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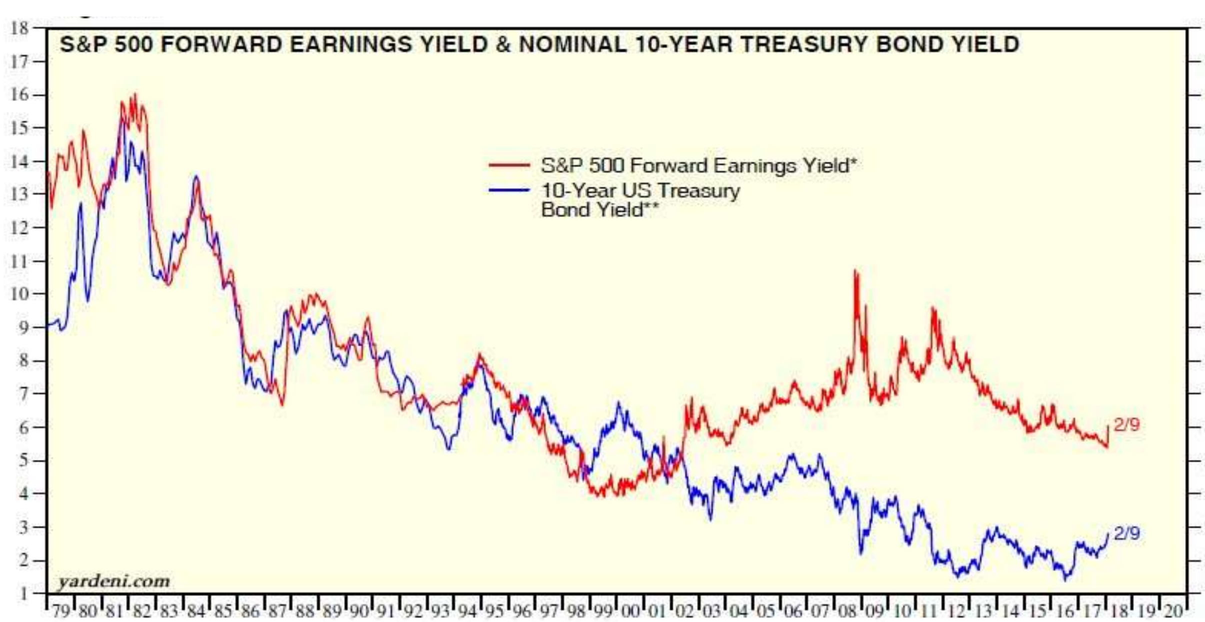
FIRST QUARTER 2018

The first quarter of 2018 saw a sharp spike in stock and bond market volatility and weakness in those markets, reflecting geopolitical and trade concerns and worries about higher inflation and rising interest rates. Increasingly popular, momentum-oriented FAANG stocks outpaced all other U.S. equity sectors, far outperforming the rest of the market with an average gain of 13.2% in 1Q18. The top performing S&P 500 stock by far this year has been Netflix, up 75% from Jan. 1-April 17th. Netflix has posted outstanding revenue growth but after 24 years in business it generates *negative free cash flow* of roughly -$4Bn annually while its $140Bn market cap represents a 9X estimated 2018 revenues. Meanwhile, value stocks with low multiples of free cash flow (and attractive free cash flow yields) have been increasingly out of favor, which should provide opportunities for patient investors. As in the past, historically large spreads in valuations and performance between value and growth is unlikely to be sustained.

The overall P/E for the S&P 500 declined in the first quarter to 16.9X consensus 2018 earnings is reasonable, especially relative to very low interest rates. The S&P 500's earnings yield (earnings divided by price) relative to 10-year Treasury bond yields remains historically high at 3.1 percentage points (the current 5.9% earnings yield minus the 2.8% 10-year Treasury yield). This generous earnings yield/bond yield spread provides a fundamental valuation underpinning for the equity market and a cushion against modestly rising interest rates.

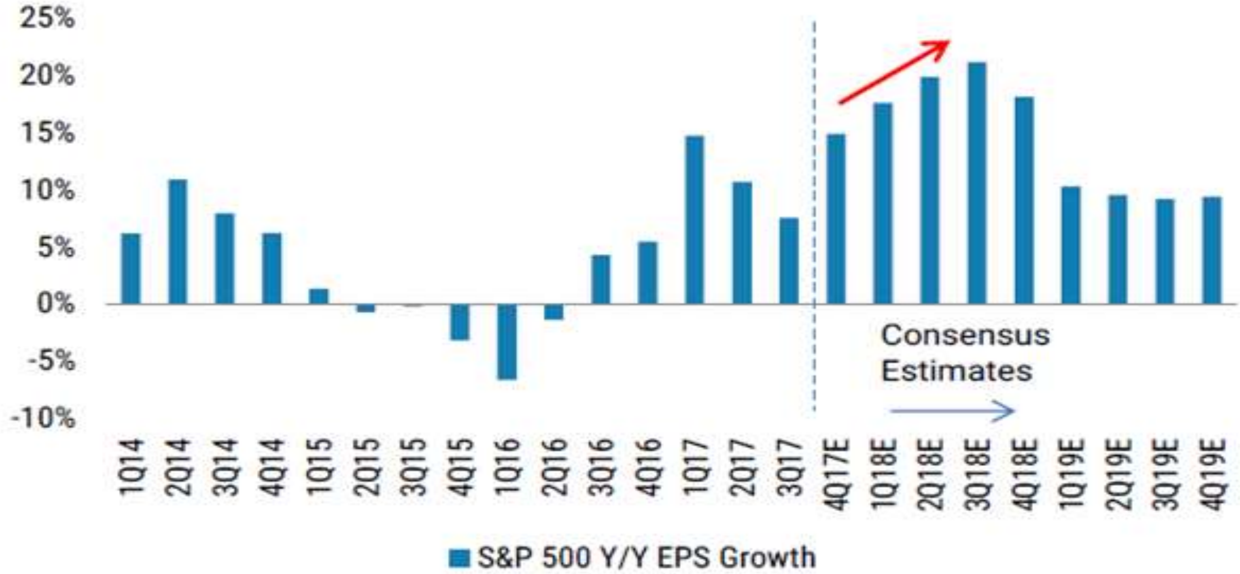
Equity Valuations Still Appear Cheap Relative to Treasury Yields



* Year-ahead forward consensus expected earnings divided by S&P 500 stock price index. Monthly through March 1994, then weekly.
** Monthly through March 1994, then weekly.
Source: Thomson Reuters I/B/E/S and Federal Reserve Board.

As a result of the cut in the effective corporate tax rate to 22% from 27%, higher oil prices and improving sales growth, consensus earnings estimates for the S&P 500 have increased significantly to a gain of 18% in 1Q18. Lower tax rates should provide about 7 percentage points to the first quarter earnings gain. S&P earnings are expected to grow 32% over the next two years (20% for the full year 2018 and 11.5% for 2019) vs. 22% at the end of Nov. 2017. Consensus revenue growth is estimated at a robust 7.2% in 2018, double the cycle average of 3.3%, which would mark the fastest gain since 2005.

2018 Could See the Best Earnings Growth Rate In Years



Source: Thomson Reuters, Morgan Stanley Research

Share buybacks are expected to rise by at least 23% in 2018 to a record level in 2018, funded by roughly $100Bn in higher corporate earnings and $200Bn in cash repatriation, with tax reform a major contributing factor. Dividends are likely to rise about 12% and cash acquisitions are estimated to surge 16% to a cycle high. Despite these projected higher capital returns, the payout ratio from buybacks and dividends are estimated at only 81% and 77% of earnings, for 2018 and 2019, respectively.

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Tax Reform Positive for Equities

Exhibit 1: Summary of our S&P 500 cash spending estimates
as of February 23, 2018

$ Billions	2015	2016	2017E	2018E
Capital Usage				
Capital Expenditures	$662	$618	$620	**$690**
Share Buybacks	589	550	527	**650**
Dividends	415	434	460	**515**
Cash Acquisitions	401	361	310	**360**
Research & Development	258	280	295	**325**
Total Capital Usage	**$2,324**	**$2,242**	**$2,212**	**$2,540**
% Year/Year Growth				
Capital Usage				
Capital Expenditures	(5)%	(7)%	0 %	**11 %**
Share Buybacks	5	(7)	(4)	**23**
Dividends	10	5	6	**12**
Cash Acquisitions	119	(10)	(14)	**16**
Research & Development	6	8	5	**10**
Total Capital Usage	**13 %**	**(4)%**	**(1)%**	**15 %**

Source: Goldman Sachs Global Investment Research.

We believe the secular bull market is likely to stay intact this year, despite short term corrections, in the absence of excessive valuation or any meaningful signs of the next recession. The fiscal stimulus of tax cuts and spending deals is resulting in stronger economic growth, increasing R&D and capex, buybacks and dividends and the highest level of business and consumer confidence in years. The CBO increased its June 2017 real growth forecast by 1.4 percentage points in 2018, 0.9 percentage points in 2019 and 0.25 percentage points in 2020. Looking further ahead, tax reform momentum will subside in 2020 with full corporate investment expensing phased out starting in 2023 at a time when the Fed is tightening and a reduced labor force with the aging population will constrain global growth. These forces will likely represent a medium term challenge for the economy and equities.

INTEREST RATES, INFLATION AND FIXED INCOME

The investment grade bond market, as measured by the Bloomberg Barclays Aggregate bond index, declined -1.46% in 1Q18. Treasury yields rose significantly during the quarter, and spread widening of non-Treasury fixed income sectors also contributed to the negative price return.

Better-than-expected payroll and wage data (average hourly earnings increased by 2.9% YOY in February) raised inflation concerns and pushed up Treasury yields as the market priced in a less accommodating Fed policy. Bond yields were also pressured by the growth boost and inflation implication resulting from fiscal policy expansion, including The Tax Cuts and Jobs Act and the Bipartisan Budget Act of 2018.

Fed Chairman Powell’s testimony to Congress in February was perceived as hawkish. He noted that “some of the headwinds the U.S. economy faced in previous years have turned into tailwinds,” and the case for inflation increasing to the Fed’s 2% target has strengthened. The FOMC raised the funds rate target range by 0.25% to 1.5-1.75%. The median dots in the Summary of Economic Projections remained unchanged in 2018 at 2.125% (2 more hikes), Dots were revised higher for both 2019 and 2020 to 2.875% (3 hikes) and 3.375% (2 hikes due to the economic growth boost from the tax and spending bills).

The Fed raised the median projection for core PCE inflation by 0.1% each in 2019 and 2020 to 2.1%, above the Fed’s 2% target for the first time in this tightening cycle. Market expectations also increased correspondingly, anticipating the core PCE inflation to reach 2.0% by Q3 of this year.

United States | Browse | Private | Official

Actual / Forecasts | Probability of Recession 15.0%

Indicator	Q2 17	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19
Real GDP (YoY%)	2.2	2.3	2.6	2.8	2.8	2.7	2.7	2.7	2.5	2.5
Real GDP (QoQ% SAAR)	3.1	3.2	2.9	2.5	3.1	2.9	2.7	2.4	2.4	2.3
Consumer Spending (QoQ%	3.3	2.2	4.0	2.2	2.9	2.7	2.5	2.3	2.4	2.3
Government Spending (QoQ	-0.2	0.7	3.0	1.0	1.4	1.6	1.7	1.4	1.3	1.2
Private Investment (QoQ% S	3.9	7.3	4.7	5.7	5.4	5.3	5.0	4.4	4.2	4.0
Exports (QoQ% SAAR)	3.5	2.1	7.0	2.5	3.5	3.5	3.5	3.3	3.2	3.0
Imports (QoQ% SAAR)	1.5	-0.7	14.1	4.5	4.6	4.6	4.5	3.8	3.8	3.6
Industrial Production (YoY %)	1.9	1.3	3.0	3.6	3.0	3.8	2.7	2.6	2.5	2.4
Price Indices										
CPI (YoY%)	1.9	1.9	2.1	2.3	2.6	2.6	2.3	2.2	2.3	2.4
PCE Price Index (YoY%)	1.6	1.5	1.7	1.8	2.0	2.1	1.9	1.9	2.0	2.0
Core PCE (yoy%)	1.5	1.4	1.5	1.6	1.8	2.0	2.0	2.0	2.0	2.1

Source: Bloomberg

The Fed is expected to continue to hike rates at a measured pace in a gradual effort at normalization. Importantly, market implied Fed Fund rates have converged to that of the median Fed dots for 2018, and the differential has narrowed for 2019 and 2020.

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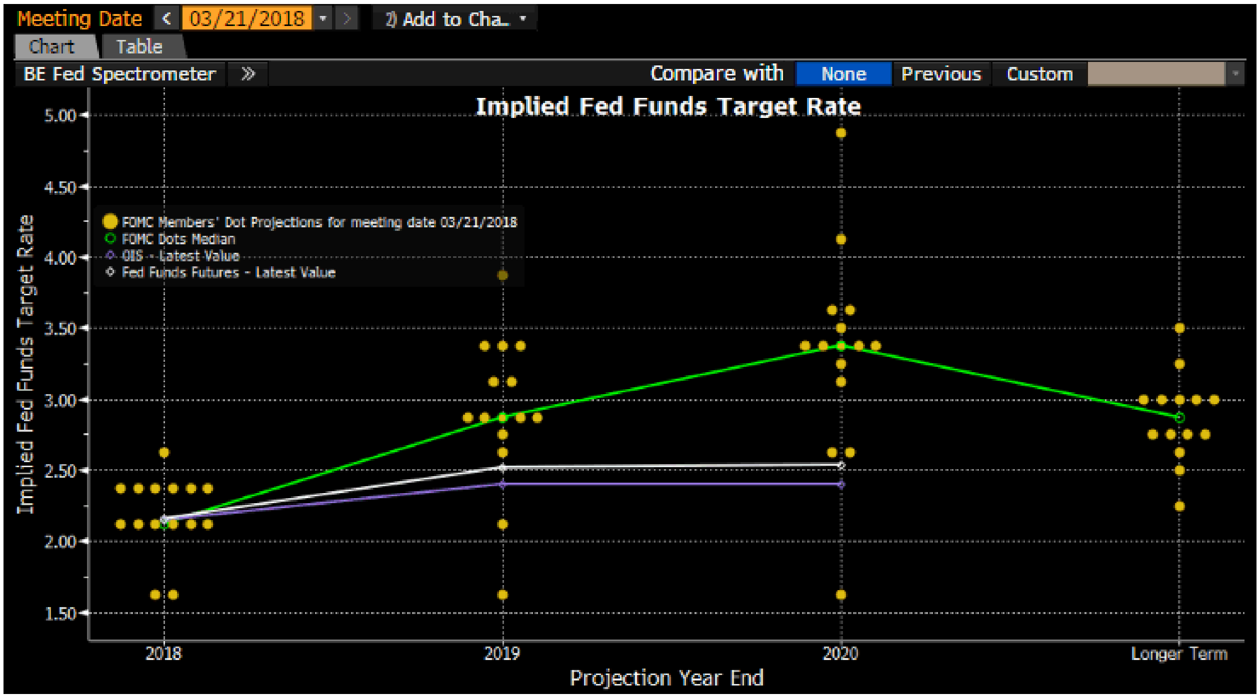
FED Dot Plot



Source: Bloomberg

	2018	2019	2020	LT
FOMC Dots Median 3/21/18 (Green)	2.13	2.88	3.38	2.88
Market Implied (White)	2.16	2.52	2.54	

Source: Bloomberg

As the Fed continues its normalization, market volatility has also increased. Equity volatility (using S&P 500 Index Options VIX as a proxy) spiked significantly during the quarter, even as interest rate (using Merrill Lynch Yield Curve Option Volatility Estimate MOVE Index) and foreign exchange volatility (using Deutsche Bank Currency Volatility CVIX Index) have remained range-bound.

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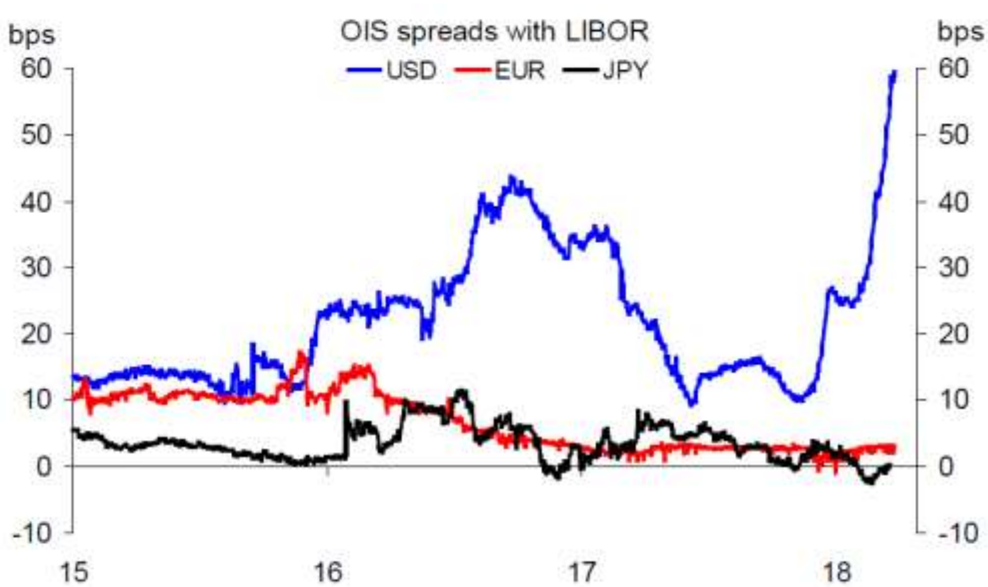
Normalized Volatility Indices

Source: Bloomberg

The cost of short term borrowing has increased with 3-month LIBOR at 2.31%, the highest since 2009. The USD LIBOR-OIS spread, difference between LIBOR and Overnight Index Swap rate (a barometer of fears of bank insolvency) has increased to a level not seen since the financial crisis.

Global LIBOR – OIS Spreads



Source: Deutsche Bank

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The spike in spreads was somewhat technical, due to expectations of overseas cash repatriation by U.S. businesses, and higher U.S. Treasury Bill issuance. Nevertheless, this spike impacted borrowing costs for corporations resulting in a tightening of financial conditions.

Chicago FED National Financial Condition Index (NFCI)

Source: Bloomberg/Chicago FED

The market is concerned that rising US protectionism would elicit retaliation by trading partners such that any escalation into a trade war would have significant adverse effects on global economic growth, including increasing inflation pressure, dampening business and consumer confidence, and reducing capital investment. Fed Chair Powell noted that “trade has become a more prominent risk to the outlook.”

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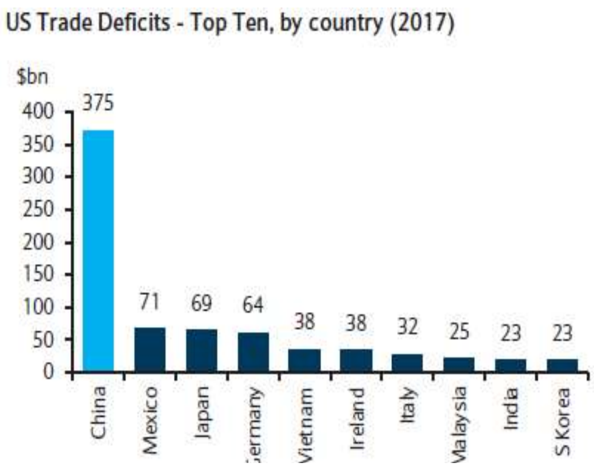
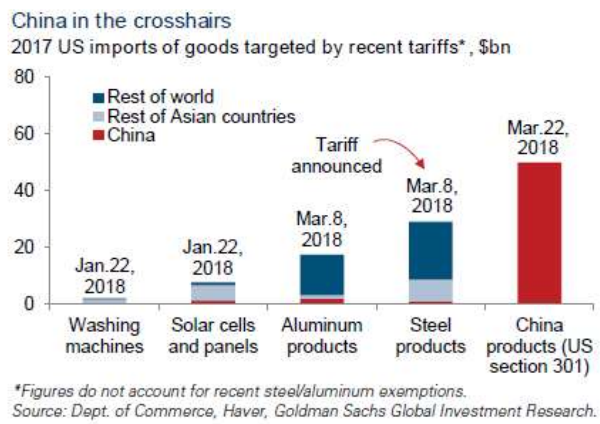
U.S. Trade Deficits



Source: Goldman Sachs

U.S. Trade Tariffs



Barring a material escalation of trade and/or geopolitical tensions, global growth should remain robust in 2018 as advanced economies continue to improve (Europe) or operate near full capacity (United States), while the recovery in commodities should support growth in developing countries. The latest inflation data across advanced economies also remains subdued, which is instrumental to the gradual tightening by major central banks such as the ECB and the BoJ. However, overall U.S. rates should remain above that of other developed economies given the more advanced stage of U.S. monetary policy tightening.

Global Yield Curves

	2 Year	5 Year	10 Year
US	2.27%	2.56%	2.74%
UK	0.82%	1.11%	1.35%
Japan	-0.13%	-0.10%	0.05%
Germany	-0.61%	-0.10%	0.50%

Source: Bloomberg

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Source: Bloomberg

Our base case is that rates should continue to drift upward modestly and incrementally. Indeed, current interest rate levels should enable short/intermediate maturity higher quality securities to outperform and with stand the relatively modest pickup in overall rates we foresee.

US Yield Changes

	6/30/2017	3/31/2018	Change
2-Year UST yield	1.38%	2.27%	0.88%
5-Year UST yield	1.89%	2.56%	0.67%
10-Year UST yield	2.30%	2.74%	0.44%
30-Year UST yield	2.84%	2.97%	0.14%

Source: Bloomberg

Higher mortgage rates reduce the economic benefit of mortgage refinancing, which implies a slower prepayment rate that benefits our MBS strategy by enabling the strategy to earn the higher coupon for a longer period of time. Accordingly, relative to many bond strategies, moderately higher interest rates can therefore benefit our Agency MBS strategy.

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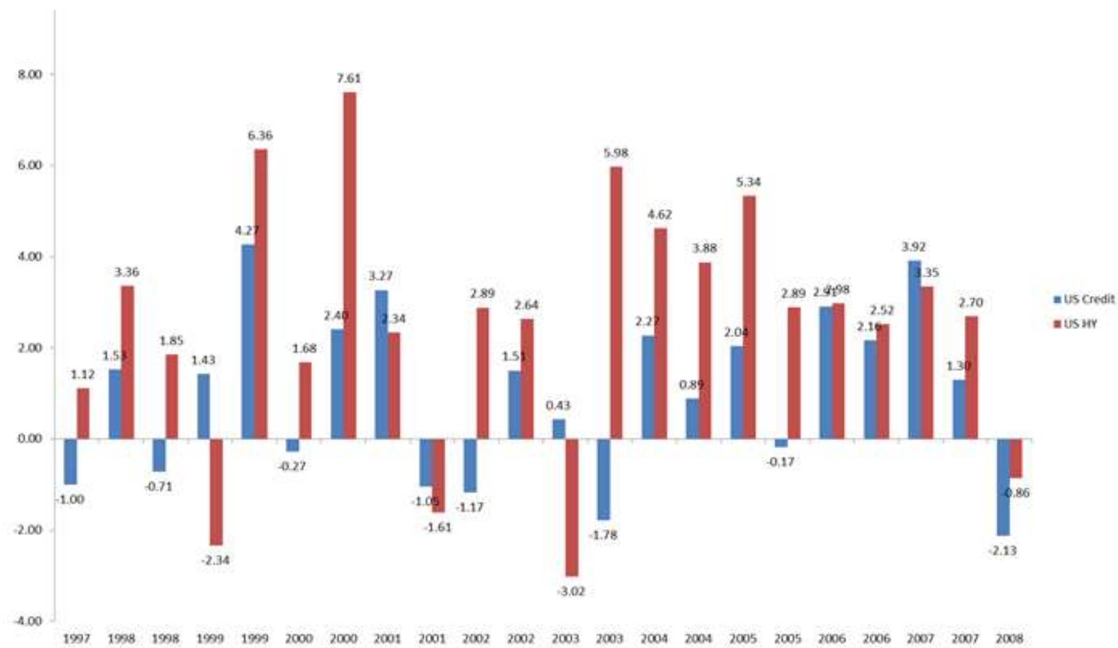
Source: Deutsche Bank

Thanks to massive monetary easing over the past several years, the thirst for yield has richened sector yield premiums, particularly within the credit sectors. As the Fed's program to normalize rates proceeds, we see this as perhaps an indication that spreads should correct, with those sectors that have richened the most going on to weaken the most. More specifically, the credit space is most vulnerable to deterioration in yield premiums, as reflected in the credit sector's Q1 performance YTD.

Historical Q1 returns for IG Credit and HY



Source: Barclays

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While generic MBS issues represents at best only fair relative value, we continue to add value selectively, in bottom up terms, a number of cheap issues that do not even reside within the overall MBS index (e.g. multifamily and re-performing MBS). As specialists within the U.S. Agency MBS space, our universe of available fixed income securities encompasses the following:

MD Sass Agency MBS Investment Universe

*   *   *

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April 18, 2018

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