3rd Quarter 2018

Monetary policy continued its expected trajectory of balance sheet normalization and interest rate tightening. The FOMC concluded its meeting toward the end of September with a largely anticipated 25 basis point rise in the target range for the Federal Funds rate and a commensurate increase in the discount rate. As of quarter end, the Fed Funds target range stood at 2%-2.25%, with the effective rate settling at the midpoint of 2.15%. In addition, the Fed continued its balance sheet normalization process and indicated that, in keeping with previously announced schedules, its monthly caps for maturities of Treasury and Agency MBS will increase to $30 billion and $20 billion respectively. Accordingly, the Fed will continue reinvesting maturities in so far as they exceed the previously specified caps.

Changes to the FOMC statement and the summary of economic projections suggest that the Federal Reserve views the economy as steadily progressing towards its policy objectives as well as moderately higher expectations for growth and unemployment. The major change to the statement was the removal of the phrase "the stance of monetary policy remains accommodative." This indicates that the Fed believes that its policy normalization process is progressing as expected and that policy may be approaching a neutral stance.

Lastly, the Fed reasserted its expectation of one more rate hike this year in December bringing the total number of interest rate increases for the year to four. For 2019, the Fed projects that the Fed Funds rate will end at 3.1%. This implies approximately three rate hikes planned for next year.

Fiscal policy is very expansive with widening deficits that are helping to boost economic growth by pumping money into the economy. However, these deficits could come with long-term costs. In 2009, deficits swelled after the economy contracted sharply. Unemployment soared and revenues plunged as the Federal government raised spending to cushion the shock. Deficits reached nearly $1.5 trillion which was approximately 10% of GDP. The deficit did not fall below $1.0 trillion until 2013 when growth improved and policymakers approved tax increases and spending curbs. Today's deficit is increasing towards $1.0 trillion. What's different is the deficit is increasing during a period of economic growth not in a period of economic weakness. U.S. public debt is 78% of GDP; however, in 10 years it is expected to grow to 96% of GDP. When the ratio of government debt to GDP exceeds 90%, the rate of economic growth falls by approximately 1%. By the end of this year, the Federal government will have incurred more debt than the total debt owed by all U.S. households across mortgages, credit cards, student loans and personal loans for the first time in history.

Areas where growth in spending will rise sharply are entitlement programs and net interest owed on the federal debt. The combination of the need to finance the fast-growing budget deficit and rising interest rates has the potential to create a serious budget issue. Interest expense is already the fastest growing major government expense. Within a decade annual interest payments will exceed $900 billion. That's up from a record $523 billion in interest paid in the year ended September 30. In a decade, interest on the debt will equal 13% of government spending, up from 6.6% in 2017. Given that the total public debt of the U.S. is nearly $16 trillion, even a small uptick in interest rates can cost the government billions. This rise in deficits portends additional debt financing by the Treasury which will put further upward pressure on interest rates. Many voices across the political and policy spectrum are uncomfortable with the current fiscal outlook but neither Republicans or Democrats have shown any leadership in restoring fiscal discipline.

The yield curve largely dominated the macroeconomic conversation during the third-quarter. Many market participants pointed to the ominous signal that an inverted yield curve portends. Although the curve flattened considerably over the course of the quarter, the curve never inverted. Nonetheless, the sustained flattening since the beginning of the year caused a stir among market participants and commentators. The spread between 10-year and 2-year U.S. Treasury securities fell from 33 basis points at the end of the second-quarter to 24 basis points at the end of the third-quarter. Additionally, towards the middle of the quarter, the indicator reached its lowest level of the current cycle. This sparked the interest of market participants and policy officials, as the fear of a coming inversion could signal an economic downturn. Fortunately, the economy expanded at an annualized rate of 4.2% during the second quarter, supported by strong payroll growth which helped push the unemployment rate down to a cyclical low of 3.7%-near a 49-year low. This surge in growth is unlikely to be sustained, as trend growth remains subdued due to productivity and labor constraints. In the longer term, the boost provided by tax reform will likely fade and the sluggish gains in productivity and labor force growth begin to assert themselves. In addition, the uncertainty associated with the escalation of trade disputes may further impair growth.

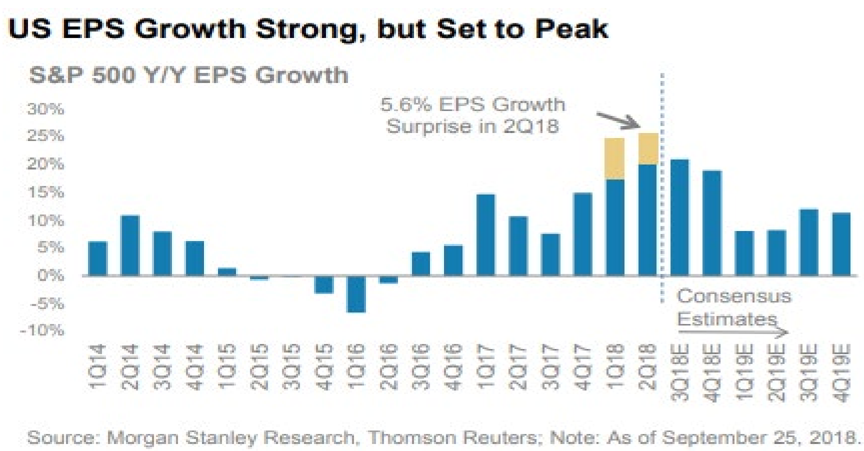
Rising inflation is likely to surpass the Fed's target of 2%. Year-over-year CPI for both the headline and core indices have now topped 2%. The core PCE, the Fed's preferred index, has risen to the target level of 2%. Healthcare inflation has been in a narrow band since 2013 due to the sequestration budget as well as the Affordable Care Act which called for reining in Medicare reimbursement rates. Pressure on healthcare inflation to remain low is over as Medicare payments to hospitals have accelerated plus the unwinding of certain aspects of the ACA will put upward pressure on healthcare inflation. In addition, the recent acceleration in wage rates when combined with still sluggish productivity growth will put cost pressures on employers. Furthermore, we have gone from globalization to rising trade protectionism resulting in inflationary tariffs.

VAAM has had an outlook of relative strength for the U.S. dollar. Given the appreciation in the USD from April to August, we now think the USD will appreciate at a slower pace. The combination of a tightening monetary policy and a stimulative fiscal policy will support continued USD strength. There have been ramifications of the strengthening USD. The combination of a strong USD and rising interest rates have hit emerging markets currencies, stocks, and fixed income markets. Particularly those countries with a high percentage of public and private sector debt denominated in U.S. dollars. There have been significant declines for some emerging market currencies vis-à-vis the USD. This makes the USD denominated debt in these countries much more difficult to service and pay back. Emerging markets weakness has so far been contained and has not significantly impacted the world's largest economies.

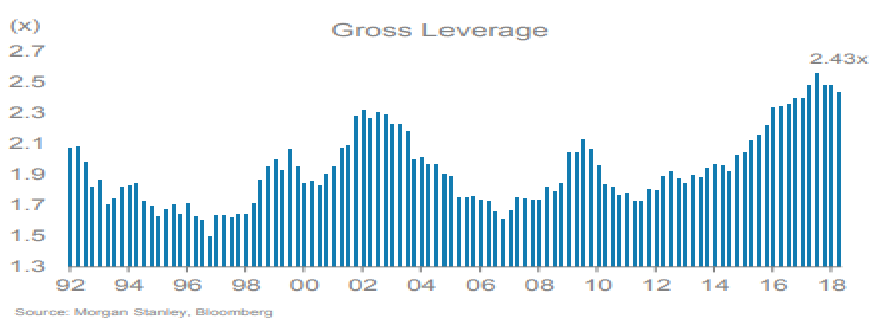
Trade policies continue to be problematic. Tariffs are inflationary, hurt economic growth and raise uncertainty. Adverse trade policies not only impede economic growth but can also cause economic contraction. This can occur due to the negative impact on consumer and business confidence resulting in lower spending by the consumer and less investment by the business sector. The economic impact is less for countries having a trade deficit than those running a trade surplus. It is easier to have a trade war when a country has an economy gaining economic momentum versus a country that is losing momentum in economic growth. This contrast is exemplified in U.S. growth that is gaining momentum whereas China's growth rate is slowing. Chinese growth in investment, factory production, and consumer spending have all slowed this year. The U.S. has a comparative advantage vis-a-vis China in their trade confrontation. The U.S. imports $505 billion a year from China whereas it exports only $130 billion in goods. Therefore, the U.S. can place tariffs on 3.9 times the volume of Chinese imports versus what China is able to place tariffs on their imports from the U.S. The U.S., and other countries, have built a credible case that China does not permit reciprocity when it comes to equal treatment of another country's imports. However, the U.S. approach to solving this trade disparity has been misguided. The U.S. has failed to build a coalition of other countries to confront China. Instead, Trump has alienated our NAFTA, European Union and Asian allies (Japan and South Korea) and chosen to approach this as a bilateral rather than multilateral issue. While still optimistic that reason will prevail and there will be a mutually amicable negotiated settlement, such as the tentative NAFTA and South Korean accords, there is a danger that the dispute evolves into a protracted and economically damaging trade fight on a longer-term basis.

Corporate Securities

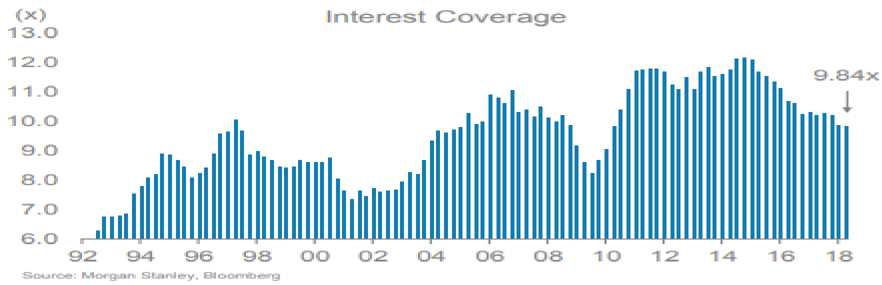
The corporate bond sector, after shrugging off strong corporate financial performance during the second quarter, responded to those same factors during the latest quarter. Corporate earnings, ongoing strength in capital expenditures, the tax cut and the strong U.S. economy continues to provide a near-term solid foundation for corporate credit financial fundamentals. As shown in the table below, the earnings per share growth rate have been extremely strong over the past two quarters, approximately 25%, and actual reported earnings easily exceeded analyst expectations. In fact, approximately 85% of companies reported earnings that matched or exceeded expectations, while 72% of companies had sales that exceeded expectations. The results were broad based as only the energy sector did not have at least 80% of the companies exceeding earnings expectations.



Cash flow, as measured by earnings before interest, depreciation, and amortization ("EBITDA") has also been growing though not as strongly as earnings. Over the past several quarters, EBITDA growth has exceeded the growth in debt. Gross leverage (Total Debt/EBITDA) has declined from its all-time high but remains elevated compared to history at 2.43 times.



The strong EBITDA growth has allowed interest coverage (EBITDA/Interest) to remain at a reasonable level, though down significantly from its best levels achieved during this economic cycle. Rising interest should continue to pressure this corporate financial indicator over the coming quarters.



Your portfolio remains overweight to the corporate bond sector based on the strong economy and this position was beneficial to your portfolio during the third quarter. Corporate spreads contracted versus comparable U.S. Treasury rates during the quarter. For instance, the ICE BofAML 1-10 year Corporate Index ("Intermediate Index") spread ended the period at 0.93% down 0.15% from the beginning of the quarter. This spread is still 0.20% wider from earlier in the year but remains significantly below the long-term average spread of 1.24%. The Intermediate Index outperformed U.S. Treasuries by 1.07% during the quarter and has now also outperformed by 0.32% for the year-to-date. Shorter-dated corporate bonds also had a strong quarter with spreads of the ICE BofAML 1-3 Corporate Index ("Short Index") contracting from 0.73% to 0.57% on 9/30/2018. The excess return of the Short Index is 0.55% for the full year. The long-term median spread of this Index is 0.91%.

New investments include Oracle Corporation and Union Pacific Corporation. Oracle is a leader in enterprise software with a focus on databases. 80% of their revenues are from software with the remaining from hardware and consulting. The company has generated relatively consistent free cash flow and their current cash position exceeds their total debt outstanding. EBITDA/Interest Expense was approximately 8 times for the 12 months ended 8/31. The issue is rated A1/AA-. Union Pacific is a rail transportation company with routes from all major West Coast and Gulf Coast ports to the east, Canada and Mexico. The company had over $10 billion of EBITDA during the past 12 months. Their credit fundamentals are strong for their rating, Baa1/A-. They had EBITDA/Interest Coverage of 13.8 times, Total Debt to EBITDA of 2.2 times and Net Debt to EBITDA of 2.0 times. Their earnings exceeded analyst expectations. Your portfolio remains overweight to the sector. Based on the current valuation of the sector, excess returns are expected to modestly outperform other fixed income investments.

Asset-Backed and Mortgage-Backed Securities

While U.S. Treasury securities backed up in the third quarter, asset-backed (ABS) and mortgage-backed (MBS) securities performed well. Short ABS had a total return of 0.61% and an excess return versus same duration Treasuries of 0.29%. MBS had a total return of -0.12%, but this translated to 0.20% excess return versus Treasuries. Both sectors contributed positively to your portfolio's performance because they outperformed the Treasuries against which they are benchmarked.

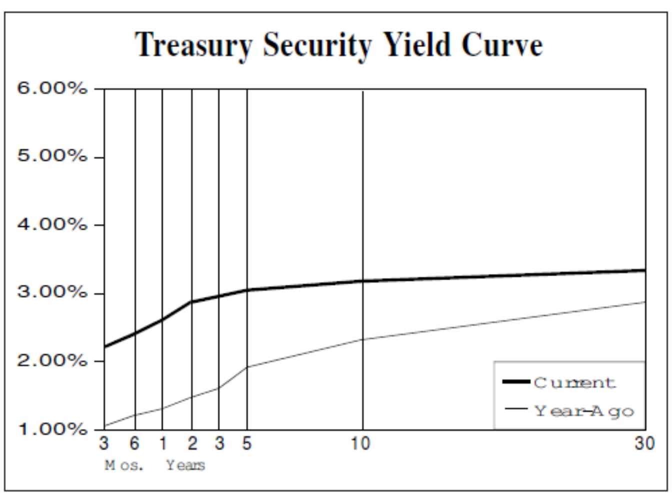
As the U.S. Treasury curve continues to sell off, particularly on the short end, ABS is becoming more appealing to investors. Most ABS in circulation are short in duration, mostly less than five years. Additionally, many ABS have floating rate coupons that readjust with market rates on a monthly basis. Given that short rates are now at relatively high levels compared to longer rates, investors are investing more money in these short ABS. Your portfolio continues to be overweighted to ABS. Particularly, it is invested in short fixed and floating rate AAA-rated tranches of ABS backed by auto and credit card loans. With the strength in the consumer sector of the economy, auto and credit card ABS continues to perform well, with low delinquency rates. In the third quarter, we added to your floating rate ABS holdings. We bought NMOTR 2017-C A, which is a 2-year AAA-rated security backed by Nissan auto loans. Its coupon fluctuates with changes in interest rates, which benefits your portfolio as rates rise.

The MBS component of your portfolio is invested in short super seasoned Agency MBS which offer default and prepayment protection. The Agency rating insulates these securities from defaults. Due to the seasoning of the collateral backing these securities, they experience stable prepayment levels that do not fluctuate greatly with movements in interest rates. This phenomenon was well tested in the third quarter. As rates rose securities backed by newer loans extended in duration, which had an adverse impact on their pricing. In contrast, the short super seasoned Agency MBS maintained their average life. Carefully choosing securities of this type provides your portfolio with exposure to the additional yield of MBS, while mitigating the prepayment risk of extension and contraction associated with MBS.

Selected Yields

	Recent (10/3/18)	*3 Months Ago (7/3/18)*	*Year Ago (10/4/17)*
TAXABLE			
Market Rates			
Discount Rate	2.50	2.25	1.75
Federal Funds	2.00-2.25	1.75-2.00	1.00-1.25
Prime Rate	5.25	5.00	4.25
30-day CP (A1/P1)	2.21	2.06	1.19
3-month Libor	2.41	2.34	1.34
U.S. Treasury Securities			
3-month	2.22	1.96	1.06
6-month	2.40	2.12	1.21
1-year	2.61	2.31	1.31
5-year	3.05	2.72	1.92
10-year	3.18	2.83	2.32
10-year (inflation-protected)	1.06	0.72	0.50
30-year	3.34	2.96	2.87
30-year Zero	3.35	2.97	2.96

	Recent (10/3/18)	*3 Months Ago (7/3/18)*	*Year Ago (10/4/17)*
Mortgage-Backed Securities			
GNMA 5.5%	3.73	3.44	2.43
FHLMC 5.5% (Gold)	3.83	3.36	2.69
FHLMC 5.5%	3.81	3.32	2.49
Corporate Bonds			
Financial (10-year) A	4.15	4.00	3.29
Industrial (25/30-year) A	4.37	4.24	3.87
Utility (25/30-year) A	4.45	4.21	3.90
Utility (25/30-year) Baa/BBB	4.89	4.56	4.21
S&P 500 High Yield Corp. Bond Index	5.12	5.32	4.33
Foreign Bonds			
Canada	2.55	2.16	2.12
Germany	0.48	0.31	0.45
Japan	0.14	0.03	0.06
United Kingdom	1.58	1.28	1.38
Preferred Stocks			
Utility A	6.08	5.93	5.78
Financial A	5.47	5.81	5.78
Financial Adjustable A	#REF!	5.47	5.47



Source: Value Line, Inc.

Federal Reserve Data

BANK RESERVES

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

	Recent Levels			Average Levels Over the Last...		
	09/26/18	**06/12/18**	**Change**	**12 Wks.**	**26 Wks.**	**52 Wks.**
Excess Reserves	1725103	1786600	-61497	1791091	1861528	1988843
Borrowed Reserves	326	255	71	250	162	96
Net Free/Borrowed Reserves	1724777	1786345	-61568	1790841	1861366	1988747

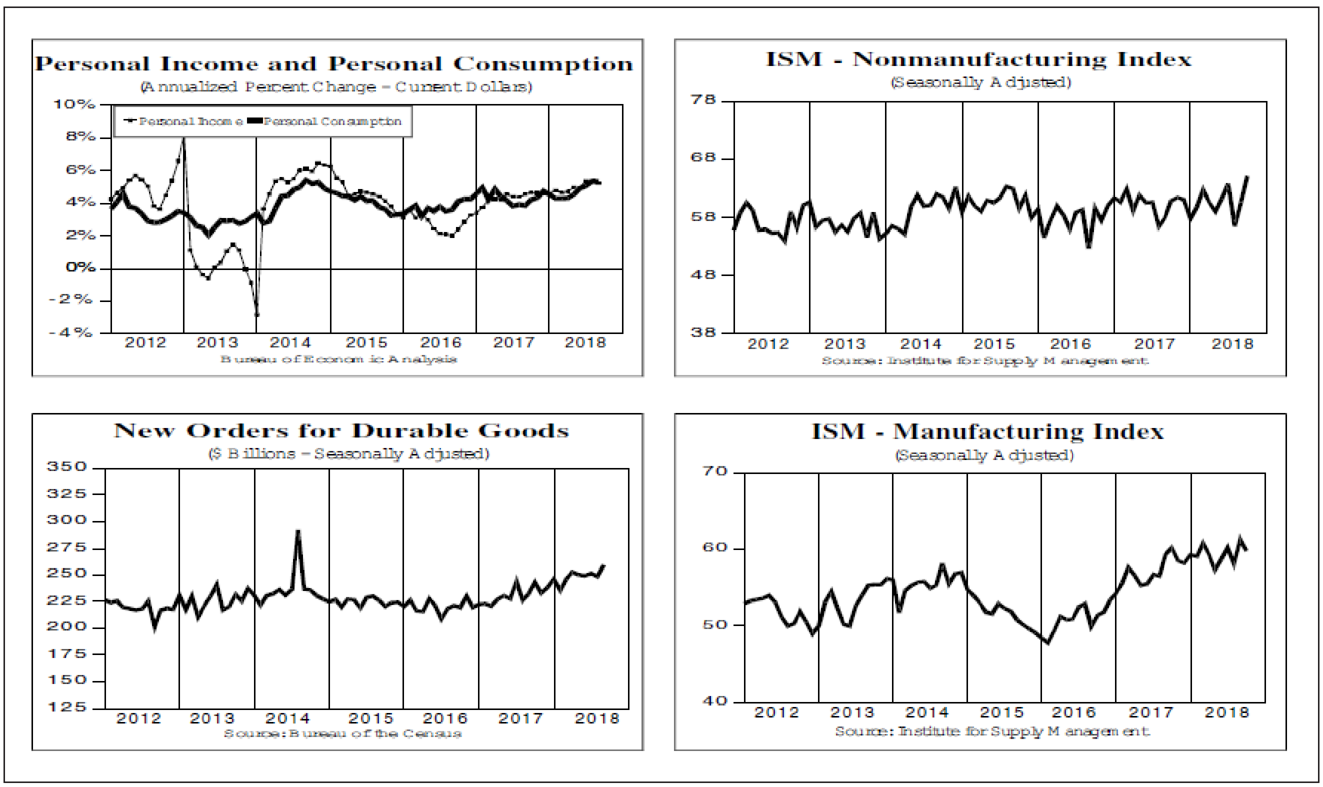
MONEY SUPPLY

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

	Recent Levels			Ann'l Growth Rates Over the Last...		
	09/17/18	**09/10/18**	**Change**	**3 Mos.**	**6 Mos.**	**12 Mos.**
M1 (Currency+demand deposits)	3750.3	3742.6	7.7	8.8%	5.1%	5.0%
M2 (M1+savings+small time deposits)	14248.3	14230.3	18.0	3.7%	4.8%	4.0%

Source: Unites States Federal Reserve Bank

Tracking the Economy



Source: Value Line, Inc.