CARRET
Asset Management

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Carret Credit Insight

The Collapsing Yield Curve

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Firm AUM

$2.5 Billion

On March 21st, the Federal Reserve Board (FED) raised the Fed Funds Target Rate 0.25% to a range of 1.50% to 1.75%. This was the sixth rate increase since they initiated tightening of monetary policy in the fourth quarter of 2015. As of March 31st, the Fed Funds Rate registered 1.68% and the 3 month Treasury yielded 1.72%. This is a meaningful change from the 0.17% the 3 month Treasury yielded at the end of 2015. This is evidence that the FED controls short rates. The FED has pushed short rates (enhanced cash) from essentially zero into the 2% range (3 - 6 month investment grade fixed income securities).

While the FED controls short rates, investors set intermediate and long rates; however, the FED can use Quantitative Easing programs to *influence* longer rates. This can be illustrated by observing that the 10 Yr Treasury yield increased from 2.27% at year end 2015 to 2.74% on March 31, 2018 – a rise of only 47 basis points while the FED increased overnight rates by 150 basis points. Short term yields rise with investor expectations for tighter FED policy while longer rates move based on investor expectations of economic growth and inflation.

The yield curve has collapsed as the FED increased short rates and investors did not increase longer rates proportionally. The 2 – 10 U.S. Treasury spread has contracted to 0.47%, the lowest level in 10+ years. Historically, this spread crossing into negative territory has been a strong predictor of a recession rearing its ugly head. We believe Mr. Powell, the new FED chair, and his team are not interested in pushing this spread into negative territory. Accordingly, while the FED's policy moves have been "data dependent" over the past 2 ½ years, we believe the 2 - 10 Treasury spread has become a new critical data point for the FED.

With the 2 – 10 spread at historic lows, we are at an important inflection point. If the FED delivers on its projection of 2 to 3 more hikes this year and investors do not move long rates higher, the FED will create a scenario where the 2 - 10 spread could turn negative. We believe the FED would be reluctant to create this scenario. If the market increases 10 Yr rates as a result of a pick-up in inflation or accelerating economic growth, the FED would surely use that opportunity to continue increasing rates. The tightening in the 2 – 10 spreads indicates that the FED and investors do not see eye-to-eye on the economic

Key Interest Rates	3.31.18	12.31.17	12.31.16
Prime Rate	4.75%	4.50%	3.75%
Fed Funds Rate	1.50% – 1.75%	1.25% – 1.50%	0.50% – 0.75%
3 Month U.S. T-Bill	1.72%	1.39%	0.50%
5 Yr U.S. Treasury Note	2.56%	2.21%	1.92%
10 Yr U.S. Treasury Bond	2.74%	2.41%	2.44%
10 Yr AAA Municipal Bond	2.44%	1.99%	2.33%
10 Yr A Corporate Bond	3.78%	3.25%	3.49%

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

outlook. As we have repeatedly stated, the FED is simply trying to "normalize" policy to arm themselves for the next downturn. They are doing a terrific job – moving "gradually" without disrupting the economy. Investors, however, aren't increasing rates at the same pace – indicating a cumulative "investment community" view that longer term inflation and economic growth will remain sub-par.

We are diligently focused on generating attractive returns given our risk parameters (risk vs. reward). Controlling interest rate risk becomes "more basic" in a flat yield curve environment. Consider this, the 2 Yr Treasury is yielding 2.26%, the 5 Yr is yielding 2.56%, and the 10 Yr is yielding 2.74%. Investors are only gaining a return of 0.47% for taking an additional 8 years of interest rate risk. Historically, investors should reap a return of 1.0 - 1.5% for this additional risk. We frequently say, "we like to take risk, when we are rewarded for taking it". Today, the fixed-income markets are not rewarding investors for taking incremental risk. Accordingly, we 1) remain focused on keeping duration in the 4 Yr range and extending modestly as opportunities arise and 2) keeping quality high as debt levels continue to escalate.

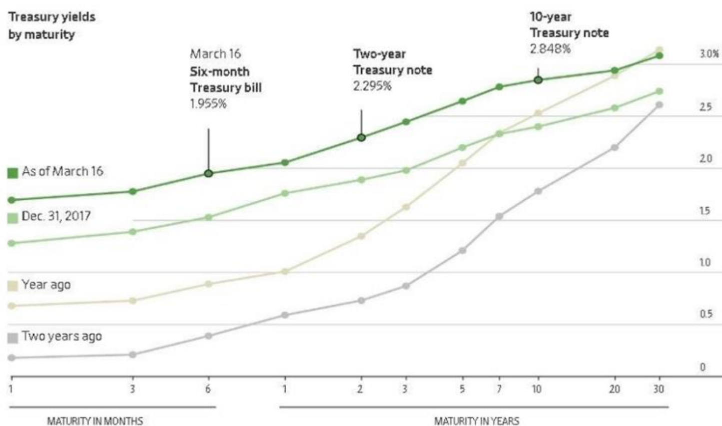
2 – 10 Yr US Treasury Spread

Source: Bloomberg

During the quarter, inflation and GDP growth remained modest. The February core consumer price index rose 1.8% while producer prices showed signs of inflation with core prices up 2.7% - the fastest pace in four years. Wage growth continues to remain tame, increasing 2.6% in February (below estimates of 2.8%). GDP looks set to expand by 2.0% for the quarter. The FED's Summary of Economic Projections, forecasts 2018 GDP growth of 2.7%, unemployment at 3.8% and PCE inflation to average 1.9%; however, they now expect inflation to trend higher in the "coming months" instead of the "year ahead".

The Bottom Line: We continue to expect rates to creep higher (our 10 Yr U.S. Treasury forecast remains at 3.00% - 3.25%) as global Central Bank intervention lessens, U.S. fiscal policy stimulus initiatives kick in, a tight labor market eventually leads to wage growth, commodity prices remain strong, and the GOP continues to push an infrastructure bill. We believe the 2 – 10 spread and wage growth remain the key "data points" for the FED. With the unemployment rate holding at 4.1% in February (the 5th straight month at this level) and the Tax Reform Plan expected to contribute 0.5% to GDP growth during 2018, we believe the wind is blowing towards higher rates. We focus on macro shifts to add value and thus are keeping duration short and quality high.

Treasury Yields by Maturity



Source: Treasury Department

Investment Grade Taxable Bonds

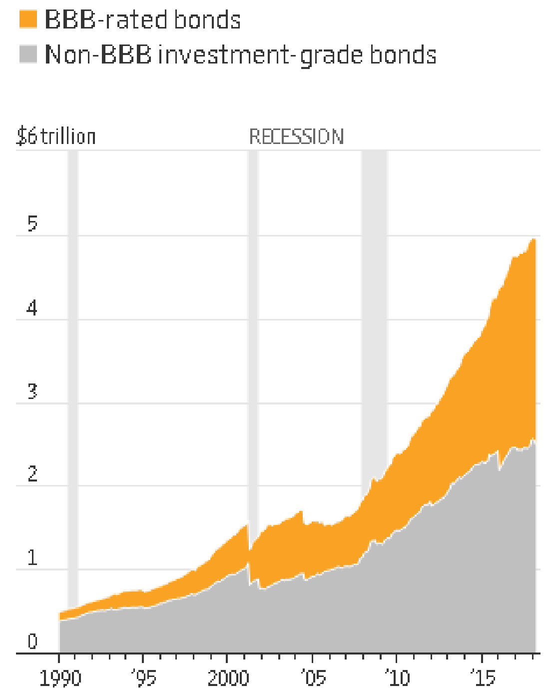
The effect of the low interest rate environment of the past several years is beginning to show in the corporate bond market. Since December of 2008, U.S. corporate debt has increased from $2.5 trillion to $6.2 trillion. The spike in debt issuance over the past 9+ years is a result of the FED lowering interest rates to historically low levels. The FED took rates to rock bottom levels in an effort to stimulate the economy and spur business investment. The result is that many companies

issued debt to fund dividends, stock buybacks, mergers, and capital expenditures. Despite the recent modest rise in rates, we expect this trend to continue: corporate America is anticipated to implement $842 billion of share buybacks in 2018. This would be approximately 60% higher than in 2017 and higher than the previous record set in 2007 – just prior to the 2008 financial crisis.

Corporate America took advantage of the interest rate environment to extend the maturity profile of their debt and lock in low interest payments. In doing so, the amount of BBB rated bonds has increased $1.2 trillion over the past five years to account for 50% of the investment grade market. This $2.5 trillion segment of the corporate bond market is now the most ever for BBB rated companies. The expansion of BBB rated bonds is based on two factors: 1) BBB rated companies issuing more debt and 2) ratings downgrades to the BBB rung due to the issuance of excess debt. Entering the 10th year of this economic expansion, it is worth mentioning that in the event of an economic downturn, some companies, that have increased their leverage, could be faced with higher interest payments and potential credit downgrades. Additionally, in a rising rate environment, some may find it difficult, or expensive, to refinance debt. Despite the increased leverage, strong corporate earnings and continued economic growth should allow corporate America to maintain its current debt levels without negative effects in the year ahead.

BBB Debt Balloons

Amount of U.S. investment grade debt outstanding, by rating category

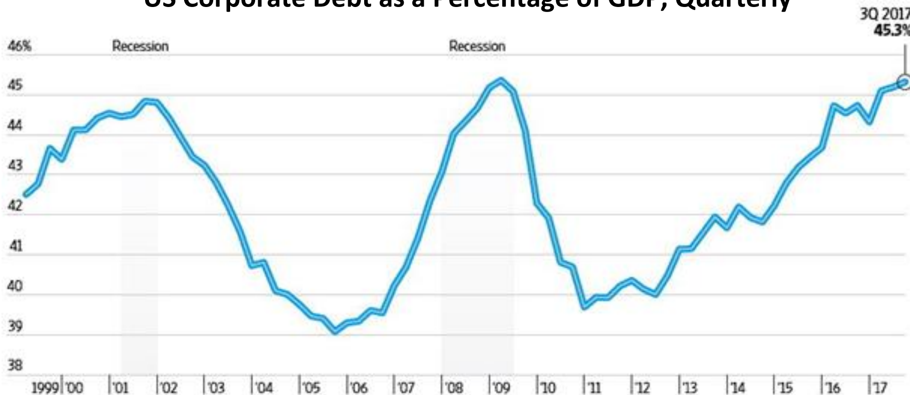


Source: WSJ, Morgan Stanley, Citigroup

As of March 31st, we remain over-weight corporate bonds with an emphasis on A and BBB credits. The 5 Yr Treasury yield moved higher during the first quarter having started the year at 2.21% and ending the quarter at 2.56% - a 35 bp increase in yield to kick off 2018. Relative to 5 Yr Treasuries, corporate spreads widened during the quarter with A rated spreads increasing from +46 bp to +70 bp and BBB rated spreads moving from +82 bp to +107 bp. The first quarter saw additional flattening of the yield curve with the 2 - 10 Yr spread falling to +47. As spreads have widened and the curve continues to flatten, we have decreased our exposure to BBB rated credits and maintained a short duration bias. Given our current market views, we are focused on keeping interest rate risk in the 4 Yr duration range and average portfolio credit quality above A-. Considering the current credit profile of the market, this will allow us to maintain an appropriate risk return trade off in the event of widening corporate bond spreads and/or increasing rates.

Our ***Taxable Bond Strategy*** is focused on high quality investment grade (IG), intermediate maturity bonds. Our taxable portfolios are structured to generate an average yield to maturity (YTM) of 3.20% with a duration of 3.3, and an average credit rating of A-.

US Corporate Debt as a Percentage of GDP, Quarterly



Source: WSJ, Moody's Investor Service

High Yield Bonds

Investor anxiety over rising interest rates and equity market volatility (HY bonds share a higher correlation with the equity market than IG bonds do) has been apparent in the HY bond market. During the 1st quarter, investors pulled $6.5 billion out of the five largest HY bond ETFs,

according to FactSet. Additionally, there have been five straight months of outflows from HY ETF's. Despite this frenzy, HY had a better performing quarter than its investment grade counterpart, a testament to the higher coupon cash flow of this sector of the market. We expect coupon cash flow to continue to be a buffer against interest rate volatility. Also helping to pare declines was the lack of new HY supply coming to market, which kept a lid on rates. HY issuance is down over 30% for the 1st quarter of 2018 compared to the 1st quarter of 2017.

HY bond yields moved in tandem with the U.S. Treasury market during the 1st quarter as yields increased from 5.72% at the beginning of the quarter to 6.19% at quarter end as measured by the Barclays U.S. HY Index. Spreads, as measured by the Barclays U.S. HY Index vs. the 5 Yr Treasury, held steady during the 1st quarter, having increased only 12 bp to +363 bp. Spreads remain below the 20 year historical average of +578 bp.

Barclays US Corp HY Index vs 5 Yr US Treasury (with spread)

Source: Bloomberg, Barron's

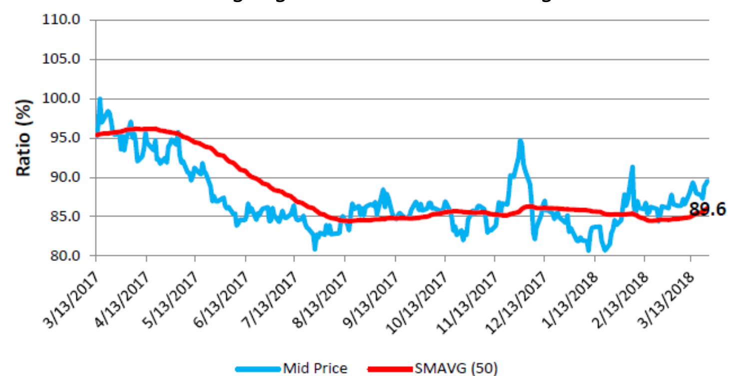
As yields and spreads remain near historical lows, we are maintaining a short duration bias and high quality HY focus. Throughout the quarter, we have looked to increase our exposure to BBB rated issuers. At quarter end, our ***Opportunity Strategy***, on average, had a YTM of 5.07%, a duration of 3.6, and an average credit rating of BB-. Our ***Leveraged Opportunity Strategy***, on average, had a YTM of 5.19%, a duration of 3.1, and an average credit rating of BB-. We remain unleveraged at quarter end. In the current market environment, it is important to remain patient in anticipation of the opportunities that the market presents.

Investment Grade Municipal Bonds

After the significant spike in 4th quarter 2017 new issue supply, municipal issuance has been notably light to start the new year. It comes as no surprise that the pre-tax reform rush would be followed by a gradual rebuilding of the supply coffers. Other than credit specific events, supply and demand dynamics continue to drive the IG municipal marketplace. Tax reform has reduced the amount of refunding issuance, which over the past decade, represented roughly 50% of new bonds issued. The amount of new project financing has been stable to start the year which we view as an encouraging nod to necessity over excess. Demand, on the other hand, has been quite robust in the 1st quarter as investors adjust to the new tax codes. Over $12 billion in net municipal bond mutual fund inflows were recorded in the 1st quarter. Interestingly, the first week in January posted the largest one week inflow since 2007. We also observed an uptick in demand from separately managed accounts, foreign buyers, and insurance companies. An additional demand push has come by way of corporations. The FED released a report of municipal holders in March confirming that corporations continued to add to their municipal exposure despite lower tax rates. The "new" tax brackets and the elimination of the State and Local Tax (SALT) deduction have not deterred municipal bond investing for mid-tier income levels

AAA 10 Yr Muni-to-Treasury Ratio

Trending Higher Than Historic Averages

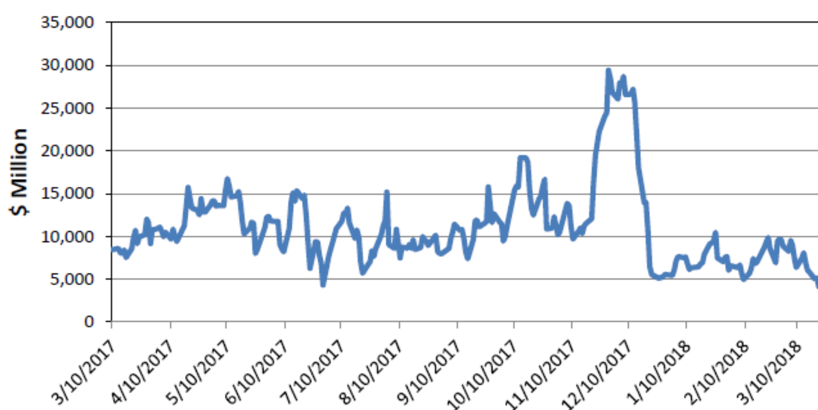


Source: Bloomberg

on up. In states where SALT is meaningful (CA, NY, and NJ for example), the new combined effective tax rates have magnified municipal bond demand even further.

During the quarter, market yields (5 Yr AAA) trended higher in sympathy with rising U.S. Treasury Bond yields. The yield was 1.70% on December 31st and closed at a quarterly high of 2.06% on March 31st. The municipal bond curve steepened during the 1st quarter reversing the flattening trend of late 2017. The 2 - 10 Yr AAA Muni spread was 46 basis points on December 31st and peaked at 94 basis points in mid-March. The change in slope is primarily a normalization of spreads magnified, a bit, by short-end strength combined with long-end weakness. Our intermediate duration bias is currently the pivot point on today's yield curve. Intermediate-term Treasury yields have increased at a quicker pace than comparable municipal bonds. The 10 Yr AAA ratio closed the quarter at 90% after bottoming at 81% in mid-January. The historic average for this ratio is 85%. As a result of yield curve tilt, the short-end ratios have become expensive while the long-end has become attractive. Accordingly, we extended duration over the past quarter given the rise in rates and the new attractiveness of longer dated bonds.

An additional boost to market demand and liquidity may come from Washington, DC. A bipartisan bill is poised to pass the House and Senate to re-categorize municipal bond debt as a high-quality liquid asset (HQLA). This should make municipal debt more attractive for banks to hold in order to meet regulatory standards.



Source: Bloomberg

From the credit perspective, Moody's published a report on Local Government Bonds that highlighted a few key positives for the municipal market. These include a recovery in property values, increased reserves, healthy cash balance liquidity, and stable direct debt. The report also noted that pensions continue to be a challenging issue for local governments. Our high-quality, intermediate-duration bias continues to add value from a risk reward perspective. We will continue to opportunistically add value through practical trading and reinvestment of redeemed bonds. Additionally, we continue to find value in diversification across sectors, ratings, and maturities. Our municipal bond portfolios are state-specific or state-focus where appropriate (general market in approach otherwise). Essential service revenue bonds and high quality general obligation bonds are providing sound value in today's landscape.

Our ***Municipal Bond Strategy*** is focused on high quality IG, intermediate maturity bonds. Our municipal bond portfolios are structured to generate an average YTM of 2.31% (Tax Equivalent Yield of 4.16% - assumes 44.5% combined effective tax bracket) with a duration to maturity of 3.9 years, 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 returns with an emphasis on tax-efficient cash flows.

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.

Enhanced Cash: Carret's Enhanced Cash Strategy is designed to provide excess returns above those offered by cash equivalents, while focusing on capital preservation and liquidity. The strategy invests in ultra-short duration investment grade bonds. Our custom approach opportunistically utilizes tax-advantaged municipal bonds to enhance overall after-tax returns when appropriate.

Mutual Fund Strategy:

Kansas Tax-Exempt: The American Independence Kansas Tax-Exempt Bond Fund's objective is to preserve capital while producing current income that is exempt from both Federal and Kansas state taxes. The Fund seeks to generate monthly income and principally invests in investment-grade bonds of intermediate maturity.

For more complete information on the American Independence Funds and AI Funds, you can obtain a prospectus containing complete information for the Funds by calling 866.410.2006 or by downloading them from this web site. You should consider the Fund's investment objectives, risks, charges and expenses carefully before you invest or send money. Information about these and other important subjects is in the Funds' prospectus. The prospectus and, if available, the summary prospectus, should be read carefully before investing.
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