Taplin, Canida & Habacht

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Fixed income market update

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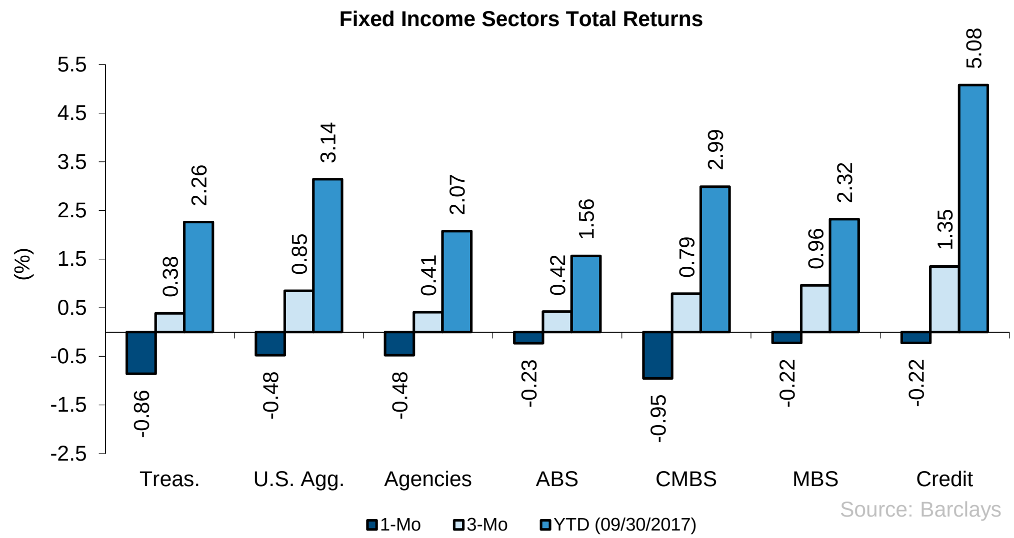
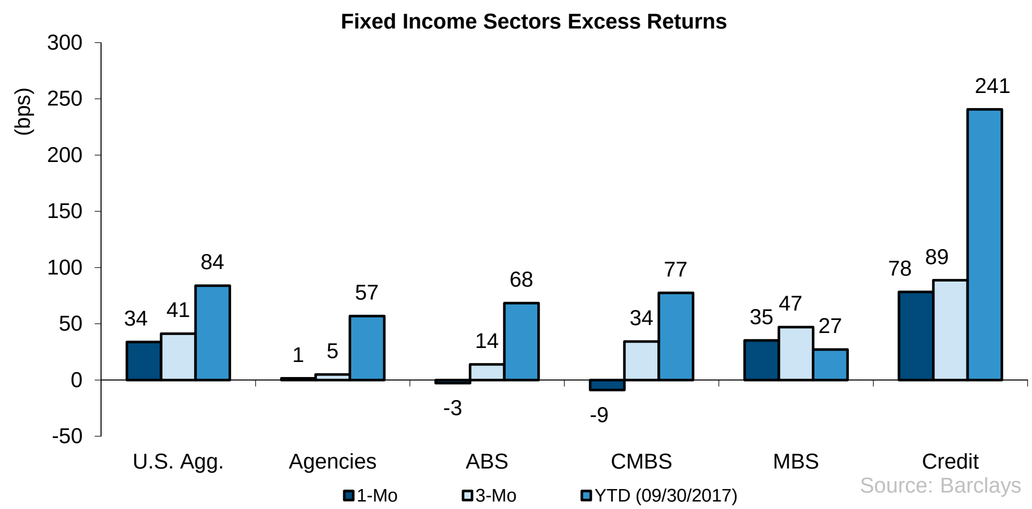
Fixed income market update

- For the quarter ended September 30, 2017, the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.85%. Year to date, the index has returned 3.14%.

- U.S. Treasuries returned 0.38% during the quarter as the yield on the 10-year U.S. Treasury rose to 2.33% from 2.30% at the end of June. For the quarter, long Treasuries (+0.58%) outperformed intermediate Treasuries (+0.34%).

- Mortgage-backed securities (MBS) returned 0.96% during the quarter, outperforming duration-matched Treasuries by 47 basis points. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index tightened 10 basis points to end the quarter at 22 basis points.





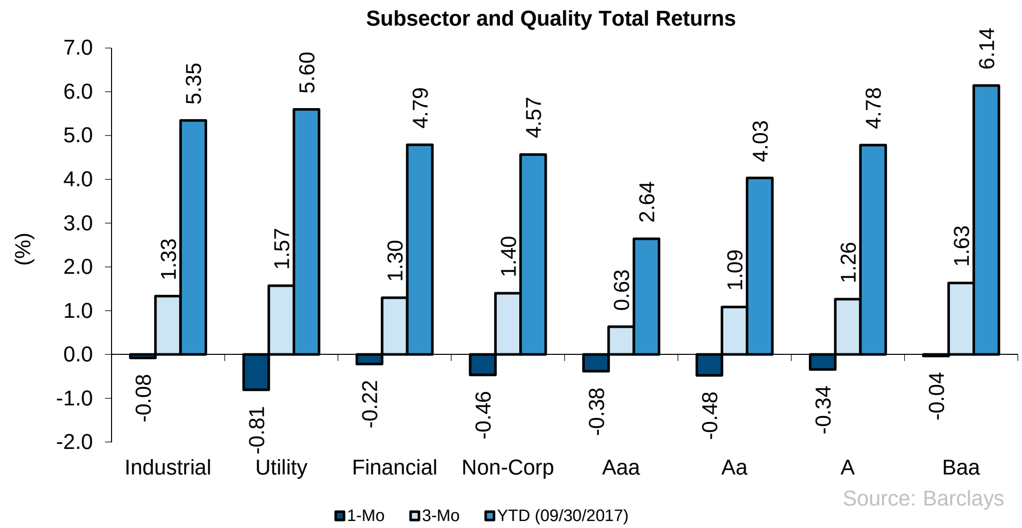
Investment cannot be made in an index. **Past performance is not necessarily a guide to future performance.**

Fixed income market update (continued)

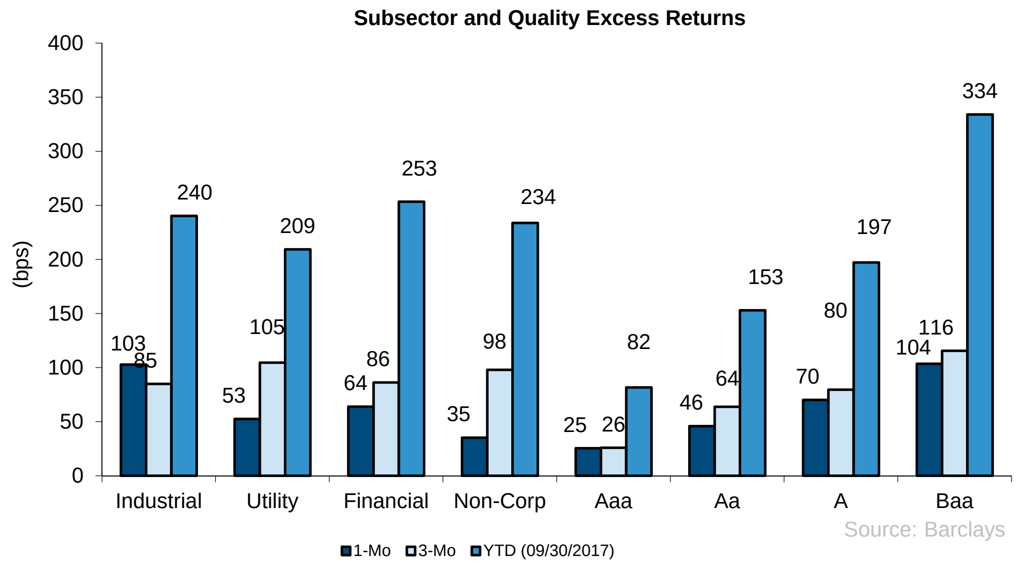
- Credit securities returned 1.35% for the quarter, outperforming Treasuries by 89 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 96 bps, 7 basis points tighter than at the end of June. For the quarter, long credit (+2.17%) outperformed intermediate credit (+0.99%) by 94 basis points on a duration-adjusted basis.

- For the quarter, on a duration-adjusted basis, utilities delivered 105 basis points of excess returns, outperforming non-corporates, financials and industrials by 7, 19 and 20 basis points, respectively.

- BBB rated securities delivered 116 basis points of excess return for the quarter, outperforming AAA, AA and A rated securities by 90, 52 and 36 basis points of excess return, respectively. High yield delivered 160 basis points of excess return for the quarter.



Source: Barclays

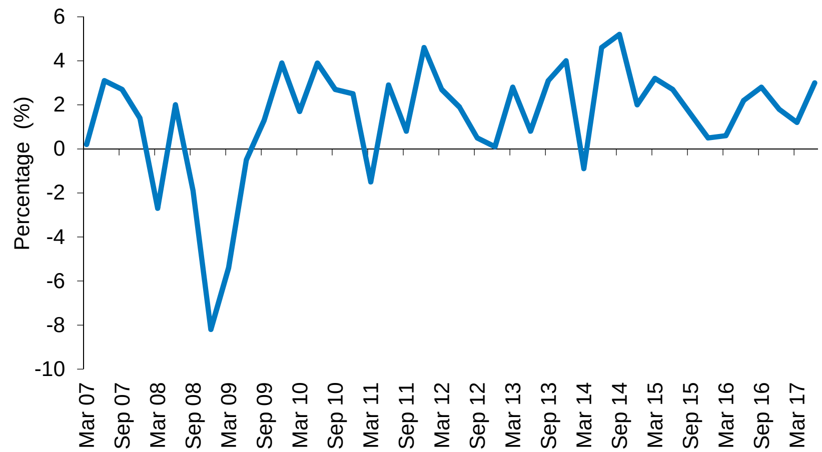


Source: Barclays

Economic update

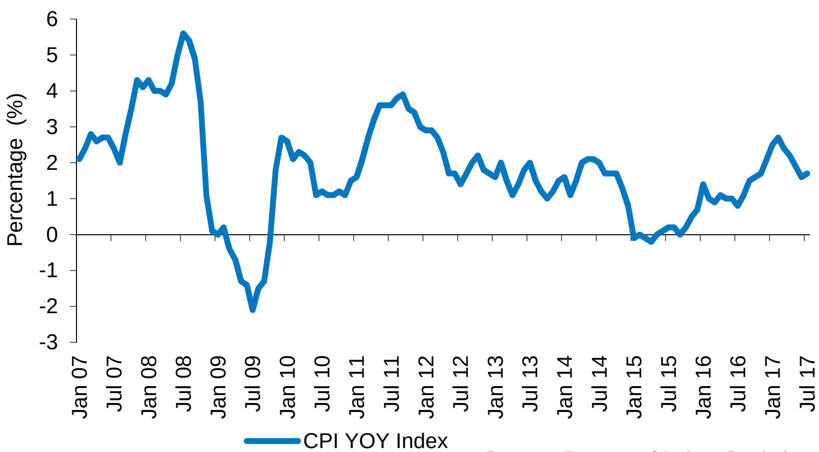
U.S. gross domestic product (GDP) growth was revised higher from 3.0% to a 3.1% annualized rate in the final reading for the second quarter. The Atlanta Fed's GDPNow third quarter growth estimate of 2.3% (as of September 29) is a marked revision downward from 3.3% at last month end. Consensus estimates from economists have declined as well to 2.2%, reflecting among other things, the impacts of Hurricanes Harvey and Irma. Those storms are estimated to have reduced third quarter GDP by up to 0.6%, while causing up to $200 billion in damages. The negative impact to GDP is expected to be largely recovered in the fourth quarter.

Gross Domestic Product (GDP)



Source: Bureau of Economic Analysis

Consumer Price Index (YoY)



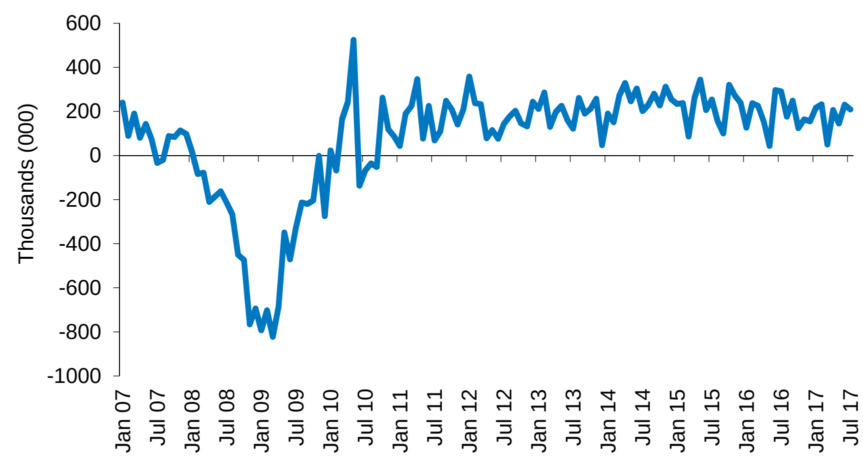
Source: Bureau of Labor Statistics

The Consumer Price Index (CPI) rose 0.4% in August and 1.9% for the past year, surpassing the consensus estimates of 0.3% and 1.8%, respectively. After four consecutive months of a 0.1% increase, core CPI rose by 0.2% for the month and 1.7% for the trailing year. The Federal Reserve's preferred inflation gauge, core Personal consumption expenditures (PCE), rose 0.1% in August, while declining by 0.1% to 1.3% for the trailing year.

Economic update (continued)

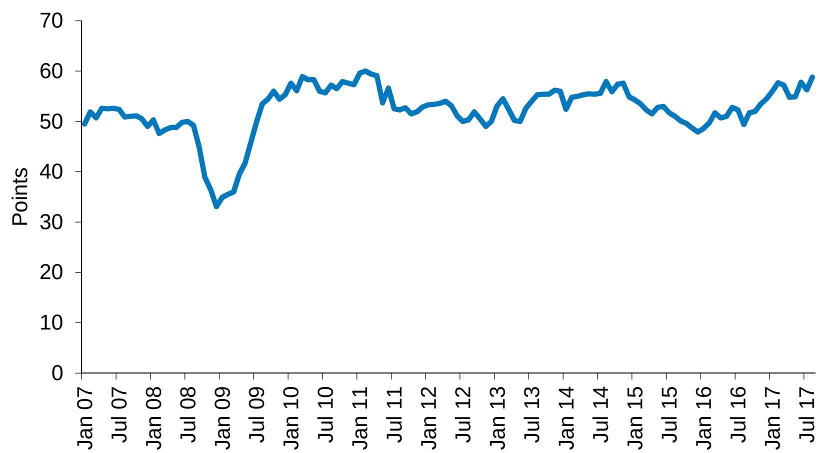
August non-farm payrolls disappointed with 156,000 jobs added, below the estimate of 180,000. Revisions to the prior two months reduced payrolls by approximately 40,000 jobs, however, manufacturing jobs rose by 36,000 jobs, the biggest increase in five years. The unemployment rate rose 0.1% to 4.4%, while the underemployment rate remained unchanged at 8.6%. Labor force participation also remained unchanged at 62.9%. Average hourly earnings rose 0.1% for the month and 2.5% for the trailing year.

Nonfarm Payrolls MOM (net)



Source: Bureau of Labor Statistics

ISM Manufacturing PMI



Source: Institute for Supply Management

The Institute for Supply Management (ISM) Manufacturing PMI hit its highest level since 2011. The August level of 58.8 exceeded expectations and represented an increase of 2.5% from July. The ISM employment index also rose to its highest level since 2011. The employment index has increased for eleven straight months and the ISM Report On Business showed the overall economy has grown for 99 consecutive months.

Economic and market perspective

- President Trump and Republicans in Congress released the framework for long discussed tax reform. The framework calls for reductions in marginal tax rates for both personal and corporate taxes, as well as the consolidation of the seven current tax brackets into three. For personal taxes the highest marginal rate would be cut from 39.6% to 35% and for corporate taxes the highest rate would be cut from 35% to 20%. Another proposed benefit for corporations is the ability to deduct business investment immediately as opposed to amortizing over time for the first five years of the plan's life. Additionally, the AMT (alternative minimum tax) and the estate tax would be eliminated. The standard deduction would be doubled and the child tax credit increased significantly. In total, these changes are estimated to cut taxes by about $5.8 trillion according to the Committee for a Responsible Federal Budget.
- Partially offsetting these cuts, would be the elimination of the state and local tax deduction, which would generate over $1 trillion in tax revenue. Current estimates are that new revenues from the plan would total about $3.6 trillion, overall reducing revenue to the Treasury by about $2.2 trillion. The framework still must be converted into legislation and go through the various stages of the legislative process. The Trump administration is targeting final passage by year end. As witnessed with another unsuccessful attempt to repeal the Affordable Care Act in September, having majorities in both houses does not ensure the legislative process will proceed neatly.
- Tensions with North Korea continued during September. President Trump addressed the United Nations in a call for unity against the rogue nation. North Korea continued to provoke, threatening to detonate a hydrogen bomb over the Pacific ocean.
- Two major global sovereign nations had their credit ratings downgraded during September. Moody's lowered the credit rating of the United Kingdom to Aa2 from Aa1 based on fiscal conditions as well as expected impact of the Brexit vote, which had previously caused Moody's to downgrade Britain from its Aaa rating. Also during September, S&P lowered China's debt rating from AA- to A+ citing a "prolonged period of strong credit growth" that "has increased China's economic and financial risks." The downgrade follows an August warning from the IMF (International Monetary Fund) that China's debt levels were on a "dangerous trajectory."

Economic and market perspective (continued)

- At its meeting on September 19-20, the Federal Open Market Committee announced that it would commence the gradual wind down of the balance sheet in October. This announcement was widely anticipated and no changes to the prior framework or further details were announced. The plan will allow $10 billion per month to roll off the $4.5 trillion balance sheet, increasing by $10 billion per quarter to a maximum of $50 billion per month. Under this plan, $30 billion would be unwound for the balance of 2017, with up to another $420 billion rolling off in 2018. By October of 2018, the plan would reach its caps, which would allow up to $600 billion to unwind in 2019. The Fed left the Fed Funds rate unchanged at 1.00 – 1.25% as expected.

- In a speech at the NABE (National Association for Business Economics), Janet Yellen acknowledged that the Fed “may have misjudged the strength of the labor market, the degree to which longer-run inflation expectations are consistent with our inflation objective, or even the fundamental forces driving inflation,” which would suggest a more dovish path in the short run. However, in the same speech she also stated that “it would be imprudent to keep monetary policy on hold until inflation is back at two percent” and that the Fed should “be way of moving too gradually.” At the end of the month, Fed Fund Futures project approximately a 70% chance of an additional rate hike in December.

- During the month, Federal Reserve Vice Chairman Stanley Fischer, a prominent close ally of Chair Yellen, resigned his position. With Chair Yellen’s term set to expire in February of next year, President Trump is considering multiple options for the seat and has indicated he will make an announcement in the next two to three weeks. He has left open the possibility of renominating Ms. Yellen, but is also considering outside options, including meeting with former Fed Governor Kevin Warsh regarding the position in September. Gary Cohn, Director of the National Economic Council and chief economic advisor to President Trump, was long considered a front-runner for the position, but now appears to be less likely to receive the nomination.

Outlook and conclusions

- In our view, the combination of monetary policy normalization with fiscal stimulus in the form of tax cuts presents an interesting environment for fixed income investors. Fed rate hikes and balance sheet reductions would typically suggest a deliberate attempt to slow an economy to prevent overheating. However, with the current path being so restrained and telegraphed, the Fed is signaling that they are not seeking to stymie the current moderate economic growth. Tax reform and Fed normalization could potentially have offsetting economic effects. Paired with subdued inflation and low global rates, U.S. interest rates are likely to remain range bound. At the same time, both normalization and fiscal stimulus should support the outperformance of non-governmental sectors versus Treasuries. While corporate spreads have tightened, the current landscape suggests outperformance from the sector should continue.

Fixed income returns as of September 30, 2017

Index Returns as of September 30, 2017						
	Total Return (%)			Excess Return (%)		
	Month-to-Date	Quarter-to- Date	Year-to- Date	Month-to-Date	Quarter-to- Date	Year-to- Date
U.S. Aggregate	-0.48	0.85	3.14	0.34	0.41	0.84
U.S. Treasury	-0.86	0.38	2.26	-	-	-
Intermediate	-0.60	0.34	1.56	-	-	-
Long	-2.16	0.58	6.02	-	-	-
TIPS	-0.64	0.86	1.72	-	-	-
Agencies	-0.48	0.41	2.07	0.01	0.05	0.57
U.S. MBS	-0.22	0.96	2.32	0.35	0.47	0.27
U.S. Credit	-0.22	1.35	5.08	0.78	0.89	2.41
Intermediate	-0.25	0.99	3.55	0.39	0.61	1.84
Long	-0.15	2.17	8.75	1.68	1.55	3.78
Industrial	-0.08	1.33	5.35	1.03	0.85	2.40
Utility	-0.81	1.57	5.60	0.53	1.05	2.09
Financial	-0.22	1.30	4.79	0.64	0.86	2.53
Non-Corporate	-0.46	1.40	4.57	0.35	0.98	2.34
Aaa	-0.38	0.63	2.64	0.25	0.26	0.82
Aa	-0.48	1.09	4.03	0.46	0.64	1.53
A	-0.34	1.26	4.78	0.70	0.80	1.97
Baa	-0.04	1.63	6.14	1.04	1.16	3.34
High Yield	0.90	1.98	7.00	1.43	1.60	5.35
Floating Rate Notes	0.21	0.56	1.76	0.13	0.30	1.19

Source: Bloomberg Barclays

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Disclosures

All investments involve risk, including the possible loss of principal.

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