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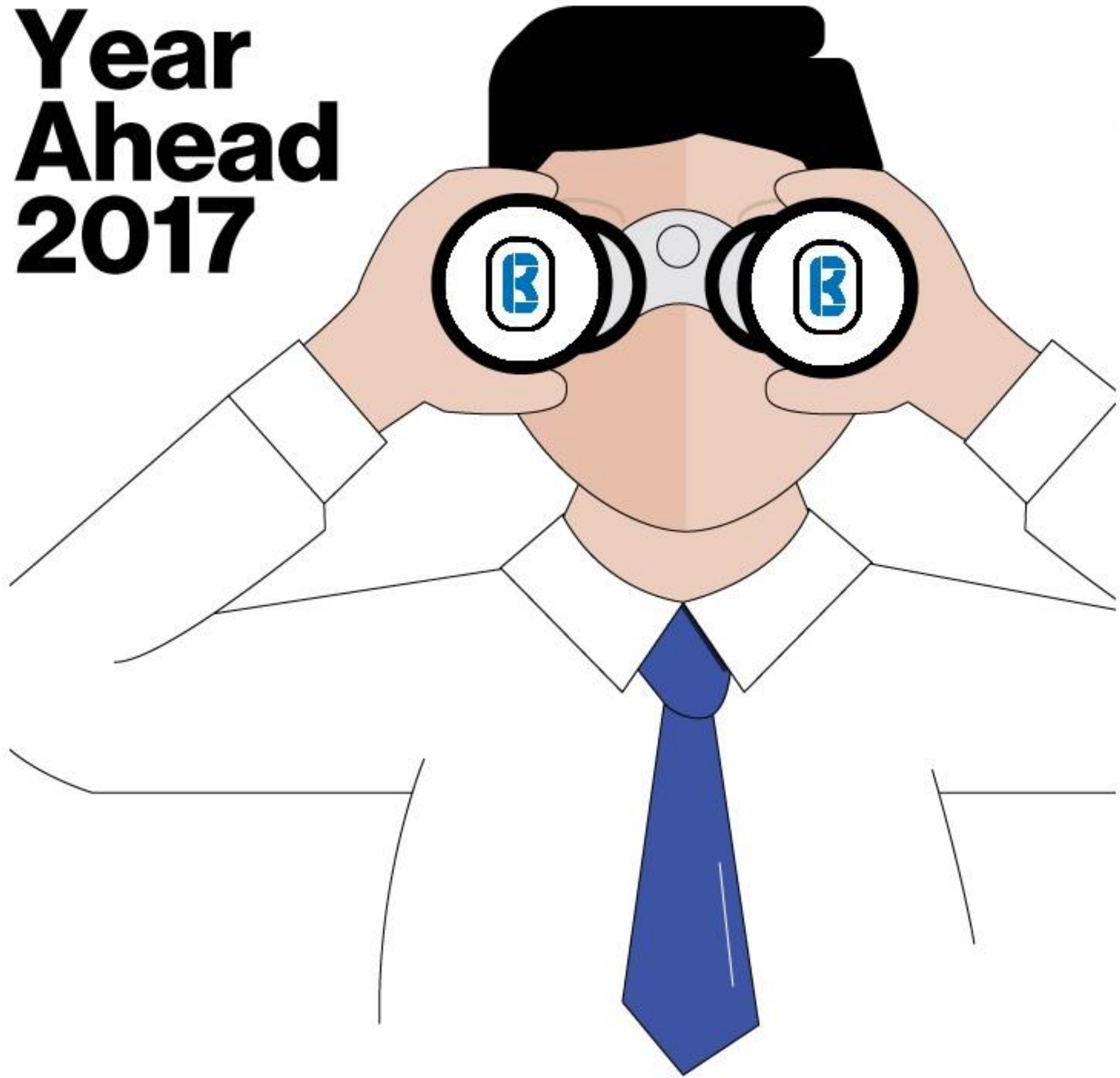

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The 2016 to 2017 Transition:

It has been a rocky year since the Federal Reserve raised interest rates for the first time in almost a decade. Next year will most likely be no different.

The December 2015 rate-hike by U.S. central bankers was supposed to herald an era of higher borrowing costs, but the exact opposite happened. Treasury yields plunged to record lows in 2016. The longest-dated U.S. bonds rallied the most during a first quarter since 2000. Talks of potential deflation were a hot topic.

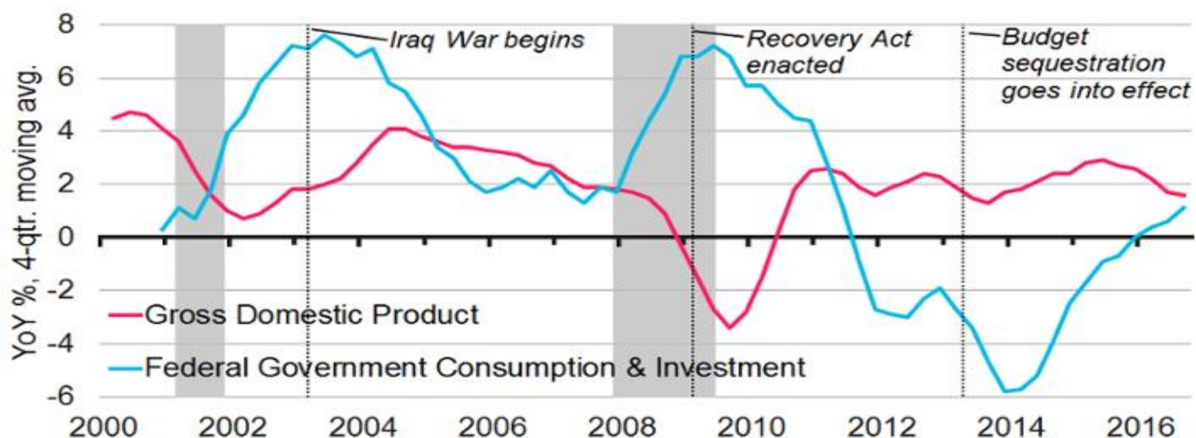
Then in November, President-Elect Donald Trump was chosen as the next president and everything changed. Bonds dived. Stocks soared. Traders are again expecting benchmark yields to rise throughout next year with three forecasted Fed rate-hikes.

The dominant view is that President-Elect Trump will swiftly enact pro-growth policies when he enters the White House in January. This would bolster riskier assets, like stocks and speculative-grade bonds, which have both been going gangbusters in recent weeks and would cause yields in Treasuries to continue climbing.

However, President-Elect Trump could find it incredibly difficult to enact meaningful initiatives within his first few months on the job. President-Elect Trump's first 100 days in office will include many major initiatives; reducing corporate / individual tax rates, reducing cumbersome regulations for business, modifying existing healthcare laws and possible changes to U.S. trade policy. Each initiative is no small task and will take time to propose and get approved through Congress. It is our view the effects of these positive changes will not be felt until later in 2017 or the beginning of 2018.

The U.S. economy has improved and is growing at a 2% GDP pace, but structural head winds remain. An aging U.S. population and technology automation could be road blocks for the U.S. to jump to a 3.5% GDP pace with the Trump proposed initiatives.

Will Trumponomics Yield Fiscal Tailwinds?

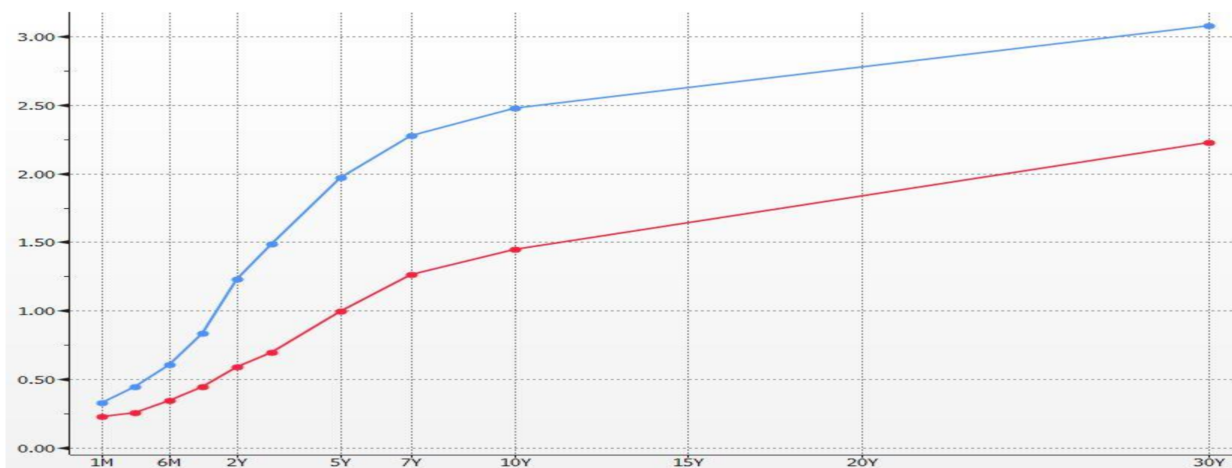


Source: BEA, Bloomberg

2016 Bond Review:

Interest rates have risen much further and faster than expected to end 2016. From a post-Brexit low of 1.37% in July, the benchmark 10-year Treasury yield hit a high of 2.64% the second week of December, after the Federal Reserve hiked the federal-funds rate for the first time all year and indicated that it may hike three more times in 2017.

U.S. Treasury Curve July 1st 2016 (Red) vs Current (Blue)



Source: Bloomberg

One of the big arguments for why benchmark U.S. yields were so low in 2016 stemmed from the ultra-low rates abroad. Japanese and European investors were flooding into the U.S. to capture higher returns than what they could achieve domestically.

That has not changed. U.S. bonds are yielding the most relative to similar German debt on record. The dollar-denominated bonds are also offering a hefty premium over similar Japanese notes.

U.S. Treasuries Yielding Most Relative to German Bonds on Record

Source: Bloomberg

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2017 Projections:

At Carty & Company, we believe the markets could turn more risk-averse after the presidential inauguration, when President-Elect Trump may run into political hurdles. We project the 10-year yield, currently at 2.5%, will potentially end next year around 2.85%. Keeping a lid on rates will be political uncertainty, the rising dollar, global growth challenges, demographics, and weak U.S. productivity.

A potential issue we see is that President-Elect Trump could enact controversial, inflationary and anti-growth trade policies before he can get regulatory and tax policy changes, or infrastructure spending through Congress. As such, President-Elect Trump could damage the economy and cause market turmoil via trade policies months or even a year before he can implement meaningful tax reforms, regulatory reforms or infrastructure spending.

Our concern that President-Elect Trump could implement trade tariffs and so-called border adjusted taxes (where imports are highly taxed by the U.S. government, but not U.S. exports). This could accelerate inflation, in the form of higher import prices which cause the Fed to increase the pace of monetary policy renormalization. In this scenario, where trade policies are implemented far in advance of stimulative fiscal policies, the U.S. could slide into a recession.

After surging 60 basis points immediately following Election Day, the 10-year UST note yield has moved mainly sideways. The 10-year TIPS breakeven rate has widened to approximately 200 basis points (indicating an implied inflation rate of 2.0% over the next ten years) and has leveled off. We believe the U.S. Treasury market is pricing in stronger, but not runaway, inflation.

Overall, we believe 2017 will bring more volatility to the markets. Active portfolio management with a focus on price and credit risks are going to be our main priority with clients.

2017 Year-End Forecasts:	
Fed Funds Rate	1.25% with 2 Fed Rate Hikes
2-Year UST Note Yield	1.80%
10-Year UST Note Yield	2.85%
Core Inflation Average	2.20%
GDP Average	2.50%

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2017 Portfolio Management:

Crystal balls are understandably a bit cloudy, given the surprising turn of events in U.S. politics and rates. But more interest-rate volatility is likely and staying flexible will be a good approach in 2017.

For our clients who we helped liquidate long-duration bonds *prior to* the spike in interest rates this year, we recommend conservative extension now that rates are higher. There is a higher yield to price risk ratio currently and conservative duration extension is likely to do well if growth expectations for the U.S. economy cool.

For prospective clients who still own significant long-duration debt, we still recommend scaling back and being strategic about the yield curve to maximize steepness.

A "barbell" strategy that pairs long-duration assets with safe, short-term securities makes sense for 2017. Ultrashort-bond funds have returned 1.68% in 2016. This product type provides a good place to stay defensive and wait for a chance to either buy riskier securities on a selloff if exuberance fades, or pick up safe bonds at even higher yields if growth continues.

The last time the Federal Reserve raised interest rates in 2005 through 2006, the best performing bond portfolios had a barbell strategy with mortgage-backed securities (MBS) or investment-grade, floating-rate securities such as Agency ARMs on the front end. Municipal bonds were positioned on the long end for yield. MBS amortizes its principal balance, allowing investors to use that extra liquidity to reinvest into rising rates or for depository clients, to fund loan growth. Municipal bonds historically lose less in value than comparable maturity agency or corporate bonds with similar maturities. This makes municipals a good risk/reward investment on the long end of the barbell.

Mortgage-Backed Security Bonds

MBS has had a good run in 2016 with the Bloomberg Barclays US MBS Index generating a total return of 3.6 percent. The Fed was on hold for much of the year, so mortgage investors had been concerned with prepayment risk. Now, if rates rise, that scenario may flip and we focus more on extension risk: Slowing prepayments that could lengthen the expected average lives of MBS investments.

MBS yields are derived from the underlying mortgage prepayment speeds, so making sure prepayments have been consistent and investing in seasoned bonds with a track record spanning multiple years is important. This allows clients to purchase higher coupon investments without incurring more risk.

On the next page we will analyze an MBS investment with attractive characteristics:

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2017 Portfolio Management (continued):

As an example, let's review the below FN AH9015 mortgage-backed security. Characteristics such as prepayment speeds, loan size, geographic concentration, and seasoning are among the most attractive features in specified pools. These metrics will be the focus of our brief analysis.

This pool's prepayment speeds have been very consistent (**1**). It also has a low average original loans size, AOLS, of $96,829 (**2**). A homeowner with a mortgage balance of $100,000 or less is relatively unlikely to refinance, because doing so might only reduce their monthly payment by a small amount, say $40. The maximum allocation is only 11.3% to Pennsylvania, so the mortgage geographic's are diversified (**3**). The weighted average loan age, WALA, is 70 months so there is a good track record to analyze (**4**).

Higher coupon MBS bonds tend to perform better in rising rate environments because of their higher coupon payment and also because they typically have higher prepayment speeds. These speeds do not slow down as much as lower coupon bonds in rising rates because the mortgage holders have less incentive to prepay their mortgages.

A mortgage holder with a 3% coupon payment passed through to the investor will make minimum payments as rates rise and prepay more on a higher rate car loan or credit card. A mortgage holder with a 4.0% coupon passed through like this pool, (**5**) has more incentive to continue their normal prepayments. This means less extension of principal coming back to the investor and more consistency. Higher liquidity for the investor means a more defensive security.

FN AH9015 Mtge | 98) Export | Page 1/2 Security Description

CUSIP 3138ABAR0 | 4.466(98)70 | FNCI 4 S | Pool Level | 95) Buy | 96) Sell

1) Summary | 2) Comments

Pool	FN AH9015	16) Seasoning	FNCI 4 S	As Of	12/2016
Type	(CI) Conventional Conv 15 years Level pay	17) Vintage	FNCI 4 2011	Issue Date	03/01/2011
Traits	30/360			Maturity Date	03/01/2026
11) Seller	Jpmorgan Chase Bank, N...				

12) Pool Information

Coupon	4.000	WAC	4.466	Orig WAC	4.457	Factor	0.27357126
		WARM	98	Orig WAM	179	Orig Amt	57,961,765
		WALA	70			Curr Amt	15,856,673

13) Collateral Information

						Prepay	CPR	PSA
WAOLTV	48	AOLS	96,829	Orig TPO	1.20	1 Month	16.5	275
WAOLTV-HPI	41	WAOLS*	97,428	Curr TPO	0.43	3 Month	17.6	294
WAOCLTV	47	MAXLS	110,000			6 Month	17.0	284
WAOCS	762	WAOLT	180			1 Year	17.2	287
		WAODTI*	23			Life	14.2	294

14) # Loans 291 | Delay 54 (24)

18) States	%UPB
Pennsylvania	11.3
California	11.2
Georgia	8.2

TRACE Eligible

15) Paydown Information (PDI PERF)

* Value calculated by Bloomberg

Source: Bloomberg

During the past 8 weeks since the Presidential Election, higher coupon MBS has declined less in value with less prepayment slowdown than lower coupon MBS.

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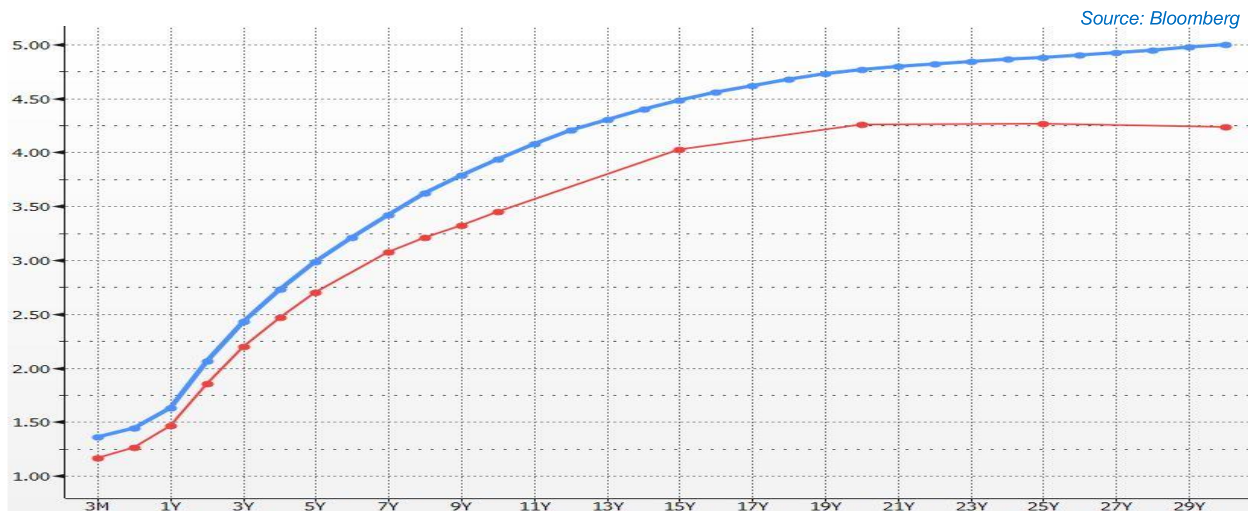
2017 Portfolio Management (continued):

Municipal Bonds

Municipal bonds have sold-off since Election Day because of their typically longer-duration and the proposed Trump tax-rate cuts. When analyzing the Municipal yield curve currently vs. Corporates and Treasuries, Municipal spreads look very attractive.

Comparing the A-Rated Tax-Exempt Municipal yield curve vs A-Rated Corporate and assuming a proposed middle tax-rate cut of 25%; the A-rated Municipals deliver a tax-equivalent yield of 2.80% on a 5-year bond and 3.65% for a 10-year bond. This Municipal yield beats Corporate bonds by 25bps at 5 years and 30bps at 10 years. In the below graph, A-rated Taxable Municipals beat A-rated Corporates by similar margins.

A-Rated Corporate Curve (Red) vs A-Rated Taxable Municipal Curve (Blue)



Some important things to note about municipal investments is their price and credit risk. Higher coupon municipals are more defensive and lose less in a rising rate environment. Investing in the 4-5% coupon stacks is where we see the most value.

Credit risk will be the theme for Carty & Company clients in 2017. A-rated municipal bonds tend to carry similar credit risk as AA-rated corporates, making municipal bonds a more attractive investment. We see a great deal of municipalities in portfolios that are labeled as investment grade by credit rating agencies such as S&P, Moody's and Fitch that have fiscal deficits. Making sure the issuer of any investment has rock solid financials that won't disrupt interest payments or the return of principal is paramount.

Our Municipal Credit Review Summary transparently shows which municipalities in a portfolio are healthy and which ones are risky. On the next page we will elaborate why this report is crucial for anyone with municipal investments:

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Municipal Credit Review Summary:

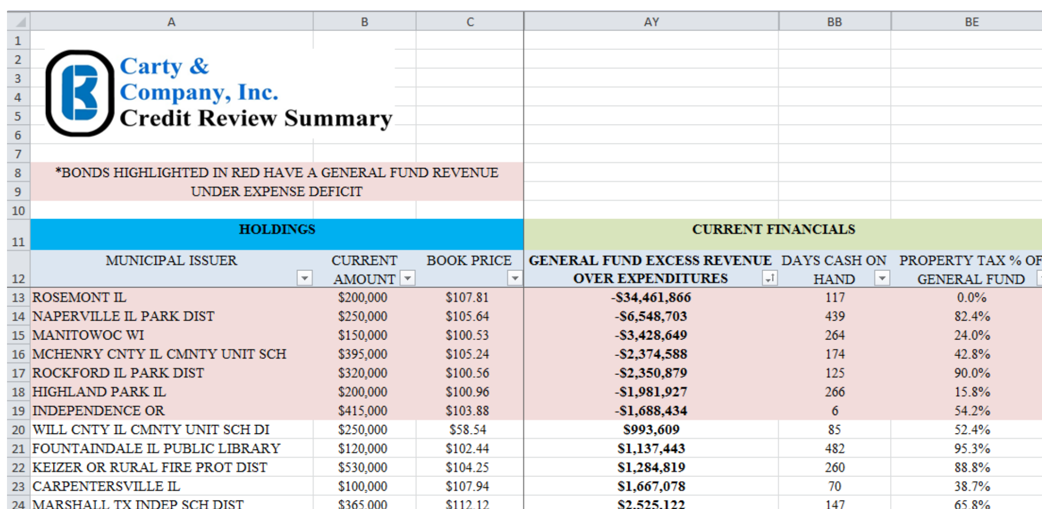
Our depository clients are receiving more scrutiny from regulators than ever before in regards to municipal credit analysis. Municipalities are like any other business where good money management and healthy financials are the foundation of their credit. This means it is important to review the most recent financial information on any municipal bond to make sure there have been no recent material events which may affect liquidity or point to a future downgrade or default.

S&P, Moody's and Fitch credit rating agencies are good tools to use when determining the suitability of an investment. However, these credit ratings should be just the first step in determining whether the issuer is high grade or speculative.

Most depositories have a loan watch list where they keep an eye on underperforming loans to make sure deteriorating financials won't materially affect repayment. Municipal bonds are loans to state or local governments, so having a municipal watch list is a continuation of risk management. We make sure to stay in front of risks by analyzing municipal financial updates and new material events as they become available.

Carty & Company's Municipal Credit Review Summary is a report that examines the financials of every municipal bond in an investment portfolio. It analyzes the municipality's most recently released financial information so portfolio managers can review the underlying fundamentals of their investments on one spreadsheet.

As an example, below is a screen shot within the Municipal Credit Review Summary. Highlighted in bold is the General Fund Excess Revenue Over Expenditures column. The bonds highlighted in red have general fund deficits. This is a particularly important metric to use when measuring if a municipality has a balanced budget or not.



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Credit Review Summary

*BONDS HIGHLIGHTED IN RED HAVE A GENERAL FUND REVENUE UNDER EXPENSE DEFICIT

HOLDINGS			CURRENT FINANCIALS		
MUNICIPAL ISSUER	CURRENT AMOUNT	BOOK PRICE	GENERAL FUND EXCESS REVENUE OVER EXPENDITURES	DAYS CASH ON HAND	PROPERTY TAX % OF GENERAL FUND
ROSEMONT IL	$200,000	$107.81	**-$34,461,866**	117	0.0%
NAPERVILLE IL PARK DIST	$250,000	$105.64	**-$6,548,703**	439	82.4%
MANITOWOC WI	$150,000	$100.53	**-$3,428,649**	264	24.0%
MCHENRY CNTY IL CMNTY UNIT SCH	$395,000	$105.24	**-$2,374,588**	174	42.8%
ROCKFORD IL PARK DIST	$320,000	$100.56	**-$2,350,879**	125	90.0%
HIGHLAND PARK IL	$200,000	$100.96	**-$1,981,927**	266	15.8%
INDEPENDENCE OR	$415,000	$103.88	**-$1,688,434**	6	54.2%
WILL CNTY IL CMNTY UNIT SCH DI	$250,000	$58.54	**$993,609**	85	52.4%
FOUNTAINDALE IL PUBLIC LIBRARY	$120,000	$102.44	**$1,137,443**	482	95.3%
KEIZER OR RURAL FIRE PROT DIST	$530,000	$104.25	**$1,284,819**	260	88.8%
CARPENTERSVILLE IL	$100,000	$107.94	**$1,667,078**	70	38.7%
MARSHALL TX INDEP SCH DIST	$365,000	$112.12	**$2,525,122**	147	65.8%

Source: Carty & Company, Bloomberg

Municipal Credit Review Summary (continued):

Other financials in the Credit Review Summary include but are not limited to;

- General Fund Revenue Growth
- Total General Fund Balance
- Days of Cash on Hand
- 1 Year Asset Growth
- 1 Year Revenue Growth
- Total Debt
- Operating Margin
- Net Profit Margin

Most of our depository clients are portfolio managers who are also CEO's, CFO's and Presidents wearing multiple hats. The ability to review the financials of an entire portfolio's municipal holdings on one spreadsheet is an organized approach to risk management. This report is designed to maximize performance, uncover hidden risks and highlight strengths.

Summary:

Carty & Company is a partner in education and transparency is paramount to making intelligent investment decisions. Unlike many pundits, we do not see the UST yield curve steepening with inflation. We believe, now that the economy should receive some help from the fiscal policy side, the Fed will look to renormalize more rapidly than the single rate-hikes of the past two years. How quickly the Fed will renormalize monetary policy depends on economic data and what policies President-Elect Trump will pass through Congress (not as easy of a task as some might believe).

Our base case is for the Fed Funds Rate to finish 2017 at 1.25% and for the 10-year UST note yield to end 2017 around 2.85%. We expect the 2-year UST note yield to track closely to the Fed Funds Rate. This would place the 2-year UST note yield at approximately 1.80%. If this forecast comes to fruition, the benchmark UST 2-year to 10-year curve would be sloped by 105 basis points, about two-thirds the current yield curve slope. We see a general yield curve flattening trend occurring during 2017 that reinforces our conservative duration extension philosophy in our clients' portfolios.

For more information, please contact your Carty & Company Representative at 901-767-8940. We look forward to 2017 and appreciate your business.

This Year Ahead 2017 Report is created by Ryan Coombs, Vice President of the Fixed Income Research & Strategies Department at Carty & Company, Inc. Mr. Coombs is a member of the Economic Club of Memphis and an award winning fund trader with over 9 years of experience partnering with portfolio managers to maximize investment performance.

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