CARRET
Asset Management

July 2017

Carret Credit Insight

## The Market Tells Yellen & Team… "Be Patient"

**Portfolio Managers**

**Jason R. Graybill, CFA**
212.207.2339
jgraybill@carret.com

**Neil D. Klein**
212.207.2340
nklein@carret.com

**Firm AUM**

**$2.5 Billion**

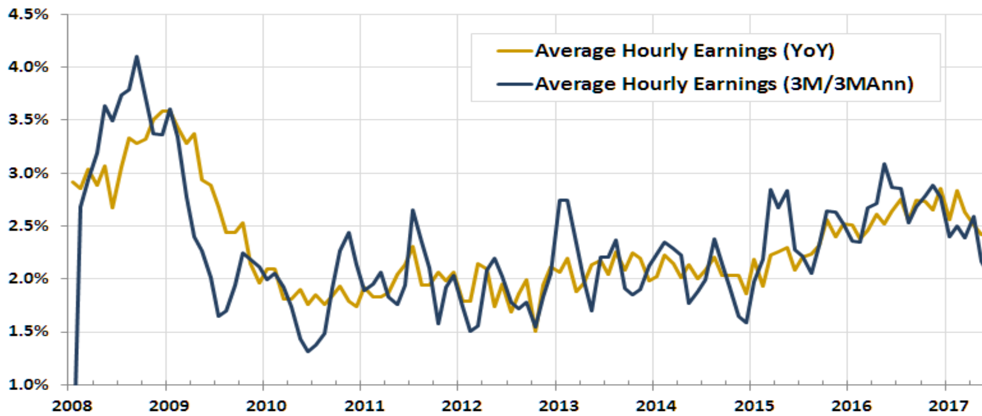
On June 14th, the Federal Reserve Board (FED) raised the Federal Funds Rate for the 4th time since initiating this crawling tightening cycle in December of 2015. It raised the overnight lending rate by 25 basis points to 1.00% - 1.25%. In addition to the rate increase, the FED disclosed its "plan" to shrink the balance sheet, which we previously termed "Reverse QE". The plan is to let the FED's portfolio of bonds to gradually shrink by allowing $6 billion in Treasury bonds and $4 billion of Mortgage Backed Securities (MBS) to simply roll-off (mature) each month. Recall that the size of the balance sheet is $4.5 trillion and the FED is targeting an initial $10 billion per month of roll-offs. Put another way, the FED is simply reducing Operation Twist, thus reducing its monthly buying of Treasury and MBS bonds. If the market can't replace the FED's appetite for $10 billon a month of bond purchases, interest rates will have to increase to bring new buyers into the market. We note that $10 billion a month or $120 billion a year is not a market moving amount in the bond world. Accordingly, this move initially should have a limited impact on interest rates. We anticipate the FED will formally announce Reverse QE at the September meeting with implementation in the 4th quarter.

The rate hike on June 14th and the foreshadowing of Reverse QE is occurring against a backdrop of softer economic growth and a weakening of core inflation. For the 1st quarter, GDP growth registered a sub-par 1.4%, while expectations for the full year 2017 have declined to 2.2%. The June labor report was mixed as payroll growth was strong; however, wage growth was weak – an unusual combination that is challenging the FED's goal of normalizing monetary policy. The June unemployment rate was 4.4% and wage growth declined modestly - a key indicator of future inflation. The Year-over-Year (YoY) rate of growth for wages in June was a disappointing 2.5%. The 3Month-over-3Month (3M/3M) report declined to an annualized rate of 2.0% from a peak of 3.1% in May of 2016. Core CPI and Core PCE both declined during the quarter ending June at 1.7% and 1.4% respectively (see chart), exhibiting movement away from the FED's 2% target. At this stage of the game, we believe wage growth is the key variable when attempting to anticipate future FED moves. The FED is still forecasting another rate hike in the 2nd half in tandem with Reverse QE; however, the bond market is telling the FED to be patient.

| Key Interest Rates | 6.30.17 | 12.31.16 | 12.31.15 |
|---|---|---|---|
| Prime Rate | 4.25% | 3.75% | 3.50% |
| Fed Funds Rate | 1.00% – 1.25% | 0.50% – 0.75% | 0.25% – 0.50% |
| 3 Month U.S. T-Bill | 1.02% | 0.50% | 0.18% |
| 5 Yr U.S. Treasury Note | 1.88% | 1.92% | 1.76% |
| 10 Yr U.S. Treasury Bond | 2.30% | 2.44% | 2.27% |
| 10 Yr AAA Municipal Bond | 1.99% | 2.33% | 1.93% |
| 10 Yr A Corporate Bond | 3.29% | 3.49% | 4.05% |

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

# Carret Credit Insight



*Source: Vining Sparks, BLS*

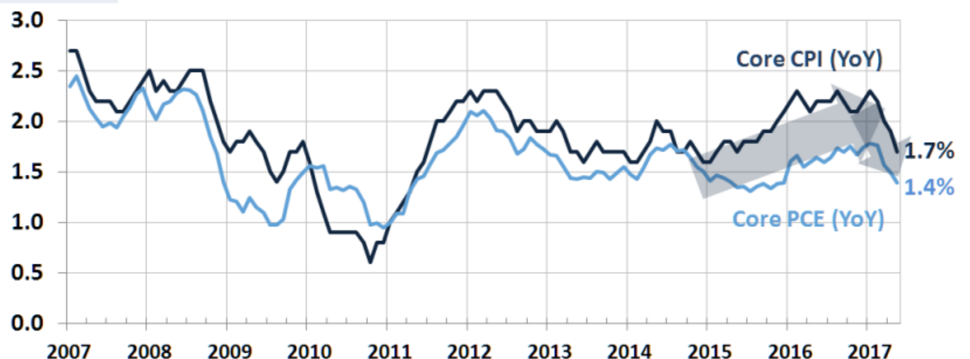
While the FED has increased the FED Funds rate (moving short rates higher) four times in the past eighteen months, intermediate to long rates have ignored the FED and trended sideways. Intermediate to long rates are more influenced by economic factors, mainly inflation and economic growth. On the day of the first FED hike in nearly a decade, December 16th of 2015, the 10 Yr Treasury registered 2.30%. On June 30, 2017, the 10 Yr Treasury stood at 2.30%. While the overnight rate increased 100 basis points, the 10 Yr Treasury held constant. Investors have flattened the yield curve (as measured by the 2 to 10 spread of +92 at quarter end) indicating that bond investors do not see a pick-up in economic growth or inflation on the horizon.

With inflation declining into a June range of 1.4% to 1.7%, we continue to view the fair value of the 10 Yr U.S. Treasury at +150 over CPE/CPI, equating to a range of 2.9% to 3.2%. With continued Central Bank intervention into the global fixed-income markets, we are keenly aware of the manipulative impact of these actions – depressing rates below fair value. Given our view of fair value, we continue to keep our duration shorter than our benchmarks as we view interest rate risk as a greater risk than credit risk at this point in the cycle. We continue to search for undervalued sectors / issues within the broad bond market to identify opportunities.

***The Bottom Line:*** We expect U.S. economic growth to continue at a 1.5% - 2.0% pace absent material tax reform and infrastructure spending. During 2017, we anticipate inflation will hover close to the FED's 2% target and unemployment will remain at low levels. We antipcate the FED will initiate Reverse QE at the September meeting with implementation in the 4th quarter. Absent a solid inflation report and above expectation GDP growth, the FED will be hard pressed to both taper and raise rates in the 2nd half of the year.

## Investment Grade Taxable Bonds

The 2nd quarter rate hike by the FED caused the short end of the curve to rise but prompted little to no movement in the intermediate to long end of the treasury curve. With this, the Investment Grade (IG) yield curve moved in tandem with U.S. Treasuries. Investors searching for income find themselves extending out along the curve to eke out higher yields, albeit by taking on interest rate risk in the process. Despite corporate earnings having flattened out over the last 8+ quarters, the earnings



*Source: Vining Sparks, BLS*

outlook for 2017 remains strong, bolstering the outlook for corporate bonds. From a supply perspective, corporate bond issuance has slowed in the second quarter after coming off record issuance to start the year. This has kept a lid on longer dated yields and spreads.

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 1.88% - a slight drop despite the FED pushing up short-term rates. Relative to 5 Yr U.S. Treasuries, A rated spreads fell to +57 basis points and BBB rated spreads tightened to +98 basis points and are fairly valued from a historical standpoint. We continue to watch spread levels as we determine broad sector allocations. At the end of May, we decreased our corporate bond exposure by reinvesting called bonds into U.S. Government securities. This allocation allows us to take an appropriate amount of risk with the returns the market is presenting. Having remained significantly underweight U.S. government securities since the financial crisis of 2008, we anticipate slowly increasing our Treasury and Agency exposure in the quarters ahead.

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 2.68% with a duration of 3.3 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 2.67%, a duration of 3.9, and an average credit rating of A-.

## High Yield Bonds

The HY bond market continued its strong performance in the first half of the year. The iBoxx High Yield Index returned 2.1% during the 2nd quarter, as spreads over U.S. Treasuries fell 19 basis points to 3.73% as measured by the Barclays U.S. HY Index. Despite yields continuing to decline, investors have not shied away from the HY market. U.S. companies have tried to meet this demand, having issued almost $8 trillion in debt since 2010, according to the International Monetary Fund. An interesting observation about the HY market is how the structure of new issuance has changed. Companies are able to sell debt with ever lower yields while extending the maturities of their bonds. Despite these factors, issuance of the lowest grade debt has fallen while bonds rated just below investment grade are making up more of the HY market.

**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%

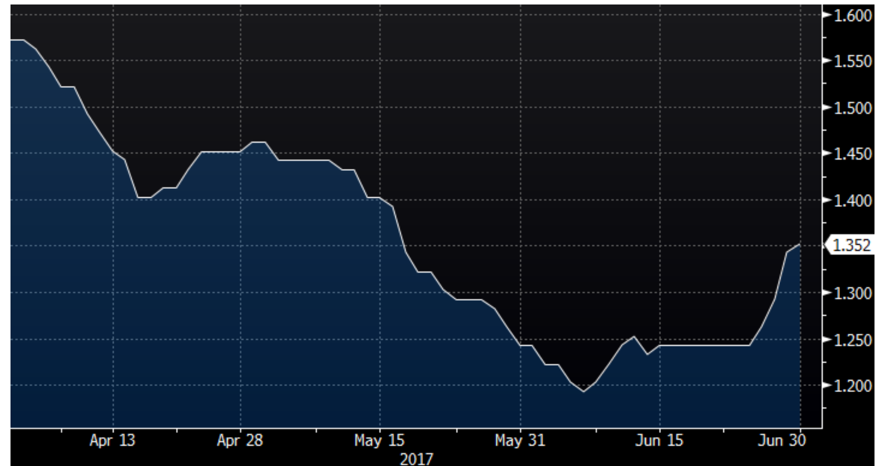
*Source: Bloomberg, Barrons*

At quarter end, our ***Opportunity Strategy***, on average, had a YTM of 4.49%, a duration of 4.0 and an

average credit rating of BB-. Our ***Leveraged Opportunity Strategy***, on average, had a YTM of 4.48%, a duration of 2.8, and an average credit rating of BB-. As yields have declined and spreads have tightened, we are continuing to shorten our duration and increase average credit quality. A combination of slow growth, low inflation, and low interest rates has been positive for the HY market; however, yields and spreads have declined to levels that do not justify taking on additional interest rate and credit risk at this time.

## Investment Grade Municipal Bonds

**5 Year AAA Municipal Yield**

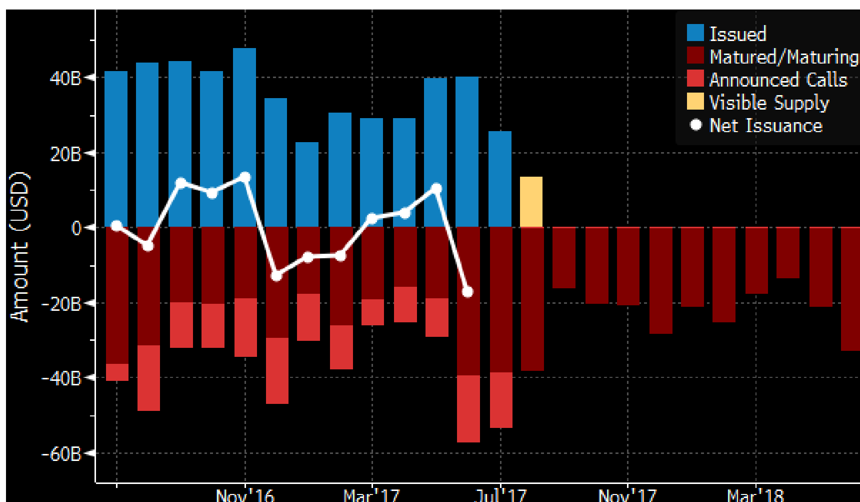



*Source: Bloomberg*

As with most spring and summer months in the municipal market, demand dominates the landscape. Like clockwork, May, June, and July are months in which redemptions, calls, and maturities spike. This year is no exception. In fact, we expect that this year's redemption season may top previous records. We are projecting $100+ billion in redemptions during June, July, and August with June being the largest month. This year's redemption spike comes as no real surprise to us as we recall that 2007 was a huge new issuance year. Combine that with the assertion that municipal bonds are generally issued with 10 years of call protection, the cash invested into those 2007 new issue bonds is now coming home to roost.

At quarter-end, mutual fund flows (one indicator of demand) more than doubled the average weekly inflow seen year-to-date. The week ending June 28th experienced $496 million in inflows compared with the weekly average of $219 million. Thus far in 2017, the market has had 24 weeks of positive inflows compared with only 2 weeks of fund outflows. The Separately Managed Account (SMA) contribution to demand has been quite strong as well over the same period.

**Net New Municipal Issuance Turns Negative**




*Source: Bloomberg*

In additional to high domestic demand, foreign buyers are back in the municipal markets. Foreign holdings of debt issued by U.S. states and local governments rose 16% in the 4th quarter of 2016 reaching a record level of $106 billion. The rationale continues to be the perceived low risk, attractive relative yields, and diversification benefits. We expect this trend to continue especially as global rates remain at or near today's historic low levels.

From the supply side, 2017 has been lagging expectations. We anticipate roughly $95 billion in new issue supply in the three months from June to August. This three month time frame had $108

billion in new issue supply last year. Municipal supply is trailing last year's pace due in part to issuer concerns over tax and FED policy along with the uncertain path of political and economic stimulus.

During the quarter, market yields (5 year AAA) ranged from a high of 1.57% on April 3rd to a low of 1.19% on June 7th. The closing yield for the quarter was 1.35%. The municipal bond curve has flattened in sympathy with rising short-term U.S. Treasury yields. Looking at the 2 year to 10 year AAA Muni relationship, the curve has flattened from 146 basis points to 97 basis points since mid-March of 2017. This tells us that overextending maturities may be met with less incremental yield. The flatness of today's curves helps to confirm that we are in the "right part of the market" given our desire to appropriately balance reward and risk.

From a credit perspective, the state of Illinois side-stepped a junk credit rating as state legislators overrode the Governor's veto to ratify a budget. Also this quarter, the state of Kansas, in a surprise move, voted to override the governor's veto of a tax bill that was designed to raise taxes while shrinking an expanding budget gap. The bill will raise taxes to provide the needed funds to solve the state's financial shortfall. A credit that we do not own but are watching closely for potential ripple effects is Hartford, CT. On May 30th, Moodys, citing the lack of progress on the budget gap, put Hartford's Ba2 long-term rating on negative watch and warned of further potential downgrades. However, in the broad sense, state and local governments are generally stable, reflecting multiple years of modest economic growth combined with continued state and local austerity.

Our high-quality intermediate-duration bias continues to add value from a risk reward perspective. We will continue to opportunistically add value through proactive trading and reinvestment of redeemed positions. Additionally, 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). Essential service revenue bonds and high-quality general obligation bonds are providing sound value in today's landscape. Our composite has a YTM of 1.76% with a duration of 3.8 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.

*For more complete information on the American Independence Funds and Rx Funds, you can obtain a prospectus containing complete information for the Funds by calling 866.410.2006 or by visiting www.americanindependence.com. 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 Fund's prospectus. The prospectus and, if available, the summary prospectus should be read carefully before investing.*
*Shares of the American Independence Funds and Rx Funds are distributed by Matrix Capital Group, Inc., which is not affiliated with RiskX Investments, LLC, or Carret Asset Management, LLC.*

*Past performance may not be indicative of future results. Different types of investments and investment strategies involve varying degrees of risk, both short-term and long-term, including principal loss and fluctuation. No client or prospective client should assume that any material in this document serves as the receipt of or a substitute for, personalized advice from Carret Asset Management, LLC or from any investment professional. Due to various factors, including the passage of time and changing market conditions, such content may be outdated and no longer reflective of current holdings or position(s). Information contained herein is from what we believe are reliable sources but cannot be guaranteed.*