Carret Credit Insight — Mid-Year Review

So Much for Interest Rate Predictions

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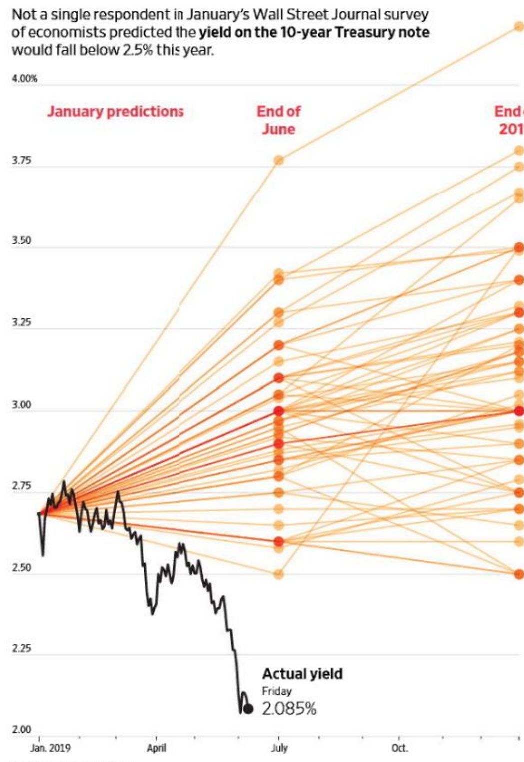
Firm AUM

$2.9 Billion

Often predictions turn out to be wrong… The yield on the 10 Yr U.S. Treasury kicked off the year at 2.68%. All indications were that rising interest rates were forthcoming. The FED had just telegraphed that it anticipated raising the Federal Funds Rate (FFR) twice during 2019. A January Wall Street Journal survey (see chart at right) of the most respected economists/strategists on Wall Street predicted, on average, that the yield would end 2019 north of 3.0% with a range of 2.50% to 4.25%. We were in the rising rate camp as well, with a year-end estimate of 2.75% to 3.25%.s After all, global economic growth looked solid, U.S. corporate earnings were set to rise 8.0%, and wage gains (inflationary) were increasing.

10 Yr Treasury note – WSJ Survey of Economists



Source: WSJ Survey of Economists, Tullett Prebon

By March, the FED telegraphed it would hold rates steady as global uncertainties started to increase. By the end of June, FED Chairman Jerome Powell was signaling that the odds of a rate **CUT** were increasing due to uncertainties related to global growth and protracted trade negotiations, as well as concerns related to the U.S. debt ceiling, below trend inflation, and renewed Brexit anxiety. During the FED's June meeting, several members agreed with Powell that "the combination of these factors strengthens the case for a somewhat more accommodative stance of policy". As we enter the first week of July, the Fed Funds

Key Interest Rates	6.30.19	12.31.18	12.31.17
Prime Rate	5.50%	5.50%	4.50%
Fed Funds Rate	2.25% – 2.50%	2.25% – 2.50%	1.25% – 1.50%
3 Month U.S. T-Bill	2.12%	2.45%	1.39%
5 Yr U.S. Treasury Note	1.75%	2.51%	2.21%
10 Yr U.S. Treasury Bond	2.00%	2.68%	2.41%
10 Yr AAA Municipal Bond	1.63%	2.28%	1.99%
10 Yr A Corporate Bond	2.99%	4.11%	3.25%

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

Futures imply a 99% probability of a rate cut at the July 31st Federal Open Market Committee (FOMC) meeting. In a short 6 months, everyone, including the FED, missed the direction of interest rates.

Bloomberg Barclays Global Aggregate Negative Yielding Debt ($ tril)

Source: Bloomberg

Jerome Powell recently said "risks to the favorable baseline outlook appear to have grown. The crosscurrents have reemerged, with apparent progress on trade turning to greater uncertainty and with incoming data raising renewed concerns about the strength of the global economy." He indicated that "if you see weakness, it's better to come in earlier rather than later." St. Louis FED President James Bullard, stated that "now is a good time for an insurance cut with growth expected to slow and inflation running below target".

On July 1st, the current U.S. economic expansion celebrated its 10 year anniversary and became the longest expansion on record. We do not see a recession on the horizon; however, we recognize that political headwinds may expand as the year progresses and the election of 2020 looms. Trade negotiations have had a negative influence on the global economies (uncertainty related to the outcome). China, void of elections, has a longer time horizon for negotiations than the U.S. While we do not feel that the FED's shift to a more accommodative policy will have a stimulative impact, we view the highly anticipated and likely rate cut on July 31st as an insurance cut to help prolong the expansion.

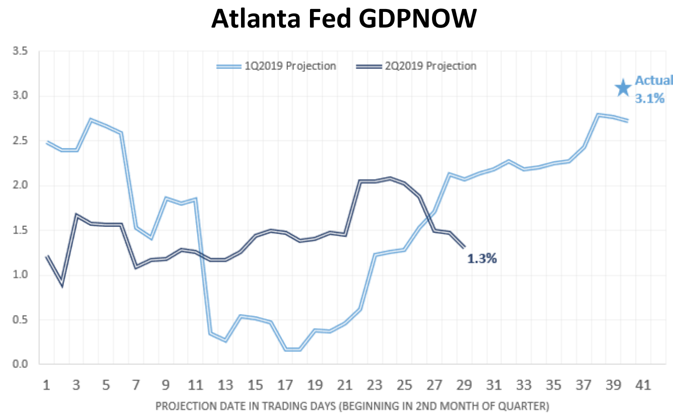
Professional investors are expected to have an outlook (prediction) for economic growth, inflation, and interest rates. These forecasts often deviate from reality. We frequently discuss our focus on keeping our investment process straightforward without distractions. We focus on duration management (which does involve interest rate forecasting), credit quality management (which involves forecasting economic growth and the health of corporate America and municipalities), and sector and spread management (which involves analyzing the overall bond market for attractive risk/reward opportunities). If we get one of these three correct, relative to our benchmarks, it provides us the opportunity to add value. We, along with a bevy of economists and strategists, have been off on our interest rate predictions. However, we have been spot-on with our quality and sector outlooks.

On the international front, the dollar amount of bonds trading at negative yields has hit a new high, closing in on the $13 Trillion level (see chart above). Negative yielding bonds moved from the sovereign markets into the corporate markets with select, foreign, short maturity investment grade (IG) and high yield (HY) bonds trading at negative levels for the first time. The European Central Bank (ECB) stands at the ready to add more fuel to the negative rate fire, if needed (which we believe will happen). Mario Draghi, the President of the ECB, said that "additional stimulus will be required if the economic outlook doesn't improve." He added that the "commitment to keeping interest rates low could be bolstered, further by cuts and renewed asset purchases". Negative rates in Japan and Europe continue to impact FED policy, the dollar, and thus trade.

FED's Economic Outlook: The FED's latest *Summary of Economic Projections* reduced its inflation forecast for 2019 while keeping economic growth expectations unchanged. FOMC members indicated they foresee "sustained expansion of economic activity" and a move towards 2% inflation; however, they realize that "uncertainties about this outlook have increased." The key changes were as follows:

- Headline inflation is expected to grow at a slower pace of 1.5%, versus the 1.8% predicted in March
- Core inflation forecasts were dialed back, and are now expected to rise by 1.8% this year, compared to the 2% expected previously
- GDP growth is still expected to be 2.1% for the year, while the unemployment rate is now expected to hold at a 50 year low of 3.6%

There are currently eight participants, out of seventeen, who believe the FFR will end the year lower, and seven participants who believe the FFR will be 50 bp lower. The median projection for the target FFR by year-end 2020 fell 50 bp to 2.125%. This marks the first Summary of Economic Projections in which FED officials have collectively signaled a lower FFR expectation in a future year.



Source: Atlanta Federal Reserve, Vining Sparks

Economic Highlights: The final reading for 1st Q GDP growth registered 3.1%. Forecasts for the 2nd Q have declined from 2.0% to 1.3%, according to the Atlanta FED (consensus remains at 1.8%). Accordingly, first half GDP is expected to post a solid 2.2%+ rate of growth. Full year expectations for GDP growth approximate 2.1%, indicating a slightly slower back half of the year.

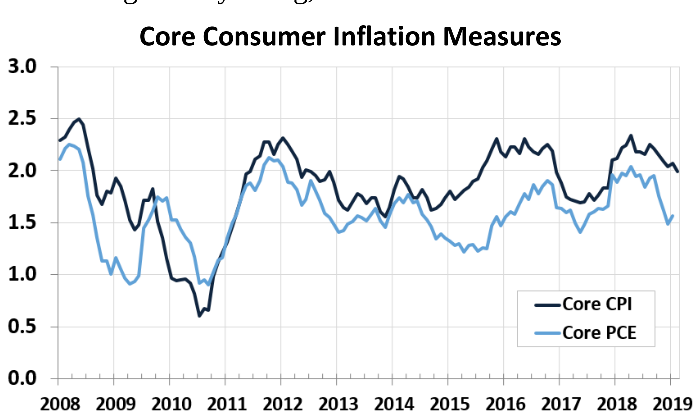
The May unemployment rate rose to 3.7% and the labor force participation rate rose to 62.9%. June wage growth was tame as average hourly earnings edged down from +3.2% to +3.1% - the weakest rate of annualized growth in ten months.

On the inflation front, May Producer Prices (PPI) declined to its lowest level in sixteen months. Core prices, on a YoY basis, have slowed in four of the last five months and are rising at their slowest pace since January of 2018. May Consumer Prices (CPI) were softer than expected as core items posted a 2.0% price gain. The May Personal Consumption Expenditures index (PCE), the FED's preferred inflation target, held steady at the core level at 1.6%.

Bottom Line: The first half of 2019 saw interest rates fall and global economic growth slowed unexpectedly - one result of the on-going trade negotiations. Given the fragile state of global economies, the FED is being forced to implement an insurance rate cut. Recall that when the FED last raised rates, we made the argument not to. In our view, the Fed Funds Rate had reached the "neutral" level and any additional upward moves would have been counter-productive. The FED is simply moving back to neutral (inflation sub 2%) with a rate cut. We will raise the following concerns, to be discussed at length in our year-end review and outlook: with global rates essentially at zero and U.S. rates at record lows for the past 10 years, a cut in the FFR will have a nominal impact on stimulating economic activity relative to past easing cycles (this will be the first rate cut since December 16th of 2008).

Bond investors are having a good year as interest rates have continued to decline and most sectors of the bond market have experienced tightening credit spreads. While the good times continue to roll, we remain aware that the risk/reward metrics do not favor risk taking. Yields are low, inflation can emerge unexpectedly, spreads are tight, debt levels are generally rising, and new issue covenants are corporate friendly - not bondholder friendly. We continue to look for opportunities in higher quality investments recognizing that investing is a long-term, ever changing process.

Our 10 Yr U.S. Treasury forecast for 2019 has been adjusted down to 2.6% (PCE at 1.6% + a 100 bp return premium). However, as discussed above, what are predictions good for!

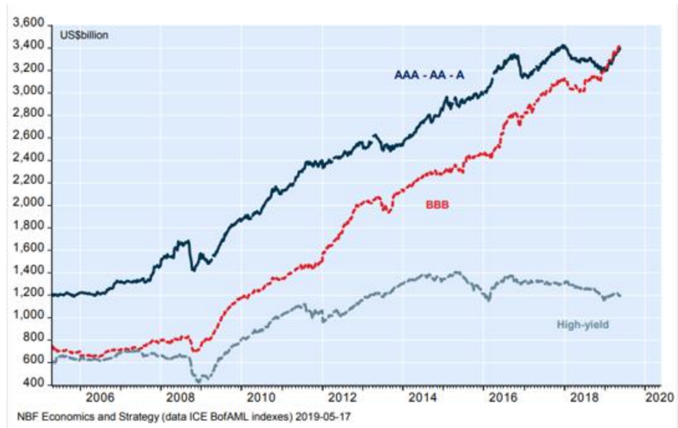


Source: BEA, Vining Sparks

Taxable Bond Strategy

U.S. Corporate Bonds

Full market value



Source: NBF Economics and Strategy (data ICE BofAML indexes)

Just when it seemed the size of the U.S. corporate bond market was leveling off, it expanded during the first half of 2019. As seen in the chart at right, the corporate bond market has significantly grown since the current economic expansion began in 2009 – hitting new highs at the end of June. It's easy to chalk this up to U.S. companies issuing more debt; however, this does not tell the entire story. Corporate bond issuance is actually down 8.1% YoY for the first half of 2019 with IG issuance falling 12.8%. A significant amount of growth in the market's size can be attributed to rising bond prices as investors pour money into IG debt. Falling yields in the U.S. Treasury market have dragged down the yields (pushing prices higher) of corporate bonds as investors find value in this section of the market. Investors abroad are driving the search for yield as over $600 billion of foreign corporate bonds are trading with negative interest rates (was essentially $0 to start the year) – U.S. yields are being impacted by international demand. With central banks around the world signaling more stimulus, it's hard to see when the U.S. will cease to be a favored market for yield hungry investors.

$600bn in corporate bonds globally trade at negative interest rates

Source: Bloomberg Finance LP, DB Global Research

As of June 30st, we remain overweight corporate bonds with an emphasis on A and BBB credits. During the first half of 2019, 5 Yr A rated yields fell 109 bp (3.62% to 2.53%) and 5 Yr BBB yields fell 122 bp (4.23% to 3.01%). Relative to 5 Yr U.S. Treasuries, corporate spreads tightened over the past six months with A rated spreads falling from +111 bp to +78 bp and BBB rated spreads moving from +172 bp to +125 bp. We find these levels relatively attractive given the persistently low yields of government debt. The 1st half of the year saw the 2 - 10 Yr spread close at +27 bp – while wider than it began the year, we still have a very flat U.S. Treasury yield curve. Given the flatness of the treasury curve and corporate bond spread tightening, we are focused on keeping interest rate risk near a 3 Yr duration target; however, we continue to patiently watch for opportunities to extend duration as the curve returns to a more normal shape.

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 2.50% with a duration of 2.8, and an average credit rating of A-. During 2019, we remain overweight corporate bonds relative to our benchmark. We have increased our exposure to U.S. Treasuries and U.S. Agencies which make up 19% of the portfolio. Through the first half of the year, we reduced our exposure to BBB rated credits from 45% to 42%, taking advantage of the strength in this segment of the bond market.

Opportunity & Leverage Opportunity Strategies

Investors' appetite for yield increased in the first half of the year as 5 Yr U.S. Treasury yields declined to 1.75% after beginning the year at 2.51%. We are seeing demand for HY increase as investors move from BBB credits (IG) into BB credits (HY) as investors take on more risk in search of yield (income). As of June 30th, HY spreads, the yield differential between U.S. Treasuries and HY bond yields, have tightened 87 bp this year while rates on 5 Yr U.S.

Treasury bonds have declined 76 bp. This combination has resulted in meaningful returns for HY investors as the iBoxx HY Corporate Bond Index has returned 10.1% year to date. At mid-year, HY yields sat at 6.10% down from 7.95% at year-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, tightened to +435 bp versus +522 bp at the end of the year. Spreads continue to remain below the 20 Yr historical average spread of approximately +580 bp indicating HY bonds, on a historical basis, are extended.

Barclays U.S. Corp High Yield Index vs 5 Yr U.S. Treasury

(with spread)

Source: Bloomberg

At mid-year, on average, 23% of our Opportunity Strategy was invested in IG bonds while the Leverage Opportunity Strategy had 51% invested in IG bonds. We continue to take advantage of high coupon callable issues – this strategy has increased the turnover in portfolios; however, it is benefitting returns while reducing volatility. As the U.S. Treasury yield curve flattened and inverted, we made an active effort to shorten portfolio durations and have continued to enhance portfolio quality as the global economic environment slows and U.S. earnings growth expectations have declined. We are positioned extremely well for volatility to increase – if credit spreads widen or interest rates rise, we are prepared to capitalize on the downdraft this would bring to the index.

As of June 30th, our ***Opportunity Strategy***, on average, had a YTM of 4.14%, a duration of 2.7, and an average credit rating of BB. Our ***Leveraged Opportunity Strategy***, on average, had a YTM of 3.71%, a duration of 2.0, and an average credit rating of BBB-. We once again remain unlevered at mid-year.

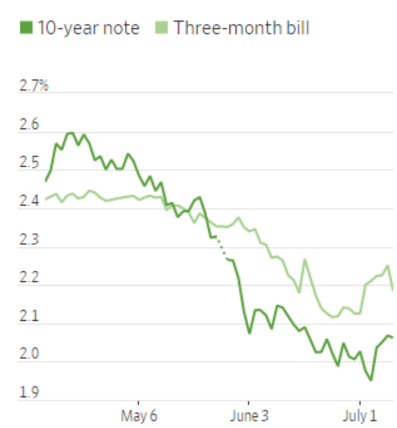
Enhanced Cash Strategy

The 2nd Quarter of 2019 began with ultra-short interest rates (less than 1 Yr) relatively flat, and 3-month U.S. Treasury yields matching those of their longer 10 Yr brethren. However, as the quarter progressed, and rates remained moderately flat inside 6-months, rates dropped significantly from there, so much so, that that they were inverted out to 1 Yr and longer. We ended June with the highest yielding U.S. Treasury bonds (less than 10 years) maturing in just 1-month.

Looking forward, with both the bond market and the FED indicating one or more cuts in the FFR this year - and the potential return of a more normally sloped yield curve - we expect to extend portfolio duration and lock in as much yield as the IG bond markets will provide.

Throughout the quarter, there were several articles in the financial press highlighting some of the more common investment solutions in which to allocate Cash, such as Mutual Funds, ETFs, U.S. Treasury Bills, and bank CDs. While these seem to be the perennial favorites of the masses, bond funds can be expensive, and investors have typically had to choose between yield or liquidity in selecting one of these other solutions. Additionally, several banks offering higher yielding savings accounts have already dropped their rates significantly to get ahead of a FED move. We believe our Enhanced Cash strategy provides active bond management and an attractive yield, without giving up quality or liquidity.

Yields on U.S. Treasuries



Source: Tullett Prebon

Our ***Enhanced Cash Strategy*** invests in a tactful mix of liquid, ultra-short duration, IG 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 2.22% YTM, an average credit rating of A, and a 4-month duration.

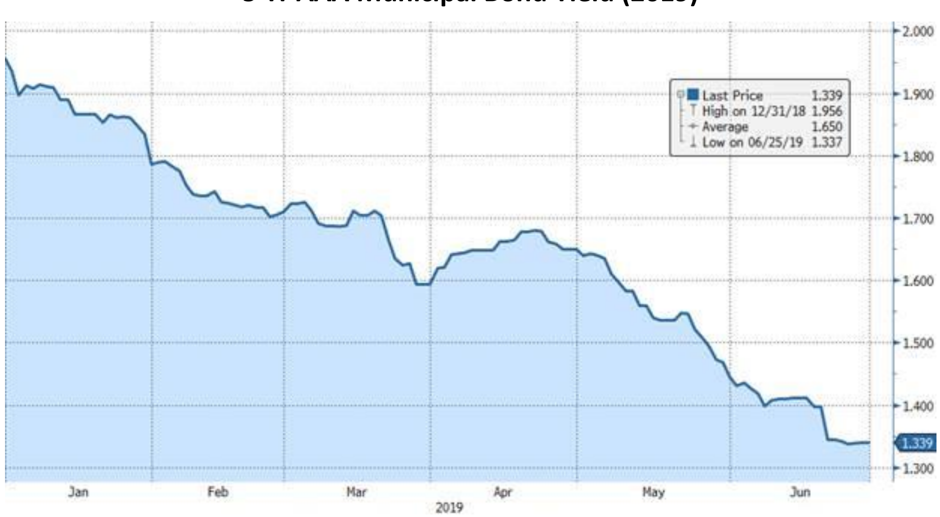
Municipal Bond Strategy

Municipal bond investors continue to revel in favorable market conditions. The positive return metrics and market fundamentals have been driven primarily by hefty demand and sound credit conditions. The first half of 2019 added dimension to an already established solid foundation. The 10 Yr municipal-to-treasury ratio (a key evaluative tool) began the year at 88% and dropped to a record low point of 72% in late May. This tells us that municipal bonds, for a period, became overvalued, relative to U.S. Treasury bonds. The ratio returned to "fair value", based on historic norms, in mid-June. Through the first six months of the year, new issue supply has averaged $27 billion per month which is just below the pace of calendar year 2018. Demand, as mentioned above, continues to be quite strong. During the first half of the year, over $50 billion has flowed into municipal bond mutual funds and ETFs. According to Lipper Data, net inflows into mutual funds have been positive for 24 consecutive weeks. Separately Managed Accounts have also continued to experience significant inbound flows.

The underlying driver of municipal performance has been the imbalance between supply and demand. There are just more dollars chasing fewer bonds. We believe that this dynamic will continue for the foreseeable future. According to Bloomberg Analytics, there is more than $175 billion coming due (calls and maturities) in the second half of the year. These dollars will likely battle for market supply which is clearly running well under that pace.

The demand side of the story continues to go way beyond the high tax states. Municipal investors, nationwide, continue to find value in the perceived safety of municipal securities combined with attractive relative yields and cash flows. For many investors, the tax reform act of 2017 reignited the attractiveness of municipal bonds. Strong demand from the high tax states such as CA, NY, NJ, and MN served to magnify demand even more. Thus, we are finding that taxable equivalent yields (TEYs) – across all maturities – are quite attractive on a relative basis.

5 Yr AAA Municipal Bond Yield (2019)



Source: Bloomberg

During the first half of 2019, market yields (Example: AAA 5 Yr) moved sharply lower from 1.96% on January 1st to 1.34% on June 30th. Keep in mind the inverse relationship between bond yields and prices. Thus, prices have increased over the past six months driving positive returns across most municipal bond investment portfolios.

At times, the slope of the yield curve (2s to 10s) can influence our duration decisions more than yields. Earlier in 2019, the curve reached a near-term peak of 55 bp before falling 22 bp in May. However, since the mid-May trough, the curve has actually steepened a bit. Nonetheless, from a historical perspective, the muni curve is still super flat. The 10 Yr average is approximately 150 bp (including the recent period of flatness). Thus, our intermediate duration focus is designed to balance risk-and-return metrics.

Municipal bond yields remain relatively attractive within our preferred segment of the yield curve. We continue to see forward-looking value for tax free investors especially those in mid-to-high tier tax brackets. At mid-year, 5 Yr yields

(A to AAA) ranged from 1.72% to 1.34% while 7 Yr bonds ranged from 1.85% to 1.41%. Crossover buyers continue to realize attractive TEYs on a relative basis compared with U.S. Treasury Bonds and IG Corporate Bonds.

From the credit perspective, conditions have generally improved, with upgrades exceeding downgrades. In fact, Moody's upgrades have exceeded downgrades for 7 consecutive quarters. Moreover, Moodys issued a report in May stating that all but two states (IL and NJ) are prepared to weather a moderate recession without significantly affecting their credit quality. This is due largely to healthy reserves and strong financial flexibility. Moodys also notes that the states with the highest revenue volatility have appropriately stockpiled reserves. Shifting gears, in April, there was renewed chatter around a potential multi-trillion dollar U.S. infrastructure plan. While we believe that an implementable plan is essential, we believe that any real progress on this topic is a longshot. Political "will" and concrete details are still lacking, leaving a gap that appears way too wide to traverse. An infrastructure plan has the potential to ramp-up municipal supply levels and break the imbalance dynamic mentioned earlier in this piece.

Our high-quality, intermediate-duration bias continues to seek balance in preservation of principal, total return, and cash flows. We will continue to opportunistically add value through credit research and yield curve positioning. Our municipal bond portfolios are managed as either state-specific or state-focused (general market in approach otherwise). Blending essential service revenue bonds with high quality general obligation bonds continues to be a cornerstone of our municipal bond portfolio strategy. As we alluded to above, we continue to be constructively optimistic in our expectations for the municipal marketplace.

Our ***Municipal Bond Strategy*** is focused on high quality IG, intermediate maturity bonds. Portfolios are structured to generate an average YTM of 1.77% and a TEY of 3.42%* with a duration to maturity of 4.0, 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 seeks 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.