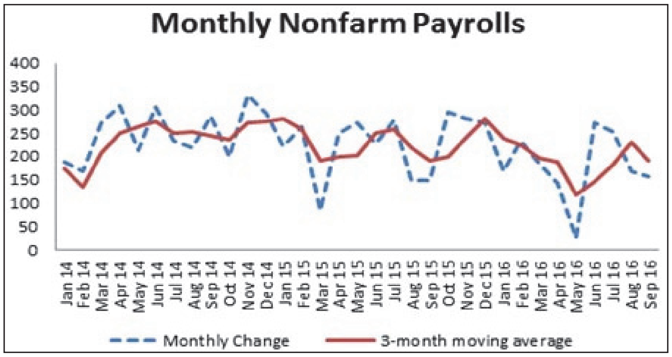
Third Quarter 2016 Economic Review: Still "Data Dependent"

While listening to a recent Fed member press conference, we had to chuckle when a reporter asked: "How long will it be before what is considered the "new normal" is considered just "normal"? Their answer, while lengthy and somewhat convoluted, was that the "new" normal is now simply "normal." The Fed continued to adjust its projections and monetary policy guidance based on incoming economic data. Once again in September, the Fed postponed a hike in the Fed Funds rate, instead choosing to remain "data dependent." In our opinion, we doubt the data is going to vary much from the no longer "new" trend: low growth, low inflation, and low rates.

The U.S. Congress established three key objectives for monetary policy in the Federal Reserve Act: maximizing employment, stabilizing prices, and moderating long-term interest rates. The first two objectives are sometimes referred to as the Federal Reserve's dual mandate. In this edition of the quarterly review, we will update readers on data concerning both of these mandates, provide an update from our energy analyst, and briefly discuss the upcoming election.

Data Dependent – Labor

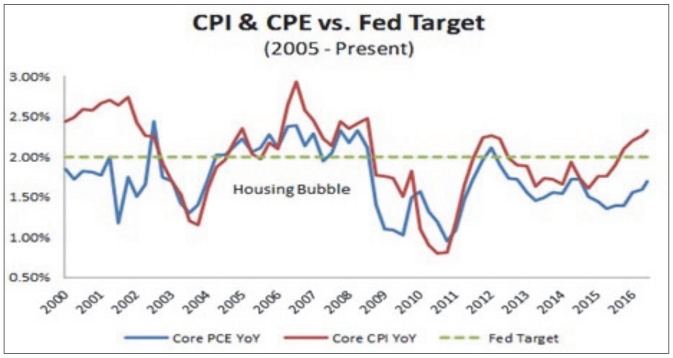
The U.S. economy added 156,000 jobs in September on a seasonally adjusted basis, which was modestly weaker than expected. Revised data showed slightly stronger job growth for the prior month than originally reported. Overall, job growth has moderated somewhat for most of 2016 vs. the prior two years, but generally remains healthy. Household Survey Data showed the unemployment rate ticked up to 5.0 percent, as some healthy increases in labor force participation offset employment growth. The labor force participation rate has increased from 62.4% to 62.9% in the last twelve months, indicating some workers previously on the sidelines are gaining confidence in their job prospects. Still, we believe significant slack remains in the labor market and that the labor data on its own does not support significant concern about inflation. Even when the unemployment rate dropped below 4.0% in the early 2000's, the economy demonstrated no meaningful inflationary impact (review the inflation discussion below for further detail).



Source: US Bureau of Labor Statistics, OIM

Data Dependent – Inflation

The Personal Consumption Expenditure Core Price Index (PCE), the Fed's preferred inflation metric, was most recently measured at 1.7% year-over-year (YoY), above 2015's low of 1.3% but below the Fed's stated target of 2.0%. The trend in the "Core" Consumer Price Index (CPI) YoY suggests that PCE could continue to head higher. Furthermore, there have been some nascent signs of wage growth. Average hourly earnings rose 2.6% YoY in September, moving above the 2.0% trend we have seen through most of the recovery. While these data points suggest that the Fed's inflation target is well in reach, we have our doubts. Core PCE has trended below 2.0% for nearly 16 years now, only exceeding this hurdle during the housing bubble. Underlying global economic weakness will be a source of import deflation and while oil prices have risen off their recent lows, they still remain subdued on a historical basis. We believe a truly data dependent Fed would delay a rate increase past December; however, the Fed has strongly telegraphed a desire to hike, the market appears prepared, and the Fed will not want to further denigrate its credibility. These factors will likely result in a 25 basis point rate hike in December.



Source: Bloomberg (<PCE CYOY Index GO>, <CPI XYOY Index GO>); OIM

Energy Update – Matt Burrell, OIM Energy Analyst

The recent news from OPEC suggesting they will consider a production freeze in late November has sent oil prices higher. Russia weighed in as well indicating it would join OPEC to stabilize the market. However, oil prices are likely to remain in check by abundant storage levels. In the U.S. alone, inventories are roughly 150 million barrels higher than those maintained through the first half of this decade.

The industry has adapted to lower oil prices with significant gains in productivity and efficiency. Advanced technology and improved completion techniques have allowed companies to drill more productive wells. The more productive wells combined with lower labor and equipment costs have led to lower overall breakeven economics for new wells. Today, many companies can achieve double-digit returns on their capital in a $40/bbl oil environment.

As a result of these developments, we are comfortable with a market-weight in energy credit exposure. The Exploration and Production (E&P) companies we hold feature low cost structures and flexible drilling programs. We hold Midstream operators that have proved resilient due to their ability to reduce capex spending and distributions to shareholders. Refiners face some headwinds from lower margins so we're investing in credits that are conservatively capitalized with the ability to reduce debt. Service providers bore the brunt of cost reductions by their E&P clients but we believe they will also be among the first to recover as more drilling rigs go back to work.

Miserable Americans and the Presidential Election

It was recently reported that the median real U.S. household income rose 5.1% last year to $56,516. While this is good news, we need much more of the same. Many people find it hard to fully understand why so many Americans seem as unhappy with their current status and the direction of the country as a whole. The graph below depicts where this deep seated angst may be coming from. While the headline increase in household income was impressive in 2015, it is rising from a very deep hole. Median household income remains

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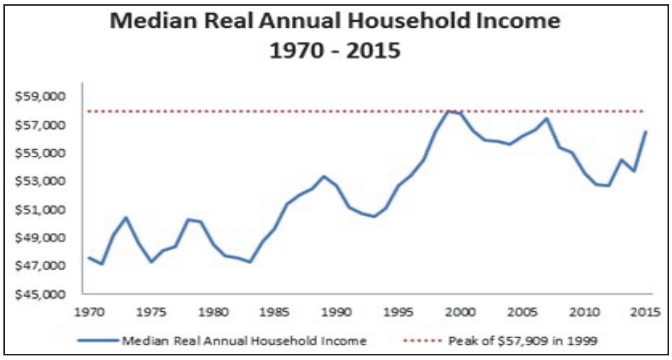
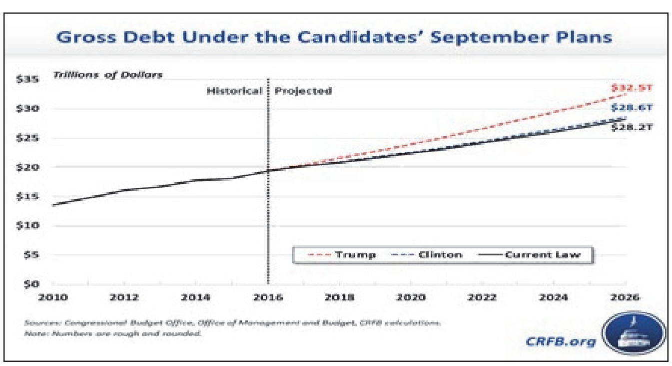
lower than it was before the financial crisis in 2007, and even that number had not recovered to the previous peak from 1999. The standard of living for the median worker in America has not meaningfully improved for 16 years!



Source: Bloomberg (<HOUIMEDI Index Go>), OIM

Hyperbole about globalization, illegal immigration and national defense have overshadowed the seriousness of these topics in the current election cycle. Real policy debates are needed to educate voters so that informed decisions can be made in the voting booth. We are not going to dig any further into what has become some rather unsavory waters around this presidential election. What we can predict with relative certainty is that the next president will inherit an economy that will likely enter into or flirt with a recession during their term, while the national debt will continue to grow. Below is a graph presented by the Committee for a Responsible Federal Budget depicting growth of the Gross Debt based on programs outlined by both major party's nominee. The debt would grow significantly faster under the Republican plan presented. Investments are needed in our country. While our infrastructure decays, so do the skills of many people who have remained underemployed during the recovery. Both are important areas that our federal government needs to address over the next four years.



Capital Markets and Performance

The third quarter of 2016 witnessed more interest rate volatility on concerns for global growth and the decisive Brexit vote which concluded the second quarter. After posting historic record low yields in early July, the third quarter finished with a slight increase in interest rates across the entire yield curve. The bellwether 10-year Treasury yield closed at an all-time record low of 1.36% on July 8th only to see a slight increase in the quarter to close with a yield of 1.54%. The Barclays Capital U.S. Aggregate Index returned 0.46% in the third quarter which brought the year-to-date return to an impressive 5.80%. Continuing a trend from previous quarters, lower quality bonds outperformed higher quality bonds and corporate securities were the best sector performers as investors continue to search for additional yield for their portfolios. Within the corporate sector, Industrials outpaced Financials followed by Utilities. High Yield bonds continued their impressive performance with the BofA/Merrill Lynch High Yield Master II Index returning 5.49% in the quarter resulting in an outstanding 15.32% return year-to-date.

We are very pleased to report that all of our composites witnessed strong performances versus their respective benchmarks. As we have discussed in previous quarterly commentaries, our overweight to the corporate sector has continued to benefit performance.

How we are positioning portfolios?

This past quarter the credit sector reported excellent returns across nearly all sectors and ratings categories as noted above. We remain convinced that the spread sectors offer long-term value in addition to adding a level of protection from slowly rising interests rates. The U.S. economy continues to "muddle along" and global economies, while still struggling, will not alone lead our economy into a recession. Clipping higher coupons provided by corporate bonds should result in superior portfolio performance over the long term, and our clients witnessed that first hand during the third quarter. While market fluctuations can cause short-term underperformance, our long-only style of investing in fundamentally sound companies has delivered positive results with reduced volatility over the long-term. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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