Improving Economy, Trump Bump, or Reduced FED Intervention

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

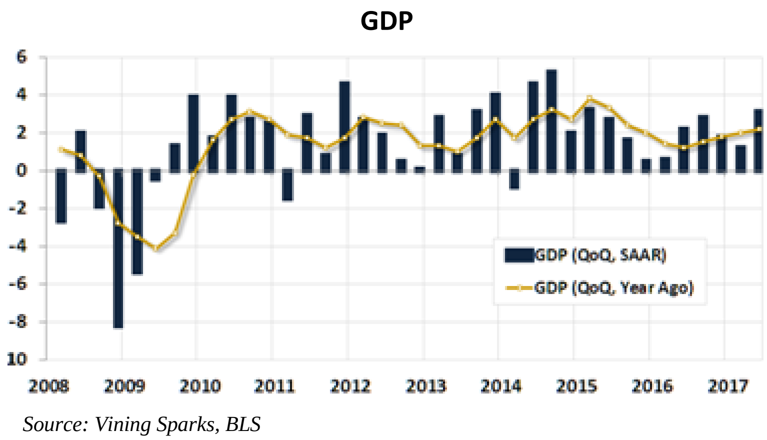
The Federal Reserve (FED) has been using a phrase for several years that most investors find both obvious and vague. It's a phrase we have put little emphasis on up until now. The phrase "data dependent" simply means that the FED is open to raising rates "dependent" on improving incoming data. We have previously made the argument that the FED is simply raising rates in preparation for the inevitable economic slowdown (we still believe in business cycles) as the current GDP and inflation data hasn't warranted multiple rate hikes. While we do not see a slowdown in the near term, we believe the economy will be challenged by 2019 – 2020. We have also argued that interest rates (as measured by the 10 Yr U.S. Treasury bond) would be higher absent global central bank manipulation. We have been forecasting a modestly higher interest rate environment with an expectation that the 10 Yr U.S. Treasury should be closer to 2.75% - 3.00% absent this intervention. Our sector allocation decisions coupled with our focus on credit research has enabled us to add value while maintaining a shorter duration focus (we have taken on credit risk in our taxable strategies in lieu of interest rate risk). In the final weeks of the 3rd quarter, the 10 Yr U.S. Treasury yield rose from 2.04% to 2.33%. Why the move? Was it an improving economy, a Trump bump, or reduced FED intervention – it was ALL three.

The economy has improved over the course of 2017. During the 3rd quarter, wage growth increased to a 2.9% rate and the unemployment rate declined to 4.2%. Wage growth remains below historic recovery trends (3.5%+); however, wage growth registered its highest year over year growth rate of this recovery in September. Wage growth is a key metric that we watch in terms of anticipating rising inflation – higher wages pull inflation upwards. As we enter the 4th quarter, economic growth is accelerating on solid confidence, consumer activity, and increased business investment. GDP growth for the 2nd quarter settled at 3.1%. Personal consumption rose a solid 3.3%, business investment (ex. inventories) rose 6.7%, residential investment contracted 7.3%, and government spending contracted 0.2%. This marked the first quarter since the 1st quarter of 2015 that growth topped 3.0%. Most economists are anticipating 3rd quarter growth in the 2.5% range. In the Summary of Economic Projections, expectations for GDP growth for 2017 were revised upwards from 2.2% to 2.4%. Core inflation expectations were also marked lower from 1.7% to 1.5% for year-end 2017 and from 2.0% to 1.9% for year-end 2018. While inflation continues to remain tame, the economy has modestly perked up.

Key Interest Rates	9.30.17	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	1.06%	0.50%	0.18%
5 Yr U.S. Treasury Note	1.92%	1.92%	1.76%
10 Yr U.S. Treasury Bond	2.33%	2.44%	2.27%
10 Yr AAA Municipal Bond	2.00%	2.33%	1.93%
10 Yr A Corporate Bond	3.22%	3.49%	4.05%

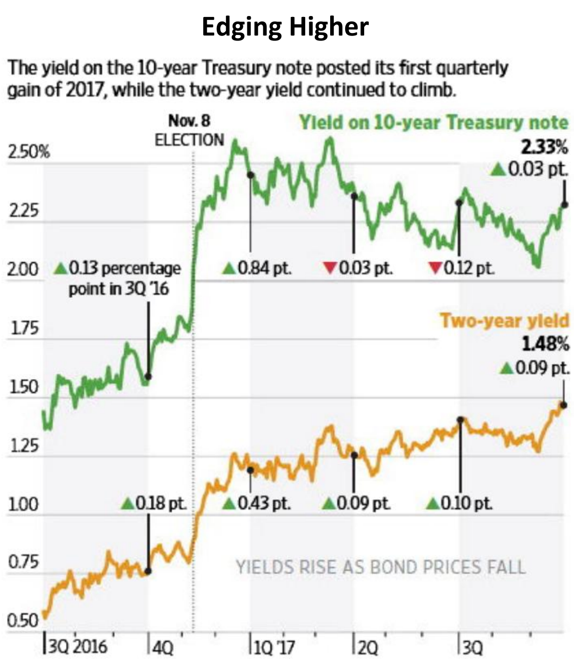
Source: Bloomberg, Wall Street Journal, Reuters, Municipal Market Data (MMD), FactSet

Carret Credit Insight



Source: Vining Sparks, BLS

The Trump bump, as the media has coined it, mainly refers to the rise in the equity markets that coincided with the November elections (we equate the equity market moves to numerous factors – not just Trump). The Trump bump is also influencing interest rates, in our opinion, as the economy is benefiting from optimism regarding potential tax reform, repatriation of off-shore cash, infrastructure spending, and reduced regulation from Washington. Consumer and business confidence has increased over the course of the past year (again, a result of numerous factors). The chart below illustrates the movement in interest rates since the November 8th election. While no substantive legislative reforms have come to fruition, the expectations are rising, creating market risks if they are not delivered. We believe that as 2018 approaches, interest rate moves will be heavily impacted by the success or lack thereof out of Washington.



Source: Ryan ALM, The Wall Street Journal

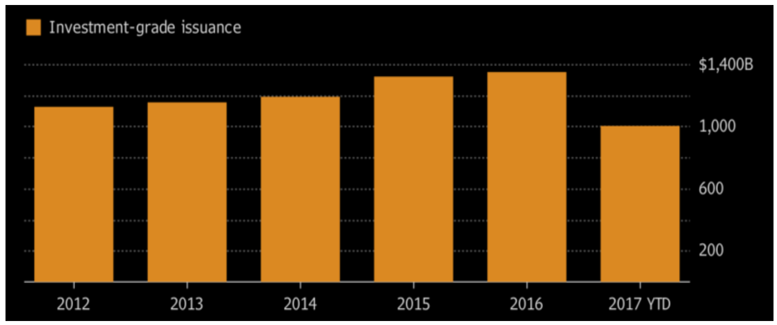
While the FED has already hiked rates twice during 2017, to a range of 1.00% to 1.25% and is telegraphing an additional rate hike at its December meeting (the bond market is giving them the green light with the futures market indicating a 75%+ probability of a hike), FED intervention is on a subtle decline. For the record, we would prefer if they skipped a December hike and instead waited until the POTUS made it clear if Chair Yellen will be staying or departing. The big news from the FED during the 3rd quarter was the vote to begin "normalizing" its balance sheet. Starting in October, the FED will let up to $10 billion per month roll-off from their monthly cash flows (they can adjust this amount every three months "data dependent"). While this is a nominal amount of money given the size of the FED balance sheet - $4.5 trillion, the direction of the announcement is significant. The FED has now reduced central bank intervention by increasing the FED Funds Rate from 0.00% - 0.25% to 1.00% - 1.25% and initiated the process of shrinking the Balance Sheet. While a FED Funds Rate close to 1.25% remains near historic lows and the balance sheet reductions will take years, the FED has moved from a position of adding monetary stimulus to a tightening stance.

The Bottom Line: The devastating hurricanes during the 3rd quarter will distort the incoming economic data over the coming months. Historically, the long term impact is nominal to positive (economically speaking) as those negatively impacted rebuild homes and businesses and auto sales perk up as cars are replaced. We will be watching closely for wages to be pulled higher as demand for workers increases in the impacted areas. The POTUS will be announcing his pick for the FED Chair in the coming months. Yellen may remain, but the probability looks low. Our view: whoever gets the job will be slow to raise rates. While economic growth has perked up, inflation hasn't followed. We are closely watching wage inflation and rents for clues on the near term direction of inflation. We expect rates to slowly creep higher as FED intervention lessens. As rates have moved higher over the past few weeks, we are working hard to increase duration. We continue to focus on credit quality as spreads have tightened and this expansion is long in the tooth.

Investment Grade Taxable Bonds

Corporate bond yields fell during the 3rd quarter despite modestly rising U.S. Treasury yields. The most prominent reason for lower yields is the insatiable demand by yield hungry investors. The U.S. corporate bond market has seen over $1.2 trillion in new issuance this year – the eighth straight year that issuance has topped $1 trillion. Despite this new supply, investor demand continues to be more than adequate as U.S. taxable bond funds have experienced net inflows for over 40 straight weeks. By guzzling up debt, corporate bond investors are telling the market that the U.S. economy is strong and companies are expected to continue to perform well.

Another Record Year?
At the current pace, investment grade issuance would top 2016's $1.35 trillion



Source: Bloomberg

As of September 30th, we remain over-weight corporate bonds with an emphasis on A and BBB credits. The 5 Yr U.S. Treasury note remains range bound throughout 2017 having started the 3rd quarter at 1.88% and ending the quarter at 1.92% - a round trip having started the year at 1.92%. Relative to 5 Yr U.S. Treasuries, A rated spreads fell to +50 basis points and BBB rated spreads tightened to +86 basis points and are fairly valued from a historical standpoint. We are continuously monitoring spreads and will be looking to increase our allocation to U.S. Treasury securities should spread compression continue in the quarters ahead. When spreads are low and corporate debt demand is high, the risk reward balance is integral to determining broad sector allocations.

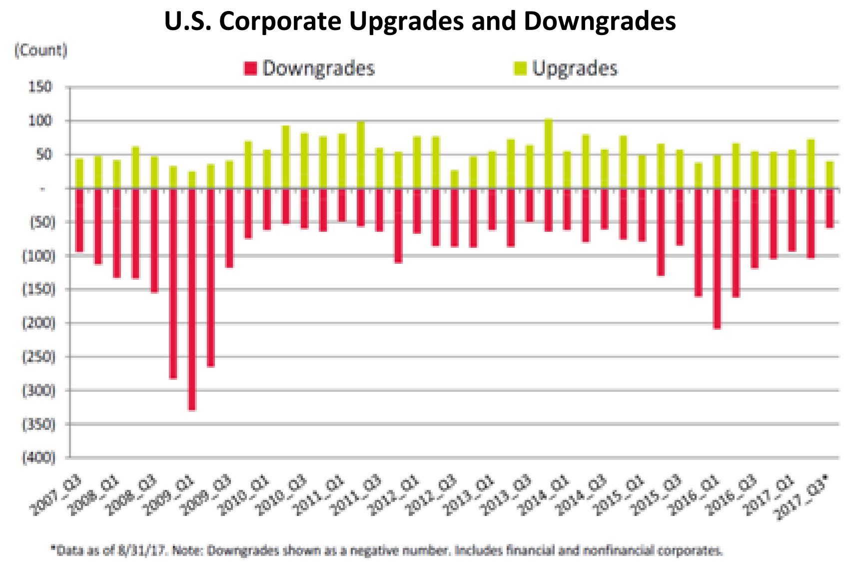
Our ***Taxable Bond Strategy*** is focused on high quality investment grade (IG), intermediate maturity bonds. Our taxable portfolios are structured to generate an average yield to maturity (YTM) of 2.49% with a duration of 3.3, and an average credit rating of A-.

The ***American Independence Carret Core Plus Fund***, at quarter end, had 82% of its assets invested in IG bonds and 14% invested in high yield (HY) bonds (the maximum permitted exposure to HY is 20%). At quarter end, the Fund had a YTM of 2.68%, a duration of 3.7, and an average credit rating of A-.

High Yield Bonds

The HY bond market continued its strength during the 3rd quarter of 2017 as the economy modestly improved, the stock market advanced, and the issuer default rate remained below histroical averages. A significant share of defaults stem from the continued struggles of energy companies – S&P Global Ratings estimates the August 2017 3.3% default rate would be a mere 2.0% excluding energy bonds. We continue to remian underweight the Energy sector. HY market confidence continues to attract investors, thus having yields round out the quarter at 5.45% as measured by the Barclays U.S. HY Index. Spreads, as measured by the Barclays U.S. HY Index vs. the 5 Yr U.S. Treasury, remained below the 20 year historical average of 578 basis points, having fallen during the 3rd quarter from 373 to 351 basis points.

At quarter end, our ***Opportunity Strategy***, on average, had a YTM of 4.19%, a duration of 3.5, and an average credit rating of BB-. Our ***Leveraged Opportunity Strategy***, on average, had a YTM of 4.31%, a duration of 2.8, and an average credit rating of BB-. As yields have remained near historical lows, we are maintaining a short duration bias and high quality high yield average credit quality. According to S&P Global Ratings, downgrades are 40% lower and upgrades are 10% higher year to date through August versus the same period in 2016. We continue to "do our homework" when scrubbing investments and ensure that our companies have adequate "safety nets" in place to offer some protection in the event of an unexpected economic downturn.

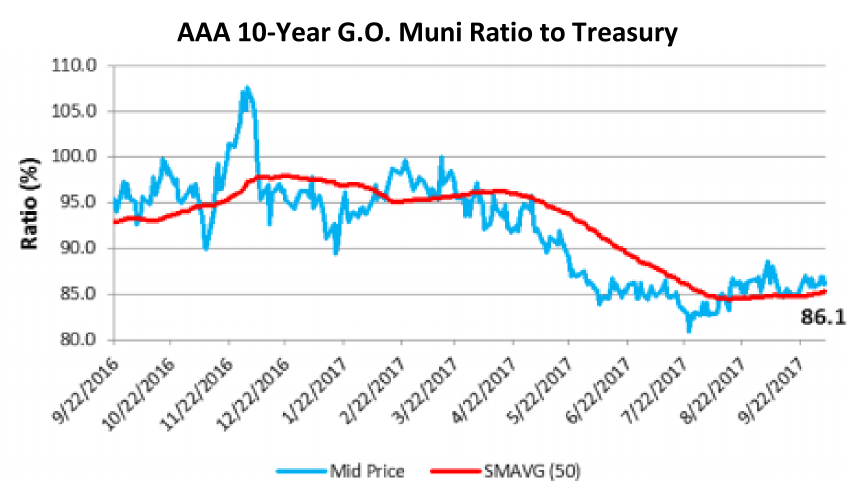


Source: S&P Global Ratings

Investment Grade Municipal Bonds

Despite the utter devastation from this year's hurricane season, the municipal bond landscape has once again proven to be quite resilient. As with Hurricane Katrina back in 2005 and Sandy in 2012, these storms raise the level of fear associated with municipal debt. Fortunately, just as the storm surge dissipates, so does the worry over the financial stability of municipal credits. By way of an example, Hurricane Harvey affected over 400 Moody's rated municipalities. Subsequently, Moody's placed 37 of those credits under "review" and commented that "the majority of these issuers are smaller entities with concentrated revenue sources and limited financial flexibility". The state and local credits received an "all clear" from the rating agencies at quarter-end.

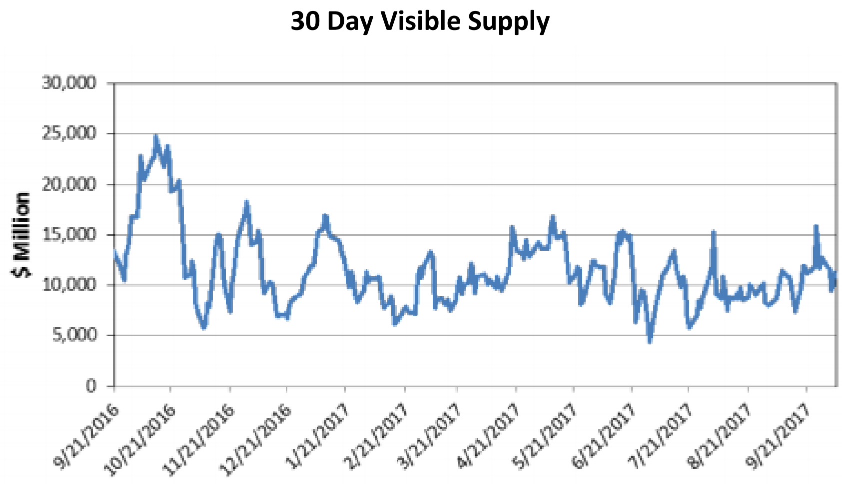
Sadly, on the other hand, it is important to note that the escalating Puerto Rico debt crisis is expected to be impacted by the damage left in the wake of Hurricane Maria. At this stage, we do not see any major impact on the broader municipal market as a result of the Commonwealth's faltering debt load.



Source: Bloomberg

Although it is too early to project the outcome of Washington's current tax reform plan, we do expect greater volatility as new tax brackets are negotiated and the future of the state-and-local tax (SALT) deduction is debated. Moody's has weighed in early noting that the initial plan may create challenges at the federal, state, and local levels while potentially benefitting corporate America. As we mention above, we believe that we are in the early rounds of what may prove to be a long fight with many twists and turns to come. We fully expect to be writing more on this topic as details begin to fill in.

Carret Credit Insight



Source: Bloomberg

Against the headwinds of three major hurricanes and the early stages of tax reform, the municipal bond market remains driven primarily by supply and demand dynamics and market fundamentals. We expect average levels of new issue supply combined with above average demand through year-end. On September 30th, according to The Bond Buyer, new issue YTD supply totals were north of $275 billion which is roughly 15% lower than September 30th of 2016. The lion share of new issuance continues to be refunding deals designed to allow municipalities to refinance their older, higher-cost debt. As rates edge higher, the degree of refunding has started to slow while new project financing continues to be relatively stable. From the demand side, July and August were huge redemption months with over $50 billion in proceeds from calls and maturities potentially searching for replacement bonds. Additionally, mutual funds ended the quarter by drawing in $378 million in positive fund flows which marks the 11th consecutive week of net positive inflows. The Separately Managed Account (SMA) contribution to demand has been quite strong as well over the same period. With global rates at historically low levels, foreign buyers continue to increase their exposure to municipal bonds. Foreign ownership of municipal debt is roughly $100 billion which is nearly triple the level compared with 10 years ago.

During the quarter, market yields (5 Yr AAA) were somewhat volatile while ultimately ending “unchanged” from the beginning of the quarter to the end. The yield was a 1.36% on 7/1/17 and was a 1.37% on 9/30/17. The market yield ranged from a high of 1.40% on 7/7/17 to a low of 1.10% on 9/8/17. The municipal bond curve has flattened in sympathy with rising short-term U.S. Treasury yields. Looking at the 2 Yr to 10 Yr AAA Muni relationship, the curve has flattened from 146 basis points to 98 basis points since mid-March of 2017. 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 Connecticut remains mired in a budget impasse and is currently operating on the governor’s executive orders. Hartford bonds are trading below investment-grade with a CC credit rating. S&P has recently put 9 towns on credit watch stating that the impasse could reduce aid to local municipalities in the 4th quarter. We are cautiously optimistic that the state will work to resolve the fiscal challenges over the next few quarters. We do not have any exposure to the City of Hartford and only have nominal exposure to other local Connecticut credits. However, we keenly examine events, such as this one, to uncover signs of potential ripple effects spreading to other parts of the municipal market. In the broader sense, state and local governments remain generally stable, reflecting multiple years of modest economic growth combined with continued fiscal 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 in 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 1.71% with a duration of 3.8 and an average credit rating of AA.

CARRET
Asset Management

October 2017

Carret Credit Insight

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.