CARRET Asset Management

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Carret Credit Insight

The FED Raises Rates, Investors Fight Back, The FED Concedes

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Firm AUM

$2.5 Billion

Our thesis in the October *Carret Credit Insights* was that the FED had reached a neutral stance with the September rate increase. That hike brought the Fed Funds Rate (FFR) to 2.00% - 2.25%. With inflation stagnant in the 2.0% range, we believed that neutrality had been reached. However, the FED disagreed with us, and on December 21st, hiked rates again, bringing the FFR to 2.25% - 2.50%. Additionally, the FED telegraphed two additional hikes in 2019. Investors, in turn, sent the FED a message: **stand down – you're at neutral – being patient is prudent.**

Another long running thesis we have argued is proving accurate: the FED has been raising rates and unwinding its balance sheet (Quantitative Tightening) to build a monetary arsenal for the next economic downturn. The FED has pushed Quantitative Tightening in the midst of a benign economic growth environment coupled with tame global inflation. The result: bond investors sent the FED the "stand down" message in the form of a flat to slightly inverted yield curve. This inversion spooked equity investors, who quickly drove the S&P 500 down by 19.8% during the final quarter of 2018 (peak to trough). The FED quickly took action to stabilize the equity markets. This worked as the S&P 500 rebounded in the last week of the year. Bond investors, on the other hand, told the FED that enough is enough. At quarter end, the 1 Yr U.S. Treasury yielded 2.61% while the 7 Yr Treasury yielded 2.58%. Yield curve inversions have historically foreshadowed a pending recession. While we do not see a recession in 2019, we recognize that risks of an economic slowdown have increased, caused by a slew of economic factors. These include a shift from quantitative easing to quantitative tightening, on-going China trade wars and tensions, escalating geo-political strife, the return of volatility, Brexit uncertainty, the government shutdown, and the looming battle for the 2020 Presidency.

As a result of the yield curve inversion and equity market volatility, the FED conceded to the market, as officials indicated that they would increasingly rely on the "evolution of the outlook as informed by incoming data." We interpret this to mean that the FED understands that they have reached a neutral stance. Additionally, Chairman Powell pledged that the FED "will be paying very close attention to what incoming economic and financial data are telling us." His colleague, NY FED President John Williams, emphasized that "officials are listening carefully to the markets" and that if the economy slowed more than expected, the FED would "re-assess" and "shift views on monetary policies." Within days, investors fought the FED and the investors won – an unusual turn of events in an unusual tightening cycle.

Key Interest Rates	12.31.18	12.31.17	12.31.16
Prime Rate	5.50%	4.50%	3.75%
Fed Funds Rate	2.25% – 2.50%	1.25% – 1.50%	0.50% – 0.75%
3 Month U.S. T-Bill	2.45%	1.39%	0.50%
5 Yr U.S. Treasury Note	2.51%	2.21%	1.92%
10 Yr U.S. Treasury Bond	2.68%	2.41%	2.44%
10 Yr AAA Municipal Bond	2.28%	1.99%	2.33%
10 Yr A Corporate Bond	4.11%	3.25%	3.49%

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

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During 2018, the 10 Yr Treasury fluctuated between 2.41% and 3.23%. While the year provided renewed volatility, Treasury yields ended 2018 at their lowest levels since the first half of the year. The 2 Yr closed at 2.50%, but ended 62 bps higher than year-end 2017. The 5 Yr closed at 2.51%, up 30 bps from its 2017 close, and the 10 Yr closed at 2.68% rising a meager 25 bps during 2018. The short end was pushed higher by four FED rate hikes while long rates barely moved as investors projected slower growth ahead and subdued inflation.

FED Actions: The FED said it will continue to allow its balance sheet to gradually and predictably roll off to a range of \$2.5 - \$3.5 trillion. At year end, the balance sheet stood at \$4.1 trillion down from \$4.5 trillion in October of 2017 when the normalization process was initiated.

Economic Highlights: 3rd quarter GDP expanded by a solid 3.5% following the 2nd quarter 's 4.2% growth, making the middle of 2018 the best two consecutive quarters of growth in four years. 4th quarter estimates of GDP, and consumer and business confidence are on the decline as a result of the negative impact of the trade wars, U.S. government closure, and return of market volatility.

The October and November unemployment rate registered 3.7% and while the December rate increased to 3.9%, it was a result of more people entering the labor force – a positive development. During 2018, an average of 217,000 people entered the labor force each month; this was the 2nd best annual entrance rate of this expansion. Typically, full employment pulls wages upwards. During this cycle, wage inflation has been suppressed as more people seek work. However, it has percolated upward more recently as December wage growth increased at a 3.2% rate – a high for the cycle.

The Core Consumer Price Index (CPI) increased at a rate of 2.2% in December. Over the past two months, consumer prices have shown weaker growth than expected. Inflation globally has been limited as a result of disinflationary demographic trends and subpar economic growth. As a result, the real rate of U.S. inflation appears to be hovering at the FED's 2.0% target.

FED's Economic Outlook: The FOMC's latest *Summary of Economic Projections* lowered the FED's estimate for 2019 GDP from 2.5% to 2.3%. Core CPE inflation estimates for 2018 were reduced to 1.9%. For 2019, the Core PCE inflation estimates were reduced to 2.0%. Longer run unemployment estimates increased slightly. These are not projections that would necessitate a need for additional rate hikes; however, the FED is still projecting a median forecast of two hikes in 2019. If this occurs, the Fed Funds Rate would hit 3.00% – 3.25% against a year-end 10 Yr U.S. Treasury yield of 2.68%.

Bottom Line: 2018 was arguably the strongest year since the current economic expansion began in late 2009. During the year, we witnessed 3%+ GDP growth, record low unemployment, increasing wage growth, record corporate earnings, strong business and consumer confidence, and household net worth at new highs. However, as the year concluded, expectations for slower growth eroded confidence. Many economists are now expecting a recession in the foreseeable future. We are not in that camp. We see continued economic growth (albeit at a slower rate), modestly rising corporate profits, and tame inflation in 2019. We are aware that the probability of a recession in 2020 and beyond has increased. Our primary focus is on the next 6 - 12 months and investing accordingly. Additionally, we are aware that all three sectors of the economy (Government, Business and Consumer) are once again holding record debt levels (in \$ terms). Simply put, this will require a greater focus on credit quality in the years ahead. We are up to the task.

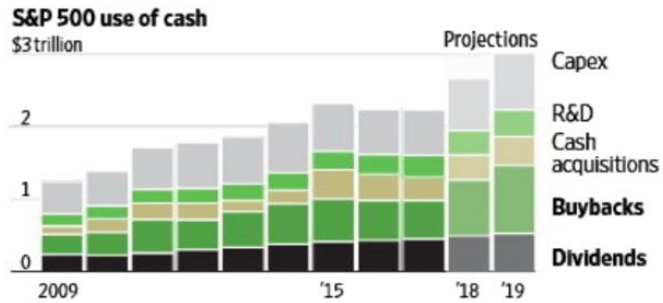
We believe the FED will be on pause for the first half of 2019, and will be challenged to raise rates twice in 2019. With the 2 to 10 spread at 18 basis points, the FED has reached a neutral stance and will be data dependent. Our 10 Yr U.S. Treasury forecast for 2019 is 2.75% - 3.25% as inflation remains around 2.0% and global central banks continue to manipulate rates to the downside. We continue to see risk / reward favoring shorter duration, higher quality fixed income securities.

Taxable Bond Strategy

The U.S. investment grade (IG) corporate bond market was in the media a considerable amount during 2018. Much of the news surrounded the growing amount of corporate debt in the marketplace; especially the increasing share of BBB rated instruments. We have written in the past that credit ratings firms are more likely to downgrade rather than upgrade. The rating agencies are evaluating how Corporate America performs through a full economic cycle.

Spending Spree

Dividend and buyback spending jumped in 2018, and companies are expected to continue diverting large sums of cash to shareholders next year.



Source: The Wall Street Journal, Goldman Sachs Global Investment Research

Another particularly notable statistic is that the outstanding value of U.S. corporate debt has hit 46%+ of GDP, a new record high. Although this is true and may have been a red flag in the past, with more U.S. companies generating revenue from around the globe, how relevant is U.S. GDP solely as a measure of risk? An alternate view outlines that the total amount of credit market debt as a percentage of the market value of equities is near historic lows, falling to just over 30%. Additionally, corporate America is still flush with cash. While an increasing amount of cash is being used for stock buybacks, companies can quickly halt the buybacks and pay down debt in the event of a downturn.

In light of this, the overarching theme of the U.S. corporate fixed income market during the 4th quarter is an investor bias towards higher quality assets. We have been focused on increasing the credit quality of our portfolios for the last several quarters. Widespread de-risking out of equities and high-yield may have led to demand for IG bonds, although not equally across the ratings spectrum. If we look broadly at corporate bond yields by rating, BBB rated securities, on average, rose more than similar maturity A rated bonds. Bonds rated AA saw their yields fall during the quarter. U.S. government bond yields also fell throughout the quarter with the exception being the short end of the U.S. Treasury curve (1 year maturity and under) which rose on the heels of an additional FED hike.

As of December 31st, we remain over-weight corporate bonds with an emphasis on A and BBB credits. During 2018, 5 Yr A rated yields rose 95 bps (3.62% vs. 2.67%) and 5 Yr BBB yields rose 120 bps (4.23% vs. 3.03%). Relative to 5 Yr Treasuries, corporate spreads widened during the year with A rated spreads increasing from +46 bps to +111 bps and BBB rated spreads moving from +82 bps to +172 bps. We find these levels attractive given the lingering low rate environment. The 4th quarter saw the 2 - 10 Yr spread fall to +18 bps at quarter end – this is the tightest spread we have experienced during the current expansion. In addition, the Treasury curve inverted this quarter with the 1 Yr closing 10 bps above the 5 Yr. Given this unusual interest rate environment, we are comfortable keeping interest rate risk in the 3 - 4 Yr duration range.

Our ***Taxable Bond Strategy*** is focused on high quality IG, intermediate maturity bonds. Portfolios are structured to generate an average yield to maturity (YTM) of 3.51% with a duration of 3.0, and an average credit rating of A-. Relative to our benchmark, we remain overweight corporate bonds although we have been increasing our exposure to US Treasuries and US Agencies. We remain focused on increasing the overall credit quality of the portfolio.

Opportunity & Leverage Opportunity Strategies

Equity market volatility during the 4th quarter upset the HY market as the correlation between the two asset classes once again held firm. The decline in oil prices during the 4th quarter also sent ripples through the HY market. Oil prices, as measured by West Texas Intermediate (WTI) crude, ended the year 25% lower than it started, and off 40% from its early October peak. Oil prices dropped from $76 per barrel in October to the 2018 low of $43 on December 24th, a 44% decline. As we experienced during 2015, when WTI crude prices dropped sharply, it upset the HY market. While the energy/oil sector is a smaller component of the HY index today than it was in 2015, it remains one of the largest sectors of the HY market at 14% of the index. Our outperformance versus the index during 2018 was aided by our significant underweight position in energy. The HY index returned a negative 1.5% for the year, while our tilt towards higher quality, HY as the year progressed, produced attractive relative returns for both our Opportunity and Leveraged Opportunity Strategies.

As we enter the later stages of this economic cycle, we are focused on both earnings risk (the risk of a decline in earnings and thus an ability to repay debt) and balance sheet risk (aggressive over-leveraging). Both are considered key risks when investing in HY especially at the later stages of an economic cycle, both risks increase. Accordingly, we have shortened portfolio duration, enhanced quality, and we "know what we own."

As we closed out 2018, HY spreads, the yield differential between U.S. Treasuries and HY bond yields, widened materially, and should create opportunities for 2019. At year end, HY yields sat at 7.95% as measured by the Barclays U.S. HY Index. Spreads, as measured by the Barclays U.S. HY Index vs. the 5 Yr Treasury, widened to +544 bps versus +329 bps at the end of the 3rd quarter. Spreads returned to more normal valuations relative to the 20 year historical average spread of approximately +580 bps. As the yield curve has flattened/inverted, we find value at the short end of the HY curve.

At year end, our ***Opportunity Strategy***, on average, had a YTM of 5.99%, a duration of 2.9, and an average credit rating of BB. Our ***Leveraged Opportunity Strategy***, on average, had a YTM of 6.05%, a duration of 2.6, and an average credit rating of BB. We were unlevered during 2018; however, as spreads widened throughout the 4th quarter and values returned to a more attractive levels, we look for opportunities to redeploy leverage in 2019.

Enhanced Cash Strategy

While the yield curve continued to flatten and even invert in some cases, the ultra-short portion of the curve (inside 1 year) was a welcome safe-haven, and offered significant value in the 4th quarter.

IG Corporate bonds continued to provide meaningful yield advantages relative to comparable Treasuries. IG Municipal bonds, while a smaller allocation in most portfolios, also performed well. However, replacing maturing municipal bonds was, at times, less advantageous at the ultra-short end of the municipal curve. Thus, we tended to add more Treasury bonds to portfolios, which are not only higher in quality and more liquid, but are also exempt from state and local taxes.

Our ***Enhanced Cash Strategy*** is invested in a tactful mix of liquid, ultra-short duration Corporate, U.S. Agency, and U.S. Treasury bonds. We add tax-advantaged Municipal bonds to enhance overall returns when appropriate. At quarter's end, our portfolios averaged a 2.59% YTM and a 2.70%* Taxable Equivalent Yield (TEY), with an average credit rating of A+, and just a 4 month duration.

Municipal Bond Strategy

Municipal bond yields rallied late in the 4th quarter as the imbalance between supply and demand reached a crescendo. More specifically, demand, which had been percolating throughout the year, accelerated while municipal supply remained notably light. Combine the supply and demand dynamic with falling U.S. Treasury yields and the stage was set for a pronounced year-end rally. The 10 Yr Treasury yield fell by 48 bps from November 1st through year-end while 10 Yr AAA Rated Municipal yield fell by 41 bps during the same period. The municipal-to-treasury bond ratio averaged 86% for the quarter, confirming fair value.

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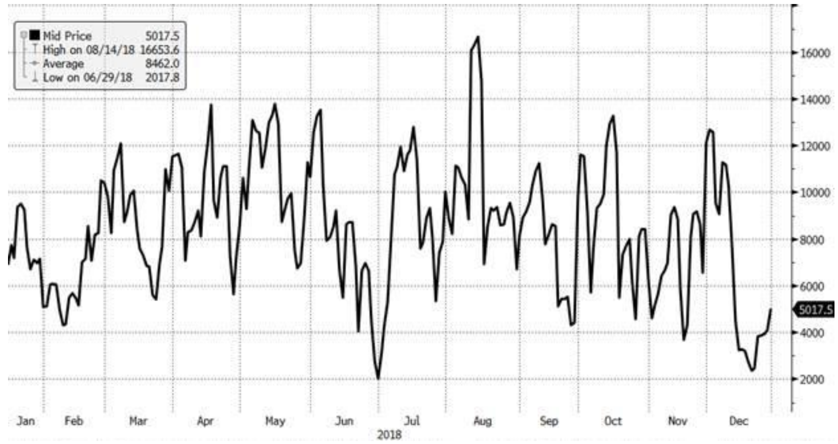
Lighter overall supply along with a more conservative approach to debt is surely a positive for the municipal marketplace. The market ended the year as it began, with a month of very light supply. 2018 issuance was down roughly 20% for the year compared to 2017. The lighter supply figures have mainly been driven by the lack of pre-refunding deals, higher rates (earlier in the year), and a more austere approach to debt by municipalities. 2018 issuance was $325 billion compared to $410+ billion for 2017. Refunding deals, as a result of 2018 tax reform, fell by more than 50% this year (from $154 billion to $74 billion). We project 2019's total new issuance to be in the $350 billion ballpark.

30 Day Visible Supply

2018 Issuance Down 20% Year-over-Year



Source: Bloomberg

From the demand-side, it did not take much to tilt the scales in demand's favor. Retail-oriented mutual funds experienced weekly outflows for much of the quarter. However, strong interest from institutional investors and insurance companies was able to fill in the demand gap. Additionally, stronger than expected redemption flows, and demand from separately managed accounts in the 4th quarter, put added pressure on subdued supply levels. In the last week of the year, on the heels of improving market sentiment, net-flows into municipal mutual funds turned positive with an influx of $1.35 billion.

During the quarter, market yields (5 Yr AAA) moved sharply lower along with a flattening of the yield curve. 5 Yr AAA yields fell by 26 bps in the quarter while the 2 - 10 Yr segment of the yield curve flattened by 13 bps. The current level of "flatness" is a rarity in the municipal bond market. The serial nature of municipal issuance includes a degree of imbedded steepness (municipal bonds are generally issued in sequential maturity year order ranging from 1 to 20+ years). 10 Yr AAA yields fell by 31 bps during the quarter. However, from peak (11/06/18) to bottom (12/31/18) the 10 Yr AAA average fell by 49 bps. Municipal bond yields remain compelling in our preferred segment of the yield curve. At quarter-end, 5 Yr yields (A to AAA) ranged from 2.30% to 1.95%. Crossover buyers, in mid-to-high tax brackets, continue to realize attractive taxable equivalent yields versus comparable taxable bonds.

From the credit perspective, a recent report by the National Association of Budget Officers highlights that state fiscal conditions continue to show signs of improvement and greater stability. According to this report, 40 states had general fund revenue collections that outpaced 2018 projections. Furthermore, Moodys published its annual sector outlook in early December and placed a stable outlook on state credits, local governments, public power, toll roads, public ports, and water and sewer bonds. These seven sectors are highly represented throughout our portfolios.

Our high-quality, intermediate-duration bias continues to balance risk, return, preservation of capital, and cash flows. We will continue to opportunistically add value through our high-credit-quality bias and yield curve positioning. Additionally, we continue to find value in structural and sector diversification. Our municipal bond portfolios are state-specific or state-focused where advantageous (general market in approach otherwise). A principal focus of our municipal bond strategy continues to be on blending essential service revenue bonds with high quality general obligation bonds. We enter 2019 with watchful optimism for the municipal marketplace. Positive fundamentals permeate the landscape and the trends that ignited the year-end rally still appear to be in place.

Our ***Municipal Bond Strategy*** is focused on high quality IG, intermediate maturity bonds. Portfolios are structured to generate an average YTM of 2.23% and a Taxable Equivalent Yield (TEY) of 4.31%* with a duration to maturity of 3.8 years, and an average credit rating of AA.

** Assumes 48.3% Combined Effective Tax Bracket*

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.