VANDERBILT Ave.
ASSET MANAGEMENT

4th Quarter 2018

VAAM's view of the U.S. economy is one of continuing growth but losing momentum as 2019 progresses. We have an outlook of higher than consensus growth in the first half of 2019 followed by a significant slowing in the second half with a rising possibility of a hard landing. Our growth estimates are for first-half growth of approximately 3% (concentrated in the 2nd quarter) followed by second-half growth under 2%. In recent years the economy has been, on average, performing below consensus during the first quarter. The pattern has been slow growth during the first quarter with the economy picking up as the spring and summer seasons arrive. The economy will be led by the consumer (70% of GDP). Solid fundamentals underlie the consumer led by a very strong labor market that supports consumer income and confidence. In addition, the consumer has been helped by the tax reduction legislation. In the third quarter, consumer spending grew by 4.0%. A large deficit in the current fiscal year will provide stimulus; however, the stimulus effects will be waning vis-à-vis a year ago. The corporate tax reduction and economic growth should support business investment spending. However, this sector has recently lagged partially due to trade policy uncertainty, higher interest rates, the global growth slowdown and recent volatility in the financial markets. Some of the funds repatriated from overseas have been used for stock buybacks and dividend increases rather then capex investment. Business spending on equipment grew at the slowest pace in nearly two years in the third quarter. While inflation does not appear to be an imminent problem, we think there will be a gradual rise in inflation.

While the labor market has been a key support to economic growth, there are potential headwinds on the horizon. Unemployment at 3.9% is near the lowest since 1969. Year-over-year wage gains at 3.2% are the largest since April 2009. Monthly job growth is the highest uninterrupted expansion on record. The strong December job gains pushed total U.S. employment above 150 million jobs for the first time. Powered by income gains, consumer spending increased by the most in seven years in October. Our outlook of a gradual rise in inflation could hold back real income gains. A continued sluggish labor force participation rate will serve as a break on potential growth

There are other potential obstacles to growth. The Federal Reserve recently raised the fed funds rate for the fourth time in 2018 by 25 basis points to the 2.25-2.5% level. Higher interest rates are beginning to weigh on sales of autos and homes. The Fed said there would be two more increases in 2019 as they near their neutral rate level, which neither stimulates or restrains economic growth, but that the increases would also be dependent on incoming economic data. Powell indicated that the Fed's quantitative tightening, i.e. the shrinking of the balance sheet, would be on an autopilot reduction of $50 billion per month. At his press conference following the FOMC meeting, Powell's tone seemed to dampen his view of the significance of recent financial market volatility.

With respect to quantitative tightening, since October of 2017 the Fed has been steadily reducing its holdings of U.S. Treasury, Agency, and Agency MBS. The Fed's quantitative easing to support the economy coming out of the Great Recession resulted in bond buying that raised their balance sheet from approximately $800 billion to $4.5 trillion at the peak (currently at approximately $4 trillion). The Fed is now paring its bond holdings by $50 billion a month.

A couple of weeks after his press conference, which was followed by increased financial market volatility and declining equity prices, Powell moderated his tone and message. He offered assurances that the Fed would not move quickly to raise rates. He said the solid wage growth number did not alarm him and should not be taken as a signal that prices were set to spiral out of control. Powell emphasized that the slow pace of inflation allows the Fed to postpone judgments about the resilience of the economic expansion. He said the Fed will be watching for evidence of weakness and that the health of the economy would ultimately determine the course of policy. Powell also signaled a willingness to include changes to the Fed's gradual runoff of its balance sheet in any review of monetary policy.

The tax cuts and spending increases are viewed as one time events whose stimulus effects will wane over time. These budget deficits and resultant debt levels have serious ramifications that will have to be dealt with. The current fiscal year deficit of $1 trillion is up from approximately $800 billion last fiscal year. A decade from now the interest payment on the government debt is expected to reach $900 billion, 13% of the federal budget versus 6.6% in 2017, surpassing Medicaid, defense, and children's program expenses combined. This is a result of higher debt levels at higher interest rates. The U.S. publicly held debt of $15.7 trillion (78% of GDP) will rise to $28.7 trillion (96% of GDP) in 10 years. When the ratio of debt to GDP exceeds 90%, the rate of economic growth will fall by approximately 1%. Many voices across the political and policy spectrum are uncomfortable with the current fiscal outlook. However, neither party has shown any leadership in restoring fiscal discipline.

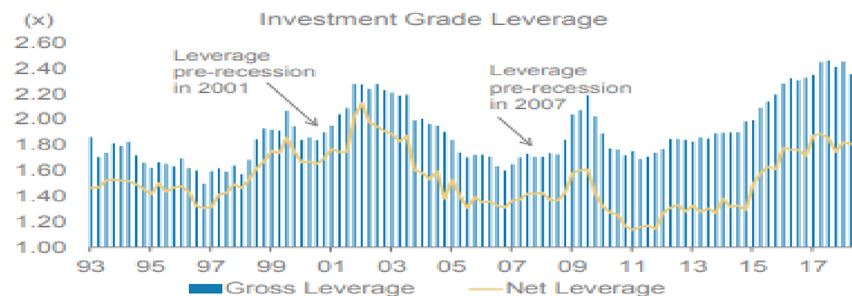
Another major impediment to economic growth is trade policy uncertainty. We have moved from globalization to trade protectionism. While the tariffs are inflationary, the main impact of the tariffs will be the increased uncertainty about the trade and business environment along with the risk of future escalation. This could have a significant adverse impact upon consumer and investor sentiment.

The Trump administration has established a deadline to reach a trade agreement with China by March 1 and it is in both countries' interest to reach an agreement. China has experienced a significant economic slowdown which is compounded by the high financial leverage in their system along with a lack of clarity to accurately assess how serious the problems are. Consumer and business confidence in China are declining, car sales have plunged, the housing market is stumbling, and some factories are letting workers off for the Lunar New Year holiday two months early. China does not have a quid pro quo in imposing tariffs on U.S. imports. In 2017, the U.S. imported $506 billion in goods from China while exporting only $130 billion, resulting in a U.S. trade deficit of $376 billion.

Corporate, Asset Backed, Mortgage Backed Securities

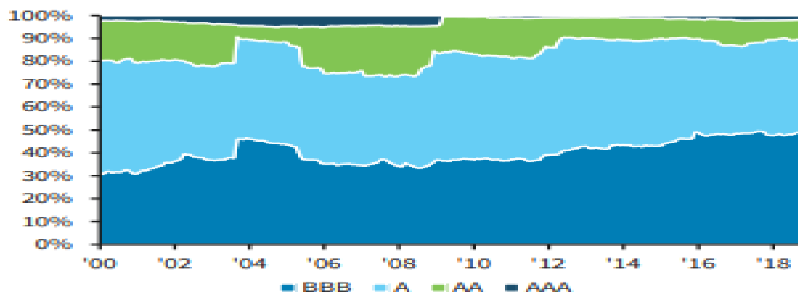
The corporate bond market succumbed to several factors during the final quarter of the year. A significant drop in equity prices, trade worries, slowing global growth and falling oil prices drove spreads wider. For instance, ICE BofAML 1-10 Year Corporate Index spreads rose by 0.46% versus comparable U.S. Treasury yields. The spread ended the year at 1.39%. It now exceeds the historical median spread of 1.24% from 12/31/1996. The last time it exceeded that level was during July of 2016. Shorter maturity bonds did better than longer corporate bonds as the spread on the ICE BofAML 1-3 Corporate Index rose to 0.93%, an increase of 0.36% during the fourth quarter. It ended the year approximately equal to the median spread of 0.91%. The rise in spreads resulted in the sector underperforming U.S. Treasury issues by 1.80% and 0.47% respectively. The longer index ended the year with a negative excess return of 1.46% while the shorter 1-3 index was a positive 9 basis points for the full year.

During the quarter, your portfolio's exposure to corporate bonds was modestly reduced but remained above a relevant benchmark exposure. The overweight was a drag on relative performance during that period. The position was based on strong corporate earnings and stable financial fundamentals. For instance, 3rd quarter earnings of the S&P 500 met or exceeded market expectations for over 80% and sales exceeded for over 60%. The results were broad based as all industry groups exceeded market expectations by 75% for earnings and 50% for sales. These numbers exceed "normal" results. Though the market anticipates a slowdown in earnings growth over the coming quarter, the early earnings for the fourth quarter point to continued outperformance, as 78% of companies that have reported have exceeded/met expectations and 60% have exceeded sales. These results are based approximately on the first 20% of companies to report. Growing cash flow provides support to the market absent a material slowdown in economic growth. As shown in the graph, however, investment grade leverage remains elevated but has been relatively stable over the past several years.



The increase in leverage has been driven by two factors during the expansion. First, a dramatic increase in "BBB" debt as a percent of the overall Investment Grade Corporate Bond Market.

Barclays estimates that BBB debt comprises 52% of the Index versus below 40%, which was the case as recently as 2011.



Source: Factset, Bloomberg, CapIQ, Barclays Research

Since lower rated issuers will in general have greater leverage than higher rated ones, the relative increase in BBB will result in higher leverage for the overall index. Secondly, investment grade issuers have leverage consistent with a high yield rating. Morgan Stanley estimates that up to 38% of the Investment Grade Corporate Universe based on leverage alone would be rated BB or lower. A downgrade from investment to non-investment grade may result in a significant move in the price of the bond versus the overall market. The likelihood is that such a rating agency action will increase as the economy slows. In addition, approximately 20% of the market is held by investors that require daily liquidity (i.e. ETFs) based on Federal Reserve data. The combination of these factors can exacerbate spread moves.

Based on current conditions, your portfolio remains modestly overweight corporate bonds. The sector is at fair value or better after the recent rise in spreads, which supports this positioning. In order to protect your portfolio given the aging expansion, it is underweight BBB-rated securities, especially the lowest classification of BBB-, which bears the highest risk of a downgrade to non-investment grade. In addition, the sector's duration is shorter than the 1-3 Corporate Index duration. The shorter duration limits the adverse price movement from spread widening, while benefiting the portfolio from the higher income versus short U.S. Treasuries.

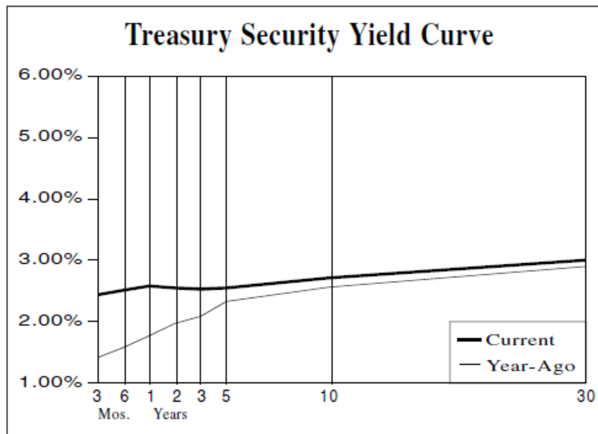
During the past quarter, your portfolio added Verizon Communications Inc. Verizon is the leading wireless provider in the United States and provides wire line voice, data services and Internet services. Their focus is upgrading their wireless service to 5G. Their current financial fundamentals are consistent with their Baa1/BBB+ rating. Leverage (Net Debt/EBITDA) was 2.51 and Interest Coverage was 10x (EBITDA/Interest). Dividends during the quarter comprised 21% of EBITDA, and CapEx was 36%. The Company is committed to reducing their leverage to 1.8x.

Where guidelines permit, Asset Backed Securities ("ABS") and Mortgage securities are held. The ABS are highly rated ("AAA"), short duration, and very liquid. The investments are supported by either auto receivables or credit card receivables. The mortgage investments are all Agency guaranteed and due to their seasoning and/or structure are of shorter duration than the

Mortgage Index. During the past quarter, both sectors performed better than other risk sectors due to their higher quality. The following graph shows the relatively better performance of the sector versus corporate bonds.

Selected Yields

	Recent (1/9/19)	3 Months Ago (10/10/18)	Year Ago (1/10/18)
TAXABLE			
Market Rates			
Discount Rate	3.00	2.75	2.00
Federal Funds	2.25-2.50	2.00-2.25	1.25-1.50
Prime Rate	5.50	5.25	4.50
30-day CP (A1/P1)	2.48	2.29	1.56
3-month Libor	2.78	2.42	1.70
U.S. Treasury Securities			
3-month	2.44	2.26	1.42
6-month	2.51	2.43	1.58
1-year	2.58	2.65	1.77
5-year	2.55	3.00	2.33
10-year	2.71	3.16	2.56
10-year (inflation-protected)	0.94	1.06	0.57
30-year	3.00	3.35	2.90
30-year Zero	3.05	3.36	2.94



	Recent (1/9/19)	3 Months Ago (10/10/18)	Year Ago (1/10/18)
Mortgage-Backed Securities			
GNMA 5.5%	3.74	3.74	2.93
FHLMC 5.5% (Gold)	3.83	3.88	3.10
FHLMC 5.5%	3.80	3.80	3.00
Corporate Bonds			
Financial (10-year) A	3.96	4.19	3.46
Industrial (25/30-year) A	4.29	4.45	3.82
Utility (25/30-year) A	4.36	4.51	3.89
Utility (25/30-year) Baa/BBB	4.78	4.97	4.16
S&P 500 High Yield Corp. Bond Index	5.51	5.36	4.58
Foreign Bonds			
Canada	1.98	2.54	2.16
Germany	0.28	0.55	0.54
Japan	0.03	0.16	0.09
United Kingdom	1.26	1.73	1.29
Preferred Stocks			
Utility A	5.99	6.17	5.87
Financial A	5.47	6.10	5.85
Financial Adjustable A	5.47	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...		
	01/02/19	12/19/18	Change	12 Wks.	26 Wks.	52 Wks.
Excess Reserves	1510096	1603484	-93388	1637918	1714505	1853916
Borrowed Reserves	83	73	10	133	191	127
Net Free/Borrowed Reserves	1510013	1603411	-93398	1637786	1714313	1853789

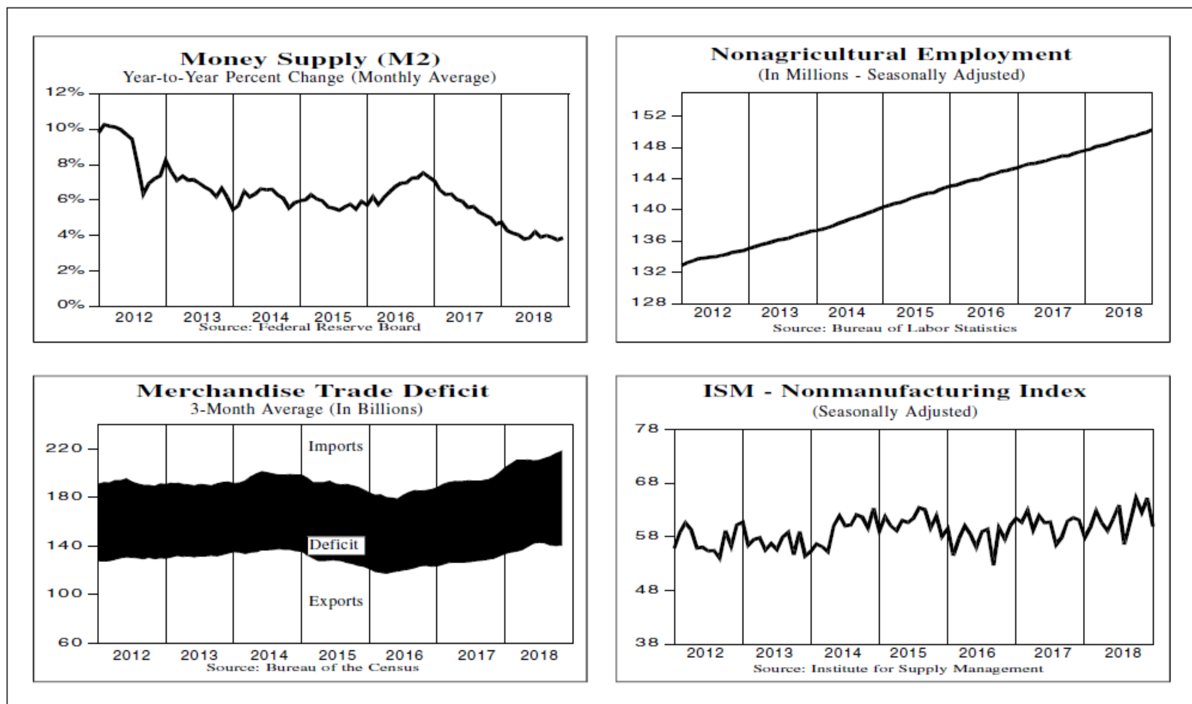
MONEY SUPPLY

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

	Recent Levels			Ann'l Growth Rates Over the Last...		
	12/24/18	12/17/18	Change	3 Mos.	6 Mos.	12 Mos.
M1 (Currency+demand deposits)	3796.0	3771.3	24.4	5.1%	7.3%	5.0%
M2 (M1+savings+small time deposits)	14498.9	14414.3	84.6	7.1%	5.2%	4.8%

Source: Unites States Federal Reserve Bank

Tracking the Economy



Source: Value Line, Inc.