Perspectives

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2017 Outlook

January 2017

In this issue of “Perspectives” we offer our thoughts on the year ahead, recognizing that few details are known and potential outcomes remain unclear from the incoming Trump Administration and the Republican-led Congress.

US Growth → Higher: 2.5-2.7%

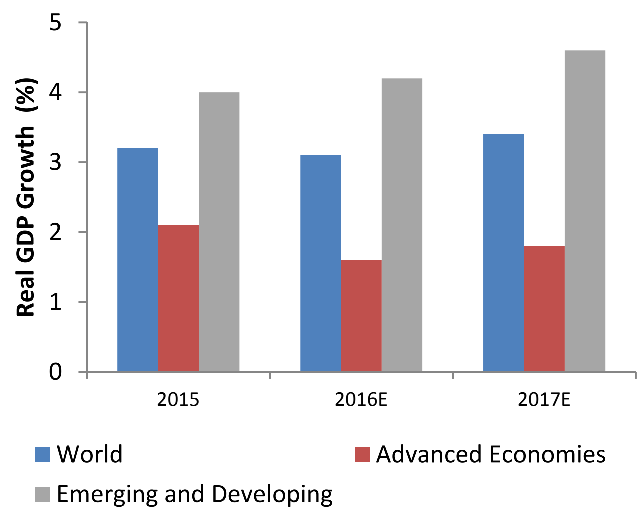
We believe US real GDP growth will improve in 2017 after a disappointing performance in 2016 (1.6% expected). Favorable conditions should keep spending levels solid: nominal wages are accelerating at about 4%, consumer confidence is sitting near cycle highs, and there is no real stress in the labor market as non-farm payroll growth has averaged near 200K over the last 12 months. In addition, households have reduced their debt burdens over the past decade and debt servicing costs are low. Tax reform could cause this pace to increase if lower income consumers benefit (income tax cuts on high income earners as well as corporate tax cuts tend to have a lower multiplier effect). Government spending will likely be a mixed bag, with higher federal outlays but continued sluggishness from state and local as pension costs weigh on budgets. *Risks to the outlook include: A) hard landing by China; B) trade war; C) weaker growth stemming from tighter financial conditions (higher interest rates, stronger dollar (USD), potential cut in QE measures from foreign central banks).*

Foreign Outlook

European growth remains low but steady. We expect real GDP growth of 1% in the Eurozone in 2017. Political risk remains quite high in Europe and the immigration crisis is still a threat to stability, so the risk appears skewed to the downside (political uncertainty impacts economic activity via demand and investment channels and through financial market volatility). In addition, monetary policy may begin to be tapered next year as doubts persist on the efficacy of extraordinary measures.

The U.K. economy is threatened by Brexit risks. Most economists expect slower growth due to heightened uncertainty over the next two years. Consumers and businesses are expected to cut spending as they await further details on how Brexit will affect various segments of the economy. Budget pressures are expected to worsen and inflation is also predicted to rise due to the weaker exchange rate.

Exhibit 1: Prior to the US elections, growth was set to marginally improve, but at similar levels to previous years



Source: International Monetary Fund World Economic Outlook (October 2016)

China’s rebalancing is proving difficult for commodity-related companies and countries. Risks from a growing debt bubble are real, but authorities appear to be allowing a cyclical rebound this year which has helped stem the fall in commodity prices. China remains intent on rebalancing away from heavy industrialization toward a consumption economy, but Trump’s proposed trade policies could hamper this effort should it result in slower overall growth and/or a trade war. Other geopolitical tensions with the new Administration could also disrupt the economic story.

Other developing economies are expected to grow more rapidly than developed economies as the worst of the recession has likely passed (Argentina, Russia, Brazil). We expect real GDP growth of 4.6% for Emerging Economies in 2017.

Inflation → Higher: 2+%

In the US, third quarter core CPI rose at a 1.7% annual rate and the Fed's preferred inflation measure, core Personal Consumption Expenditures (PCE), also stands at this 1.7% rate. Trump's potential policies could prove inflationary while others could have the opposite effect, but it does appear inflation measures will move higher, led by healthcare and wages. Therefore, we expect core PCE to hit and possibly exceed the 2% target in 2017.

Other Important Factors

Surprise election results in the UK and US had sizeable impacts on the financial markets during 2016. We think political risk will continue into 2017 with investors focused on a "soft" or "hard" Brexit in the early spring and national elections in both France and Germany shortly thereafter. Right-leaning parties have been gaining favor across Europe as anti-immigration, anti-EU, and social inequality sentiments take hold increasing the chances of other nations seeking to leave the EU.

Early rhetoric from the President-elect regarding trade deals and tariffs, if acted upon, could result in threatened countries imposing similar measures on the US. As global growth expectations are revised lower, a trade war impacting already lackluster global trade increases the susceptibility of global expansion.

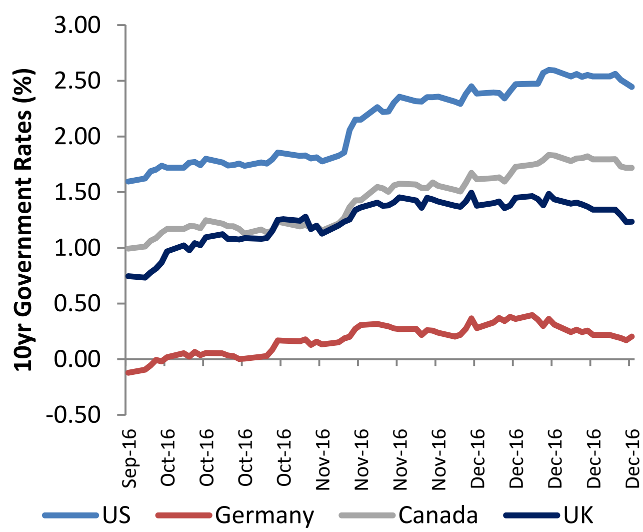
Years of extremely accommodative monetary policy and ultra-low interest rates forced investors to search for yield. One of the beneficiaries was the emerging markets segment. If rates continue to rise in the US, capital flows may reverse, leaving funding gaps in fragile economies that have come to depend on foreign demand. Additionally, a strengthening USD increases the debt load for countries that issued USD-denominated liabilities, while simultaneously, places downward pressure on commodity prices that many emerging market nations rely upon via exports.

Interest Rates & Monetary Policy: Tighter

The Fed just increased their expectations for raising rates in 2017 from two to three rate hikes. For perspective, one year ago they predicted up to four rate hikes in 2016 yet only executed one. Still, with inflation rising toward their target and the unemployment rate below 5%, it appears the economy can withstand higher short term rates.

While we do not attempt to forecast interest rates, it should be noted that since the election bond yields have moved higher in the US as well as other key developed economies as shown in the chart. Much of this move appears to be in reaction to President-elect Trump's proposals that could prod growth, inflation, and the deficit higher. The yield curve has steepened as the long end has risen more than the short end, partly due to the inflation element. After such a big move, we do not believe rates will change significantly over the next year, but the impetus is likely toward higher rather than lower rates and the era of ever-lower rates appears to be over for now. We do expect rate volatility to be higher than what was experienced during 2016 since so many elements are "up in the air" and subject to major change.

Exhibit 2: Interest rates around the world have steadily increased led by the US



Source: Bloomberg

Corporate Bonds: Earnings are the Key

Our outlook is stable for the corporate market predicated on the view that GDP in the U.S. improves (perhaps to 2.7% in 2017 vs. ~ 1.6% expected in 2016), global growth rises moderately (toward 3.2% from 3.0% expected for 2016), corporate earnings growth for the S&P 500 recovers markedly (to 12.2% vs. 0.2% expected for 2016), and the default rate moderates.

Looking ahead, earnings may be impacted by yet-to-be-determined policies of President-elect Trump:

- Foreign trade
- Regulation
- Healthcare
- Immigration
- Personal/corporate tax rates

All have the potential to alter operating conditions in a number of industries by varying degrees. However, corporate earnings are expected to see broad-based improvement based on lower personal income and corporate taxes and less regulation. As it relates to current holdings, our initial assessment, based on the limited information currently available, finds the net impact on overall credit quality may be neutral-to-slightly positive as the positive and negative impacts by industry largely off-set one another.

Early indicators predictive of credit on a two-year horizon have recently begun to signal spread widening, but do not indicate an imminent slowdown in the economy or meaningful downturn in the broader credit cycle. Lending conditions have tightened at the margin as measured by the percentage of banks tightening terms on corporate and industrial loans, commercial real estate, auto and now consumer loans, according to the Fed's most recent Senior Loan Officer Survey.

Companies' financial policies and actions managing the balance sheet bear close scrutiny now that leverage is near peak levels. For several quarters, credit ratios have steadily weakened as companies added debt in excess of earnings. Favorably, a summary of 2Q and 3Q16 fundamental data shows a broad slowing of the credit deterioration and excluding commodity sectors, stabilization of some metrics. With debt attractive at low rates, companies borrowed heavily to fund merger and acquisition activity, cater to shareholder activism and buy back stock. ***Considering that leverage tends to rise and/or peak during recessions, our main concern is the fact that leverage is near peak levels during a period of economic growth.*** This means that leverage will likely peak at a much higher level than in the past when a downturn finally hits --- unless companies are more discerning about future debt growth and take advantage of the expected rebound in growth and corporate earnings during 2017 to strengthen credit ratios. In any event, during this period of low corporate debt yields, companies have taken advantage of the strength in markets and at least locked in low long-term borrowing rates to address near-term liquidity and financing needs. This has positioned many of them well for the future.

We recognize that President-elect Trump's policy agenda will be a key driver of industry performance going forward. For instance, Trump proposed eliminating the Dodd-Frank Act (banking) and advocated repeal of the Affordable Care Act (healthcare and pharma) during his campaign. As a result, we will monitor the degree to which any regulatory changes he makes modify credit quality and adjust our investment strategy for the banking and healthcare sectors accordingly. *We will follow the same approach for all industries considering there is the potential for operating conditions to be altered by varying degrees (favorably or unfavorably) given that his policy agenda spans foreign trade, regulation, healthcare, immigration and taxes.*

Exhibit 3: Initial assessment on credit quality of potential fiscal, regulatory, trade, and immigration policy of Trump administration

Select Industries	Net Impact
Automotive	Negative
Retailers	Neutral
Energy	Positive
Technology	Neutral
Aerospace/Defense	Positive
Healthcare	Negative
Financial	Positive
Utilities	Neutral

Source: Opus Investment Management, Inc.

Defaults

Moody's default rate forecasting model predicts default rates will trend lower in 2017. For reference, the trailing 12-month global speculative-grade corporate default rate closed October at 4.7%, up from 4.5% in September and 2.8% in October 2015. Going forward, Moody's expects the global speculative-grade corporate default rate to end this year at 4.3% before trending even lower to 3.3% by October 2017. The benign default rate outlook is underpinned by issuer-friendly credit markets allowing companies to refinance as needed and noticeably tighter high yield spreads, particularly for issuers in the commodity sectors. In addition, default risk for commodity sectors, the main driver of defaults since 2014, is expected to decline as weaker companies have been weeded out and surviving companies are relatively stronger. However, Moody's still expects default risk to remain higher for commodity sectors than for other sectors.

Municipal Bonds

We favor positioning with a skew toward the revenue sector given dedicated revenue sources for debt service payment that have fared better in rare bankruptcy proceedings and are ring-fenced from state and local entitlement program liabilities. Within the revenue sector, we continue to favor essential services such as electric power and water and sewer. For general obligation bonds, the focus remains on states and local jurisdictions that have:

- A large and growing tax base, diversified economy, favorable wealth and employment metrics, low taxpayer concentration, and manageable retiree benefit obligations

- A demonstrated, responsible management of municipal finances in the form of structurally balanced and timely budgets over time.

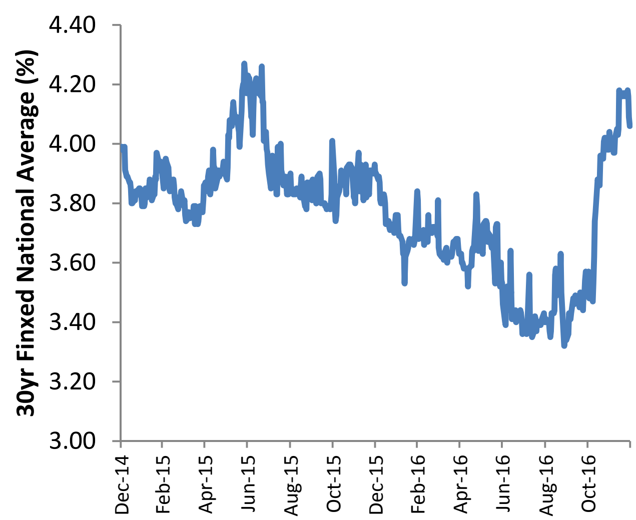
In addition, we seek to diversify by region, sub-sector, and issuer to the extent possible recognizing that debt issuance is driven by demographics, tax policy, constitutional limits and other regional factors. We seek to avoid issuers with heavy reliance on short-term debt, off-balance sheet contingencies, substantial derivative exposure and bond issues with extraordinary structural features.

Lastly, corporate tax reform, which was a pillar of President-elect Trump's candidacy, could dramatically reduce the value of tax-exempt municipal bonds should the personal income tax rate be lowered dramatically as suggested by both Trump's and the House Ways and Means Committee's proposals. While it's too early to tell how likely this outcome is, we believe the municipal market will remain attractive for both individual and institutional clients regardless of any proposed tax changes, but market yield levels may go through a period of adjustment.

Securitized Sector

For much of the past year, we have been positioning portfolios with an underweight to the residential MBS (RMBS) sector due to poor (tight) valuations. Now that interest rates have moved materially higher, much of the RMBS sector is no longer refinanceable, a major change from 2016, and valuations have improved. Also, with respect to supply/demand, we expect the Fed will remain a key buyer of RMBS and continue to reinvest paydowns throughout the year. Any tapering of reinvestments should be pushed out to 2018 or later and we certainly do not expect any outright sales of RMBS holdings by the Fed. These factors now lead us to advocate a neutral weighting in RMBS.

Exhibit 4: Higher mortgage rates should reduce the embedded optionality in mortgage securities making them more attractive than in 2016



Source: Bankrate.com US Home Mortgage 30 Year Fixed National Average

The CMBS market will continue to grapple with new risk retention requirements that go into effect at the end of 2016, keeping new supply low for the coming year. As a result, spreads should remain range-bound and fairly attractive for a high quality sector. We continue to advocate an overweight to CMBS in light of these factors.

We are also overweight ABS since spreads are likely to remain range-bound and credit quality is sound. Other potential regulatory policy changes from the Trump Administration could impact the securitized sector, but these would likely be longer term in nature and should not affect the broad sector materially in 2017.

Looking Ahead

We hope you have found these comments helpful and we look forward to meeting with you in 2017 to discuss specific portfolio actions.

Happy New Year!