Taplin, Canida & Habacht

November 1, 2017

Fixed income market update

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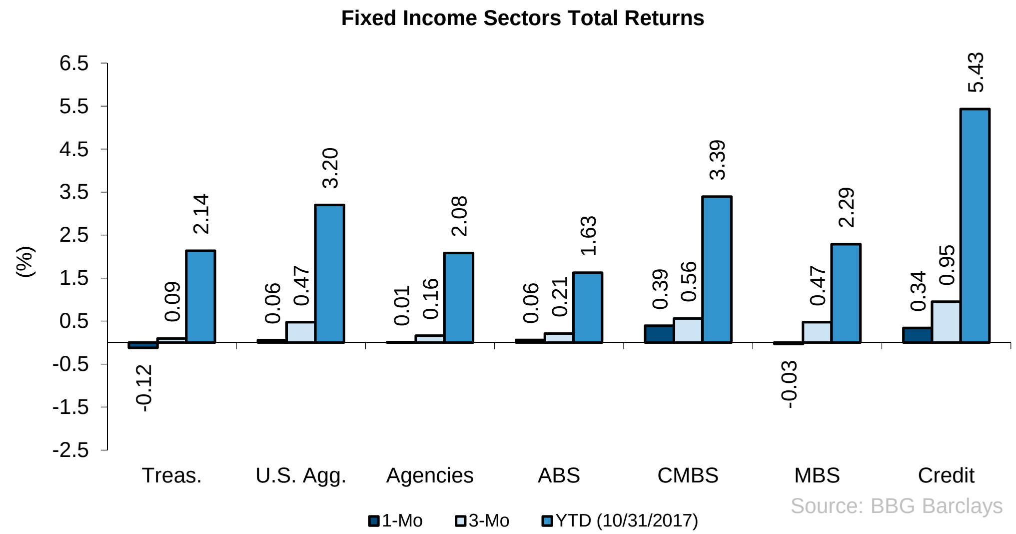
Fixed income market update

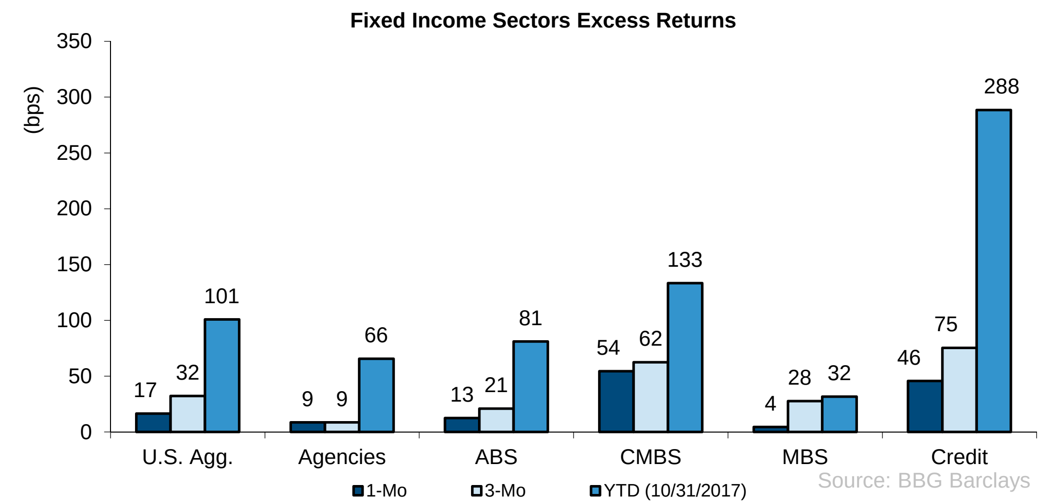
- For the month ended October 31, 2017, the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.06%. Year to date, the index has returned 3.20%.

- U.S. Treasuries returned -0.12% during the month as the yield on the 10-year U.S. Treasury rose to 2.38% from 2.33% at the end of September. For the month, long Treasuries (-0.08%) outperformed intermediate Treasuries (-0.13%).

- Mortgage-backed securities (MBS) returned -0.03% during the month, outperforming duration-matched Treasuries by 4 basis points. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index tightened 1 basis point to end the month at 21 basis points.



Source: BBG Barclays



Source: BBG Barclays

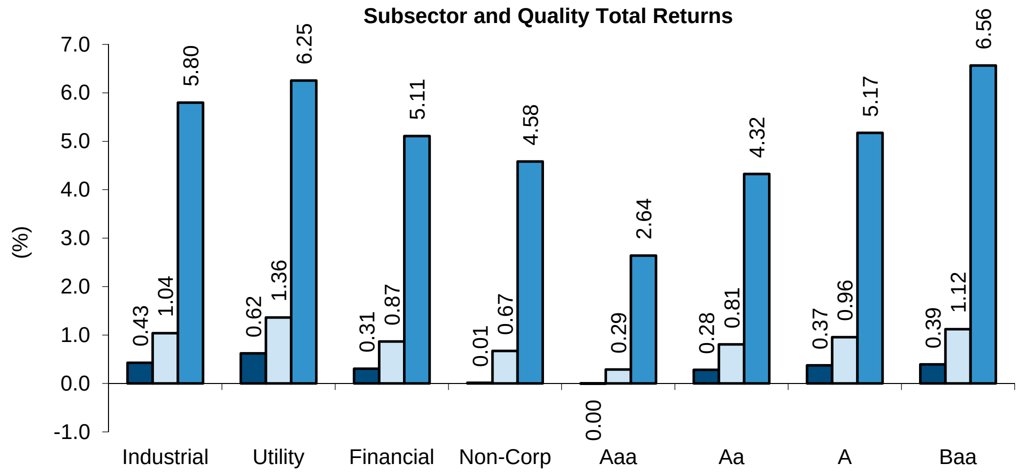
Investment cannot be made in an index. **Past performance is not necessarily a guide to future performance.**

Fixed income market update (continued)

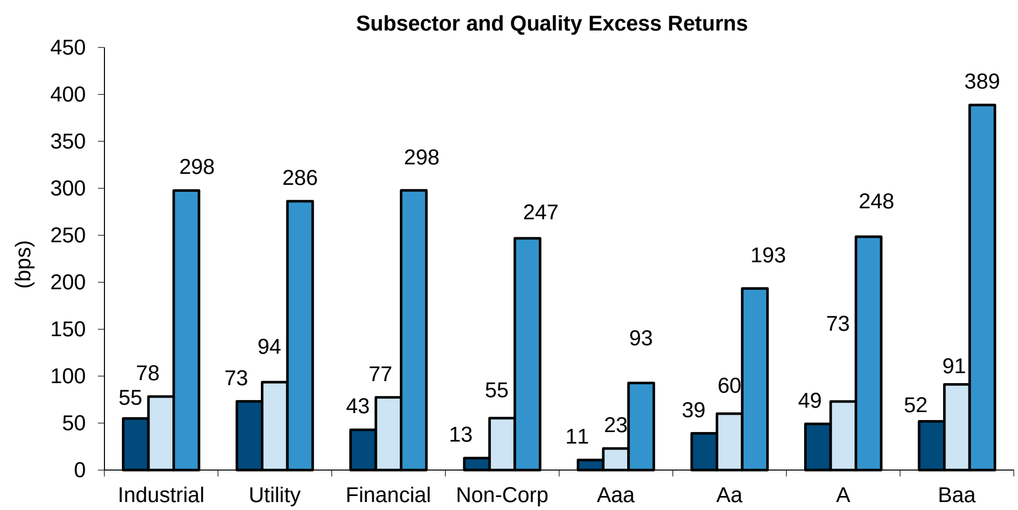
- Credit securities returned 0.34% for the month, outperforming Treasuries by 46 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 91bps, 5 basis points tighter than at the end of September. For the month, long credit (+0.72%) outperformed intermediate credit (+0.17%) by 52 basis points on a duration-adjusted basis.

- For the month, on a duration-adjusted basis, utilities delivered 73 basis points of excess returns, outperforming industrials, financials, and non-corporates by 18, 30 and 60 basis points, respectively.

- BBB rated securities delivered 52 basis points of excess return for the month, outperforming AAA, AA and A rated securities by 41, 13 and 3 basis points of excess return, respectively. High yield delivered 51 basis points of excess return for the month.



Source: BBG Barclays



Source: BBG Barclays

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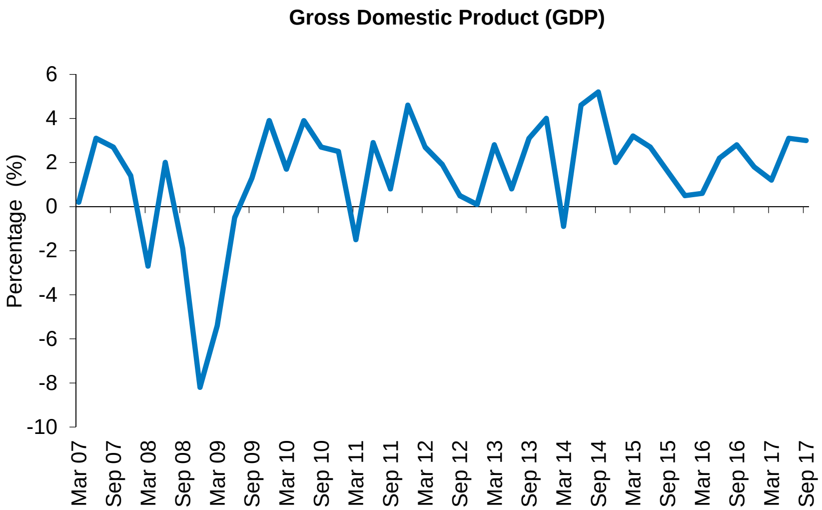
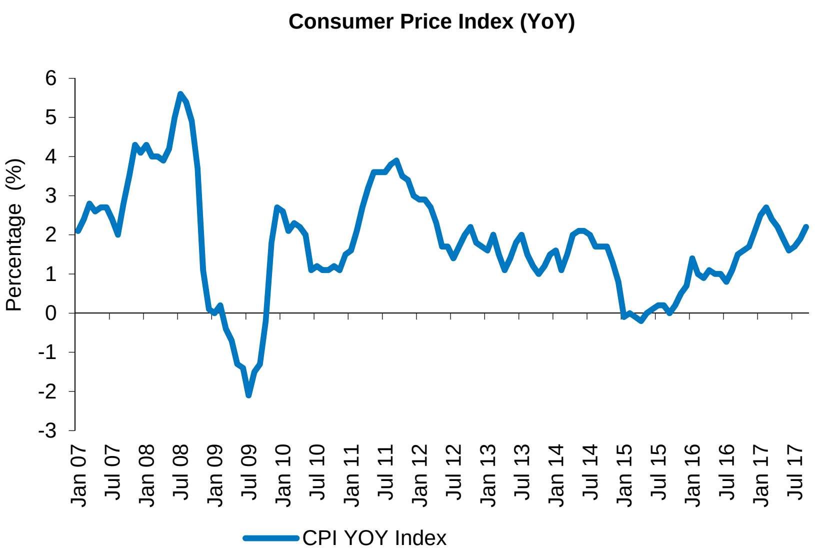
Economic update

U.S. gross domestic product (GDP) grew at a 3.0% annualized rate for the third quarter, exceeding expectations which had been lowered based on the impacts of hurricanes Harvey and Irma during the quarter. Paired with a strong second quarter, 3.1% growth, this marks the strongest six month period of growth since 2014. Consumer spending (+2.4%) remained strong, though residential spending fell 6% after falling 7.3% last quarter. The Atlanta Fed's GDPNow estimates 2.9% growth (as of October 30) for fourth quarter growth.



Source: Bureau of Economic Analysis

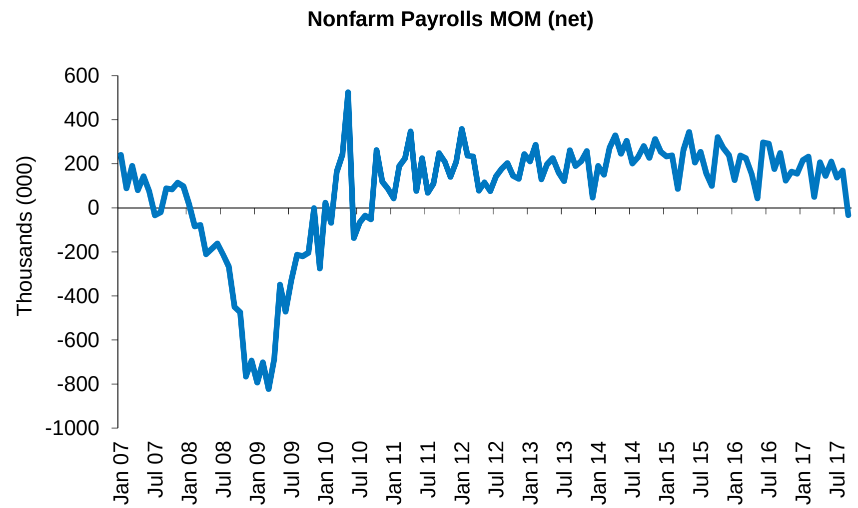


Source: Bureau of Labor Statistics

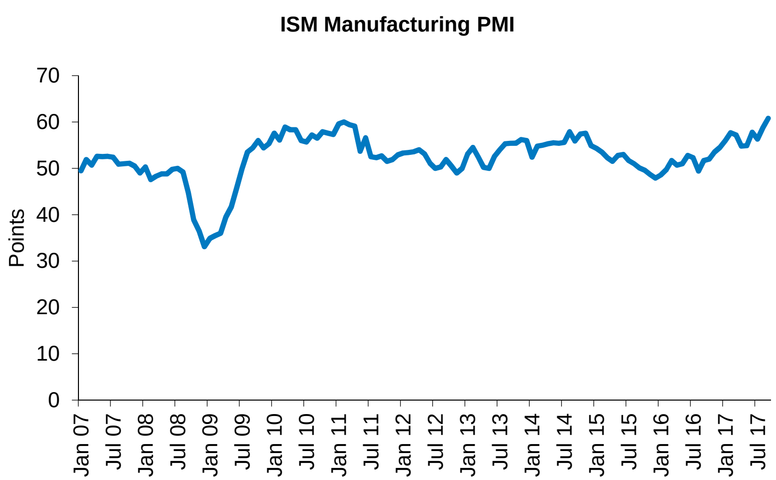
The Consumer Price Index (CPI) rose 0.5% in September and 2.2% for the past year. The increase was biggest in eight months, but was below estimates, which reflected rising gas prices due to Hurricane Harvey's impact on gasoline refining activity. Core CPI, which excludes the impact of energy and food, rose by a more modest 0.1% for the month and 1.7% for the trailing year, for the fifth consecutive month.

Economic update (continued)

Non-farm payroll data for September showed 33,000 jobs lost in the month, the first decline in jobs in seven years. The balance of the report was more positive though, as the unemployment rate declined to 4.2%, the lowest level in 16 years, and average hourly earnings rose 2.9% for the trailing year. Labor force participation rose to 63.1%, the best level since the first quarter of 2014, while the underemployment rate dropped from 8.6% to 8.3%, the lowest level in a decade.



Source: Bureau of Labor Statistics



Source: Institute for Supply Management

The ISM manufacturing index rose to 60.8, reflecting the 13th straight month of expanding manufacturing activity and the highest level of the index since 2004. According to the Manufacturing ISM® Report On Business®, the overall U.S. economy has grown for 100 consecutive months. The Conference Board reported that consumer confidence hit its highest level since 2000, rising to 125.9 in October from 120.6 in September.

Economic and market perspective

- The House of Representatives passed a budget resolution, which will make it easier for Congress to pass tax cut legislation. The resolution allows the federal deficit to increase by up to $1.5 trillion over 10 years. The Senate can now pass tax legislation with a simple 51-vote majority as opposed to requiring a filibuster-proof 60 votes. After several failed attempts at healthcare reform and a delayed start to the tax reform process, the current effort has moved faster than many anticipated. However, several more contentious issues such as state and local deductions as well as the final number of tax brackets still need to be resolved. The bill was expected to be released on November 1, but has been pushed back by at least a day.
- The European Central Bank announced that it will reduce new monthly debt purchases to €30 billion a month starting in January. The purchases are currently set to run through September 2018. For the balance of this year, the ECB will continue to purchase €60 billion a month. To date, the ECB has purchased over €2 trillion in assets as part of its quantitative easing program. If the program follows the path currently laid out, the balance sheet will grow close to €2.6 trillion. According to Eurostat, the unemployment rate in the Eurozone hit its lowest level since January 2009 at 8.9% in September. Growth has improved as well, with GDP increasing at 0.6% (2.4% annualized) for the third quarter. Markets are placing a near 90% probability on the Bank of England (BOE) hiking interest rates at their next meeting on November 2. This would be the first hike since 2007 and represents a change in tone from when the BOE cut rates following the Brexit vote. However, many view this rate hike as a one-off move as opposed to the beginning of a rate hike cycle.
- The S&P CoreLogic Case-Shiller home price index increased 6.1% year-over-year in August, bringing U.S. home prices to all-time highs.
- President Trump decertified the Iran nuclear deal in mid-October. The move does not withdraw the U.S. from the deal, but the president indicated that could be the ultimate outcome pending further work with Congress and U.S. allies. At the same time, President Trump also authorized the Treasury Department to impose sanctions against the Islamic Revolutionary Guard Corps.

Outlook and conclusions

- Minutes from the Federal Open Market Committee's September 19-20th meeting were released in October. The minutes indicate that the Fed expects to raise the Fed Funds rate one additional time this year. Markets project no chance of a rate hike at the October 31-November 1 meeting, but a two-thirds likelihood at the December meeting. The minutes also showed inflation to be a topic of debate at the Fed, with members questioning if low inflation levels should impact future rate hike decision or if low inflation was more temporary in nature.
- President Trump is expected to announce his selection for the next Chair of the Federal Reserve on November 2. The current front-runner for the nomination is Jerome Powell, a Fed Governor since 2012. Other known contenders include John Taylor, the academic known for the "Taylor Rule" that offers prescriptions for monetary policy, and the current Chair Janet Yellen. While the market views Taylor as more hawkish and Yellen and Powell as more dovish, all three are well respected, well established candidates, who the market would view as good stewards of monetary policy.
- In our view, an equally compelling and cogent argument could be made for interest rates to move either higher or lower from their present levels. On the one hand, geopolitical pressures continue to surface and the much anticipated fiscal stimulus, which appears priced into risk assets, has not come to fruition. On the other, slack in the labor market continues to abate, bringing with it expectations that the gap between realized inflation and the Fed's target will narrow in the coming quarters. Though a case can be made that the directional nature of interest rates remains less certain than a number of participants suggest, it is the magnitude of any such changes for which we are much more confident. Simply put, we don't foresee where interest rate changes will be too dramatic near-term, in either direction. With growth in the 2.0-2.5% range and core inflation bracketing 1.5%, there is not a lot of room for the Fed chairperson—any Fed chairperson—to push through dramatic changes in monetary policy. Likewise, the world has come a long way from Brexit, and while that story continues to develops, global economic growth has stabilized sufficiently to make the lows tested during that period unlikely to resurface. With a fairly neutral view on duration, and cross-sector analysis quite pedestrian as well, we have turned-up our focus on bottom-up security selection, as within this realm both volatility and differentiation still exists. We continue to identify stories where the market has overreacted entirely, or not at all, making for attractive opportunities to both build and exit positions. In short, despite the Home Run derby like performances during the World Series, in a bottom-up fixed income world, it's time to hit singles.

Fixed income returns as of October 31, 2017

Index Returns as of October 31, 2017				
	Total Return (%)		**Excess Return (%)**	
	Month-to-Date	**Year-to- Date**	**Month-to-Date**	**Year-to- Date**
U.S. Aggregate	0.06	3.20	0.17	1.01
U.S. Treasury	-0.12	2.14	-	-
Intermediate	-0.13	1.42	-	-
Long	-0.08	5.94	-	-
TIPS	0.21	1.94	-	-
Agencies	0.01	2.08	0.09	0.66
U.S. MBS	-0.03	2.29	0.04	0.32
U.S. Credit	0.34	5.43	0.46	2.88
Intermediate	0.17	3.73	0.30	2.15
Long	0.72	9.53	0.82	4.67
Industrial	0.43	5.80	0.55	2.98
Utility	0.62	6.25	0.73	2.86
Financial	0.31	5.11	0.43	2.98
Non-Corporate	0.01	4.58	0.13	2.47
Aaa	0.00	2.64	0.11	0.93
Aa	0.28	4.32	0.39	1.93
A	0.37	5.17	0.49	2.48
Baa	0.39	6.56	0.52	3.89
High Yield	0.42	7.45	0.51	5.89
Floating Rate Notes	0.25	2.01	0.17	1.37

Source: Bloomberg Barclays

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Disclosures

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

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