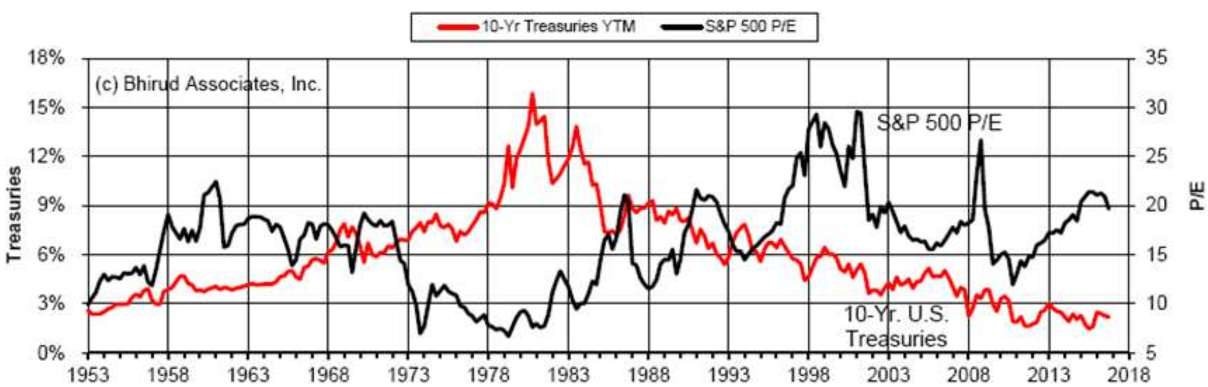
2018 MARKET OUTLOOK

As 2018 begins equities are posting record highs supported by broadening synchronized global economic growth, benign inflation and bond yields and a world economy awash in liquidity. The "wealth effect" from the rise in stock prices coupled with the recent tax bill has spurred increased estimates of U.S. economic growth and corporate earnings. Economists are increasing their estimates of U.S. GDP growth. The consensus estimated S&P 500 earnings growth has increased to a robust +13% for 2018, aided by the cut in the marginal corporate tax rate to 21% from 35%. The current 2.4% level for the benchmark 10-year U.S. Treasuries is supportive of the S&P 500's P/E as shown in the chart below:

S&P 500 P/E and 10-YEAR TREASURY YIELD TO MATURITY



Although the S&P's current multiple has risen it appears justified by low bond yields and stronger earnings growth. The P/E probably will not expand, and a rise in inflation and bond yields would likely trigger a contraction in P/E multiples. To the surprise of most, inflation remains low at around 1.5% (below the Fed's 2% target for core PCE) while unemployment continues to decline and global growth is improving. Average hourly wages continue at a 2.5% annual pace despite the decline in unemployment from its current 4.1%, a 17-year low.

AVERAGE HOURLY EARNINGS AND CPI

Faster economic growth (GDP rose 3.2% in 3Q17) and tightening labor markets will likely trigger higher wages, increased commodity prices, and rising inflation; the only question is when. As long as secular forces prevent an inflationary spiral, there is no reason for the Fed to tighten aggressively, cause an inverted yield curve and risk a recession, which would kill the bull market. Meanwhile, the market remains focused on the economic fundamentals and continues to ignore heightened political risks and uncertainties brought about by this surreal presidency. Global trade has improved despite rising protectionist tariffs and increased tensions between the United States and China and other neighbors, which could spur future trade wars.

The goldilocks economic environment has extended this bull market to its 9th year and if it continues through July it will be the longest bull market on record. Late stages of market cycles can bring a “melt up” in risk assets and elevated investor sentiment. Investor sentiment has risen sharply over the past few quarters, with nearly 60% of individual investors bullish (and nearly 3.8 times as many bulls as bears) according to the American Association of Individual Investors.

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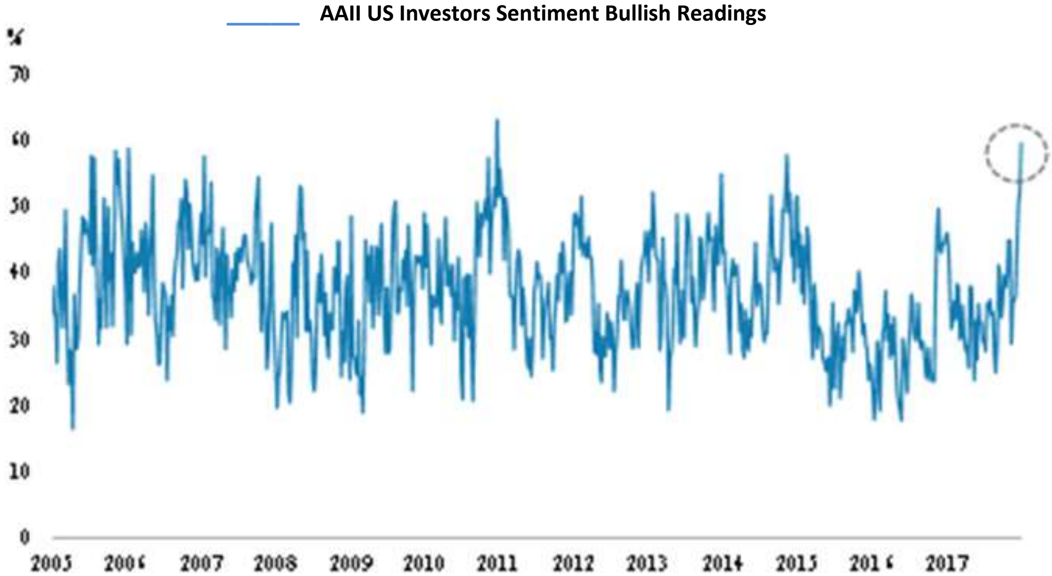
INVESTOR BULLISHNESS INCREASING

AAII US Investors Sentiment Bullish Readings



Source: Bloomberg, Morgan Stanley Research, As of January 4, 2018

The S&P 500 has gone nearly 400 days without a 5% decline from its 52-week high, the second longest such streak on record, another sign of positive investor sentiment. The S&P 500's volatility as measured by the VIX is near its low at around half its long-term average of 19. We may be on the verge of a shift in sentiment from optimism to euphoria that can put stocks ahead of the fundamentals. If we are in the early stages of a melt up in stock prices, increased diversification and other risk controls will be important to prevent large drawdowns, since sharp corrections can occur when no one expects it.

EXTREME SPREAD BETWEEN GROWTH AND VALUE STOCKS

Fundamental value investing has a long record of strong performance. However, 2016 and 2017 were very challenging years for value investing, as investors chased momentum and growth stocks that meaningfully outperformed. The Russell 1000 Value index gained 11% in 2017, trailing the Russell 1000 Growth index gain of 28% by an unusually large 17 percentage points. The biggest drivers of this outperformance of growth indices have been the Technology stocks, which increased by a powerful 39% in 2017. Technology companies have generally beaten earnings expectations, propelled by strong growth by innovative and disruptive technology leaders. The rising trend to passive investing through the $3 trillion growing ETF market and increased flows into index funds helped to fuel the surge in megacap tech growth stocks.

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When the next financial shock occurs, the most popular, crowded high momentum growth stocks are likely to be particularly pressured by a rush for liquidity, while out of favor, contrarian undervalued equities are likely to hold up better.

FIXED INCOME OUTLOOK

The overall investment grade bond market, as measured by the Bloomberg Barclays Aggregate bond index, returned 0.39% for the 4th quarter of 2017, and 3.54% for the whole year. In contrast to market expectations for higher interest rates for 2017, 10-year Treasury yields ended 2017 at only slightly lower at 2.41% versus 2.45% at the prior year end. However, intra-year 10-year yields were relatively volatile with a high of 2.63% in Q1 and a low of 2.04% in September. Overall, the market's expectation of a regular Fed hiking cycle propped up short maturity yields while softer inflation prints (along with softening inflation expectations) depressed longer maturity yields.

In December, the Federal Reserve raised the federal funds rate by 25 basis points, to a range of 1.25% to 1.5%, as was widely expected. With Q3 real GDP growth of 3.2% and an unemployment rate of 4.1% in December, the FOMC commented that "job gains have been solid and the unemployment rate declined further." The median 2018 GDP growth projection was raised to 2.5% versus 2.1% in September, and the 2018 unemployment rate forecast was revised lower to 3.9% from 4.1%. However, even as the Fed had accounted for the impact of the upcoming tax cuts, the median dots remained unchanged in 2018 and 2019, rising only in 2020 to a higher terminal rate.

Markets also focused on the tax reform bill. The Tax Cuts and Jobs Act passed both the House and the Senate. For mortgage investors, the higher standard deduction and lower mortgage interest deduction (from $1mn to $750K) might reduce borrower incentive in certain segments of U.S. housing market. The flattening Treasury yield curve could imply that the market is pricing in a steady Fed hiking pace, but with less long term economic impact.

The nomination of Jerome Powell as new Fed Chairman has reinforced the market's conviction of a steady but gradually increasing Fed Funds rate path. With New York Fed President Dudley announcing his retirement in mid-2018, Fed official turnover continues to raise uncertainty about the composition of the FOMC. However, given the Fed's emphasis of the differentiation between balance sheet run-off and interest rate normalization, characterizing the former as akin to "watching paint dry" and the latter as more data dependent, the market continues to expect policy continuity. Overseas, the ECB extended the Quantitative Easing program for 9 months from Jan 2018 until Sept 2018 at a reduced size of 30 billion Euros per month. The ECB also emphasized the change of asset purchase size was not a "taper" but merely a "downsize" of Eurozone QE. Longer term, the market is expecting gradual policy normalization by other major global central banks.

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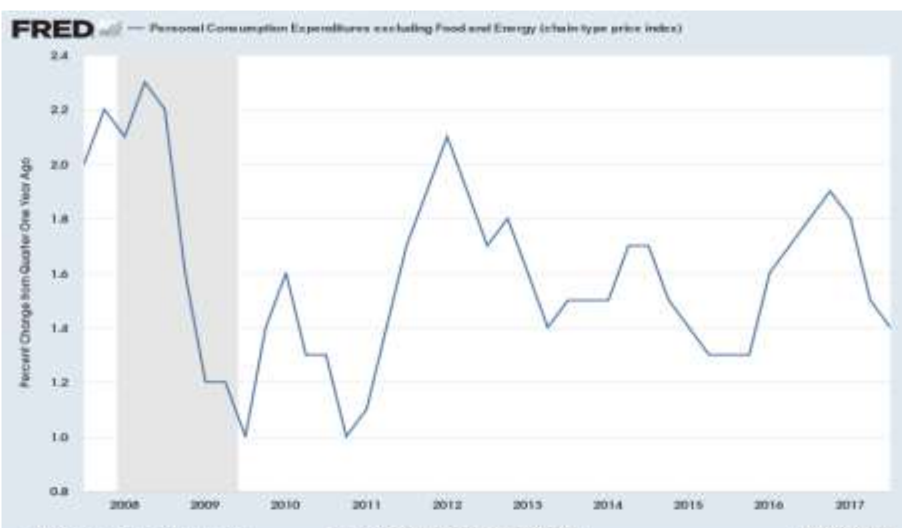
The December FOMC statement characterized economic growth as “rising at a solid pace”, and the Fed had decided to raise rates “in view of realized and expected labor market conditions and inflation.” The labor market has been stronger than expected as the FOMC had projected the jobless rate would bottom out for the full economic cycle at 4.1%, but actual unemployment ended 2017 at 4.1%. The Fed now projects the unemployment rate to hit 3.9% in 2018.

DECLINE IN THE U.S. UNEMPLOYMENT RATE

The Fed continued to miss on its 2% inflation target, as evidenced by the core PCE. Whether or not core inflation will rebound in 2018 is a key question.

CORE PCE REMAINS SUBDUED



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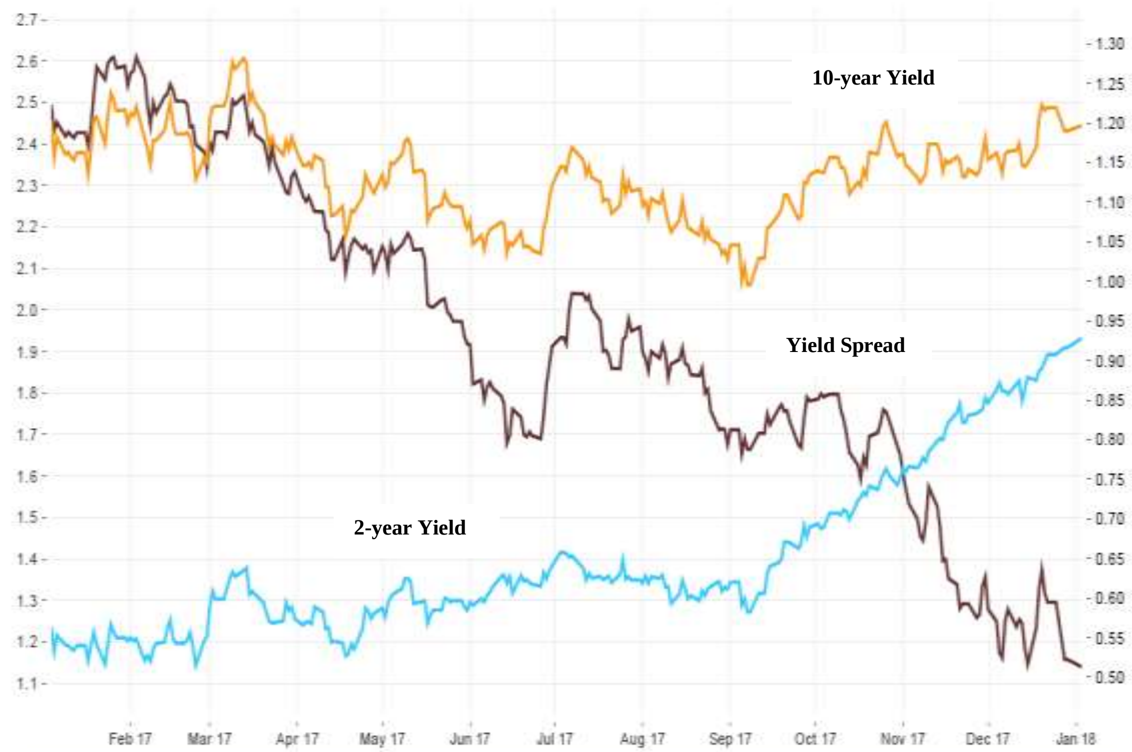
The flattening yield curve continued to raise the specter perhaps of a policy mistake by the Fed in the context of the conflicting signals conveyed by the labor market and inflation.

2-YEAR AND 10-YEAR TREASURY YIELD SPREAD



Source: Barclay's, Bloomberg

Importantly, there remains a substantial mismatch between the Fed's medium-term 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 for 2019 and 2020. The market may incorrectly infer that the Fed's efforts at balance sheet adjustment are equivalent to a form of monetary tightening. The Fed may be planning on both balance sheet adjustment and raising the Fed Funds rate. This would subsequently lead the market to reprice interest rates abruptly higher.

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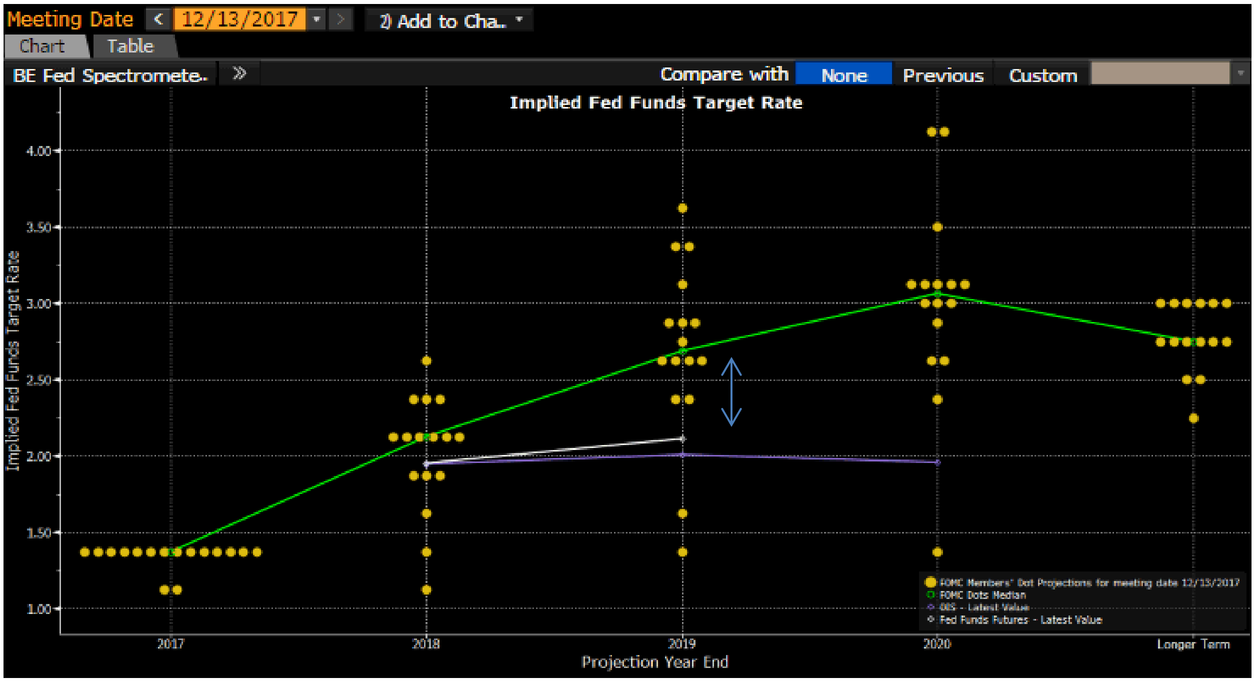
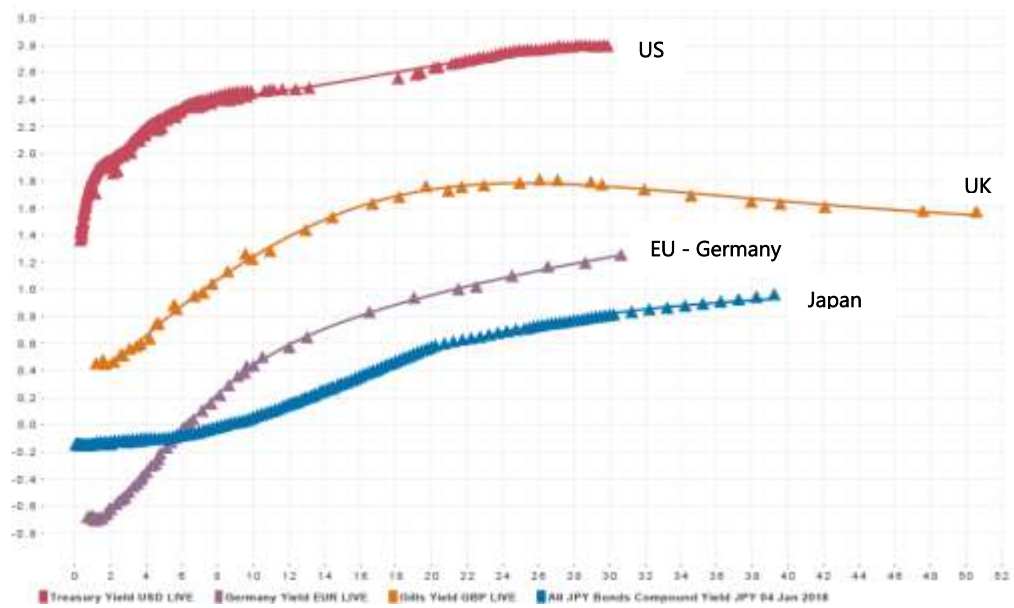
FED DOT PLOT OF PROJECTED FED FUNDS RATE



	2018	2019	2020	LT
FOMC Dots Median 12/13/17 (Green)	2.13	2.69	3.06	2.75
Market Implied (Purple)	1.96	2.05	2.01	

Globally, core central banks are set for a gradual normalization of monetary policy, led by the Fed. Even as global sovereign rates adjusted higher, U.S. sovereign yields remain higher than other developed markets, as shown on the following page.

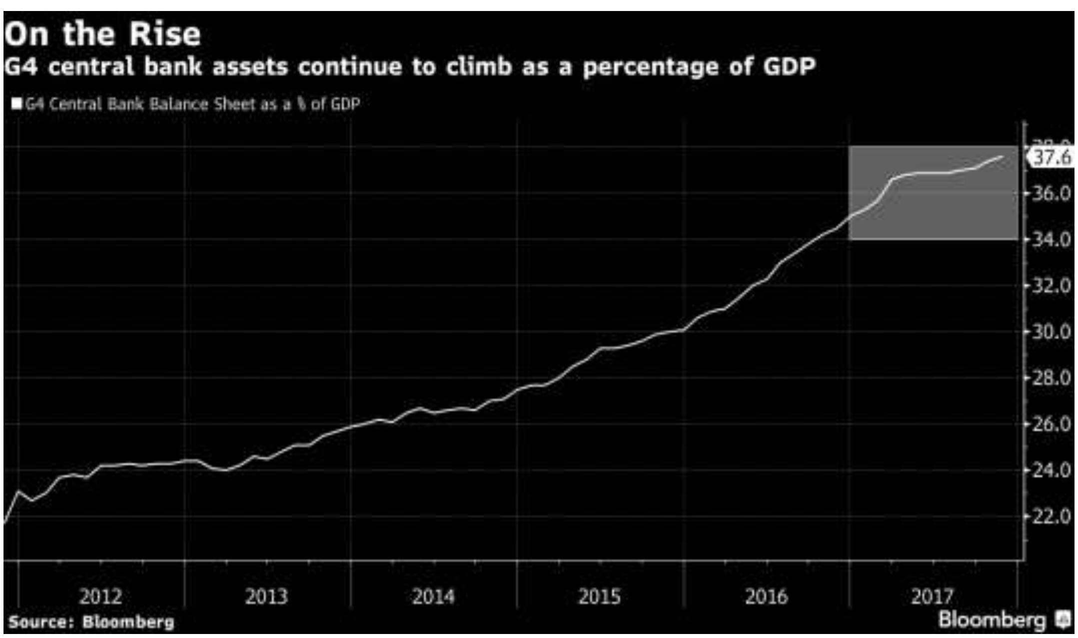
GLOBAL YIELD CURVES



Source: Barclay's

With inflation not yet a concern, the central banks' focus would first be on the growing assets on their balance sheets. Even as the Fed started balance sheet run-down in October, and the ECB plan to cut asset purchases by half starting in 2018, the market reaction has been somewhat muted. Any surprise move might lead to significant market volatility

G4 CENTRAL BANK ASSETS AS % OF GDP



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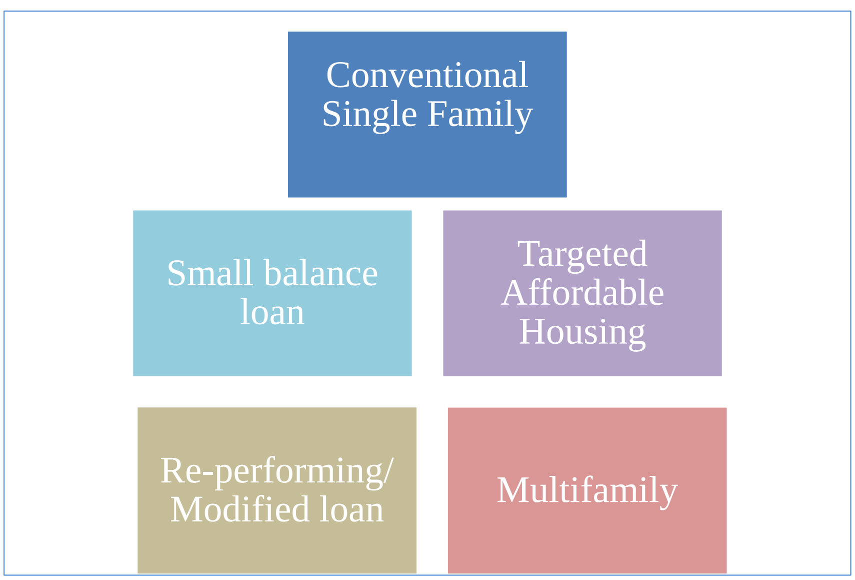
In the meantime, spread products had a very good performance in 2017, especially credit.

Sector	Absolute Return	Relative Return to Treasury
Treasuries	2.31%	
High Yield	7.50%	6.10%
Investment Grade Credit	6.18%	3.35%
Agency Mortgage-Backed	2.47%	0.52%

As the Fed gradually shrinks liquidity in the financial system, we believe the superior income advantage offered by US Government Agency securities provides a mitigating factor to the upward drift in global yields.

Lastly, we believe 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 debt instruments.



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We would like to take this opportunity to wish our clients a happy and prosperous New Year!

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