2nd Quarter 2016

Overview

The U.S. economy is reasonably strong, with steady growth since 2009 and a 4.9% unemployment rate. The U.S. dollar has also been quite strong.

Some of the dollar rally reflects a more negative global outlook. The economies of Europe, Japan and many emerging markets have remained exceptionally weak, making the U.S. look comparatively strong. Factor in the United States' traditional role as the beacon of stability in turbulent times, and American assets look more attractive than their underlying economics would suggest.

Most worrisome is that there are some feedback loops between the strong dollar and economic weakness abroad. Many international companies, especially in China and emerging markets, owe debt in dollars, so a stronger dollar makes their debts more onerous and creates spillover economic weakness. Also, of course, the stronger dollar is undermining American exporters, slowing growth in the U.S.

The world's central banks are well aware of these forces, of course, and are trying to combat them. The European Central Bank and the Bank of Japan are in the middle of huge programs to try to pump money into their financial systems by buying assets. The Federal Reserve and the Bank of England have been delaying interest rate increases in hopes of achieving higher inflation and more solid growth.

In the aftermath of Brexit, analysts and financial markets are now pricing in even slower interest rate increases by the Fed, the Bank of England ultimately lowering rates and a possibility of yet more easing programs by the E.C.B. and the Bank of Japan.

U.S. economy

We anticipate real GDP growth accelerating in the second quarter from the first quarter's 1.1% annualized gain. We forecast growth climbing to an annualized rate of approximately 3.0% during the second half of 2016. The labor market continues to exhibit strength and has averaged 226,000 new jobs per month during the last 30 months. June showed a gain of 287,000 jobs which is the strongest month of hiring since last October. This is a sharp rebound from the May gain of 11,000 jobs. It is important to recognize that the monthly employment data is an inherently noisy data set and that other indicators show the economy continues to grow. In addition, the payroll figures have a large margin of error and are subject to large revisions. Wages have increased 2.6% compared with a year earlier, matching the fastest annual growth rate since July 2009. Consumer spending (approximately 70% of GDP) has been climbing at a solid pace after a winter slowdown, supported by stronger wage growth. Fed Chairman Janet Yellen cited the rebound in household outlays as a key factor underlying the central bank's expectations for continued economic growth. April and May retail sales reports suggest that consumer spending has rebounded. Personal spending rose 0.4% in May from a month earlier. That followed a 1.1% jump in April, the sharpest rise in nearly seven years. In addition, consumer confidence increased to an eight-month high in June. Another linchpin to the economy has been the auto industry. With gas prices lower and credit plentiful, the industry has posted strong sales numbers. In addition, housing continues to recover as a result of lower mortgage rates and an increase in the household formation rate.

Despite outlining the economic strengths above, there remain some confusing signals with regard to the economic outlook. We address some of these below:

- **Will the recent U.K. Brexit decision be a significant headwind to U.S. economic growth?** The U.S. economy should be relatively immune to Brexit ramifications despite increased economic and political uncertainty. While U.K. trade with the U.S. will decline, U.S. imports and exports with the U.K. account for less than 5% of America's total international trade in goods and services. There will be a bigger drag on trade when factoring in a weakened E.U. and Euro. However, aggressive monetary easing by the Bank of England, European Central Bank and the Bank of Japan along with prospects for additional Federal Reserve interest rate increases receding, should make for a continued low interest rate environment. Lower rates will push against the hit that the economy takes on trade. The economic and political ramifications will play out over a longer period of time. Although the eventual U.K.-E.U. relationship is uncertain, the possibility exists of reactions moderating over the next several months and an accommodation being negotiated that is beneficial to both sides.
- **Can the U.S. economy gain momentum while there is weakness globally?** Cumulative progress since the Great Recession has been strongest in the U.S. and prospects for the year ahead remain solid. This is the primary reason for the Fed's initial interest rate normalization step last December. In other economies however, sluggish conditions have prompted central banks to aggressively ease monetary policy (negative rates, quantitative easing, encouraging currency devaluations). The 1998 Asian financial crisis effects to the U.S. economy were limited. In addition, the U.S. is not overly dependent on sales to other regions (exports are only 12.5% of GDP).
- **Can the U.S. economy grow while manufacturing is in decline?** The U.S. economy has become heavily service oriented, allowing for expansion to continue in that sector while more generally manufacturing is in retreat.
- **Are low oil prices abnormal and do they indicate economic weakness?** Investors believe prices in the $40-$50 range are below norm. However, oil prices have averaged below current levels 68% of the time going back to 1986. Oil exceeding $80 per barrel is the exception and not the rule.
- **Should equity markets move in the same direction as oil prices?** Since mid-2014 (when oil prices started their recent decline) there has been a positive correlation between oil and equities which has not been historically the case. Some investors believe low oil prices signal lower global demand, lower economic activity and lower equity prices. Global oil demand grew 1.7% in 2015 which represents the fastest growth in four years. This implies that lower oil prices are primarily due to higher supplies.
- **Are lower oil prices a positive or a negative?** It is estimated that every penny reduction in the price of gas adds $1 billion to the pocketbooks of U.S. households. Tracking prices going back to 2014, as much as $193 billion has been saved by households (provided price declines are sustained over a 12 month period). The impact of this price relief far exceeds stimulus efforts such as the Middle Class Tax Relief & Job Creation Act of 2012 which injected $125 billion into the economy.
- **Is the Fed's inability to attain its inflation target a sign of economic weakness?** The Fed uses the Personal Consumption Expenditures Price Index as its inflation gauge and the PCE deflator has been weaker than other indicators of underlying inflation. Core (excludes food and fuel) PCE inflation has a 22% weighting in health care versus an 8% weighting within the CPI. Administered weights in Medicare and Medicaid have been held in check by law. In addition, there are two important trends for inflation for 2015-2016. Prices for consumer goods have remained soft such as the apparel sector which is largely imported and more sensitive to movements in the U.S. dollar. However, prices for consumer services, which are more sensitive to trends in the domestic economy and labor markets, have been on the rise. Rising costs for medical services such as doctors, hospitals and health insurance is a reversal in a trend that saw cost increases for these services slowing in recent years.

The yield curve flattened further and shifted downwards by the end of the 2nd quarter, as market expectations of the path of interest rates were revised downward as a result of unexpectedly dovish communications from the Fed. The spread between the 10-year and the 2-year U.S. Treasury notes narrowed 16 basis points from the previous quarter to 89 basis points. The table below shows the yield curve at the end of the first quarter and the second quarter of 2016.

	31-Mar	30-Jun	Change
3-monthTreasury Bills	0.20	0.26	0.06
6-month Treasury Bills	0.38	0.35	-0.03
2-year Treasury Note	0.72	0.58	-0.14
5-year Treasury Note	1.21	1.00	-0.21
10-year Treasury Note	1.77	1.47	-0.30
30-year Treasury Bond	2.61	2.29	-0.32
10-year vs. 2-year (bps)	105	89	-16

The curve shifted downwards by an average of 16basis points. The overarching theme this quarter has been "lower for longer," as yields on safe assets across the globe rallied. As of quarter end, nearly $10 trillion of bonds globally carried negative yields.

The slope of the curve, measured by the spread between 10-year and 2-year notes, reached its lowest level in over six years. While traditionally this would indicate a substantial deterioration in the economic outlook, the behavior of this indicator during an abnormal interest rate environment has yet to be determined. Nonetheless, the market appears to expect interest rates to remain depressed for some time to come. This is further evidenced by recent movements in the Fed Funds futures markets, where the market is pricing in a minimal probability of a rate hike during the third quarter.

As highlighted in our last letter, from a historical standpoint, the curve appears to be sending mixed signals. On the one hand, the market is anticipating a continuation of monetary accommodation. On the other hand, the falling slope is a bearish signal for the economy. Although geopolitical events and global economic concerns have influenced this rally, the persistence of these movements especially in the fixed income market suggests these are not transitory effects. This is in stark contrast to the movements in the equity market, where post-Brexit losses were effectively reversed shortly thereafter.

Corporate Securities

The corporate bond market stabilized during the second quarter after a volatile first three months. Spreads over comparable U. S. Treasury securities moved tighter over the period until the Great Britain vote to leave the European Union on June 23rd. Spreads then widened modestly through month end. For instance, intermediate corporate bonds began the quarter at a 1.46% spread to U.S. Treasury issues, reached a tight of 1.31% before retreating to 1.37% by quarter end. Shorter corporate bonds followed a similar path, 1.08% to 0.97% to 0.92%. Spread tightening and incremental income combined to provide positive excess returns over U.S. Treasury issues of 0.82% for intermediate bonds and 0.50% for 1-3 year maturities.

Your portfolio has an overweight allocation to the sector as valuations remain attractive and company financial fundamentals remain supportive. During the last earnings season, 76% of S&P 500 companies reported better than expected or in line earnings versus market expectations which is a solid result. Other financial fundamentals continued to show modest deterioration but they remain at reasonable levels. As reported by Morgan Stanley, gross leverage for investment grade issuers rose to 2.33 times from 2.23 times in the prior period, while net leverage remained stable at 2.05 times. In addition, interest coverage fell to 10.4 times from 10.8 times but remains above the peak of the prior economic cycle. Solid cash flow generation and low interest rates for new corporate debt has allowed corporations to increase debt levels while keeping their interest coverage at relatively strong levels. Finally, cash levels on corporate balance sheets fell to 13.7% from

14.6%. Like the interest coverage, this ratio remains above the highest level reached in the last cycle. Cash is expected to decline as M&A, stock buybacks and higher dividends should be greater than free cash flow. Our quantitative screen, based on BAML Lighthouse, projects 0.21% of excess return available on U.S. investment grade corporate returns. The model utilizes equity prices, equity volatility and the level of debt to predict a credit spread. This credit spread is then compared to observed credit spreads in the market to determine whether individual bonds are under or overvalued. The current 0.21% is within a normal range of .20% to .28%. Based on corporate fundamentals, your overweight to the sector is being maintained. However, our focus is on stable cash flow generating companies and an underweight to cyclical firms.

The banking sector continues to underperform due to energy sector exposure, low interest rates and global growth concerns. As discussed last quarter, exposure to the energy sector, though significant, is manageable without a serious impact on capital ratios. Energy related worries also abated during the period as oil prices remained well above stress levels. On June 23rd, the Federal Reserve released the results of the Dodd-Frank Act Stress Test. All banks exceeded their minimum stressed regulatory capital requirements under the severely adverse scenario. For the entire sector the stressed net loss declined by $185 billion while the aggregate common equity tier 1 ratio bottomed at 8.4% versus 7.6% last year. The results for U.S, issuers held in your portfolio were as follows:

Bank	Common Equity Tier 1 12/31/2015	2016 Minimum Stress	Required to Pass
Bank of America	11.6%	8.1%	4.5%
Citi Group	15.3%	9.2%	4.5%
Goldman Sachs	13.6%	8.4%	4.5%
JPMorgan Chase	12.0%	8.3%	4.5%
Morgan Stanley	16.4%	9.1%	4.5%
US Bancorp	9.6%	7.5%	4.5%
Wells Fargo	11.1%	7.2%	4.5%

As shown, the bank sector is well capitalized. Therefore, your portfolio will continue to hold securities of these companies.

Asset Backed Securities

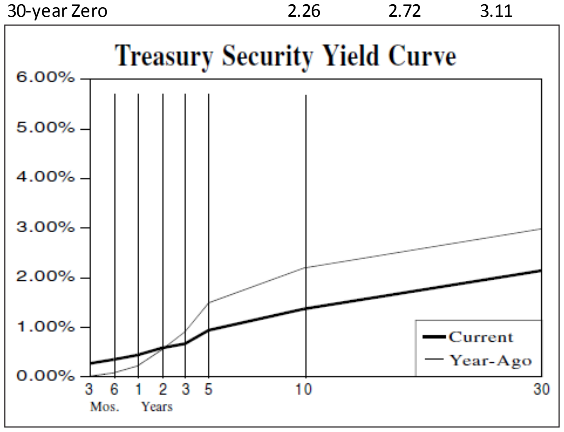
The rally that began in the first quarter continued throughout the second quarter, taking short duration asset-backed securities ("ABS") along for the ride. The total return of short ABS was 0.72% in the second quarter, which was 0.37% greater on an excess return basis versus similar duration U.S. Treasury issues.

Your portfolio continues to have an overweight allocation to ABS. We invest in only the highest quality AAA rated ABS, collateralized by credit card receivables, auto loans/leases and equipment loans. We only invest in prime auto loan securities, which offer lower yields, but significantly better credit stability than sub-prime loans. Spreads in this sector tightened in the second quarter, due to stabilized annual issuance coupled with low defaults and losses.

Additionally, the ABS in your portfolio offer stable cash flows with either locked out prepayment windows or gradual prepayments that do not fluctuate with interest rate movements. We invest in both short fixed rate and floating rate securities. This combination leads to stable returns when interest rates both rise and fall.

Selected Yields

	Recent (7/06/16)	3 Months Ago (4/06/16)	Year Ago (7/08/15)		Recent (7/06/16)	3 Months Ago (4/06/16)	Year Ago (7/08/15)
TAXABLE							
Market Rates				**Mortgage-Backed Securities**			
Discount Rate	1.00	1.00	0.75	GNMA 5.5%	1.57	1.75	1.63
Federal Funds	0.25-0.50	0.25-0.50	0.00-0.25	FHLMC 5.5% (Gold)	1.68	1.84	1.88
Prime Rate	3.50	3.50	3.25	FHLMC 5.5%	1.33	1.52	1.64
30-day CP (A1/P1)	0.46	0.38	0.13	FHLMC ARM	1.85	1.83	1.65
3-month Libor	0.66	0.63	0.28	**Corporate Bonds**			
Bank CD's				Financial (10-year) A	2.83	3.24	3.62
6-month	0.14	0.14	0.17	Industrial (25/30-year) A	3.49	3.92	4.28
1-year	0.23	0.22	0.27	Utility (25/30-year) A	3.56	3.98	4.30
5-year	0.79	0.80	0.86	Utility (25/30-year) Baa/BBB	4.01	4.53	4.69
U.S. Treasury Securities				**Foreign Bonds**			
3-month	0.27	0.23	0.01	Canada	0.97	1.21	1.52
6-month	0.35	0.35	0.08	Germany	-0.18	0.12	0.67
1-year	0.44	0.55	0.22	Japan	-0.27	-0.06	0.42
5-year	0.94	1.20	1.49	United Kingdom	0.77	1.38	1.89
10-year	1.37	1.76	2.19	**Preferred Stocks**			
10-year (inflation-protected)	-0.03	0.22	0.37	Utility A	5.88	5.93	5.97
30-year	2.14	2.59	2.98	Financial A	5.77	6.16	6.17
30-year Zero	2.26	2.72	3.11	Financial Adjustable A	5.48	5.48	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...		
	06/22/16	**06/08/16**	**Change**	**12 Wks.**	**26 Wks.**	**52 Wks.**
Excess Reserves	2307518	2309182	-1664	2308899	2317880	2414601
Borrowed Reserves	126	89	37	74	69	126
Net Free/Borrowed Reserves	2307392	2309093	-1701	2308825	2317812	2414475

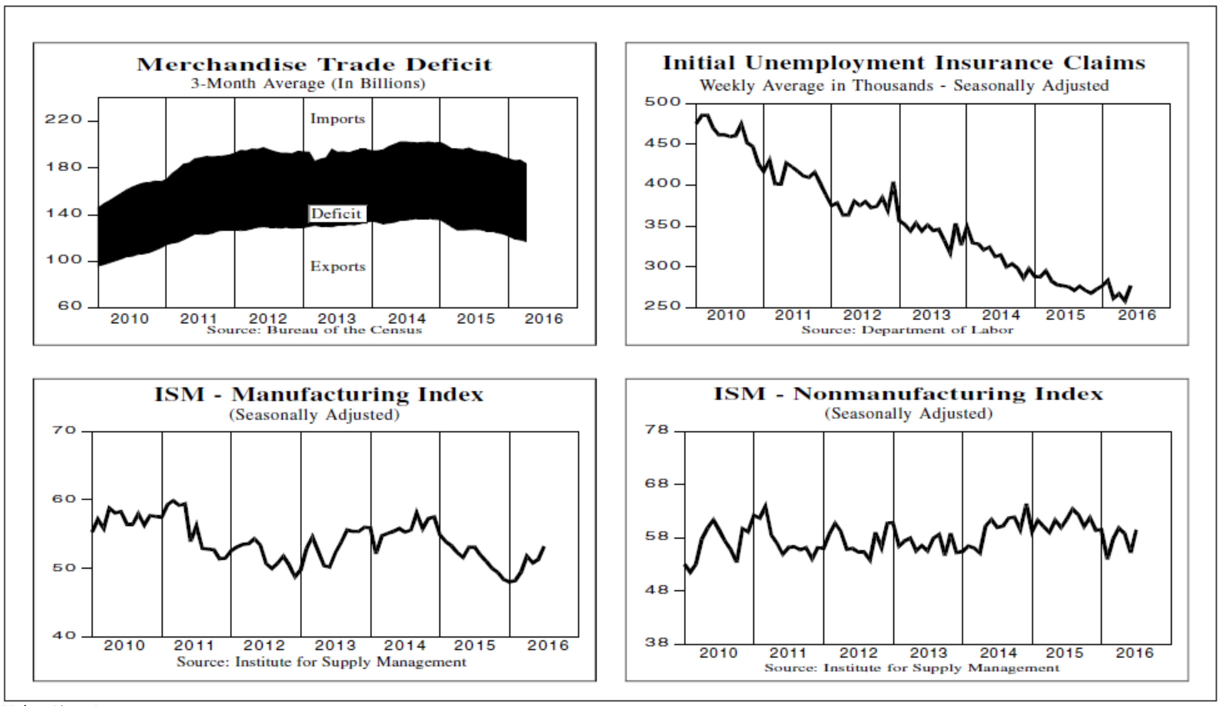
MONEY SUPPLY

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

	Recent Levels			Ann'l Growth Rates Over the Last...		
	06/20/16	**06/13/16**	**Change**	**3 Mos.**	**6 Mos.**	**12 Mos.**
M1 (Currency+demand deposits)	3233.8	3231.6	2.2	12.7%	10.2%	7.8%
M2 (M1+savings+small time deposits)	12816.7	12798.6	18.1	8.0%	7.8%	6.9%

Source: Unites States Federal Reserve Bank

Tracking the Economy



Source: Value Line, Inc.