4th Quarter 2017

Highlights

- Key market results in 4Q included more record closes for stock markets and a sharp flattening of the yield curve. Credit markets were mixed with IG and EM outperforming, but high yield lagging;
- Global economic data continued to improve in 4Q and economists raised their forecasts for 2018. The U.S. enacted tax legislation that should contribute to growth in the coming years;
- We believe the reduction in corporate taxes may prove to be a seminal event for the U.S. economy. The incentive to invest in the U.S. should bring meaningful long-term benefits.

Markets

		Returns (%)	
GIA*	Average Quality	4Q17	12 Months
Core Plus Composite	(A)	0.40	5.11
Global Credit Plus Composite	(BBB+)	0.27	5.49
Emerging Market Debt Composite	(BB+)	1.08	10.55
**Returns are net of fees*			
Benchmark Bonds			
Bloomberg Barclay's U.S. Agg. Index	(AA+)	0.39	3.54
Treasury	(AAA)	0.05	2.31
Credit	(A)	1.05	6.18
Mortgage	(AAA)	0.15	2.48
Government/Credit	(AA)	0.49	4.00
BoA Merrill U.S. Corps & Yankees	(A-)	0.96	6.07
BoA Merrill Corporate Master	(A-)	1.12	6.48
BoA Merrill High Yield	(B+)	0.38	7.48
BoA Merrill EM Corporate Plus	(BBB)	0.48	7.29
BoA Merrill Global Gov't ex-US	(AA-)	0.67	0.41
JPM Emerging Markets EMBI+	(BB+)	-0.32	8.29
JPM CEMBI Broad	(BBB-)	0.70	8.01
JPM GBI-EM Global Diversified	(BBB)	0.82	7.32
Benchmark Equities			
S&P 500	NA	6.12	19.42
Nasdaq Composite	NA	6.27	28.24
Russell 2000	NA	2.99	13.14
MSCI EAFE	NA	3.90	21.78
Europe	NA	1.89	22.13
Japan	NA	8.34	21.77
MSCI Emerging Markets Equity	NA	7.09	34.35

Markets

The fourth quarter of 2017 capped a year of better-than-expected results in global financial markets. Almost ignoring a tumultuous political scene and geopolitical tensions, equity markets delivered impressive returns, including five record closes in December for U.S. indexes. Improved economic data abroad and passage of the tax reform bill in late December, convinced economists and strategists the global economy will likely deliver superior performance in 2018. While this optimism fueled equity and many higher risk markets, long term interest rates, inflation and agricultural commodities remained stubbornly low. During the year, the yield curve flattened dramatically with 2-year yields rising by 70 basis points while 30-year yields declined by 33 b.p. leading government bonds to deliver positive, but unimpressive, returns. Credit markets generated healthy excess returns although investor flows were mixed and sectors like high yield seemed to garner tepid enthusiasm from institutional investors. Surprisingly, the U.S. dollar, which rallied during 2016's final quarter, failed to sustain the gains, and ended the year weaker against most major currencies.

The investment grade corporate bond index, the Bank of America Merrill Lynch U.S. Corporate Index (C0A0), was up 1.12% for the quarter and 6.48% for the year supported by spread compression, a decline in longer term interest rates and record investor inflows. Corporate bonds concluded a year of meaningful outperformance of government bonds in part because the yield curve shift favored the sector, which features longer duration and a lighter concentration of securities in the short end of the curve. During the quarter, the U.S. treasury index returned 0.11% and 2.44% for all of 2017. Corporate option adjusted spreads (OAS) narrowed by 7 b.p. to 99 b.p., while the yield to worst of the index rose from 3.16% to 3.27%. Issuance for the quarter eased to $297.8 billion after a quiet December, but sufficed to set a sixth consecutive annual record at $1.47 trillion.

High yield bonds had a tamer quarter as retail investor outflows offset reasonable earnings, few defaults and broad economic optimism. The Bank of America Merrill Lynch High Yield Cash Pay Index (J0A0) ended up 0.38% for the quarter and 7.48% for the year. Spreads to worst widened from 357 b.p. to 365 b.p., while the yield to worst increased from 5.34% to 5.73%. Retail investors withdrew funds every month of the fourth quarter aggregating to $9.5 billion and they took money in 8 of the year's 12 months for total withdrawals of $20.3 billion in 2017. The default rate increased to 1.27% in December from 1.07% in September, but registered a decline of 2.3% during 2017 as the strong economy and improved commodity prices enabled some stressed borrowers to refinance. Although fourth quarter new issuance was the lightest of the year at $72.5 billion, full year issuance was a healthy $328.1 billion, 15% more than 2016.

Unlike high yield, emerging markets enjoyed a year of positive investor flows. These were supported by recoveries in oil and mineral prices, which, in turn, boosted economies like Brazil and Russia. China also delivered better than forecast growth in 2017, which helped lift Asian equity markets and buoy emerging market bonds. Even prospects for presidential transitions in countries like Brazil, Mexico and Colombia did not deter investors. Venezuela, which was already troubled, defaulted during the quarter hurting returns for hard currency sovereign indexes. For the quarter, the JPM Emerging Markets Bond Index Plus (EMBI+), a dollar denominated sovereign index, was down (0.32%), largely on Venezuela's default, the JPM Corporate Emerging Markets Broad Index (CEMBI Broad) increased 0.70%, and the JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index, returned 0.82%. For all of 2017 the indexes were up 8.29%, 8.01% and 15.21% respectively. In hard currency sectors, emerging markets experienced record new issuance in 2017 with total borrowing reaching $480.2 billion.

Portfolios

Our *Core Plus Composite* consists of portfolios that can hold securities rated below investment grade, but are managed against a Core fixed income benchmark. The Composite outperformed the Bloomberg Barclays U.S. Aggregate Index, net of fees, by 1 b.p. for the quarter, and was ahead by 157 b.p. over the last twelve months. During the quarter, the best performing sector was investment grade credit followed by emerging markets debt. After a strong 9 months, high yield underperformed in the final quarter of the year. In general, credit sectors benefited from improving economic fundamentals and investor pursuit of yield. On average, the Composite had exposure of 47.2% to credit sectors, with exposure to non-investment grade rated securities approaching 14.8%. For the quarter, favorable contributions from emerging markets and investment grade credit, were offset by underperformance in high yield. The portfolio was underweight mortgages and government bonds, both of which underperformed as interest rates in the short end of the yield curve rose in anticipation of the Fed's December rate hike. Over the last 12 months all credit markets outperformed, with emerging markets and high yield doing particularly well. The portfolios held overweight exposures all year, which accounted for the bulk of the outperformance.

Global Credit Plus Composite consists of portfolios holding investment and non-investment grade credit related securities. The Composite is measured against a benchmark consisting 85% of the BofA Merrill Lynch U.S. Corporate Index and 15% of the BofA Merrill Lynch U.S. Cash Pay High Yield Index. The Composite underperformed the benchmark, net of fees, by 60 b.p. during the quarter, and was behind by 80 b.p. over the last twelve months. The portfolios had an allocation of approximately 76.3% U.S. investment grade, 11.4% high yield, and 10.5% emerging markets, of which 9.8% was investment grade rated. The best performing sectors during the quarter were U.S investment grade and emerging markets high yield. The portfolio was underweight both of these, and had a slight short of index duration exposure in its investment grade holdings. In addition, high yield underperformed, and the portfolio, while underweight, did not add value in the sector. Over the last twelve months, the portfolio's underweight to below investment grade rated securities was responsible for the underperformance.

Our *Emerging Market Debt Composite* consists of portfolios investing in dollar denominated emerging market credit securities, primarily from corporate issuers. The Composite is measured against the BofA Merrill Lynch US Emerging Markets Plus Index (EMUB). During the quarter the portfolio outperformed the benchmark by 60 b.p., net of fees, and was ahead by 326 b.p. over the last twelve months. During the quarter, and over the last twelve months, non-investment grade outperformed investment grade and Latin America outperformed Asia. The portfolio's overweight positions in Latin America, primarily Brazil, and in non-investment grade credit generated the bulk of the outperformance. In addition, the portfolio had no exposure in Venezuela, which defaulted. Asian exposure in the emerging market corporate indexes tends to be high quality and subject to movements in interest rates. Asia underperformed in December as short term rates rose after the Fed raised rates and indicated more hikes were likely in 2018.

Economy

After a banner year in global equity markets, a string of solid economic reports, including from previously lagging countries, improving employment data, and the December passage of the U.S. tax reform bill, even the pessimists acknowledged growth prospects looked better for 2018. The Tax Cuts and Jobs Act, which passed in December, did not simplify the tax code or grant consumers a short term windfall, but it radically altered the landscape for corporate investment. The reduction in corporate taxes may explain much of the U.S. equity market enthusiasm, but future economic optimism comes from the longer term benefits associated with the investment incentives. Some economists have forecast the contribution at 0.5% to 1.0% in 2018. We believe it could be much larger over the long term.

During the fourth quarter, economic data remained strong, especially in manufacturing. Global Purchasing Manager Indexes (PMIs) were notable, especially in Europe where the economy seems to be responding particularly well to a rebound in sentiment. In the U.S., economists completing the WSJ Economic Survey actually lowered their expectations for the fourth quarter of 2107, but that was likely a consequence of larger trade deficit figures, rather than weakening demand. They also raised their growth expectations for 2018 and, predictably, shifted the risk to their forecasts from downside to upside.

While we share the optimism (see our Commentary below), there are a few indicators that cause us to temper our near term enthusiasm. Along with the often cited geopolitical and Washington dysfunction risks, we are concerned by the accepted absence of inflation and, by extension, the stubbornly low long term interest rates. Historically, robust economic activity has been accompanied by a pick-up in inflation and a move higher in long rates. During the last 5 years the S&P 500 returned 13.40% per annum while long U.S. treasuries returned 3.92% and the inflation rate averaged 1.38%. Over these 5 years, the 30-year interest rate went from 2.95% to 2.74% and real GDP grew 2.2% p.a. The performance relationship between stocks and bonds is skewed and likely not sustainable, especially if economic growth comes in where most economists forecast. During the five years ended December 31, 2007, the S&P 500 returned 10.79% per annum, while long treasuries delivered 6.03%, inflation averaged 3.07% and GDP grew 2.9% p.a.

The post-2009 economic expansion was notoriously weak. Two visible components were sluggish wage gains and stagnant productivity growth. In prior quarterly letters, we ascribed changes in labor force composition, participation rate and, indirectly, productivity, to our nation's demographics. Specifically, we have an aging labor force with "barbelled" age cohorts. While we expect an increase in investment to boost both wages and productivity, it is possible the benefits could be delayed until the young, recently employed cohorts enter their most productive work years.

Scenarios

We propose three scenarios for the U.S. economy over the next 6 months:

1. Our most likely case has the economy growing between 2.5% and 3.0% in 1Q and 2Q 2018. Without being explosive, economic activity in the fourth quarter likely capped a solid second half of 2017 and built momentum going into 2018. The corporate tax cut will likely boost investment and lift economic activity as new businesses are started and foreigners find the U.S. an appealing destination for investment. Consumer sentiment has remained elevated and the prospects of lower taxes and possibly higher wages should sustain it. In addition, unexpected economic improvements in Europe, Japan and many emerging markets, bode well for a period of globally synchronized expansion. PROBABILITY 65%

2. A second scenario has the economy improving to above-trend growth of 3.25% to 3.75% over the next six months. With an unemployment rate of 4.1%, new tax-driven investment may consume economic slack quickly, boost consumption more than expected and push growth higher. This, combined with improved global activity, may build momentum that further encourages investment and lifts wages. With inflation remaining modest, the economy could deliver some strong quarters before the Fed gets forced to intervene. PROBABILITY 20%

3. A third scenario has the economy declining to a 1.0% to 1.5% growth rate. Despite incentives, business investment may not materialize in the first half of 2018, wages may not improve and growing consumer indebtedness may temper confidence. Furthermore, it is possible temporary factors, like weather in the U.S., the National Party Congress in China and elections in Europe, generated more activity than we otherwise would have experienced in 4Q 2017. Returning to a lower trend growth rate could involve a greater-than-expected reversal in 1Q 2018. PROBABILITY 15%

Market Outlook

Year 2017 closed with strong economic and markets momentum. Global growth expectations should continue to support equity markets. In fixed income, the inflation rate continues to be a quandary that will impact the evolution of the yield curve and decisions at the Fed. If the economy unfolds as we expect, inflation may materialize in the form of higher wages and higher costs of services. Longer term interest rates may move higher in response, forcing the Fed to be more proactive. While we do not expect a move sharply higher, we believe the 10-year rate could move to about 3.0% and the long bond to about 3.5% by mid-2018. While these changes will generate paltry absolute returns for bonds, we expect credit spreads to remain near current levels and creditworthiness to improve as corporations adjust their capital structures to benefit from the new tax law.

Commentary – The Tax Cuts and Jobs Act

On December 22, 2017, the much anticipated tax reform that President Trump promised as a candidate and the Republican Congress promoted both prior and post the election, became law. We believe this legislation will prove to be a seminal measure for the U.S. economy based entirely on the reduction in the corporate tax rate. Broadly measured, the act failed to achieve some of the originally proposed objectives, including the simplification of the tax code, a large reduction in individual taxes, the elimination of many deductions and others. However, the reduction in the corporate tax rate moves the U.S. from having the fourth highest rate in the world to one of the lowest rates amongst developed nations.

Corporate taxation has been the subject of extensive debate between economists and politicians for centuries. Many economists consider taxes distortionary and corporate taxes an unproductive addition to the cost of doing business. Others believe taxes should be levied on businesses because they finance the economic and regulatory foundation of the marketplace. This debate will likely never be resolved and corporate taxation will always exist, in part for three totally uneconomic reasons. The first is that governments have expanded and their excessive financial obligations cannot be funded with income or sales taxes alone. Secondly, corporate taxes are relatively easy to collect. And finally, as a corollary to the first reason above, politically, corporations are amorphous entities that are easier to tax than people. Given the foregoing, we think it is remarkable the government succeeded in passing such a meaningful reduction in the corporate tax rate.

The reason the lower tax is important is that it creates an incentive to invest. U.S. companies that might have built a plant abroad or started a new division are incented to make the investment at home. Foreign corporations wanting to do business in the U.S. have an incentive to open plants here and entrepreneurs will be eager to launch new businesses. The stock market's impressive 2017 and early 2018 performance is a testament to the likely economic benefits of the lower tax. In a January 12, 2018 Wall Street Journal editorial, Donald L. Luskin, Chief Investment Officer at Trend Macrolytics, LLC., suggested the market may not be overvalued because, as a consequence of the new tax law, he estimates earnings are likely to be higher than most expect. He adds, "My estimate also doesn't consider business migration. Some American companies with operations in low tax jurisdictions may bring these activities home. Some foreign companies may decide to forward deploy their facilities into the U.S. market. All of this again will create new businesses, factories, jobs and earnings."[1] Investment has a tremendous economic multiplier effect, with new businesses hiring more workers, broadening and diversifying the economy's commercial base, augmenting competition, and ensuring attractive prices.

Ireland is a well-known low tax jurisdiction. The small country with limited natural resources or competitive advantages, realized early it had to compete with intellectual capital by attracting investment. The country has a 12.5% corporate tax rate, lowest among the Euro area countries, which, as an aside, elicited the wrath of some member countries complaining Ireland was "taking" some of their companies. Indeed, after the 2010 sovereign crisis that engulfed the European periphery, Ireland included, the country has enjoyed among the best growth rates in the Euro area. This is not a surprise when considering that gross fixed capital formation (the investment component of GDP) grew from €29.4 billion in 2010 to €87.7 billion in 2016, a 20% annual growth rate. By comparison, investment in Spain, Italy and Greece declined over the same time period. Even regional champion, Germany, had an annual growth rate of 3.9% and, as a whole, the Euro area countries achieved only a 1.75% rate.

[1] Donald L. Luskin. "Tax Reform Has Released the Bulls." The Wall Street Journal, January 12, 2018.

Year 2017 ended with positive economic momentum, perhaps even euphoria because the world appears to be growing in synchrony. All multilateral entities raised their global growth forecasts, with many citing the likely contribution of the new tax legislation. Optimism led global equity markets to an impressive year of performance, despite substantial apprehension at the end of 2016. A question that vexed many is: what was the trigger for the noticeable shift in sentiment, both domestically and internationally? We may not have the answer, but Mr. Luskin may have put a finger on it when he wrote: "Finally, my estimate doesn't factor in the competitive global response to American tax reform. Nations afraid to be left behind may cut their own taxes in what could turn into a world-wide competition. That would be the delightful opposite of protectionism. Instead of trying to punish each other with reciprocal tariffs, nations could engage in a race to the top to see who can completely liberate their productive sector from the deadweight costs of corporate taxation."[2]

It is evident shareholders benefit meaningfully from reduced corporate taxes. What about bond holders? The new tax law limits deductibility of interest to 30% of earnings before interest, taxes and depreciation, arguably a corporation's added value. This new treatment favors the use of equity over debt in the mix of capital sources. Logical expectations for debtholders include improved creditworthiness and a near-term "technical bid" for outstanding debt. Over time, corporations will likely attempt to optimize their capital structure to maximize return on equity while minimizing their cost of capital. Below is a simple hypothetical depiction of the effect of the new law. For companies with low to modest leverage, the effect of the law is an increased return to shareholders, which helps explain the stock market's performance. For more levered companies, the law alters the capital structure considerations, favoring an increase in the use of equity.

Interest Deductibility Examples

	Low Leverage		High Leverage	
	Previous Full Deduction	New 30% Deduction	Previous Full Deduction	New 30% Deduction
Net before Interest and tax	100	100	100	100
Interest Expense	40	40	80	80
Deductible Amount	40	30	80	30
Net Taxable Income	60	70	20	70
Tax (Rates 35%, 21%)	21	14.7	7	14.7
Net Income	39	45.3	13	5.3
Distribution of Value Added				
Equity	39	45.3	13	5.3
Debt	40	40	80	80
Government	21	14.7	7	14.7
Assumed Cap structure				
Equity	500	500	100	100
Debt	500	500	900	900
Return to equity	*7.80%*	*9.06%*	*13.00%*	*5.30%*

Some people wonder whether limiting deductibility will hurt small businesses, and perhaps banks by, in effect, increasing the cost of debt. It is true small businesses may face challenges raising equity, but it is also true that full deductibility can be argued to subsidize the cost of borrowing, thereby incenting its use. Theoretically, in a world with no corporate taxes, the cost of capital and, by extension, optimal capital structure, is determined by the characteristics of the business and the nature of its cash flows. We believe businesses of all sizes will continue to borrow, but going forward more funding will come from equity. We believe this, by the way, also happens to be a desirable outcome for the long term wellbeing of the economy.

January 15, 2018

Sources: Congress.Gov, Eurostat, Bureau of Economic Analysis, The Wall Street Journal, Bloomberg.

[2] Ibid.

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Index Definitions

Bloomberg Barclays US Aggregate Index

The Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Bloomberg Barclays US Treasury Index

This index is the U.S. Treasury component of the U.S. Government index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg Barclays US Government/Credit Index

The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries and agencies. The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Bloomberg Barclays US Credit Index

This index is the U.S. Credit component of the U.S. Government/Credit index. Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

Bloomberg Barclays US Mortgage Backed Securities Index

This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Bank of America Merrill Lynch US Corporate & Yankees Index

The Bank of America Merrill Lynch US Corporate & Yankees Index tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market by US and non-US corporations and non-US quasi-governments.

Bank of America Merrill Lynch US Corporate Index

The Bank of America Merrill Lynch US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings).

Bank of America Merrill Lynch US High Yield Master Cash Pay Only Index

The US High Yield Master Cash Pay Only Index tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market.

Bank of America Merrill Lynch Global Government Excluding the U.S. Index (N0G1)
The Global Government Index tracks the performance of publicly issued investment grade sovereign debt denominated in the issuer's own domestic currency. N0G1 excludes U.S. government bonds.

JP Morgan Corporate Emerging Markets Bond Index (CEMBI)
The CEMBI tracks total returns of US dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries. Two variations are available: CEMBI Broad and CEMBI. The CEMBI Broad is the most comprehensive corporate benchmark followed by the CEMBI, which consists of an investable universe of corporate bonds. Both indices are also available in Diversified versions.

JP Morgan EMBI+ Index
The EMBI+ tracks total returns for U.S-dollar-denominated debt instruments of the emerging markets: Brady bonds, loans, Eurobonds. The EMBI+ currently covers 104 instruments across 15 countries.

JP Morgan Government Bond Index-Emerging Markets (GBI-EM)
The GBI-EM is the first comprehensive, global local Emerging Markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. Variations of the index are available to allow investors to select the most appropriate benchmark for their objectives.

S&P 500 Index
An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Nasdaq Composite Index
An index that tracks the change in the total market value of all companies listed on the Nasdaq Stock Market.

Russell 2000 Index
An index measuring the performance of the 2,000 smallest companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small cap stocks in the United States.

MSCI EAFE Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe, Australasia and the Far East.

MSCI EAFE- Europe Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe.

MSCI EAFE- Japan Index
The index is a capitalization weighted index that monitors the performance of stocks from Japan.

MSCI Emerging Markets Equity
The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.