

Carret Credit Insight



Should The FED Yield To The Yield Curve?

Co-Directors Fixed Income

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

Neil D. Klein
212.207.2340
nklein@carret.com

Firm AUM

\$2.5 Billion

We have written over the past two and a half years that the FED was raising interest rates (Fed Funds Rate) in an effort to normalize monetary policy and “prepare” for the next recession – meaning, one cannot add liquidity into a slumping economy if rates are at zero. When the FED started raising rates in December of 2015, the unemployment rate was at 5.0% and GDP growth was sub-expectations, growing 1.5% in 2016. With inflation (PCE) well below the FED’s 2% target rate, this was clearly not a “hot” economic environment that needed cooling off via FED rate hikes.

Today, the unemployment rate is at 4.0%, inflation is north of the FED’s 2% target, and GDP estimates for 2018 growth are 2.8%. For the first time in a long time, we find ourselves in an economic environment where we can argue that the FED should be normalizing rates – albeit slowly. Washington’s use of fiscal policy initiatives (primarily corporate tax cuts), coupled with a slow moving FED, has resulted in a more robust economic environment.

At the end of 2013, the 2 Yr U.S. Treasury yielded 0.40% while the 10 Yr yielded 3.00% resulting in a 2-10 spread of +260bp. Today, the 2-10 spread rests at +33bp, a result of the 2 Yr rising materially to 2.52% while the 10 Yr declined to 2.85%. In the days after quarter end, the spread has collapsed further to +26bp. The FED has pushed the short end of the yield curve higher in an effort to normalize monetary policy, while investors have not bought into the long term inflation and economic growth outlook.

The last time the 2-10 spread hit current levels was 11 years ago in July of 2007. We can all remember what happened to the economy in 2008. In fact, over the past 40+ years, every recession has been preceded by an inversion of the yield curve (see chart on the next page). Most FED Governors are expecting that the FED will raise rates at least two more times this year, three more times next year, and at least once in 2020, leaving short rates in a range between 3.25% and 3.50% by the end of 2020. With long rates at 2.85% today, the FED is only 1-2 hikes away from inverting the yield curve. As we said last quarter, we believe the FED would be reluctant to create this scenario.

Key Interest Rates	6.30.18	12.31.17	12.31.16
Prime Rate	5.00%	4.50%	3.75%
Fed Funds Rate	1.75% – 2.00%	1.25% – 1.50%	0.50% – 0.75%
3 Month U.S. T-Bill	1.91%	1.39%	0.50%
5 Yr U.S. Treasury Note	2.73%	2.21%	1.92%
10 Yr U.S. Treasury Bond	2.85%	2.41%	2.44%
10 Yr AAA Municipal Bond	2.47%	1.99%	2.33%
10 Yr A Corporate Bond	4.03%	3.25%	3.49%

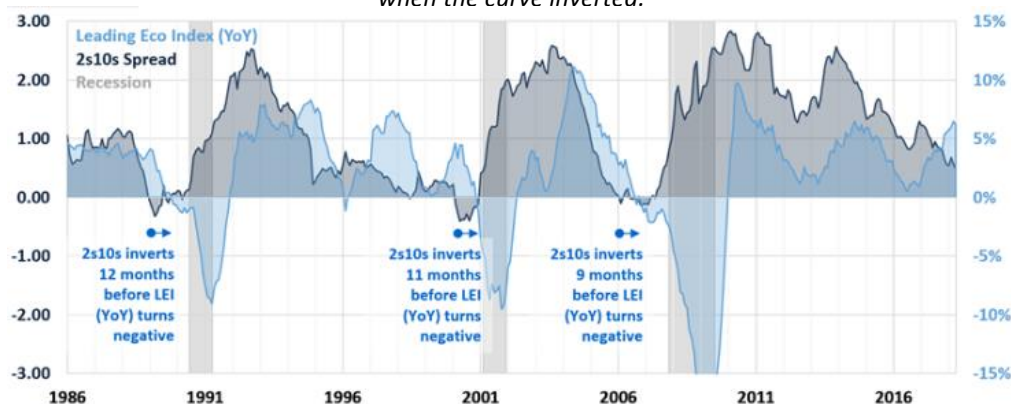
Source: Bloomberg, Wall Street Journal, Reuters, Municipal Market Data (MMD), FactSet

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A few of the FED governors have become vocal on this topic. Philadelphia FED President Harker (non-voter) said the FED should “**yield to the yield curve**”. He highlighted that inflation trends were back near the FED’s 2% target and said that if a policy move risks inverting the yield curve, “we should avoid that”. Atlanta FED President Bostic (voter) said an inversion is a “surefire sign of a recession, and that an appropriate approach to FED policy will be consistent with there not being an inversion”. Dallas President Kaplan (non-voter) said he would be reluctant to keep raising rates if the 10 Yr yield has not moved higher. At Carret, we believe the risks of the FED inverting the yield curve are too great and accordingly, they will not do it.

Curve Inverts before Data Turns Lower

The curve tends to invert well before the economic data points to a slowing cycle. In two of the three most recent recessions, the LEI index actually showed no signs of weakness when the curve inverted.



Source: Vining Sparks, Conference Board, Bloomberg

We recognize that the FED faces numerous challenges today as inflation crawls higher and the tariff war/negotiations out of Washington create “unknowns” – are these permanent moves or just negotiating tools? Whichever happens, they both have very different potential economic impacts. Unless investors move long term rates higher, the FED will be challenged to increase rates beyond the September meeting. The fed fund futures indicate a 72% probability of a hike at that meeting.

The Bottom Line: The current economic expansion began in July of 2009 and has now registered 108 months of growth. This is the second longest running expansion since April of 1991 to February of 2001 which saw a period of 118 months of economic growth. Today, we see signs of geopolitical tension that could potentially derail this expansion; however, we believe cooler heads will prevail. Accordingly, we see continued economic growth, slowly rising inflation, and in turn, interest rates that will creep higher (our 10 Yr U.S. Treasury forecast remains at 3.00% - 3.25%). We believe the FED will not invert the 2–10 spread and thus will continue to move slowly. We see risk/reward favoring short duration and high quality fixed income securities.

Investment Grade Taxable Bonds

The investment grade (IG) corporate bond market has underperformed within the fixed income arena through the first half of 2018. An increase in U.S. Treasury yields coupled with widening spreads led to this underperformance. Despite being overweight corporate bonds, our short duration bias allowed us to outperform our benchmark by approximately 20bp through the first half of 2018.

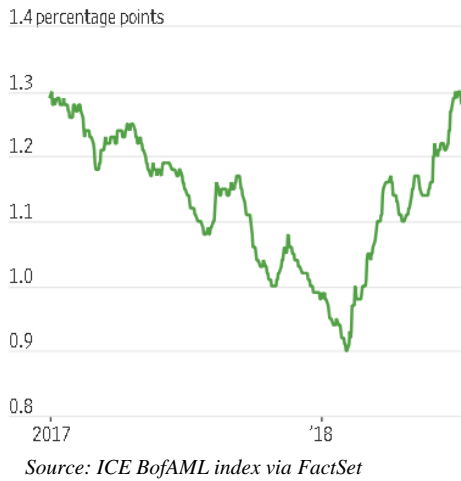
So far, 2018 has seen the supply demand balance shift. Two major buyers of U.S. corporate bonds have pulled back their purchases thus dragging down demand. Japanese investors, who had been piling into U.S. IG debt, were motivated by the arbitrage opportunity for swapping the dollar back into yen. As this trade opportunity has shifted in the other direction, there is less demand from Japan. Additionally, tech companies (e.g., Apple and Microsoft) had been investing their overseas cash hoards in U.S. IG bonds. Since the passing of the Tax Reform Plan of 2017 reduces the tax paid on repatriated cash, companies have been shrinking their bond holdings as they return the cash piles to the U.S. On the other side, we have a few media mega-deals that, if finalized, could bring a wave of new supply to the

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market. AT&T's purchase of Time Warner and Fox's sale to either Disney or Comcast could bring about a new record level of corporate supply.

Into Reverse

Yield spread of U.S. investment-grade bonds over U.S. Treasuries



As we discussed in our last commentary, the size of the corporate bond market continues to grow to historic levels. With that being said, BBB rated bonds comprise just over 50% of the total IG corporate bond market. For comparative purposes, the amount of BBB rated bonds has grown by 65% in the past 5 years vs U.S. government debt growing just 24%.

As of June 30th, we remain over-weight corporate bonds with an emphasis on A and BBB credits. The 5 Yr Treasury yield moved 17 basis points higher during the quarter having started at 2.56% and ended at 2.73%. Relative to 5 Yr Treasuries, corporate spreads continued to widen during the quarter with A rated spreads increasing from +70 bp to +81 bp and BBB rated spreads moving from +107 bp to +119 bp. The first quarter saw additional flattening of the yield curve with the 2-10 Yr spread falling to a cycle low of +33bp. Given our current market views, we are focused on keeping interest rate risk in the 3 - 4 Yr duration range and average portfolio credit quality above A-. We remain patient when taking on additional credit and duration risk – we do not want to “reach” for yield and therefore, continue to focus on targeting an appropriate return vs. risk balance.

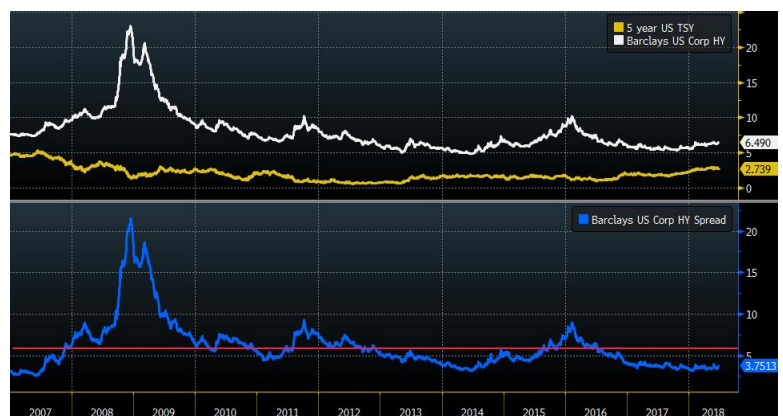
Our **Taxable Bond Strategy** is focused on high quality IG, intermediate maturity bonds. Our taxable portfolios are structured to generate an average yield to maturity (YTM) of 3.43% with a duration of 3.2, and an average credit rating of A-.

High Yield Bonds

The high yield (HY) bond market was impacted by increasing U.S. Treasury yields and widening spreads. Performance is positive for 2018, despite the price movement, as the HY market typically sustains a higher average coupon cash flow. This tends to buffer the market from price swings and is a key driver of total return. An additional boon to performance was the continued lack of new supply coming to market – through the first half of the year, new issuance is down 29% from the same period in 2017. Furthermore, when compared to their IG counterparts, HY issuers have a high concentration of operations within the U.S. – making them less susceptible to the ongoing trade tensions that have emerged globally. HY returns have had a volatile first half of the year; however, the overall total return remains positive.

HY bond yields continued their 2018 climb increasing from 6.19% at the beginning of the 2nd quarter to 6.49% 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, widened an additional +12 bp during the 2nd quarter, increasing to +375 bp. Spreads remain below the 20 year historical average of approximately +580bp.

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



Source: Bloomberg, Barron's

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As HY spreads remain near historical lows - having widened less than 25 basis points during 2018 - we are maintaining a short duration bias and high quality HY focus. At quarter end, our **Opportunity Strategy**, on average, had a YTM of 5.37%, a duration of 3.1, and an average credit rating of BB-. Our **Leveraged Opportunity Strategy**, on average, had a YTM of 5.51%, a duration of 2.5, and an average credit rating of BB-. We remain unleveraged at quarter end. In the current market environment, we remain defensively positioned as we await attractive risk-adjusted opportunities in the quarters ahead.

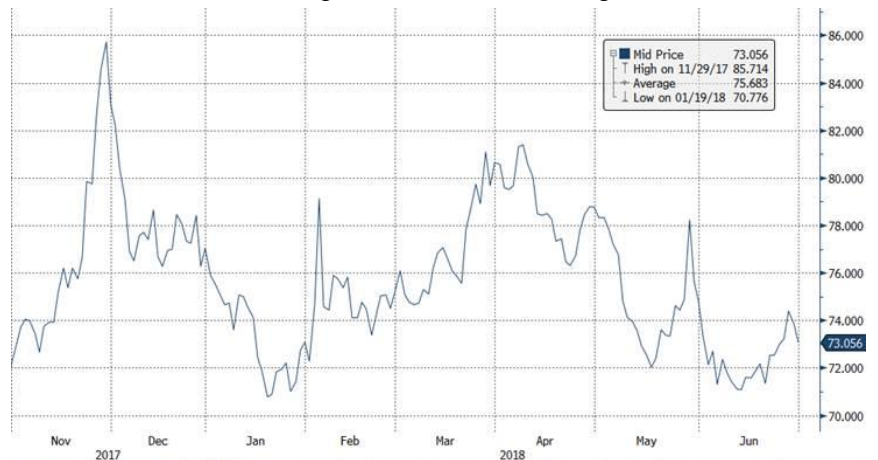
Investment Grade Municipal Bonds

The rare combination of light supply, shrinking ratios, and steepening yield curves helped to shape the municipal market during the second quarter.

As we stated in our last commentary, new issuance was exceptionally light to start the new year after the sizable jump in late 2017. The lighter-than-average trend continued into the second quarter. Year-to-date, municipal markets have produced \$158 billion in new supply, which puts the projected 2018 volume at sub-\$350 billion for the year. By comparison, the market absorbed over \$425 billion in both 2017 and 2016. The imbalance between supply and demand was pronounced in the second quarter with bond redemptions alone overriding available supply by nearly \$10 billion. As new demand is layered on, the imbalance should become more magnified. The silver lining is that the current supply/demand dynamic adds an element of firmness to current bond prices and returns.

AA 5 Year Muni-to-Treasury Ratio

Trending lower than recent averages

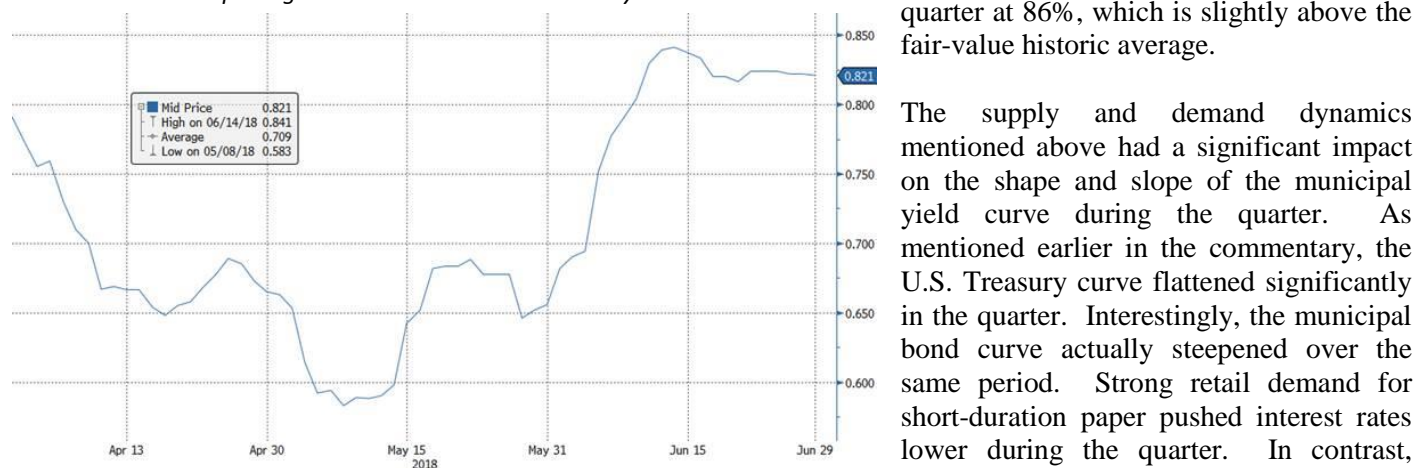


Source: Bloomberg

The muni-to-treasury ratio (MOT) helps us determine “value” in the marketplace, and can impact our yield curve decisions. A higher ratio points to good value, as municipal yields approach parity with U.S. Treasury yields on an absolute basis. A lower ratio, on the other hand, translates to potentially overvalued markets. The MOT ratio of 5 year municipal bonds declined in the second quarter, as U.S. Treasury yields moved higher while municipal yields moved lower. The 5 Yr AAA MOT ratio peaked at 81% in early April, and declined to a low of 71% near the end of the quarter. Lower ratios were observed in the shorter segments of the yield curve as retail driven buying was particularly

Municipal Yield Curve Slope (2 – 10 Year)

Steepening in contrast to the U.S. Treasury Curve



Source: Bloomberg

focused on duration reduction. In contrast, the AAA 10 Yr MOT ratio ended the quarter at 86%, which is slightly above the fair-value historic average.

The supply and demand dynamics mentioned above had a significant impact on the shape and slope of the municipal yield curve during the quarter. As mentioned earlier in the commentary, the U.S. Treasury curve flattened significantly in the quarter. Interestingly, the municipal bond curve actually steepened over the same period. Strong retail demand for short-duration paper pushed interest rates lower during the quarter. In contrast,

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lighter institutional buying - further out on the curve - allowed rates to move higher, resulting in the steepening effect. In short, strong retail demand drove down yields on the short-end of the curve while long-end yields moved higher on technical factors and the serial structure of municipal new issuance.

During the quarter, market yields (5 Yr AA) trended lower in contrast to rising U.S. Treasury yields. Municipal yields (5 Yr AA) reached a high of 2.27% early in the quarter and closed at 2.00% on June 30th.

We expect to see a shift in demand dynamics over the next few quarters as the change in the corporate tax rate (from 35% to 21%) takes hold. FED data, for the 1st quarter of 2018, shows that bank holdings of municipal debt, which more than doubled over the past 10 years, fell by 3%. This was the first quarterly decline in bank holdings since 2009. We believe that the decrease in overall new issue volume combined with increasingly strong retail demand should fill the gap left by the banks.

From a credit perspective, Moody's upgraded Florida's State GO rating to Aaa from Aa1 citing the "sustained trend of improvements in Florida's economy and finances, low debt and pension ratios, and reduced near-term liability risks". In other credit news, S&P issued a report this quarter on credit conditions for U.S. states and local governments. S&P asserts that credit conditions are firming at both the state and local levels as accelerating economic growth and federal fiscal stimulus impacts revenues. In S&P's view, current revenues, in most states, are higher than last year with tax receipts surpassing FY2018 budget estimates.

In additional credit news, the U.S. Supreme Court recently overturned a ruling that had made much of the Internet a "tax-free" zone. This "tax law change" should enable states and local municipalities to generate additional revenues from online retailers. We believe that the decision has the potential to have a positive impact on the municipal marketplace; however, the full impact should take some time to gain traction and will likely vary from state-to-state.

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-focused 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 2.30% and a Taxable Equivalent Yield (TEY) of 4.45%* with a duration to maturity of 3.9 years, and an average credit rating of AA.

* Assumes 48.3% Combined Effective Tax Bracket

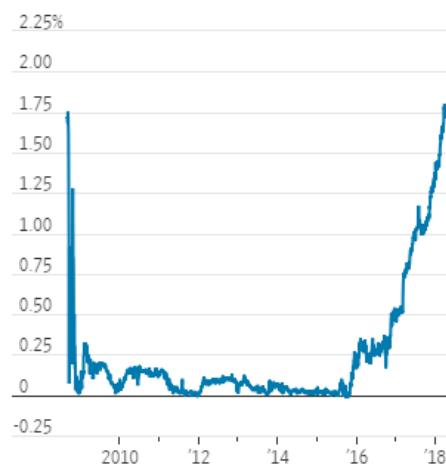
Enhanced Cash

While the FED has guided short-term interest rates higher in 2018 via two Fed Funds Rate hikes, our Enhanced Cash portfolios have benefited nicely. As rates drift higher in the ultra-short part of the yield curve, we are able to reinvest maturing bonds at higher rates, while maintaining a high level of credit quality and liquidity.

Our **Enhanced Cash Strategy** invests in a tactful mix of liquid, ultra-short-duration Corporate, U.S. Agency, and U.S. Treasury bonds, adding tax-advantaged Municipal bonds to enhance overall returns when appropriate. At quarter's end, our portfolios averaged a 2.24% YTM and a 2.38%* TEY, with an average credit rating of A, with just a 4-month duration.

* Assumes 48.3% Combined Effective Tax Bracket

Cash No Longer Trash
3 month Treasury bill yield



Source: FactSet

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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. Shares of the American Independence Funds and AI Funds are distributed by Matrix 360 Distributors, LLC, which is not affiliated with Manifold Fund Advisors, LLC and Carret Asset Management, LLC.

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