ of 2017 market swing. The attractiveness of the municipal market continues to pull in foreign buyers as well. A recent Federal Reserve study noted that foreign investment into the municipal bond market has doubled since 2009. From the perspective of supply and demand – the market experienced a good quarter as demand outstripped supply.

The Municipal-to-Treasury yield ratio confirms the health of the marketplace and the positive relative value of municipals. The ratio has declined from over 100% post-election to 85% at quarter-end (MMA AAA 5 year GO). We view a ratio of greater than 84% as an indication of good value for municipals. From a yield perspective, municipal interest rates (MMA AAA 5 Year GO) declined by 13 basis points over the quarter from 1.77% to 1.64%.

5 Yr AAA Muni vs. 5 Yr U.S. TSY



Source: Bloomberg

From a credit perspective, we are following a few state and local issuers that are facing challenging headwinds. However, in the broad sense, state and local governments are stable, reflecting multiple years of positive economic growth. State and local revenue streams continue to expand steadily while spending cuts are becoming more evident. We continue to identify continued initiatives that address the challenges of pension funding, but recognize that the "fix" will happen over the long run.

Our high-quality intermediate-duration bias continues to add value from a risk reward perspective. Our goal is to capture the lion share of the market upside with less downside risk. Portfolios will continue to be managed opportunistically but without losing sight of potential risks. Thus, we believe that we are well positioned to add value in today's yield environment. We are finding value in diversification across sectors, ratings, and maturities. Our municipal bond portfolios are state-specific or state-focus where appropriate (General Market approach otherwise). We see value in essential service revenue bonds and high-quality general obligation bonds. Our composite has a Yield to Maturity (YTM) of 1.83% with a duration of 3.5 and an average credit rating of AA-.

Separately Managed Account Strategies:

Municipal: Carret's Municipal Bond Strategy is designed to maximize tax efficiency through opportunistic portfolio management while preserving principal through practical portfolio structuring and fundamental credit analysis. We actively manage investment-grade portfolios with a diversified blend of issuers, sectors and maturities aimed at delivering consistent, risk-adjusted total return with an emphasis on tax-free current income.

Taxable: Carret's Taxable Bond Strategy is designed to achieve above average total returns with an emphasis on preservation of capital and consistent cash flow. We utilize investment-grade fixed income securities and shift across bond sectors based on changing market conditions. Our fundamental credit research and active portfolio management process has provided consistent and attractive risk-adjusted returns.

Opportunity: Carret's Fixed Income Opportunity Strategy is designed to generate a high level of current income with a secondary focus on long term capital appreciation. We utilize higher yielding fixed income securities and shift among various types of fixed income securities based on changing market conditions. We actively manage risk and reward and can respond quickly to market movements. We utilize interest rate hedges to limit duration risk.

Leveraged Opportunity: Carret's Fixed Income Leveraged Opportunity Strategy is designed to utilize low cost leverage and favorably negotiated release rates to potentially enhance our existing Opportunity Strategy returns. We actively manage leverage to augment opportunities within the high yield and investment-grade sectors of the fixed income market.

Mutual Fund Strategies:

Core Plus: The American Independence Carret Core Plus Fund's investment objective is to provide investors with a high level of current income coupled with a competitive total return. The Fund invests primarily in intermediate duration, investment-grade bonds, and may also invest up to 20% in high yield bonds. This Fund is intended for investors with a time horizon of at least 12 months seeking current income and total return.

Kansas Tax-Exempt: The American Independence Kansas Tax-Exempt Bond Fund's investment objective is to preserve capital while producing current income for the investor that is subject to both Federal and Kansas state income taxes. This Fund is intended for investors seeking investment income exempt from Federal taxes and Kansas state tax. The Fund seeks to generate monthly income focusing on investment-grade intermediate duration bonds.