SECOND QUARTER 2017 - CONTINUED SWEET SPOT

The fundamentals of strong corporate earnings, Fed policy and low inflation and interest rates continue to drive the equity market higher, while investors ignore increasing political distractions and inertia on key elements of the Administration's agenda. The United States appears to remain in a sweet spot with slow growth, accommodative monetary policy and no apparent significant excesses that tend to derail equity market bull markets. Encouragingly, market breadth is also improving, with gains spreading to previously lagging value stocks.

Whereas generally accommodative central bank policies have inflated asset prices, Core CPI inflation has decelerated and undershot expectations. Modest price inflation is positive for equities because it reduces Fed interest rate hike expectations and allows the Fed to normalize rates very gradually. If inflation increases to the Fed's 2% goal the FOMC will begin to slowly shrink the Fed's balance sheet (probably in September) and the next rate hike will likely occur in December. The Fed does not want to risk shocking the markets or triggering a recession by normalizing too quickly in the continued absence of inflationary overheating or a weak dollar.

The absence of inflationary cost pressures has helped to bolster corporate profits. S&P 500 earnings beat expectations in 1Q17 with a rise of 14% YOY, the largest increase since 2011. Although S&P 500 earnings growth is expected to decelerate in 2Q17, a healthy 6-8% YOY gain appears likely. Low bond yields, which are highly correlated to inflation, are helping to support equity valuations. The earnings/bond yield spread is now 2.9% (S&P earnings yield of 5.2% less 10 year bond yield of 2.3%), which compares favorably with the median spread of 0.8% since 1957.

The Republican Administration's stimulative policy plans face more significant near term headwinds. These headwinds are also helping in that they prevent accelerating economic growth which would risk putting upward pressure on wages and inflation with the economy at full employment. This in turn would trigger more Fed tightening, higher interest rates and a compression of P/E ratios.

Political challenges are making it more difficult to pass health-care reform and a budget resolution, which must be resolved before tax legislation can pass. There is still a reasonable chance that a corporate tax cut agreement, including lower taxes on the repatriation of foreign profits, will be reached by early 2018, but it might easily be delayed further and tax reduction will be considerably less than the $3-4 trillion in the Administration's proposal, given increased focus on revenue neutrality. Despite the abnormally high level of political uncertainty, the VIX level of volatility has been low vs. historical norms. Spikes in volatility in connection with market corrections can occur at any time, but we expect them to provide buying opportunities as long as the fundamentals remain intact.

IMPACT OF PASSIVE INVESTING ON EQUITY VALUATION

We believe passive investing has led to decreasing market efficiency and valuation distortions, as equities are mindlessly traded to match indexes, with growing emphasis on high momentum, increasingly expensive growth stocks (notably the "FANG" tech stocks). As a result, value stocks have lagged significantly until the month of June when value significantly outperformed growth, in what we see as a rational rotation and broadening of market breadth.

Passive investing will account for roughly half of all equity assets under management in the United States this year and ETFs already account for close to 50% of daily trading (while only about 14% of the overall U.S. stock market is passively held). As passive investing grows, we believe it will benefit stock-pickers by providing more undervalued opportunities. Also, an increasingly passive market may respond to a violent correction with indiscriminate and self-reinforcing selling, when the more expensive momentum stocks are likely to reverse sharply.

Fixed Income Market Recap

Market expectations of a regular Fed hiking cycle propped up short maturity yields while softer inflation prints depressed longer maturity yields. The Treasury yield curve continued to flatten during the quarter, with shorter maturity Treasury yields (three-year and less maturity) increasing and longer maturity Treasury yields decreasing.

Historical yield curve:

	3/31/2017	6/30/2017	Change
2-Year UST yield	1.25%	1.38%	0.13%
5-Year UST yield	1.92%	1.89%	-0.03%
10-Year UST yield	2.39%	2.30%	-0.08%

Source: Bloomberg

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Coming off the first quarter's tepid 1.4% U.S. GDP growth, 2nd quarter growth appears to be tracking 3%. Still, the International Monetary Fund is projecting only a 2.1% rate of U.S. growth for all of 2017. On the inflation front, key inflation prints softened in the second quarter: the May core PCE print of +1.4% (YOY) was well below the Fed's target of 2%. However, the U.S. labor market continued to strengthen as the latest headline unemployment rate of 4.3% remained lower than the Fed's structural estimate of 4.6%. Given progress on the employment front, along with the Fed's looking through the recent soft inflation data (see Chart below) as "transitory" in nature, the Fed increased the target range for the Federal Funds rates by 25 basis points to 1-1.25% in June.

Lower forward inflation expectation year to date

The June FOMC statement and press conference hinted the FOMC's desire to announce and begin the NORMALIZATION (i.e. reduction) of its $4.5 trillion balance sheet later this year (see Chart below). The Fed announced the schedule of caps pertaining to the amount allowed to mature and not be reinvested monthly on its Treasury, Agency MBS and Agency debt holdings. The caps start at $6 billion for Treasuries and $4 billion for MBS, gradually increasing each quarter to peak caps of $30 billion and $20 billion, respectively, in 5 equal increments. The Fed will continue to reinvest principal return in excess of these caps. One Fed governor suggested that balance sheet normalization would be so gradual it will be "like watching paint dry".

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Fed Balance Sheet

Aside from softer readings on inflation, also helping to flatten the Treasury yield curve last quarter was the market's pricing in reduced U.S. fiscal upside from the new administration. In contrast, upside surprises in global economic activity had accelerated global central banks' policy normalization. Both ECB President Draghi and BoE Governor Carney hinted at the gradual unwinding of their highly accommodative stance on monetary policy. Sovereign bond yields spiked on such comments, as both the 10-year Treasury and German bond yields rose by 17-20 basis points in the last week of the quarter.

Fixed Income Outlook:

With respect to the outlook for rates, bonds, and U.S. Agency MBS in particular:

The Fed median dot has conveyed one more 25 basis point hike in its target rate this year, and three rate hikes in 2018. Conversely, the market, as indicated by the Fed Funds futures, has priced in one additional hike this year, and anticipates only one hike in 2018. Financial conditions (see Chart below) have eased notwithstanding the 100 basis points of tightening in the current hiking cycle (Dec. 2015, Dec. 2016, Mar. 2017, June 2017).

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The question remains whether risk asset valuations may reverse their recent performance as the Fed continues to tighten in the current cycle.

Easing Financial Conditions

Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.

Unlike their predecessors, the Fed under Bernanke and now Yellen is intent on proceeding in transparent and incremental steps, making the current tightening campaign different than past ones. We expect the normalization to be conducted in a slow and gradual manner, and for a slow upward drift in the yield curve. Over time, we believe short and intermediate investment grade bonds should continue to outperform money market investments while longer term issues are expected to face rising interest rates and declining prices. The Fed's normalization of interest rates constitutes a macro-economic policy, of significance for all financial sectors. Given the tightness of yield premiums in alternative high grade credit sectors, we regard credit sectors as perhaps more vulnerable to spread widening as a result of the Fed's efforts to normalize policy (See Chart below). Indeed, a part of the Central Banks' objective in raising rates over time is to help correct for the perceived excess of asset valuations.

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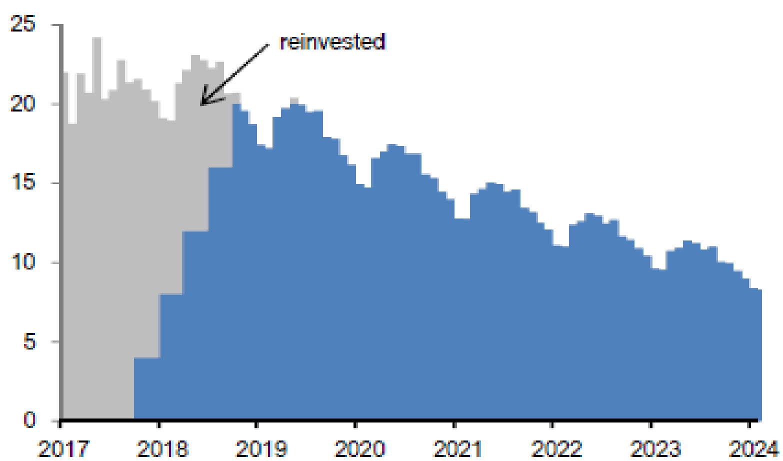
Easing Generous Central Bank Liquidity has led to dramatically tighter spreads on credit related vehicles

Index	Past 1 Year	Past 5 Years
U.S. Treasuries	+ 60 bps	+ 72 bps
Current Coupon MBS	+ 55 bps	+ 16 bps
Investment Grade Corporates	+ 13 bps	+ 2 bps
High Yield	- 221 bps	- 155 bps

Source: Bloomberg

As for the Fed's plan to cap reinvestments on U.S Treasuries and U.S. Agency MBS, the current plan implies expected runoff of $18 billion in Treasuries and $12 billion in MBS this year, and $200 billion in Treasuries and $150 billion in MBS next year. Understandably, the market has expressed a pointed concern about both the impact of these Fed balance sheet moves on rates in general, and on MBS spreads in particular. We perceive this risk for MBS spreads to be on the order of a fairly modest widening of 10-15 basis points. The reality is that the impact of the Fed's pending balance sheet actions have, to a certain extent at least, already been factored into sector yield premiums.

Monthly runoff of Fed's holdings in Agency MBS in $billions



Source: J.P. Morgan

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Globally, even as sovereign rates spiked at the end of June due to the market repricing of central bank monetary policies, U.S. sovereign yields remain attractive relative to that of other developed markets. Accordingly, the superior income advantage offered by U.S. Treasuries (and Government/Agency securities) provides a mitigating factor to the upward drift in global yields. Given that the current era is one of rather modest economic growth rates, where policymakers are focusing on reversing some of the past unconventional easing policies, this is not the kind of macroeconomic setting that suggests a major breakout toward higher interest rates.

Importantly, our style as a specialized MBS/CMO investor and our target investments, including both residential MBS and specialty subsectors (e.g. Seasoned Credit Risk Transfer; Multifamily, and re-performing loans), are well positioned to weather a cycle of higher interest rates and risk premiums while providing very attractive relative yields to similar quality and duration instruments. [Most of the holdings in the strategy have high coupons and therefore a market value above their par value. As home owners refinance we are paid back at par value. Rising interest rates are highly correlated to slowdowns in mortgage prepayments because the high interest rate on the replacement mortgage reduces the economic benefit of refinancing. A slower prepayment rate benefits our MBS strategy by enabling the strategy to earn the higher coupon for a longer period of time. Accordingly, in contrast to many bond strategies, moderately higher interest rates can therefore benefit our strategy].

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July 17, 2017