Emad A. Zikry, President and Chief Executive Officer

Corporate Bonds

The corporate bond market turned in its eighth straight quarterly outperformance versus comparable U.S. Treasury bonds. As measured by the BofA Merrill Lynch 1-10 US Corporate Index, the sector provided 0.71% of excess returns during the third quarter and 2.19% for the year-to-date. Shorter-term corporate bonds also provided attractive relative returns of 0.38% for the quarter and 1.29% during the year as measured by the BofA Merrill Lynch 1-3 US Corporate Index ("BAML 1-3"). These returns came from both the higher income of the sector as compared to U.S. Treasury bonds and credit spread tightening.

CapEx, also known as capital spending or expenditure is one way corporations can put profits to work. Other means include dividend distributions, share buybacks, paying down debt and growth through mergers and acquisitions. Until Q4-2016, CapEx growth has been declining for eight straight quarters. For example, the first half of 2016 showed quarter over quarter CapEx growth of -1.2%, however the first half of 2017 came in at 2.2%.

Weak capital investment played a role in the secular stagnation of prior years but a re-kindling can actually power the global economic expansion further. Tax legislation proposed by Republicans, if passed could also add buoyancy. CapEx is extremely important to the operations of private businesses. In order to maintain or grow market share, capital must be allocated efficiently for future growth by replenishing obsolete or aging inventory.

On a macro basis, CapEx is among a select number of factors in addition to labor and technology that play an important role in shaping the long-term growth trajectory of regional economies. The President's Council of Economic Advisors points out that business fixed investment represents 12% of GDP, yet contributes some 20% of quarterly volatility in growth, suggesting its disproportionately large impact on short-term growth.

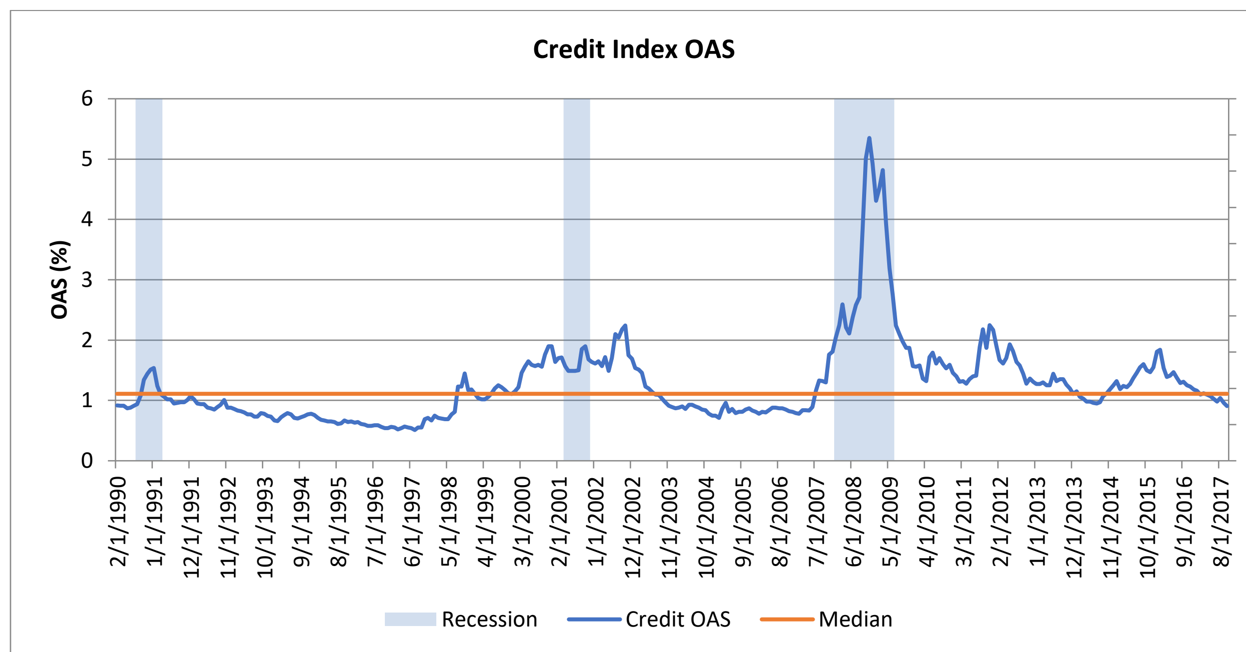
Studies show that consumer spending leads to business spending and labor gains. Thus, triggering a positive loop that encourages additional growth. Both short and long-term growth are directly influenced by business investments, so it is important to allow for a stimulative environment in order for CapEx to bring about such growth.

In 2014, a portion of the CapEx slowdown was due to investment cutbacks by energy-related businesses, however other industries also experienced concurrent slowdowns. Weakness was not limited to the U.S. but to other advanced and emerging market economies. This was primarily due to lower global growth, lower corporate profits and a shift away from capital intensive businesses.

Conditions today are now prime for CapEx to continue growing. Businesses have the cash flow capacity and demand incentives to reinvest in their operations. In fact, CapEx growth can intensify as businesses strive to enhance productivity and fortify profit margins by making the required investments necessary to

keep up with the “second machine age” digitization. In the U.S., the average age for non-residential fixed assets is 16.3 years, making inventory the oldest since 1963. Robust capital spending by businesses that have cash flow strength can buttress and extend an economic cycle.

Since Credit spreads peaked at the end of 2008, spreads have trended lower. There were few exceptions to that trend. These included European sovereign and financial credit concerns in 2011 and weakness in energy/commodity prices in 2015. These events were relatively short lived and spreads quickly retraced through the previous tights of this economic cycle. As shown in the graph below, credit spreads have now moved through the long-term median at 0.96% versus 1.11%. The mere fact that spreads are below the long term median spread does not mean that corporate bonds will move wider over the near term. Historically, spreads can remain below their long term median value for an extended period of time. For instance from 4/30/91 through 8/31/1998 spreads were only above the long term median for a single month, while during the prior recovery spreads remained below for the period from 8/29/2003 until 6/29/2007. The median spread for each period was 0.77% and 0.85% respectively. **Spreads can move below their median levels and remain there for an extended time period.**



	OAS **2/28/1998-11/13/2017**
Last	**0.96%**
Median OAS	**1.11%**
Minimum OAS	**0.51%**

Spreads from Bloomberg Barclays US Credit Index

Our Corporate Investment Process is a three-step process in which attractive Corporate Issuers are identified. These are Financial Fundamentals, a Quantitative Model, and a Qualitative review. Financial Fundaments are Interest Coverage (EBITDA/Interest Expense), Short-Term Debt, and Earnings Surprise. The Quantitative Model is from BAML Lighthouse which determines fair value through a company's level of equity, its equity volatility, and compares to the level of debt outstanding. This "Credit Risk" is compared to the company's credit default spread to determine whether it is trading rich or cheap. Qualitative screens are used to identify non-financial risks such as technical obsolescence, or legal risks. Our fundamental and quantitative screens are little changed over the past year as shown in the table below.

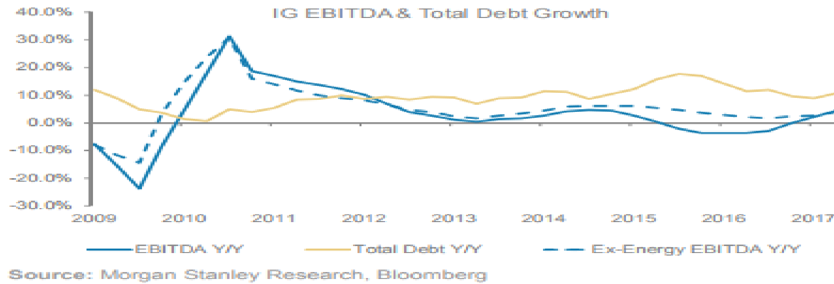
	3rd Quarter '16	4th Quarter '16	1st Quarter '17	2nd Quarter '17
Interest Coverage*	10.25x	10.32x	10.36x	10.36x
Leverage**	2.38x	2.33x	2.38x	2.44x
Earnings Surprise (Positive/Inline)***	78%	74%	79%	79%
Quantitative Model Credit OAS****	0.24%	0.20%	0.19%	0.18%

* Interest Coverage from Morgan Stanley Research & Bloomberg (EBITDA/Interest Expense)
** Earnings Surprise from Bloomberg (Gross Debt/EBITDA)
*** Bloomberg Data
**** BAML Lighthouse Quantitative Model (Incorporates Company Equity Value, Company Equity Volatility, and Company Debt to calculate a credit risk that is compared to the Company CDS to arrive at the Credit OAS)

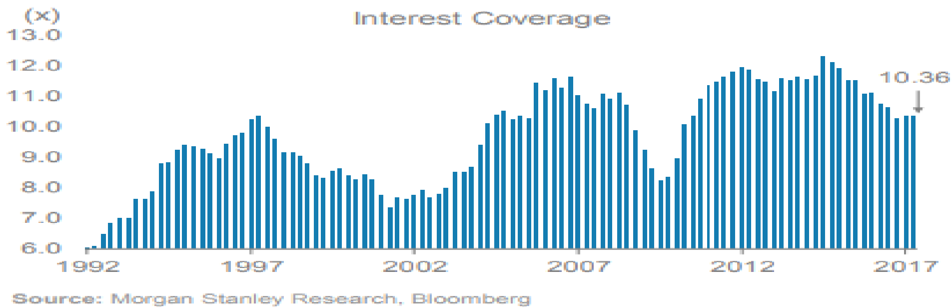
Positive credit screens include Earnings Surprise and Interest Coverage. To date, Third Quarter earnings reports from Bloomberg show 77% of S&P 500 companies reporting earnings that have exceeded or matched market expectations.

Earnings Surprise Third Quarter S&P 500 Companies				
Sector	Total	Positive Surprise	Negative Surprise	% Positive
Energy	31	23	8	74%
Materials	25	18	7	72%
Industrial	66	53	13	80%
Consumer Discretionary	65	50	15	77%
Consumer Staples	28	22	6	79%
Health Care	58	47	11	81%
Financials	67	51	16	76%
Information Tech	57	52	5	91%
Real Estate	33	26	7	79%
Telecommunication	3	1	2	33%
Utilities	28	14	14	50%
Total	461	357	104	77%

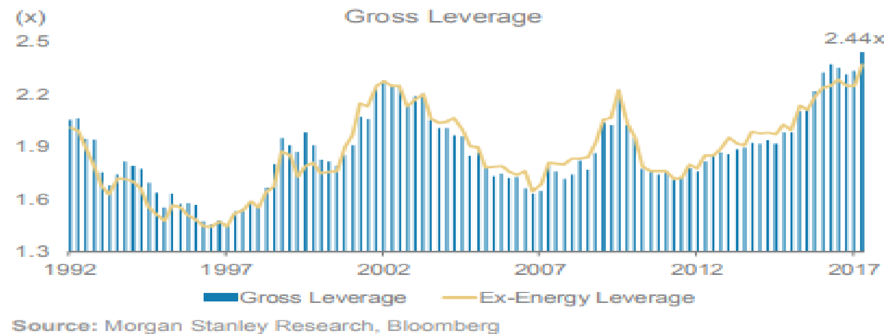
The results are providing support to both equity levels and corporate spreads. In addition, based on the most recent quarter, corporate cash flow has risen by 4% as shown in the table below.



The combination of stronger cash flow, higher debt levels (up 10% in the quarter), low Treasury yields, and relatively tight spreads have allowed interest coverage to stabilize at 10.36X but down significantly from the peak in 2014. Low cost of funding and improved EBITDA have afforded corporate interest coverage to remain relatively strong despite the significant rise in debt levels.



The rise in debt levels is most pronounced on Investment Grade Gross Leverage, which continues to rise and is now at a record 2.44 times EBITDA. (See Graph below). An estimated 26% of new debt was used for Merger & Acquisitions and share buybacks. Excluding this debt issuance, Leverage would have risen by a more modest but still significant 2.27 times.



Large cash balances on corporate balance sheets lowers the Net Leverage to a lower 1.87 times, however both leverage ratios exceed their peak levels during the last recession. As long as the economy continues to expand, the high levels of debt is unlikely on its own to drive corporate spreads wider and bond prices significantly lower.

In summary, our current overweight position to the sector is based on the following factors:

- Synchronized global growth
- Accommodative global monetary policy
- Potential for Fiscal Stimulus (U.S. tax cut)
- Growth of Corporate earnings & cash flow
- U.S. Employment & Income Growth

The U.S. economy is now late in the current economic expansion that began in 2009. Economic expansions, however, do not end simply due to "old age". Rather, they end when excesses reach extreme levels. As of today, there are no identifiable excesses in the U.S. economy. In fact, the proposed fiscal stimulus of a tax cut is likely to prolong the current expansion. Since the economy is late in the cycle, investment focus should be on less economically sensitive companies that have strong, stable cash flow, and reasonable debt levels. Corporate debt securities should continue to provide incremental returns over comparable U.S. Treasuries, while providing downside protection.

Charles P. Baker
Managing Director