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THIRD QUARTER 2017 - IMPROVING SYNCHRONIZED GLOBAL GROWTH

Whereas the U.S. has outpaced global economic growth over the past 8 years, the global economy is now in an accelerating synchronized growth mode for the first time in this expansion. The IMF is projecting growth to rise to 3.6% in 2017 and 3.7% in 2018, with improvement most notable in Japan, China, the Euro area, emerging Asia and emerging Europe. This growth, accompanied by low inflation and interest rates, has driven equity markets higher around the world. The widening breadth of economic activity is also resulting in a broadening of equity markets, to encompass previously lagging value and cyclical stocks. Long-awaited potential tax cuts by early 2018 and increased hopes of a fiscal spending boost provide optionality.

INFLATION, INTEREST RATES AND STOCK PRICES

The persistence of low inflation in developed countries has surprised nearly everyone. Low inflation has allowed interest rates to stay near historic lows and supported elevated P/E ratios for equities. September core CPI increased only 1.7% year over year (vs. 1.8% expected) and the core PCE deflator has slowed to merely +1.3%, near a record low and well below central bank targets. While inflation and interest rates remain low, P/E ratios can remain relatively high until recession fears begin to increase. We still do not see signs of an imminent recession. Although multiples are relatively high, equities remain attractive relative to bonds. With the S&P 500 at 2550, the current earnings yield for the S&P 500 is 5% based on estimated earnings of $129 for 2017. The stock yield/bond yield spread is 2.7%, with the 10 year U.S. Treasury at 2.3%, vs. the historical median of 0.8%.

Janet Yellen has said that “low inflation is probably temporary….” and that “it would be imprudent to leave rates on hold until inflation reaches 2%....” suggesting the Fed is committed to rate hikes. With the Fed becoming “path dependent” rather than “data dependent” raises the risk of a Fed policy error if inflation remains persistently below target. Alternatively, if inflation moves above target the Fed would have to increase the gradual pace of rate hikes. At this juncture, a more active Fed is most likely to hike rates in December 2017 and three or four more times in 2018.

Fixed Income Market

Following two consecutive quarters of positive total return (+1.87%), the Bloomberg Barclays Treasury Index returned +0.38% for the third quarter of 2017. Treasury yields rose somewhat modestly across the term structure during the quarter; however, income return more than offset the negative price return. The Treasury yield curve continued to flatten during the quarter, with shorter maturity Treasury yields (three-year and less maturity) increasing more than longer maturity Treasury yields. The market’s expectation of a regular Fed hiking cycle propped up short maturity yields while softer inflation prints depressed longer maturity yields.

The market's expectation is for the Fed to revise its forecasts of future fed funds interest rates. The September FOMC statement was taken by the market as modestly more hawkish than anticipated, as the median dots for 2017 and 2018 stayed unchanged from June levels, and the Fed still expects four more hikes between Q4 and the end of 2018. The FOMC statement also noted that job gains remained solid and the Atlantic hurricanes might "boost inflation temporarily".

As expected, the FOMC announced that balance sheet normalization will begin in October 2017. The normalization process calls for caps on monthly runoff for both Treasuries and MBS starting at $6bn and $4bn, respectively, and increasing quarterly to peaks of $30bn and $20bn. The market consensus is that the Fed would continue to maintain a sizable balance sheet ($2.5-$3tn) as a function of the public's need for currency. Chair Yellen indicated that the hurdle for stopping balance sheet roll-off is very high.

Bond market volatility remained high during the quarter due to both elevated geopolitical tensions related to North Korea, and domestic political uncertainty about the likelihood of a US government shutdown and hitting the U.S. debt ceiling. The debt ceiling was subsequently raised and government funding was provided through December. The market was also concerned about hurricane-related disruption to economic activity. Overseas, the ECB opened the door to tapering its Quantitative Easing bond purchases program sometime in 2018 after leaving rates on hold in September. The financial markets finished the quarter on a strong note as equities hit record levels and Treasury yields increased on potential progress in tax reform.

Bond Market Outlook

The latest IMF World Economic Outlook commented that the modest pickup in global growth remains on track with global output projected to grow by 3.5% in 2017 and 3.6% in 2018 (vs. projections of 3.4% and 3.6% at the beginning of the year). The market's focus has also shifted to central bank policy developments in the past quarter. In addition to the Fed's initiation of the balance sheet normalization program, other central banks (including the ECB, BoE, and Bank of Canada) are also making progress in terms of policy normalization. This partly explained the weakening of the U.S. Dollar year to date (fig 1). That said, U.S. government interest rates remain a compelling standout amidst the spectrum of alternative global rates, many of which remain negative. This is even more impressive given the more advanced stage of monetary tightening by the Fed (fig 2).

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Figure 1. Trade Weighted USD, Federal Reserve System

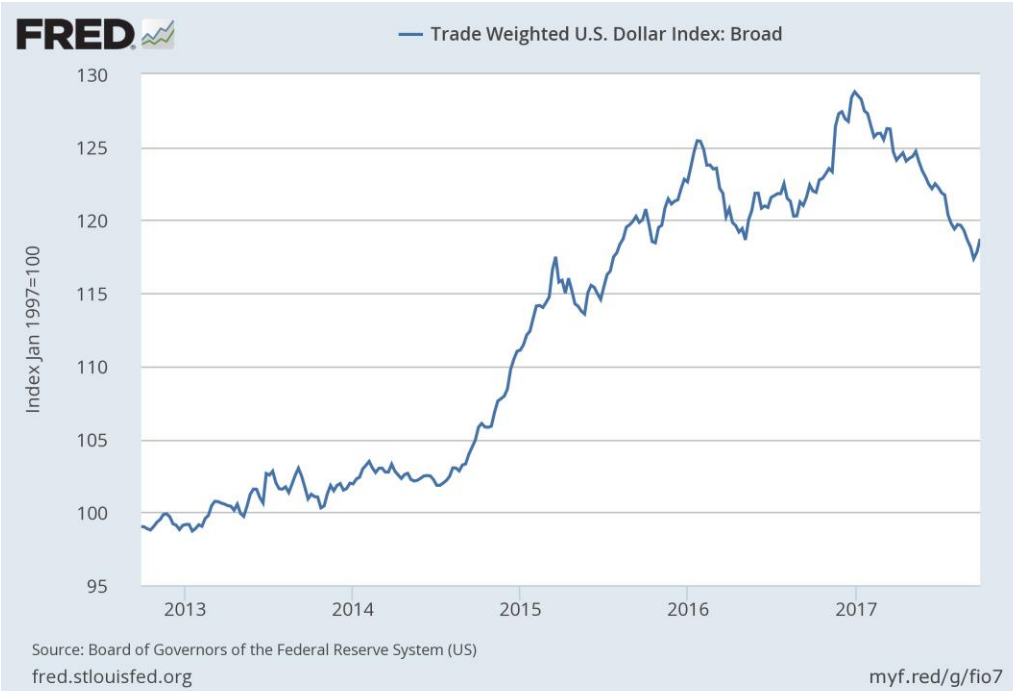

Figure 2. Global Yield Curves 9/30/2017, Bloomberg

Tenor	US	Japan	Germany	France	UK	Switzerland	Spain	Italy	Canada
1Y	1.29	-0.16	-0.74	-0.58	0.39	-0.99	-0.36	-0.37	1.39
2Y	1.49	-0.13	-0.70	-0.49	0.44	-0.85	-0.25	-0.25	1.52
5Y	1.94	-0.08	-0.27	-0.01	0.78	-0.53	0.36	0.70	1.75
10Y	2.33	0.06	0.46	0.74	1.36	-0.05	1.56	2.11	2.10
30Y	2.86	0.86	1.29	1.84	1.91	0.42	2.85	3.28	2.47

We commenced 2017 with the market expecting 2-year Treasuries to yield 1.64% and 10-year to yield 2.7%. At the end of this past quarter, the 2-year yield closed at 1.48%, and the 10-year yield closed at 2.33%. So interest rates currently are much lower than the market expected at the beginning of the year (particularly in the long end). The reasons are nuanced and as follows: The lack of pickup in inflation metrics, heightened market skepticism over the new U.S. administration's policy goals and a low-2% 2017 real GDP growth expectation largely accounted for the depressed longer maturity government yield. On the other hand, investor concern about a more assertive rate hike trajectory by the Fed led to the increase in short maturity Treasury yield. However, relative to the Fed's expectations, there remained a substantial mismatch

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between the Fed's policy rate projections and market pricing. The Fed's "dot plot' of projected interest rate policy appears to be too high relative to the market's expectation (fig 3). Finally, the market also infers the Fed's balance sheet adjustment as equivalent to a form of monetary tightening.

Figure 3. Fed "Dots Plot", Bloomberg

	2017	2018	2019	2020	LT
FOMC Dots Median 9/20/17	1.375	2.125	2.688	2.875	2.750
OIS - Latest Value	1.315	1.582	1.699		
FOMC Dots Median 6/14/17	1.375	2.125	2.938		3.000

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 $18bn in Treasuries and $12bn in MBS this year; and an estimated $200bn in Treasuries and $150bn in MBS next year. Understandably, there is concern about both the impact of these Fed balance sheet moves on rates in general, and on MBS spreads in particular. We expect the normalization of monetary policy to have an overall manageable impact on MBS spreads given its gradual and well-communicated nature. Indeed, MBS had tightened since the Fed's September announcement, indicating the runoff was largely factored into sector yield premiums (fig 4). As we have discussed in the past, the tightness of yield premiums in alternative high grade credit sectors implies that credit sectors are perhaps more vulnerable to spread widening as a result of the Fed's efforts to normalize policy (fig 5). 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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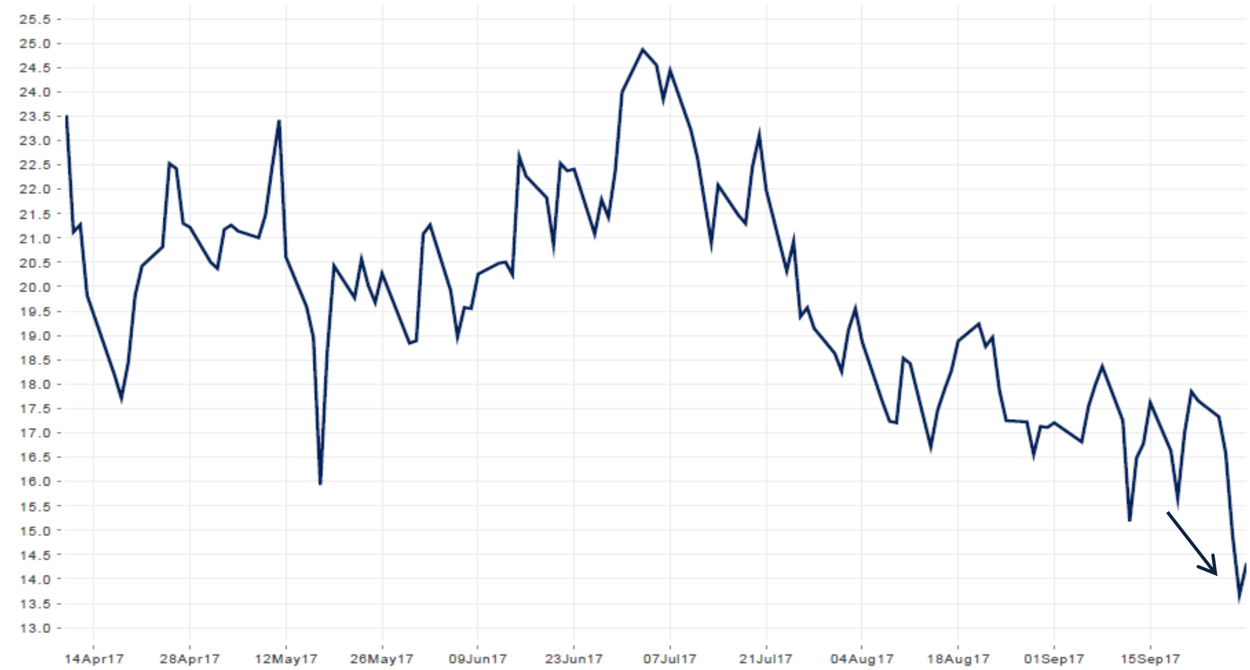
Figure 4. FNCL Current Coupon OAS, Barclays Live



Color	Expression	Last	Minimum	Maximum	Average	Std Dev	Std Dev Chg
	FNCL CC CC Option Adjusted Spread	14.295	13.677 28/09/2017	24.864 03/07/2017	19.707	2.309	1.017

Figure 5. Spread sectors yield changes

Index	Past 1 Year	Past 5 Years
U.S. Treasuries	+ 69 bps	+ 101 bps
Current Coupon MBS	+ 75 bps	+ 104 bps
Investment Grade Corporates	+ 34 bps	+ 44 bps
High Yield	- 59 bps	- 121 bps

We believe the superior income advantage offered by Agency MBS provides a mitigating factor to the upward drift in global yields. In addition, rising interest rate reduces 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 (fig 6). Accordingly, in contrast to many bond strategies, moderately higher interest rates can therefore benefit our strategy. Lastly, we believe that our style as a specialized MBS/CMO investor and our target investments, including both residential MBS and specialty subsectors (e.g., Multifamily, and modified/re-performing MBS), provide very attractive relative yields and diversification from other similar quality and duration instruments.

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Figure 6. MBA US Refi Index

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