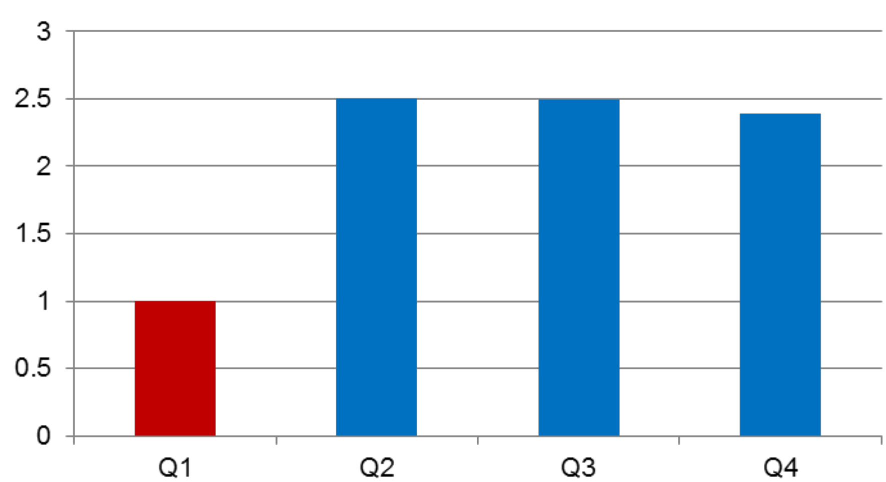
2nd Quarter 2017

VAAM's economic outlook differs from the consensus forecast because we are looking for faster growth and higher inflation. Specifically, we are forecasting economic growth of 3% annualized (year-over-year), a gradual rise in inflation approaching 3% and interest rates rising with the ten year U.S. Treasury note reaching 3%. The economic cycle from a historic perspective is somewhat long in the tooth; however, this recovery does not reflect the typical excesses associated with the end of a cycle. In fact, there are factors at work that could serve to extend the cycle. With the administration's proposals regarding taxes and regulations, we should be moving to a higher level of GDP growth. 4% GDP growth seems close to impossible given the aging of our population and weak productivity growth but even a 3% rate would be a significant improvement and more than enough to drive double digit corporate profits. Some level of tax reform seems to be emerging as a priority with the emphasis of lowering corporate tax rates to more globally competitive levels and allowing for the repatriation of significant amounts of overseas profits. A lighter regulatory environment should also help. While some of the regulations passed over the last eight years are clearly beneficial and necessary, others are open to debate. For instance, in the energy sector, we need to facilitate the monetization of the vast new supplies of energy, both oil and natural gas. Pipelines are a necessary evil in this regard. On the other hand, coal is not the answer and most corporate executives acknowledge that those days are long past. Regulation of the financial sector is another hotly debated subject. We think Dodd Frank will be reviewed and changes will be made but the bill's primary foundation will remain. Second quarter real GDP estimates will accelerate after a first quarter gain of only 1.4%. Final sales to domestic purchasers (which eliminates inventory adjustments and trade volatility) in the first quarter were up 2.3%. The first quarter also saw a pickup in business investment growth to 10.4%. While the jump in capital spending was the largest in five years, spending on energy related equipment was 40% of the gain. More investment has the potential to lead to greater productivity and higher wages which in turn will lead to greater consumer spending (70% of GDP).

In recent years, the economy has been performing below consensus during the first quarter. The pattern has been one of slow growth during the first quarter with the economy picking up as spring and summer arrive (see chart below).

Each Quarter's Average Annualized Quarterly GDP Growth Since 2010



Source: Commerce Department

In addition, we think the labor market is stronger than the overall data indicate. For example, private payroll employment is more than double that of the previous recovery. A contraction in government spending since 2009 has been a headwind to economic growth. This has the potential to change with fiscal stimulus coming from tax reduction and an infrastructure program. While the manufacturing sector has slowed, the services sector (the larger component of the economy) has continued to expand and provide job growth.

Wage push inflation has the potential to surprise on the upside. While unemployment has declined to 4.4% (near the lowest in 16 years) wage growth has stayed at 2.5% since late 2015. This partially masks the divergence between the fortunes of workers with advanced skills and those without them. The Federal Reserve cited an economy continuing to grow, albeit moderately, continuing strength in the labor market and a recent softening in inflation (which they view as transitory) when they raised the fed funds rate by 25 basis points to a 1%-1 1/4% range and outlined a plan to gradually reduce their $4.5 trillion balance sheet. While core PCE (the Fed's preferred inflation metric that excludes food and fuel) is at 1.4% versus their 2% objective, the Fed expects inflation to rebound. This is reflected in worker shortages in some parts of the country. The Fed assumes a stronger labor market will eventually flow through to faster wage growth. Their decision to raise rates along with their balance sheet plans show confidence in the economic expansion which is the third longest on record.

The yield curve flattened during the quarter, with short rates experiencing a rise in conjunction with Fed policy action. Longer rates finished the quarter mostly unchanged and the spread between 2 and 10 year rates dropped by 22 basis points. The table below shows the yield curve at the end of the second quarter.

	3/31/2017	6/30/2017	Change
3-monthTreasury Bills	0.75	1.01	0.26
6-month Treasury Bills	0.90	1.13	0.23
2-year Treasury Note	1.25	1.38	0.13
5-year Treasury Note	1.92	1.89	-0.03
10-year Treasury Note	2.39	2.30	-0.09
30-year Treasury Bond	3.01	2.84	-0.17
10-year vs. 2-year	114	92	-22

The rise in rates relative to last quarter has not been accompanied by an increase in inflationary expectations, as evidenced by the compression of the spread between TIPS and nominal yields. The 10 year breakeven rate stands at about 1.75%, a continuation of its downward trend initiated during the latter part of the first quarter. Since then, the breakeven rate has fallen through 2% and maintained a steady decline. This has led to underperformance in TIPS relative to its nominal counterpart. However, TIPS will provide outperformance and inflation protection as economic momentum builds and inflation rises greater than the consensus, in accordance with our economic outlook.

Corporate Securities

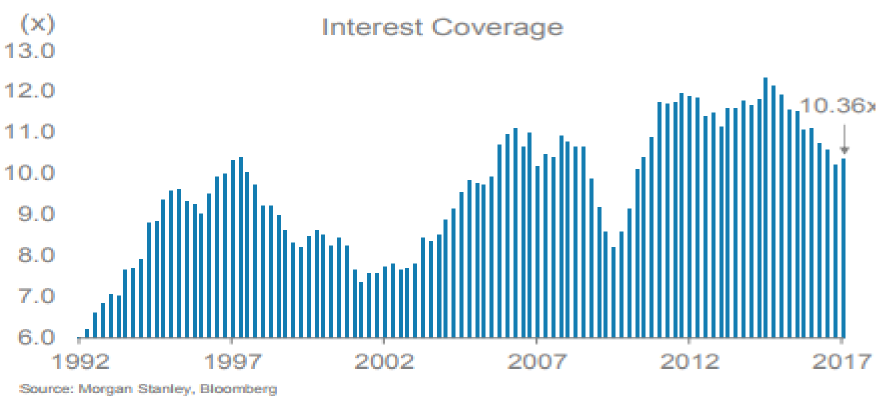
The strong performance of the corporate bond market continued during the second quarter of the year. The higher sector income and greater price appreciation due to spread tightening relative to comparable U. S. Treasury securities resulted in strong excess returns. For instance, shorter maturity corporate bonds tightened by 0.10% and provided 0.41% of excess return during the quarter as measured by the Bank of America Merrill Lynch 1-3 Year Corporate Index. The BAML 1-10 Year Corporate Index spread tightened by a similar by a similar 0.09% and due to its longer duration and higher income it enjoyed 0.77% of excess spread over the comparable U.S. Treasury Index. Excess returns for the year-to-date now stand at 0.91% and 1.45% respectively. Our over weight to the sector has been beneficial for the both the quarter and the first six months performance.

Current corporate spreads are significantly through their long term median but remain above their tightest levels as shown in the table below. They are once again approaching the tights of this economic cycle and further improvement is dependent on global economic expansion and growing corporate cash flow.

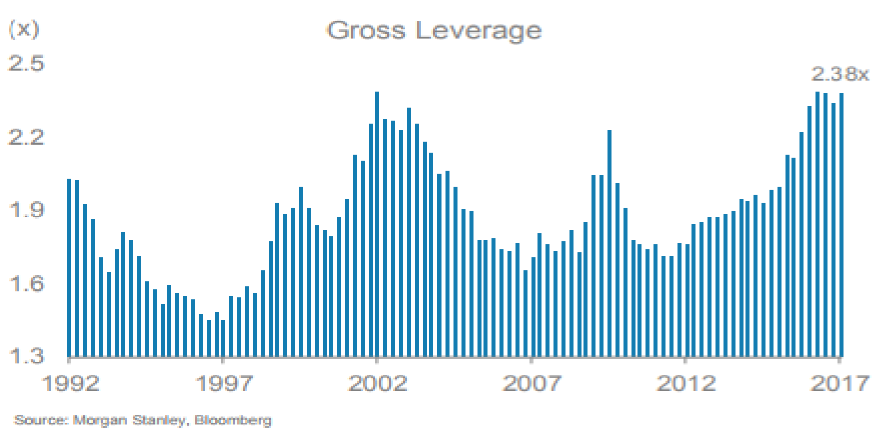
Historical Corporate Spreads
12/31/1996-6/30/2017

	ML 1-3 Corporate Index	ML 1-10 Corporate Index
LAST	65	94
Median	93	129
Minimum	39	48
Minimum 1990s	39	48
Minimum 2000s	50	71
Minimum 2010s	57	92

Our fundamental and quantitative screens indicate that corporate bonds are fairly valued. Fundamental screens are the most supportive of current corporate bond spreads. For instance, first quarter earnings were strong as 79% of S&P 500 companies matched or exceeded market expectations. Cash flow increased during the quarter and the interest coverage of investment grade companies improved modestly from the prior quarter to 10.36x.



Though interest coverage is down from its peak during the expansion, it remains significantly above the lows of 7-8x of the last two recessions. However, corporate debt leverage levels (Gross Debt/ EBITDA) remain elevated as compared to EBITDA (Earnings before Interest Depreciation & Amortization) at 2.38x.



Our concerns, though unlikely to be realized over the next several quarters, are twofold. First, leverage historically reaches this elevated level only during a recession. Secondly, approximately 50% of investment grade debt issuance has been used for refinancing of existing debt, equity buy-backs and acquisitions since 2014. These activities do not create an increase in future cash flow to support the higher debt levels that have been incurred. As long as the global economy is expanding investors are comfortable reaching for the higher yield available in this sector despite the leverage. The impact on corporate spreads of these elevated debt levels is likely to be seen only when the economy shows signs of slowing. The BAML Lighthouse Quantitative model, which incorporates equity values, equity volatility and the level of debt to calculate a fair value spread and compares this risk spread to the company's CDS to arrive at an excess spread estimate, has been relatively stable over the course of this year. As of quarter end, excess spreads were at the lower end of fair value at 0.19% compared to 0.20% at the beginning of the year. Therefore, the decrease in spreads and higher leverage has been supported and is consistent with higher equity prices and muted equity volatility. We remain overweight the corporate sector with a continuing focus on companies with a track record of stable cash flow.

During the second quarter we purchased several new names. NVIDIA is a graphics processing manufacturer. Their products are used in cutting edge applications including gaming, artificial intelligence applications, computers, robotics and self-driving cars. The company enjoys strong cash flow generation with EBITDA/Interest Coverage of almost 40x and cash that exceeds outstanding debt. They had a significant positive earnings surprise for the first quarter. BP is a diversified energy company in the oil/gas and renewable energy sectors. The interest coverage is over 12x and leverage stands at 2x. They had a positive earnings surprise in the first quarter. Their size, diversification from exploration and development through refining and retail services insulates their operations from some of the volatility of the crude oil markets. Edwards Lifesciences provides heart valves, critical care monitoring devices and catheters. Cash levels currently exceed outstanding debt levels and interest coverage is almost 50x. The company had a significant positive earnings surprise for their last quarterly report.

Asset Backed & Mortgage Backed Securities

The second quarter was another strong one for short Asset Backed Securities (ABS). Whereas short term interest rates backed up, the sector posted a total return of 0.459%, with an excess return of 0.271% versus same duration U.S. Treasuries. While interest rate uncertainty prevails throughout the markets, the combination of stable prepays, low delinquencies and AAA-rating afforded short ABS solid returns for another quarter.

Last quarter we discussed some of the negative headlines that have been pointing to rising delinquencies in sub-prime auto loan ABS. Although we only invest in prime auto loan ABS, we determined that given the negative headlines, this was a good time to reduce exposure to auto loan ABS in general. Since, despite the headlines, auto loan ABS continue to post tight spreads, we were able to sell these positions at highly competitive levels. We left approximately half of the auto loan positions remaining in our portfolios'. The positions that we retained are those with the highest FICO scores and lowest delinquencies, as well as those positions with maturities in under six months, yielding more than Agency securities.

Besides auto ABS, we are also invested in short AAA-rated credit card ABS. These securities have deep subordination levels ranging between 16% and 36%, which suffice in sheltering the 60+ day delinquencies that are mostly well under 2%. Credit card ABS offers stable cash flows that are not influenced by the markets' whims in interest rate uncertainties.

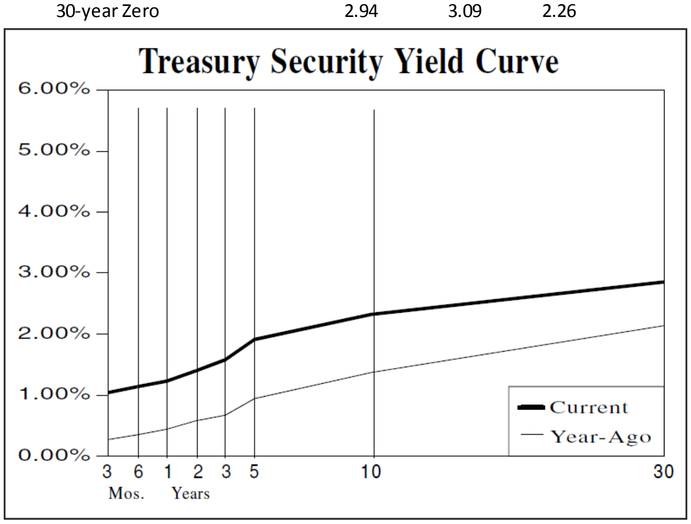
In addition to short ABS, we are beginning to invest in short super seasoned Agency Mortgage Backed Securities. Seasoned MBS are comprised of mortgages, originated many years ago, whose borrowers are now paying and have been paying an above market rate. We look for rates that are significantly above market, such as 5% or greater. Since mortgage rates haven't been at levels this high in about a decade, these mortgages tend to be approximately 10 years old, and sometimes older. The borrowers of these mortgages have gone through many opportunities to refinance but have not done so. As a result, prepayments are extremely stable and not driven by variations in interest rates. Premium MBS typically come with a high dollar price, but the securities that we invest in have a stripped down coupon, well below the rate on the underlying mortgages, so their dollar price is around 100.

This point is best illustrated with a recent purchase. We bought FNR 2015-89 KE at 99-28. Here is a security whose 4,000+ 30-year mortgage pools were, on average, originated 20 years ago, at an average rate of 8%. The security has a coupon of 2%, which allows it to have a dollar price around 100, as opposed to full coupon premium securities, which have dollar prices as high as 110. Although this security has a CMO moniker, it behaves as a pass-through and pays down according to a mortgage style amortization. Prepayments on this security have had a 1 month, 3 month, 6 month, 12 month and lifetime average of 12 CPR; so it is safe to say that the CPR going forward will remain a predictable 12 CPR. Unlike newer pools, the borrowers within this security have been paying a mortgage rate that they could have refinanced many times over, but have chosen not to, whether due to the small size of their balance or to ultimate apathy. Either way, we find the predictability of the cash flows in this security appealing.

Going into the second half of 2017, we plan to increase our exposure to these securities. We believe that regardless of the move in interest rates, these top rated Agency MBS will offer stable cash flows coupled with a substantial yield pickup.

Selected Yields

	Recent (7/5/17)	3 Months Ago (4/5/17)	Year Ago (7/6/16)
TAXABLE			
Market Rates			
Discount Rate	1.75	1.50	1.00
Federal Funds	1.00-1.25	0.75-1.00	0.25-0.50
Prime Rate	4.25	4.00	3.50
30-day CP (A1/P1)	1.21	0.73	0.46
3-month Libor	1.30	1.15	0.66
U.S. Treasury Securities			
3-month	1.04	0.80	0.27
6-month	1.14	0.91	0.35
1-year	1.23	1.02	0.44
5-year	1.91	1.85	0.94
10-year	2.32	2.34	1.37
10-year (inflation-protected)	0.56	0.33	-0.03
30-year	2.85	2.99	2.14
30-year Zero	2.94	3.09	2.26



	Recent (7/5/17)	3 Months Ago (4/5/17)	Year Ago (7/6/16)
Mortgage-Backed Securities			
GNMA 5.5%	2.43	2.37	1.57
FHLMC 5.5% (Gold)	2.69	2.42	1.68
FHLMC 5.5%	2.49	2.36	1.33
FHLMC ARM	1.81	1.75	1.85
Corporate Bonds			
Financial (10-year) A	3.41	3.50	2.83
Industrial (25/30-year) A	3.91	4.10	3.49
Utility (25/30-year) A	4.01	4.19	3.56
Utility (25/30-year) Baa/BBB	4.34	4.57	4.01
Foreign Bonds			
Canada	1.79	1.56	0.97
Germany	0.47	0.26	-0.18
Japan	0.09	0.07	-0.27
United Kingdom	1.26	1.09	0.77
Preferred Stocks			
Utility A	5.79	5.76	5.88
Financial A	5.73	5.78	5.77
Financial Adjustable A	5.47	5.47	5.48

Source: Value Line, Inc.

Federal Reserve Data

BANK RESERVES

(Two-Week Period; in Millions, Not Seasonally Adjusted)

	Recent Levels			Average Levels Over the Last...		
	06/21/17	**06/07/17**	**Change**	**12 Wks.**	**26 Wks.**	**52 Wks.**
Excess Reserves	2125729	2130559	-4830	2145605	2094846	2115770
Borrowed Reserves	87	60	27	51	36	92
Net Free/Borrowed Reserves	2125642	2130499	-4857	2145554	2094810	2115679

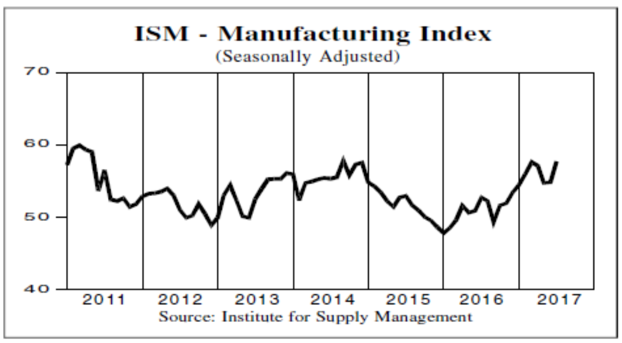
MONEY SUPPLY

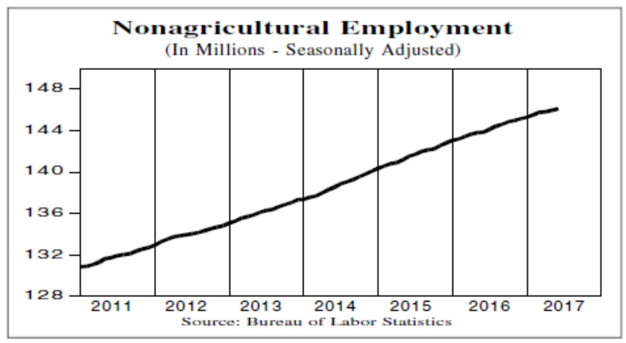
(One-Week Period; in Billions, Not Seasonally Adjusted)

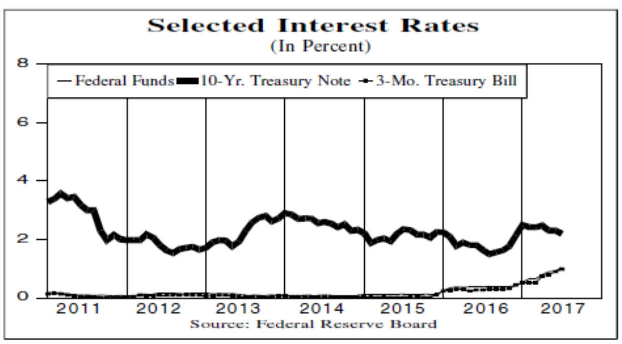
	Recent Levels			Ann'l Growth Rates Over the Last...		
	06/19/17	**06/12/17**	**Change**	**3 Mos.**	**6 Mos.**	**12 Mos.**
M1 (Currency+demand deposits)	3488.5	2506.3	-17.9	9.1%	9.4%	7.6%
M2 (M1+savings+small time deposits)	13510.2	135.5	-4.3	3.7%	5.2%	5.3%

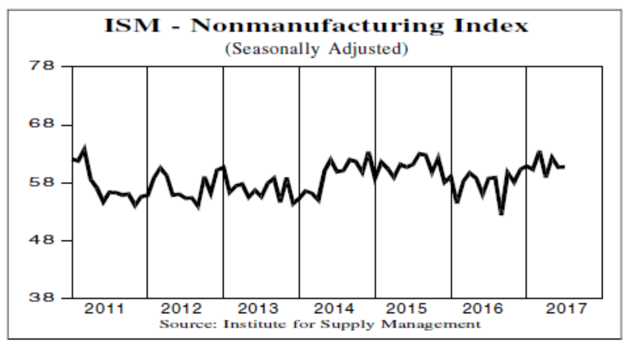
Source: Unites States Federal Reserve Bank

Tracking the Economy









Source: Value Line, Inc.