VANDERBILT Ave.
ASSET MANAGEMENT

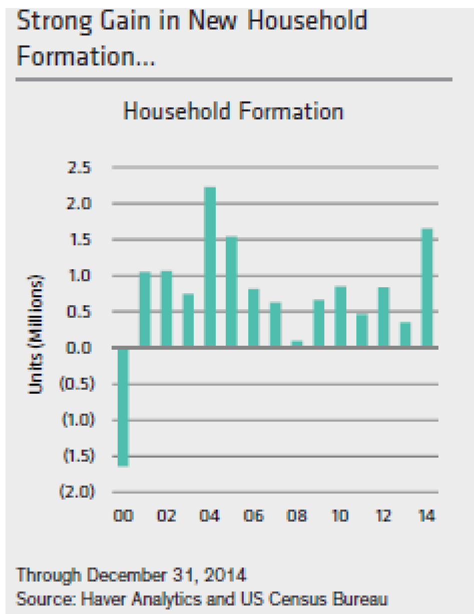
2nd Quarter 2015

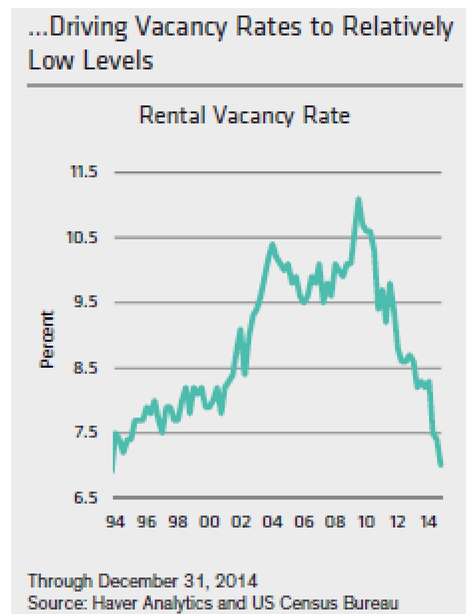
VAAM's economic outlook remains optimistic and above consensus forecast. The first quarter 2015 economic decline (-0.2% annualized) reflects a pattern of weakness in the first quarter followed by subsequent growth the remainder of the year. In 2014 we saw a similar pattern where first quarter growth was weak and the remaining three-quarters of the year saw growth of 3.1%. We think this pattern will repeat itself in 2015. First quarter 2015 growth was impeded by seasonal adjustments, the West Coast ports strike and harsh winter weather.

Investment spending by the corporate sector will be helped by strong balance sheets, continued improved interest coverage and debt leverage ratios. Low interest rates and a strengthening labor market should encourage consumer spending. For example, the auto industry has experienced strong year-over-year growth reflective of the consumer's improved finances-as well as the decline in oil prices. Cars and light trucks sold at a 17.7 million annualized rate in May, the strongest pace since July 2005. Housing continues to recover. Combined sales of new and existing houses climbed to a 5.9 million annualized rate in May, the most since June 2007. Permits for home construction in the U.S. surged to a nearly eight-year high suggesting momentum in the housing market and the broader economy.

Energy prices have been quite volatile reacting not only to the geopolitical scene but also to shifting supply and demand conditions. Lower prices reduce the activity in offshore exploration and shale drilling. As marginal supply is reduced a new equilibrium is established. This situation will not change unless and if we see an acceleration in global demand.

We may see possible upward pressure in inflation. Inflation pressure has the potential to come from the rise in rents. The firming labor market has boosted household formation and the rental vacancy rate is near a 22-year low as depicted in the following graphs:



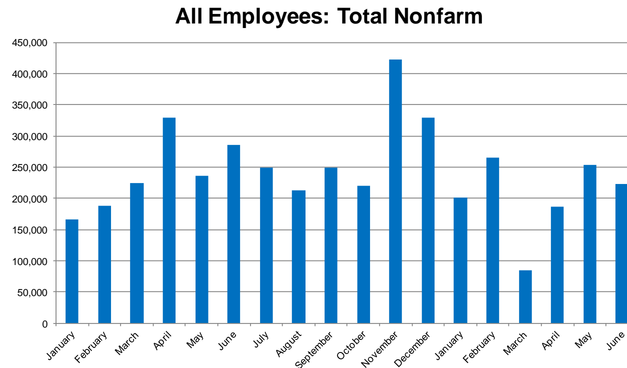


Owner's Equivalent Rent (OER) is a heavily weighted component of CPI at 24% and 32% of the core CPI (excludes food and fuel). OER and the core CPI are highly correlated. The core CPI has risen 1.8% for the 12-months through June. It is possible that rising rents could put upward pressure on OER and, as a result, the CPI.

The labor market has exhibited greater strength as depicted in the graph below:

The Labor Market Gains Traction

- Job growth has averaged 240,000 jobs per month over the last eighteen months.



Source: U.S. Department of Labor

A strengthening labor market should spill over to healthier consumer spending (70% of GDP). Indeed, household spending climbed in May from a month earlier by the most in almost six years, buoyed by gains in incomes as the U.S. job market strengthened. Over time, sustained increases in productivity are necessary to support rising wages. This labor market strength, along with the Fed's view that the economy will resume growth after the winter stall, has reinforced the view that the Federal Reserve will commence their first interest rate increase since the Great Recession. We are not disturbed if the Federal Reserve begins to raise interest rates in the third or fourth-quarter since the Fed has said the pattern of increases will be small increments on a gradual basis.

The dollar has been performing well. This reflects the fact that the U.S. Federal Reserve is on a different and more advanced path in the cycle vis-à-vis its Central Bank counterparts. The strength of the dollar obviously makes U.S. goods and services less competitive but at the same time a healthy dollar attracts capital and investments.

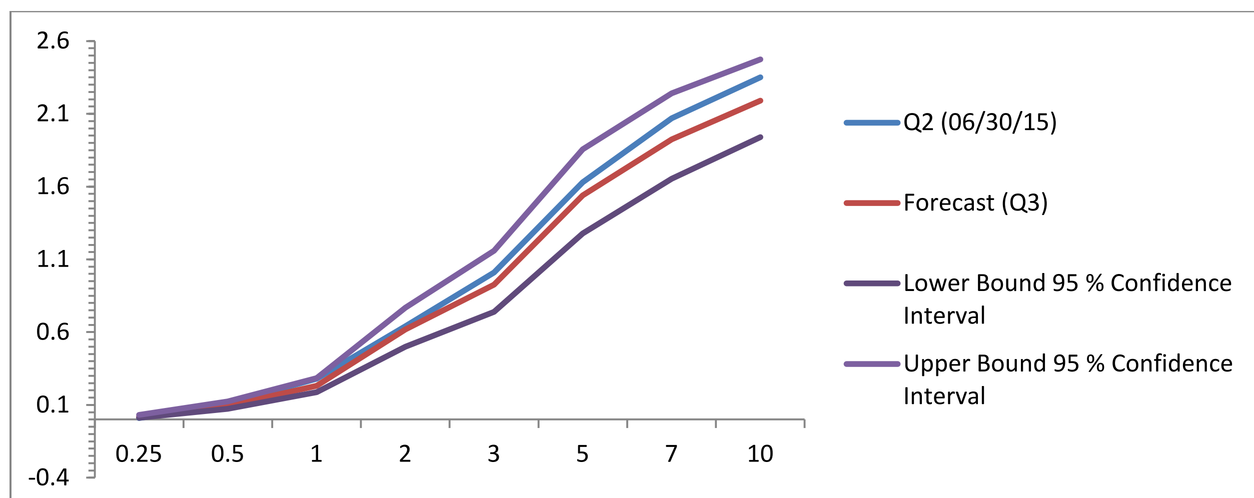
Over the quarter, the yield curve steepened as interest rates for longer dated Treasuries rose more than shorter dated ones. The spread between the 10-year and the 2-year Treasury note, a typical indicator of the slope of the curve, widened to 170 basis points. The change represents a steepening of 34 basis points from the previous quarter end. The table below shows the yield curve at first and second quarter end.

	31-Mar	30-Jun	Change
3-monthTreasury Bills	0.02	0.01	-0.01
6-month Treasury Bills	0.14	0.11	-0.03
2-year Treasury Note	0.56	0.65	0.09
5-year Treasury Note	1.37	1.65	0.28
10-year Treasury Note	1.92	2.35	0.43
30-year Treasury Bond	2.54	3.12	0.58
10-year vs. 2-year	136	170	34

Over the coming quarter, we expect the yield curve to flatten modestly as result of changes in the stance of monetary policy, which will put upward pressure on short-term rates, and improvements in the economic landscape, which may put modest pressure on long-term rates. The graph below shows our baseline forecast for the yield curve for the third quarter.

This expectation is contingent on our anticipation of the evolution of monetary policy over the course of the second-half of the year, which we expect to tighten. The Federal Reserve has indicated that when it begins to

tighten its stance on policy, it will do so by raising its target range for the overnight interest rate gradually. While the increase will be gradual, given the duration of the current zero interest rate environment, we expect to see some impact on the market. Market expectations currently assign a 12% probability of a rate increase within the third quarter.



Source: Vanderbilt Avenue Asset Management, LLC

Corporate Securities

An array of concerns, from the Greek crisis, China growth and the impact of a rate increase on U.S. economic growth, buffeted the corporate bond market. Yield spreads over comparable U.S. Treasury securities widened to 1.45% from 1.29% at the end of the first quarter. The sector underperformed Treasuries by 0.87%. Shorter maturity corporate bonds also widened but significantly less. For instance, intermediate bonds spreads moved from 1.16% to 1.25% and underperformed by 0.24%. One-to-three year corporate bonds were 0.12% wider but the combination of income and the shorter duration allowed these securities to modestly trail Treasuries by just 0.4%.

Our corporate financial fundamentals remain supportive of current trading levels. Interest coverage for the US Investment Grade Universe is a solid 10.8 times (EBITDA/Interest Expense) with the strongest sectors being consumer companies and the healthcare sector with ratios of 12.2 times and 12.3 times respectively. Healthcare, however, has seen a pick-up in merger and acquisition activity, which does increase bondholder risk in the sector. For instance, AbbVie, a pharmaceutical company, acquired Pharmacyclics for $21 billion. Approximately $17 billion of new debt will fund both the acquisition and a share re-purchase program. Similarly, Zimmer Holdings, an orthopedic, implant and surgical products company, purchased LVB Acquisition, Inc. for approximately $13.35 billion. Your portfolio invested in the new debt issued to fund the purchase price. Leverage upon completion rose to 4.1 times. Though high for their investment grade rating, the company is committed to bringing leverage down to levels consistent with their current ratings of between 2.5 to 3.0 times. M&A activity is likely to remain a risk to the credit quality of the sector but strong cash flow provides support to our investments.

During the prior earnings season, 72% of S&P 500 companies reported earnings that exceeded market expectations. Current earnings continue to run ahead of expectations. Morgan Stanley was added to the portfolio based on a significant positive earnings surprise in the first quarter. Their securities are trading around 0.35% cheap based on the BAML Lighthouse quantitative model. Your investment in Oneok Partners LP, a natural gas pipeline company operating in the upper Midwest and Mid Continent, was sold in the first quarter due to a significant negative earnings surprise.

The BAML Lighthouse model, which is based on equity valuations, volatility and debt levels estimates that investment grade U.S. corporate bonds in their universe are trading 0.18% cheap to intrinsic value. Based on solid fundamentals and reasonable valuations, your portfolio remains over weight to the corporate bond sector.

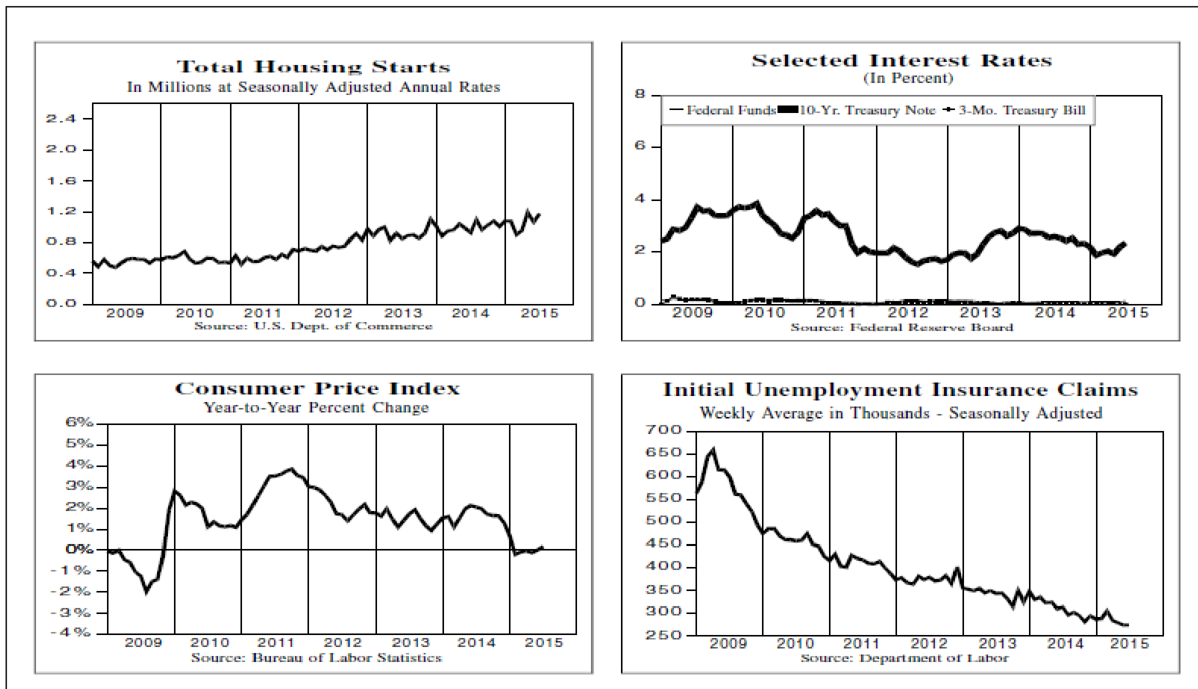
Asset Backed Securities

When interest rates increased in the second quarter, the asset backed securities index ("ABS") outperformed comparable duration U.S. Treasury issues. ABS posted higher coupon returns and tightening spreads to Treasuries, which resulted in higher pricing. The short ABS index returned 0.23% basis points, which translated to a positive excess return of 11 basis points over similar duration Treasury securities.

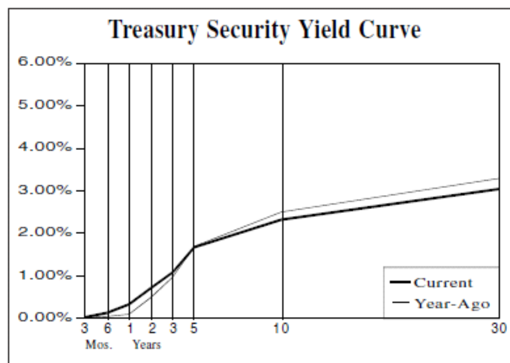
The ABS in your portfolio are high quality, short duration and AAA-rated. They are collateralized by credit card receivables, auto loans/leases and equipment loans. These collateral types continue to offer stable cash flows that do not fluctuate much with interest rates as opposed to securities backed by home mortgage collateral would.

Looking forward, we continue to maintain an overweight allocation to ABS. They offer attractive yields versus U.S. Treasury and Agency instruments, and provide an efficient, liquid place to invest as an alternative to cash.

Tracking the Economy



	Recent (6/30/15)	3 Months Ago (3/31/15)	Year Ago (7/1/14)		Recent (6/30/15)	3 Months Ago (3/31/15)	Year Ago (7/1/14)
TAXABLE							
Market Rates				**Mortgage-Backed Securities**			
Discount Rate	0.75	0.75	0.75	GNMA 5.5%	1.40	1.71	2.11
Federal Funds	0.00-0.25	0.00-0.25	0.00-0.25	FHLMC 5.5% (Gold)	1.53	1.51	2.26
Prime Rate	3.25	3.25	3.25	FHLMC 5.5%	1.26	1.34	2.06
30-day CP (A1/P1)	0.13	0.09	0.11	FHLMC ARM	1.86	1.83	1.87
3-month Libor	0.27	0.26	0.23	**Corporate Bonds**			
Bank CD's				Financial (10-year) A	3.15	3.43	3.81
6-month	0.16	0.26	0.07	Industrial (25/30-year) A	3.78	3.95	4.52
1-year	0.27	0.27	0.09	Utility (25/30-year) A	3.71	3.96	4.59
5-year	0.87	0.85	0.58	Utility (25/30-year) Baa/BBB	4.02	4.28	4.75
U.S. Treasury Securities				**Foreign Bonds**			
3-month	0.02	0.01	0.02	Canada	1.36	1.81	2.55
6-month	0.14	0.11	0.05	Germany	0.18	0.54	1.62
1-year	0.23	0.20	0.11	Japan	0.41	0.33	0.63
5-year	1.37	1.68	1.79	United Kingdom	1.58	1.79	2.77
10-year	1.92	2.19	2.80	**Preferred Stocks**			
10-year (inflation-protected)	0.16	0.59	0.57	Utility A	5.97	5.95	5.98
30-year	2.54	2.76	3.64	Financial A	6.27	6.56	6.46
30-year Zero	2.62	2.86	3.86	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...		
	06/24/15	**6/10.15**	**Change**	**12 Wks.**	**26 Wks.**	**52 Wks.**
Excess Reserves	2488373	2461157	27216	2536767	2538237	2564395
Borrowed Reserves	163	115	48	82	66	141
Net Free/Borrowed Reserves	2488210	2461042	27168	2536685	2538171	2564255

MONEY SUPPLY

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

	Recent Levels			Ann'l Growth Rates Over the Last...		
	06/15/15	**06/08/15**	**Change**	**3 Mos.**	**6 Mos.**	**12 Mos.**
M1 (Currency+demand deposits)	2979.5	2973.4	6.0	-1.5%	6.1%	6.4%
M2 (M1+savings+small time deposits)	11965.3	11935.8	29.5	4.3%	6.0%	5.8%

Source: Unites States Federal Reserve Bank