Perspectives, January 2018:

2018 Market Outlook

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In this issue of "Perspectives" we offer our thoughts on the year ahead.

Domestic Outlook:

Consumer sector: trends & outlook

Real consumer spending growth has been running at a pace of 3% in 2017, a strong level that can be traced to the rising level of employment, modest real wage gains, and rising wealth levels from higher real estate and equity markets. We believe consumption will remain relatively strong in 2018 although there could be some weakening from the current pace since the savings rate has been steadily declining, evidence that consumers are either drawing down savings or borrowing to maintain spending, which is not sustainable.

Business sector: trends & outlook

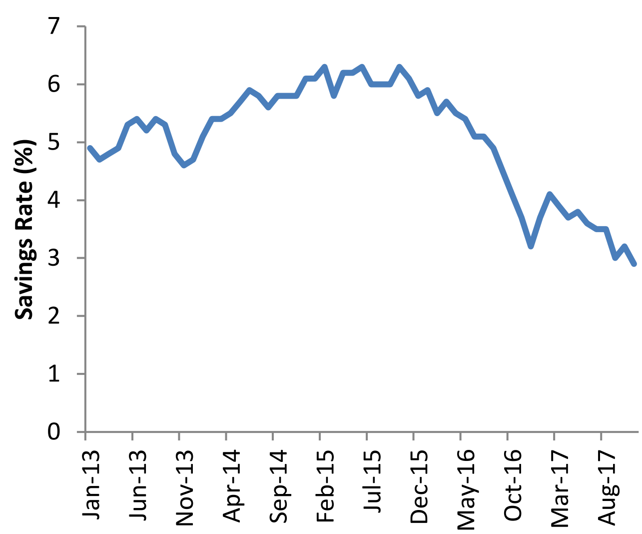
Business investment spending has increased materially in 2017 which may finally be helping lift productivity. The "animal spirits" element may be here at long last, perhaps owing to the ebullient equity market and elevated levels of consumer confidence. Corporate debt levels are elevated. Although there is a good deal of cash on balance sheets, much of this is concentrated in the hands of a few and is trapped overseas, although the new tax bill will result in some repatriation. Interest coverage ratios must be watched carefully since the credit cycle is described by most strategists as late-stage. We are seeking to avoid "cuspy" BBB issuers that may be more vulnerable to downgrade in the next downturn, as well as industries or companies that may be particularly vulnerable to disruptive technology.

GDP forecast & risks

Real GDP growth of 2-2.5% is expected in 2018 according to Capital Economics, an economic analysis firm. Headwinds include the low growth rate of the working age population, an aging population, and high debt levels. Tailwinds include the synchronous global recovery, low interest rates/favorable financial conditions, high consumer confidence, lower regulatory burden, and tax policy changes.

Risks to the outlook include: policy errors by China; trade sanctions that could escalate into a trade war; and weaker growth stemming from tighter financial conditions (due to Fed balance sheet normalization).

Exhibit 1: Consumer spending has been partially funded by a decrease in the savings rate, however, rising wealth levels and wage gains remain supportive



Source: Bureau of Economic Analysis

Foreign Outlook:

China continues to rebalance its economy away from debt-financed investment spending and the risk of a policy error is real, particularly following the recent leadership changes that concentrate more power in one individual (Xi). Europe's recovery is encouraging and will continue to be supported by accommodative monetary policy. The ECB's QE policy will be extended at a lower level into late 2018, and officials have promised no abrupt ending.

Aggressive changes to trade policy by the Trump Administration could pose a threat to the economic outlook and we will continue to monitor these developments closely.

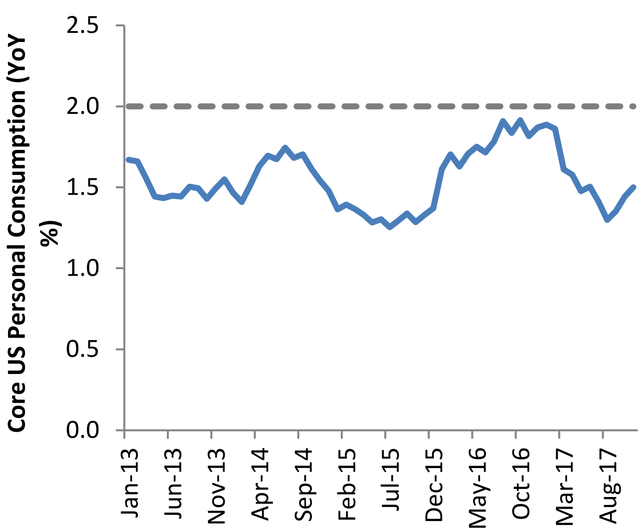
Inflation: Forecast & risks

The Fed's preferred measure of inflation, core Personal Consumption Expenditures (PCE) trended lower in 2017 even as the labor market tightened and overall slack in the economy diminished. Other measures tell a somewhat less favorable story, but inflation expectations remain low and most other developed nations are experiencing lower-than-target inflation. Most private forecasters predict inflation will rise at a faster pace in 2018 and that is certainly the greater risk given the narrowing of the output gap and the advanced stage of the US recovery. We do not believe inflation will move materially higher than the Fed's 2% target, but market fears of such a move could push rates higher in 2018.

Other critical factors

Brexit negotiations are not progressing well and a "hard exit" is looking more and more likely. Prospects for disruption to the UK economy in 2019 appear to be rising and how this could affect financial markets and certain industries remains an open question.

Exhibit 2: Inflation trended lower during the year and remained below the Fed's 2% target



Source: Bureau of Economic Analysis

Government Sector

The primary risks to be considered in the government sector are: 1) higher than anticipated inflation; 2) political risk stemming from the Trump Administration and new policies that may be forthcoming; and 3) foreign conflict or tax/fiscal stimulus which would aggravate already-stressed government finances.

Corporate Sector

Similar to last year, our outlook for the corporate market is stable and predicated on the view that GDP in the US improves to 2.4% in 2018 (versus ~ 2.2% expected in 2017), global growth rises moderately toward 3.6% (from 3.5% expected for 2017), corporate earnings for the S&P 500 remain strong, growing by 12.3% (versus 10.8% expected for 2017), and the default rate moderate.

Strength in corporate earnings continues as mid-single digit revenue growth and favorable control of expenses allows companies to benefit from positive operating leverage. Revenue expansion is expected to benefit from stronger GDP and overseas growth, steady consumer spending supported by low unemployment and income growth, stronger activity in manufacturing and technology, and recovery in energy and commodity markets pricing. Threats to earnings growth could result from higher interest rates, PPI and wage inflation, reversal of dollar weakness and global economic weakening.

Additionally, earnings may be impacted by a set of yet-to-be-enacted policies articulated by President Trump. If enacted, some have the potential to alter operating conditions in a number of industries by varying degrees. However, considering that Republicans control the Presidency and Congress, corporations are expected to see broad-based earnings improvement based on lower personal income and corporate taxes and less regulation.

Primary risks in the corporate sector include 1) Monetary policy normalization, namely in the US, could trigger faster-than-anticipated tightening in financial conditions and market volatility, 2) delays and or failure to implement the Trump Administration's pro-growth policies, 3) GDP disappointing in the US and globally, and as a result, the expected continued strength in earnings growth fails to materialize, 4) signals that we are in later stages of business and credit cycles as evidenced by leverage that remains elevated, 5) higher levels of supply and M&A activity as companies lock in low rates, supplement organic growth, cater to activism and buy stock during market weakness, and 6) geopolitical risk.

In summary, a core position in the corporate market will be maintained based on our stable outlook for the sector. Recommended positioning will take account of the likely or actual implementation of any new policies enacted by the current political Administration.

Municipal Sector

Conditions remain supportive for municipal credit, buoyed by continued economic growth, strong corporate fundamentals, low unemployment, rising property values, and a sturdy consumer. Many states and local entities are maintaining fiscal discipline as tax collections slow, but remain positive. However, credit quality remains uneven across both sectors and geographies with select individual issuers having rebuilt reserves since the financial crisis are thereby better prepared to handle the next downturn in the credit cycle.

Core challenges for the year(s) ahead remain centered on the rising costs of entitlement programs, changing demographics, volatility in energy prices for energy-producing states, and uncertainty surrounding tax reform. In addition, infrastructure spending remains on the back burner, crowded out by rising Medicaid and retiree liabilities as well as education spending, which in many states continues to be a priority. However, deferred funding of entitlement programs has and will continue to result in exponential growth of liabilities which will further constrain fiscal flexibility.

Despite the absence of meaningful legislation, including multiple failed attempts at healthcare reform, the market has continuously shrugged off the Administration's inability to translate campaign promises into policy. However, at this writing, tax reform could have a significant impact on both the economy and the municipal market.

Primary risks in the municipal sector are 1) Significantly unfunded and rapidly growing pension and OPEB liabilities, which have become a much larger component of state and local operating expenditures, further limiting financial flexibility and funding of other areas such as infrastructure while also gaining negative attention from rating agencies, 2) Any action or result related to the ongoing workout situation in Puerto Rico that reduces investor faith in the general obligation pledge, 3) Reduced state and/or federal aid, 4) Sluggish economic growth, as measured by lower GDP, would pressure state and local governments, many of which have not recovered to pre-crisis levels, and lead to lower income, sales, capital gain, or usage tax revenues, 5) Unfunded federal liabilities (Medicaid and education mandates) and 6) Unforeseen losses caused by accounting missteps or weak governance.

Securitized Sector

Residential MBS

During 2017 the Fed took steps to begin reducing the size of their balance sheet and has begun decreasing the amount reinvested each month into both Treasuries and RMBS. The Fed will reduce reinvestments into mortgage-backed securities by $4 billion each month, increasing by this same amount each quarter. This move was highly anticipated by the markets and has had very little impact on RMBS spreads. It is expected that in the short term this excess supply will be easily absorbed by the markets, however by mid-2018 the $12-$16 billion of additional supply each month could weigh on the markets and could push spreads wider. Banks are expected to remain the primary buyers of agency RMBS in 2018 as a flat yield curve and a need to increase net interest margins will likely force a rotation out of Treasuries into RMBS.

In the CMO market, production levels remain muted, with little value in structure versus collateral. A flattening yield curve and tight spreads will hurt the economics of creating the structures and will limit new supply.

At 28 bps, option-adjusted spread (OAS) for Fannie Mae 30 Year Current Coupon MBS valuations are fair. However, from a relative value perspective, RMBS continues to compare favorably to other sectors on a risk-adjusted basis.

Commercial MBS

At 80 bps, OAS for the Bloomberg Barclays CMBS index relative value remains attractive given the high-quality nature of this sector. The biggest challenges in this sector will be the continued lack of supply and weaker underwriting standards which will limit our ability to add meaningfully to the sector.

Primary risks in the securitized sector are: 1) Average life extension due to rising interest rates in the case of RMBS and due to commercial mortgage extensions in the case of CMBS, and 2) Declining quality of underwriting and lack of supply in CMBS.

Looking Ahead

We hope you have found these comments helpful and we look forward to meeting with you in 2018 to discuss specific portfolio actions.

Happy New Year!

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