CARRET Asset Management

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Carret Credit Insight

Could This Be The Year?

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Firm AUM

$2.6 Billion

Listening to the media's 2017 commentary on global economics, financial markets, interest rates and geo-politics, one would assume that the fixed-income financial landscape and specifically, U.S. interest rates would have had a turbulent year. In fact, quite the opposite occurred. The 10 Yr U.S. Treasury bond had the narrowest trading range of the past decade during 2017. The 57 basis point (bp) range spanned from a low of 2.06% to a high of 2.63%. The rate ended the year at 2.41%, 3 bp below the 2.44% where it started the year. 2017 brought a lot of noise, but not a lot of action for the intermediate / long-term portion of the Treasury yield curve. Why? Stubbornly modest inflation coupled with solid but sub-par economic growth kept a lid on rates. Could this be the year inflation and growth trend higher?

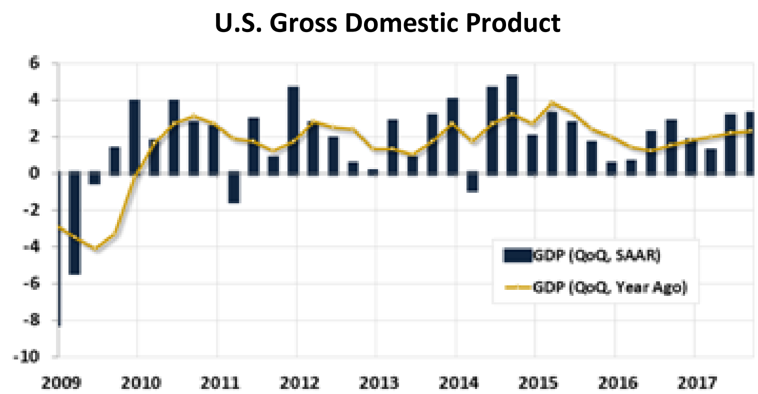
The short end of the Treasury yield curve (as measured by the 2 Yr U.S. Treasury note) sizzled during 2017, as the Federal Reserve (FED) raised rates 3 times - increasing the Fed Funds Rate by 75 bp to a range of 1.25% - 1.50%. The 2 Yr Treasury rose from 1.20% at the start of the year to 1.88% at year end, an increase of 68 bp (almost mirroring the Fed Funds Rate increase).

The long end of the curve failed to move with the short end as investors didn't "buy into" the FED's story that inflation is on the horizon. We have been making the case that the FED isn't raising rates to cool off a hot and inflation prone economy, but rather to create ammunition/flexibility for the next economic downturn. The 2 - 10 U.S. Treasury spread compressed throughout 2017, solidifying our view. The 2 - 10 spread started the year at a healthy 1.24% and ended the year at 0.53%. This spread is a live example of investor's "return premium" for investing in longer term bonds. When the economic growth outlook is improving and inflation is visible, investors demand to be "paid" more for owning long-term bonds. When the economy is tepid and inflation is benign, investors expect less for owning long-term bonds. At year end, the bond market was indicating that investors, as a group, were not anticipating an accelerating inflation rate in the foreseeable future.

We believe 2018 will bring a more volatile interest rate environment and greater opportunities for long-term investors. As mentioned, inflation and economic growth (as measured by GDP growth) form the basis for intermediate and long-term interest rates,

Key Interest Rates	12.31.17	12.31.16	12.31.15
Prime Rate	4.50%	3.75%	3.50%
Fed Funds Rate	1.25% – 1.50%	0.50% – 0.75%	0.25% – 0.50%
3 Month U.S. T-Bill	1.39%	0.50%	0.18%
5 Yr U.S. Treasury Note	2.21%	1.92%	1.76%
10 Yr U.S. Treasury Bond	2.41%	2.44%	2.27%
10 Yr AAA Municipal Bond	1.99%	2.33%	1.93%
10 Yr A Corporate Bond	3.25%	3.49%	4.05%

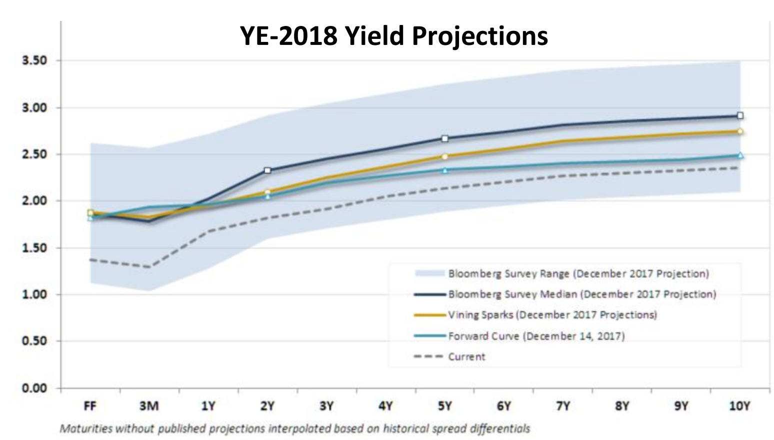
Source: Bloomberg, Wall Street Journal, Reuters, Municipal Market Data (MMD), FactSet while the FED sets/influences shorter rates. While the FED is confident that the economy is stable, they remain perplexed by the unresponsiveness of inflation (both CPI and PCE). Inflation has been stubbornly below the FED's 2% target for most of this expansion. However, we think 2018 could finally be the year inflation *creeps* higher. While we see inflation remaining at modest levels, we do see an increasing probability of economic growth and inflation trending higher in the year ahead. We believe the following catalysts could be reasons 2018 could be the year rates move modestly higher (a positive for fixed-income investors positioned appropriately):



Source: Vining Sparks, BEA

- During the last two quarters of 2017, the U.S. economy posted 3%+ GDP growth
- With joblessness at a 17 year low, it should not take much to stimulate wage gains
- Household wealth continues to post record highs given rising asset values – boosting consumer spending
- Energy / commodity prices have been trending higher
- The probability of an economic slowdown has diminished with asset values rising and fiscal stimulus ahead
- TIPS (Treasury Inflation Protected Securities) break-even levels have been rising (a sign of future inflation expectations) and recently broke the FED's 2% inflation target
- New fiscal stimulus in the form of the Tax Reform Plan of 2017 (TRP), should keep consumer and corporate confidence high
- The TRP is encouraging corporate America to increase wages and issue one time bonuses
- The TRP includes attractive business depreciation schedules – boosting business investment / spending
- Washington is pushing forward – we anticipate an Infrastructure Bill is up next
- 2018 will be the first full year of "normalizing" for the FED, allowing $8 billion in Mortgage Backed Securities and $12 billion in Treasury holdings to roll-off their balance sheet each month as they mature / pre-pay

We continue to forecast the "fair market" value for the 10 Yr U.S. Treasury at 2.75% - 3.00%. The Bloomberg Survey puts the median forecast at 2.95%. We anticipate U.S. GDP growth will range between 2.5% - 3.0% in 2018 - slightly higher than in 2017. At the December 13th FED meeting, the 2018 median dot plot indicated 2.5 rate hikes in 2018. We remain in the two hike camp as we see the incoming FED chairman, Jerome Powell, as having limited incentive to rush to hike rates. We see the 2 - 10 spread remaining tight and DO NOT believe the FED will take the spread to a negative / neutral rate – meaning, the FED will only raise short rates if the market raises long rates.

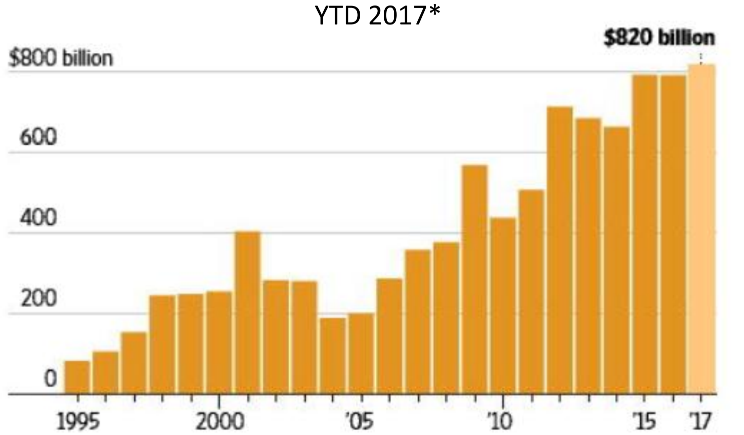


Source: Vining Sparks, Bloomberg Survey of Economists, Forward Curve

The Bottom Line: While economic growth perked up in the second half of 2017, inflation didn't follow. We are closely watching wage inflation, rents, and energy/commodity price trends for clues on the near term direction of inflation. The recently passed TRP and expected Infrastructure Bill should prolong this economic expansion into 2019, making this expansion the longest running ever. We expect rates to *creep* higher as global Central Bank intervention lessens and U.S. fiscal policy stimulus initiatives kicks-in.

Investment Grade Taxable Bonds

Investment-Grade Corporate Bond Issuance
YTD 2017*



*As of Dec. 4 †Option-adjusted U.S. investment-grade corporate bond yield premium over Treasurys

Source: Dealogic (Issuance), Moody's Financial Markets (cash), Bloomberg Barclays (spread)

The TRP should have a moderately positive impact on investment grade corporate bonds. The one time repatriation of overseas cash coupled with the lower overall corporate tax rate is positive for corporate profits; however, with more cash in their pockets, companies are likely to pay down existing debt. With historically low long-term yields, companies are more likely to retire short-term debt instead of long dated debt. This will increase the overall duration of the market, making the focus on duration management ever more critical.

We expect to see a tug-of-war on corporate bond yields in the coming year. The TRP stands to leave more cash in consumer pockets than in previous years. This cash cushion is expected to be spent and therefore boost corporate revenue. This revenue bump, in tandem with a lowered corporate tax rate to 21%, should lead to strong S&P profits in the coming year. Stronger corporate profits and margins, typically lead to tighter corporate bond spreads, relative to U.S. Treasuries. On the other end of the argument, we already have historically low corporate bond spreads. As the risk premium above U.S. Treasuries shrinks, investor demand for corporate bonds should theoretically slow as U.S. Treasury bonds become relatively attractive. Through 2017, the market seems to have ignored historically tight spreads as evidenced by investors gobbling up a record level of investment grade corporate bond issuance, with the majority coming to market in the second half of the year. We continue to focus on risk vs. reward and will increase the quality of client portfolios if we are not getting "paid" an appropriate amount at each credit rating level. During 2018, income payments will likely be a key driver of total returns.

As of December 31st, we remain over-weight corporate bonds with an emphasis on A and BBB credits. The 5 Yr U.S. Treasury note moved higher during the final quarter of 2017 having started the quarter at 1.92% and ending the year at 2.21% - its highest level since April 2011. Relative to 5 Yr U.S. Treasuries, corporate spreads remain tight with A rated spreads at +46 bp and BBB rated spreads at +82 bp. The fourth quarter saw continued flattening of the yield curve with the 2 - 10 Yr spread falling 33 bp to +53. As spread compression has persisted and the curve continues to flatten, we have increased overall credit quality and shortened portfolio durations. Given our current market views, we aim to keep interest rate risk in the 3.5 – 4.0 year duration range. This will allow us to maintain an appropriate risk return trade off should spreads widen and/or rates rise.

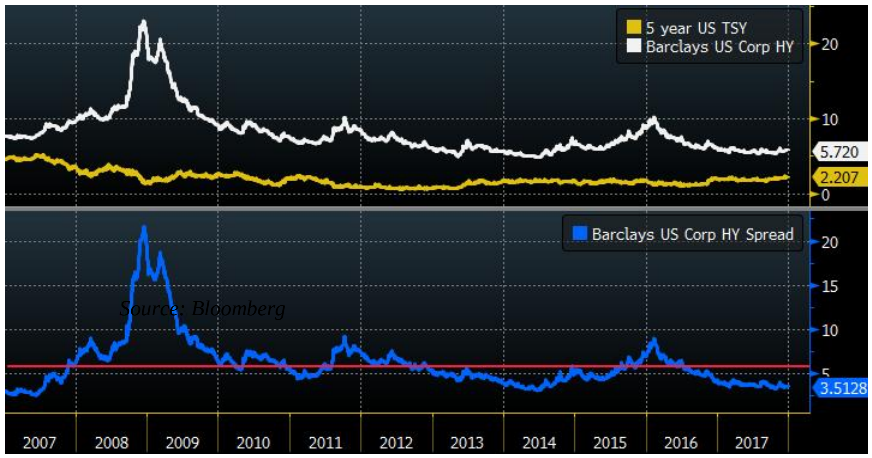
Our ***Taxable Bond Strategy*** is focused on high quality investment grade (IG), intermediate maturity bonds. Our taxable portfolios are structured to generate an average yield to maturity (YTM) of 2.62% with a duration of 3.5, and an average credit rating of A-.

High Yield Bonds

While the new tax law should increase corporate profits across the board, companies with high amounts of leverage on their balance sheets could face tax headwinds. The past benefit of deducting interest expense is not as meaningful with a lower corporate tax rate. Companies that have increased their leverage over the past decade may find that they owe more in taxes due to a reduction of this deduction than in prior years. This could lead HY companies to find that issuing debt is less attractive relative to other means of financing. Despite this, we expect the majority of the high quality HY market to benefit from increasing earnings and thus enhanced debt coverage metrics thanks to the TRP (as referenced in our Investment Grade Taxable Bond section, above). A keen focus on credit research and "knowing what we own" will be important in 2018. We remain defensively positioned as the HY market is trading at rich spreads. We are patiently awaiting a market disruption so we can opportunistically extend out and move down the quality ladder.

Barclays US Corp High Yield Index vs 5 Yr US Treasury (with Spread)

20 year average HY bond spread to 5 YR US Treasury is 5.78%



Source: Bloomberg, Barrons

The HY market moved in tandem with the U.S. Treasury market during the 4th quarter as yields increased from 5.45% at the beginning of the 4th quarter to 5.72% at year end as measured by the Barclays U.S. HY Index. HY rates declined 40bp during 2017. Spreads, as measured by the Barclays U.S. HY Index vs. the 5 Yr U.S. Treasury, stayed flat during the 4th quarter at +351 bp - below the +419 at the start of the year. Spreads remain below the 20 year historical average of +578 bp.

As yields and spreads remain near historical lows, we are maintaining a short duration bias and high quality HY focus. Throughout the year, we have reduced the duration of our Opportunity Strategies from 4.7 years to just less than 3 years. At quarter end, our ***Opportunity Strategy***, on average, had a YTM of 4.26%, a duration of 2.9, and an average credit rating of BB. Our ***Leveraged Opportunity Strategy***, on average, had a YTM of 4.59%, a duration of 2.8, and an average credit rating of BB-. We remain unleveraged at year end. In the current market environment, it is important to be patient and remain prepared to pounce on opportunities as the market presents them.

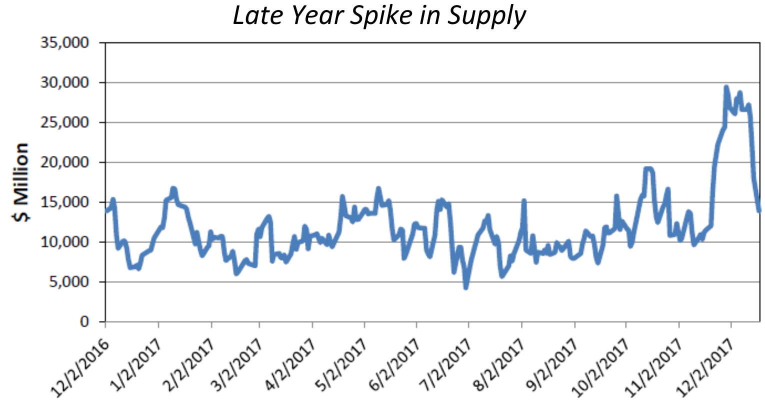
Investment Grade Municipal Bonds

Tax reform and a resulting spike in supply dominated the headlines in the 4th quarter. The pros and cons of the TRP will be debated for many quarters ahead. However, from our vantage point, we see the TRP as a net positive for municipal buyers and current municipal holders. Municipal issuers will have to adjust to a new world without advanced refundings (Pre Re's). At the eleventh hour, the final tax bill retained the tax exemption for private activity bonds in a potential nod to a 2018 infrastructure plan.

In the last few weeks of the quarter, issuers rushed to bring new bonds to market ahead of the final TRP. The issuance numbers were historic in size. There have only been 7 weeks since January 1985 where issuance was greater than $15 billion. However, supply figures in the first two weeks in December were north of $20 billion per week. For the month, the supply surge topped $57 billion. This translated to massive supply driving yields higher. Demand was reasonably strong over the period, but was ultimately swamped by the spike in supply. In a reversal of recent trends, quarterly returns reflected an oversupply in relation to demand.

Bloomberg 30-Day Visible Supply

Late Year Spike in Supply



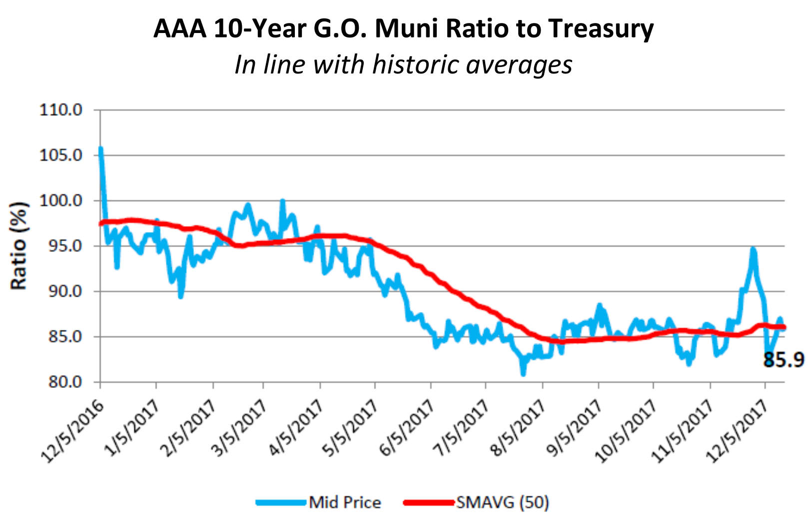
Source: Bloomberg

The "new" tax brackets and the elimination of the State and Local Tax (SALT) deduction should keep municipal bonds in favor for mid-tier earners on up. In states where SALT matters a lot

(CA, NY, and NJ for example), the new combined effective tax rates have the potential to magnify municipal bond demand even further. From the credit perspective, the lower Federal tax rates combined with the change to the SALT deduction is raising some red flags in those high income tax states. The corporate tax reduction, to 21%, may be a drain on municipal demand. However, demand from foreign investors and U.S. banks may negate some of the decline.

Eliminating advanced refundings has been something that the Treasury has been trying to do since 1986. Keep in mind that a Pre Re municipal bond is akin to a tax-exempt Treasury bond. Additionally, Pre Re municipals can erode demand for treasuries on the margin. We believe that this change will encourage issuers to seek other ways to refinance (or replace) inefficient debt in the years to come.

During the quarter, market yields (5 Yr AAA) trended higher as a result of the supply surge. The yield was a 1.36% on October 2nd and closed at a 1.69% at year-end. The market yield for the quarter peaked on November 29th at 1.79%. The municipal bond curve has flattened in sympathy with rising short-term U.S. Treasury yields. Looking at the 2 - 10 Yr AAA Muni relationship, the curve has flattened from 146 bp in mid-March to 50 bp at year-end. The flatness of today's curve helps to confirm that we are in the "right part of the market" given our intermediate duration bias. Intermediate-term U.S. Treasury yields have increased at a quicker pace than comparable municipal bonds. The 10 Yr AAA ratio closed out the quarter at 84% after reaching 95% in late November. The historic average for this ratio is 85%.



Source: Bloomberg

From a credit perspective, S&P reports that more states are experiencing some degree of budgetary pressure related to pension and other rising costs amid the shallow economic recovery. The survey revealed that states with the "best funded" ratios include New York, North Carolina, and Wisconsin. The "worst funded" states include New Jersey, Illinois, Kentucky, and Connecticut. Moody's has a stable 2018 outlook for both state and local governments. Moody's projects modest revenue growth at the state level and tax revenue increases for local municipalities allowing cities and towns to increase reserves. Moody's also expects pension pressures "to remain elevated" for local governments. However, both S&P and Moody's project that defaults will remain near-0% levels.

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 2.06% with a duration to maturity of 3.7 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 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.