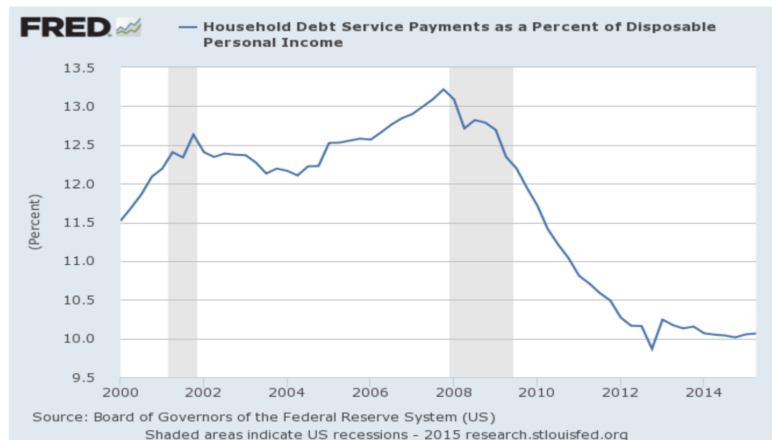
VANDERBILT Ave.
ASSET MANAGEMENT

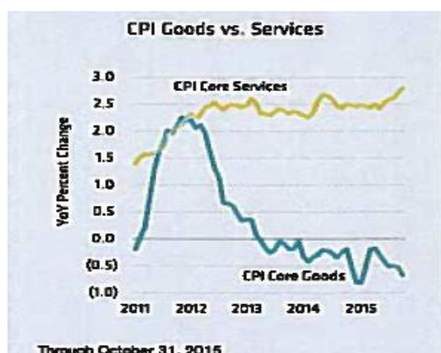
4th Quarter 2015

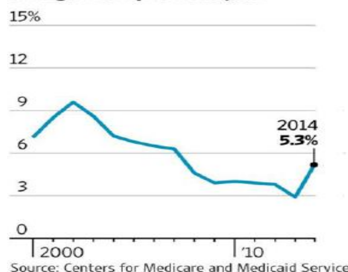
VAAM has correctly forecast, and continues to forecast, higher than consensus real GDP growth. We are forecasting 2½%-3% real GDP growth in 2016. Third-quarter real GDP growth was up 2.0% but real final sales (excludes inventory adjustments) increased 2.7%. The manufacturing sector has slowed while the non-manufacturing sector, or services, continued to expand and provide job growth for the economy. Growth was led by the consumer (approximately 70% of GDP) with an increase of 3.0%. The consumer sector continues to be helped by an improved balance sheet and a declining debt service as a percent of disposable income.



The improved job market has helped boost growth. For all of 2015, the U.S. added 2.65 million jobs, capping a two-year, back-to-back gain that was the best since the 1990s. Job growth has averaged 240,000 jobs per month over the last 24 months. With gasoline prices moving lower and credit for auto lending easy to obtain, the U.S. automobile industry has posted strong year-over-year sales numbers. As of December 2015, car and truck sales reached an annual rate of 17.5 million vehicles. This is a 5.7% increase over last year. In addition, housing continues to recover as a result of lower mortgage rates and an increase in the household formation rate.

For the first time VAAM thinks future inflation has the potential to negatively surprise. Housing costs could complicate the inflation picture. Owner's Equivalent Rent (OER) is a heavily weighted component of the CPI at 24% and 32% of the core CPI. OER and the core CPI are highly correlated. It is possible that rising rents could put upward pressure on OER and as a result the CPI. Upward pressure on rents could also feed through to higher housing costs. There are two important trends with regards to inflation. Prices for consumer goods have remained soft such as the apparel sector. Apparel is largely imported and thus more sensitive to movement in the U.S. dollar. But prices for consumer services, which are more sensitive to the trends in the domestic economy and labor markets, have been on the rise. Rising costs for medical services such as for doctors, hospitals and health insurance is a reversal in a trend that saw cost increases for these services slowing in recent years. Health care costs make up 19% of the core PCE and have been held down by once only events. The Affordable Care Act cut reimbursement rates for privately managed Medicare Advantage Plans and the Budget Control Act of 2011 cut Medicare payments another 2% starting in 2013. A temporary boost to Medicaid provider rates expired in 2015. As these effects fade, a half-percentage point will be added to health care inflation in 2016.





The financial markets' assumption had been that the Fed would not see consumer prices reach the 2% threshold until 2018. A significant reason for the markets' assumption is the continuing weakness in commodity prices. While the trend has been persistent and shows little sign of abating, a look back at previous business cycles reveals that investors should not grow complacent about the duration of low commodity prices. These prices can be volatile and turn quickly. Continued sluggish productivity growth will also be an impediment to sustained low inflation GDP growth. Potential financial market volatility could be the result of the eventual way that inflation develops. Current inflation expectations are approximately 1.5% vis-à-vis the Fed's 2% target. If expectations turn out to be too low (i.e. falsely concerned about potential deflation), this will add to volatility.

The Federal Reserve unanimously voted to raise the target fed funds rate range by 25 basis points to 0.25%-0.50%. This is the first time in nine years that there has been a rate increase. While this represents the initial step, even after the normalization process begins Fed policy will remain accommodative. The Fed has said that the pattern of rate increases should be gradual over a prolonged period and dependent upon economic data. The Fed has not attained their objective of achieving a 2% target for underlying core (excludes food and energy) inflation. However, the Fed thinks the current trend of a stronger US dollar and lower commodity prices are temporary and inflation will accelerate.

The monetary base (currency and demand deposits) has had very strong growth that would ordinarily lead to greater inflation with a lag. However, this has not occurred this cycle due to the decline in velocity, or turnover, of money. Measuring inflation as the change in the personal consumption expenditures index, which is the Fed's preferred measure, results in an increase of 1.3% during the last 12 months versus the Fed's target level of 2%.

Consistent with our expectations, the Federal Reserve hiked interest rates during the first-half of December. As the Fed initiated its first tightening cycle in almost a decade, the yield curve flattened slightly and shifted upwards by the end of the fourth-quarter. The spread between the 10-year and the 2-year Treasury notes tightened 19 basis points, from the previous quarter end, to 122 basis points. The table below shows the yield curve at the end of the third and fourth quarters.

	30-Sep	31-Dec	Change
3-monthTreasury Bills	-0.01	0.17	0.18
6-month Treasury Bills	0.07	0.48	0.41
2-year Treasury Note	0.63	1.05	0.42
5-year Treasury Note	1.36	1.76	0.40
10-year Treasury Note	2.04	2.27	0.23
30-year Treasury Bond	2.85	3.02	0.17
10-year vs. 2-year (bps)	141	122	-19

Corporate Securities

The corporate bond market enjoyed a modest rebound from the disappointing performance of the prior two quarters. Intermediate spreads versus U.S. Treasuries tightened 0.19%, while shorter corporate bonds were 0.17% tighter during the first two-months of the quarter. The rally ended, however, in December as credit spreads reversed direction rising 0.12% and 0.11% respectively. Renewed fears over global growth and weakness in energy and material prices drove the negative results in December. The excess return for the corporate sector over comparable Treasuries was positive for the quarter due to the modestly tighter credit spreads and the higher income generated by the sector. For the full year, intermediate corporate bond spreads were 0.25% wider and out to 3-year maturity notes were 0.20% wider. The greater impact of spread widening for longer maturity corporate bonds more than offset the incremental income of the sector as excess return was a -0.28%. Shorter dated corporate securities', which is our emphasis, interest income offset the price depreciation from the wider spreads as their excess return was a positive 0.38% for the full year.

Your portfolio remained overweight to the corporate sector based on valuation and supportive fundamentals assuming that the economy does not enter a recession in the near future. During the past year, your exposure to the more economic sensitive sectors such as energy and mining were reduced. Our focus is on strong cash flow generating companies in relatively stable industries and more liquid issuers. Credit fundamentals, though still strong, have begun to modestly weaken. For instance, gross leverage has reached 2.24 times up from below 2.0 times at the best levels of the cycle and EBITDA to Interest Expense is 10.5 times versus 11.0 times in the fourth-quarter of 2014. As a point of reference, this coverage was approximately 8.0 times at the end of the recession. The interest coverage ratio is holding up well despite leverage growing faster than EBITDA due to the extremely low interest rates for new debt since the last recession. During the last earnings season, 75% of S&P companies reported earnings that met or exceeded market expectations, which is in line with historical experience.

In the past quarter, American Express and Morgan Stanley were sold due to a significant earnings surprise. In addition, we continued to reduce the credit risk of your portfolio though the sale of several more issues. For instance, VW Credit was sold due to the controversy surrounding their diesel emission testing which creates an unquantifiable financial risk for the company. New investments were made in a number of financially stable issuers. Apple and Microsoft were purchased in the technology sector. Both have large cash flow generation as well as large cash positions that exceed their existing outstanding debt. Their earnings exceeded market expectations during the last quarter. Abbvie, a pharmaceutical company was also purchased during the quarter. The investment was based on a significant earnings surprise and solid cash flow that will be primarily used to pay down debt over the next 18 months that was issued to finance the purchase of Pharmacyclics during 2015. That transaction reduces the risk of a large acquisition over the near term. Within the utility sector, Georgia Power was added to your

portfolio. The company had a positive earnings surprise and relatively strong EBITDA to Interest Coverage of 8.0 times versus the industry average of 5.5 times.

Asset Backed Securities

As the fourth-quarter watched interest rates gradually increase, short asset backed securities ("ABS") outperformed comparable duration U.S. Treasury issues. Specifically, the short ABS sector's return in the fourth-quarter was 0.107% greater on an excess return basis versus Treasury issues. Additionally, short ABS posted strong returns for the year with total returns of 0.904%, outperforming Treasuries by 0.484%.

Your portfolio allocation is overweight this solid performing asset and holds short AAA-rated securities with both fixed and floating rate coupons. These securities are collateralized by credit card receivables, auto loans/leases and equipment loans. These collateral types continue to offer stable cash flows with either locked out prepayment windows or gradual prepayments that do not fluctuate with interest rate movements. As a result they have performed well as interest rates increased throughout the year.

We added some positions to your portfolio throughout the year. Specifically in the fourth-quarter, we added several credit card and auto issues. One of the credit card securities, CHAIT 2015-A1 A1, is a two-year average life floating rate Chase credit card security yielding 0.40% over the two-year Treasury. We also purchased FORDO 14-A A4, a short fixed rate security backed by Ford auto loans, yielding 0.55% over Treasuries. We continue to maintain an overweight allocation to ABS in your portfolio. ABS offer consistently strong yields over Treasuries, while providing the security of a AAA rating.

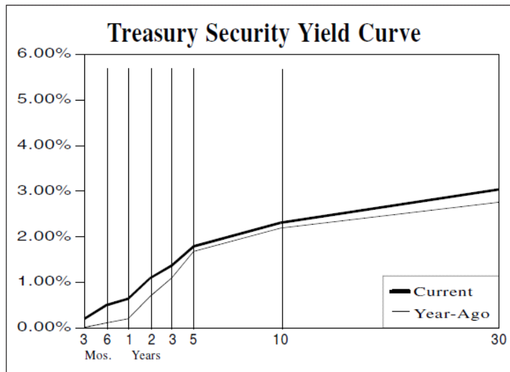
Postscript commentary subsequent to yearend

The New Year began with global stock markets down 2% on the first trading day of the year. This trend has continued through January 15 as equity markets have declined approximately 8%-12%. Weak manufacturing data out of China along with geopolitical concerns in the Middle East all contributed to the selloff. This was a continuation of a period of higher volatility that will be the "new normal" in markets going forward. The following chart highlights this increased volatility:

While not registering double digit growth, the Chinese economy is still expected to grow in the 6%-7% range. Policies to move the economy from investment driven manufacturing to a more balanced economy that relies more on domestic consumer consumption has slowed GDP growth as this recalibration is implemented. But China is expected to grow faster than any other region in the world. Chinese officials experimented with a "circuit breaker" policy to calm their volatile equity markets. This policy served only to heighten investor unrest and on January 7th the circuit breaker was suspended. The Chinese currency has weakened slightly against the U.S. dollar but some analysts believe this is intentional in order to boost exports for an economy that is worse than reported. More likely this depreciation is due to the Chinese central bank moving away from a strict dollar peg to managing the Yuan against a trade weighted basket of currencies. A concern is that a decline in Chinese GDP growth would impact emerging and developed economies that rely on exports to China. The U.S. economy is not likely to be affected since exports to China represent a much smaller percentage of GDP (less than 1%) than other developed economies. Contagion is unlikely and any spillover from the volatility in Chinese markets will be limited. Credit markets in the U.S. have not been affected and are functioning normally. In contrast, emerging markets have felt the effects much more.

Selected Yields

	Recent (12/29/15)	3 Months Ago (9/30/15)	Year Ago (12/30/14)
TAXABLE			
Market Rates			
Discount Rate	0.75	0.75	0.75
Federal Funds	0.25-0.50	0.00-0.25	0.00-0.25
Prime Rate	3.50	3.25	3.25
30-day CP (A1/P1)	0.25	0.17	0.10
3-month Libor	0.61	0.33	0.24
Bank CD's			
6-month	0.13	0.09	0.13
1-year	0.22	0.21	0.21
5-year	0.81	0.80	0.80
U.S. Treasury Securities			
3-month	0.20	0.01	0.01
6-month	0.50	0.07	0.11
1-year	0.64	0.31	0.20
5-year	1.79	1.36	1.68
10-year	2.31	2.04	2.19
10-year (inflation-protected)	0.85	0.65	0.59
30-year	3.04	2.85	2.76
30-year Zero	3.17	3.00	2.86



Source: Value Line, Inc.

	Recent (12/29/15)	3 Months Ago (9/30/15)	Year Ago (12/30/14)
Mortgage-Backed Securities			
GNMA 5.5%	2.21	1.90	1.71
FHLMC 5.5% (Gold)	2.32	2.09	1.51
FHLMC 5.5%	1.94	1.80	1.34
FHLMC ARM	1.81	1.80	1.83
Corporate Bonds			
Financial (10-year) A	3.74	3.64	3.43
Industrial (25/30-year) A	4.35	4.26	3.95
Utility (25/30-year) A	4.42	4.31	3.96
Utility (25/30-year) Baa/BBB	4.88	4.75	4.28
Foreign Bonds			
Canada	1.42	1.43	1.81
Germany	0.63	0.59	0.54
Japan	0.27	0.36	0.33
United Kingdom	1.97	1.76	1.79
Preferred Stocks			
Utility A	6.01	5.93	5.95
Financial A	5.94	6.16	6.56
Financial Adjustable A	5.48	5.48	5.48

Federal Reserve Data

BANK RESERVES

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

	Recent Levels			Average Levels Over the Last...		
	12/23/15	**12/09/15**	**Change**	**12 Wks.**	**26 Wks.**	**52 Wks.**
Excess Reserves	2471006	2629217	-158211	2514422	2525594	2528855
Borrowed Reserves	265	248	17	222	152	134
Net Free/Borrowed Reserves	2470741	2628969	-158228	2514199	2525442	2528721

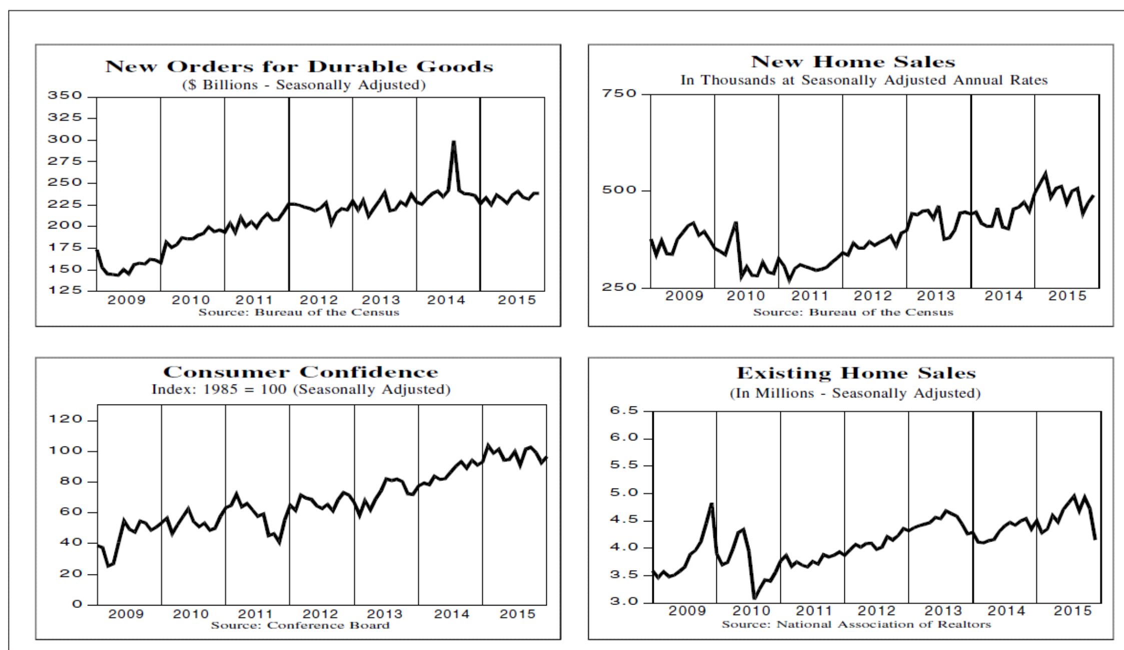
MONEY SUPPLY

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

	Recent Levels			Ann'l Growth Rates Over the Last...		
	12/14/15	**12/07/15**	**Change**	**3 Mos.**	**6 Mos.**	**12 Mos.**
M1 (Currency+demand deposits)	3048.4	3047.8	0.1	5.5%	4.0%	6.4%
M2 (M1+savings+small time deposits)	12181.9	12228.5	-46.6	5.9%	5.5%	5.8%

Source: Unites States Federal Reserve Bank

Tracking the Economy



Source: Value Line, Inc.