Welcome to Summer—Remain Alert!

Geopolitical risks continue to be at the forefront of capital markets worldwide. The launch of an intercontinental ballistic missile by North Korea and the incessant news coverage of Russian meddling in the U.S. election have risen to new levels in investors' minds. The latter has delayed much of the newly elected administration's agenda for the time present. A functional Legislative Branch will be required if pro-growth policies are to be implemented. Elections in France perhaps signaled some brewing opposition to recent political trends in the U.S. and Britain. Hopefully voters are tiring of partisanship's empty promises.

A potential catalyst for compromise (a dirty word in Washington these days) could ironically be the Affordable Care Act (ACA). Inaction will most likely result in ACA's demise. Republicans' inability to reach a consensus on "repeal and replace" may force moderates in both parties to compromise on a more sustainable version of Obamacare. Why is this important to fixed income investors? Not only do we invest in many healthcare companies on behalf of clients, the healthcare industry remains a large and important component of economic metrics, including consumer spending, inflation, and government spending. In this quarter's commentary, we will dive deeper into the healthcare dilemma.

The Federal Reserve's Duel Mandate

The Fed continues to work towards achieving the goal of full employment with price stability. So far in 2017, the Fed has maintained its tightening stance, raising the target Fed funds rate by 0.25% at both its March and June meetings. At her press conference after the Fed's June meeting, chairperson Yellen detailed the Fed's plan to reduce their holdings of Treasury and agency securities. While the timing of the plan's implementation has yet to be announced, we expect the Fed to begin reducing its balance sheet in the second half of 2017; in all likelihood with a September start. Yellen also stated that another rate increase this year, its third tightening move, is probable depending upon the evolution of data.

Inflation: Core PCE declines. Health Care Expenditure no longer a source of inflation...for now.

The Fed's preferred inflation indicator, the Personal Consumption Expenditures Core Price Index (Core PCE), is running noticeably short of the Fed's 2% target. After accelerating for much of 2016 and reaching a high of 1.8% in January 2017, Core PCE has fallen each month since, most recently reading 1.4% year-over-year in May 2017. The Fed believes this disinflation will be transitory, as evidenced by continued tightening in June despite signs of lower inflation.

Healthcare inflation, which accounts for nearly one-fourth of core consumer expenditures (excluding food and energy), has been an important contributor to disinflation recently. According to research by Deutsche Bank, for decades healthcare inflation ran as much as several percentage points above core inflation. But in the past six years, that gap has disappeared. Declining healthcare inflation has accounted for about half of the recent shortfall in Core PCE inflation relative to the Fed's objective of 2%. Their analysis suggests that government policy – most importantly the Affordable Care Act – has played an important role in depressing medical care inflation. This was done via the introduction of relatively stringent controls on the rate of increases in fees that could be charged on medical services paid for by Medicare and Medicaid. The effects of these controls were magnified by the expansion of Medicaid coverage under the ACA and increased Medicare enrollment resulting from demographic shifts. Healthcare inflation has also been held in check by private insurers' adoption of Medicare/Medicaid reimbursement schedules.

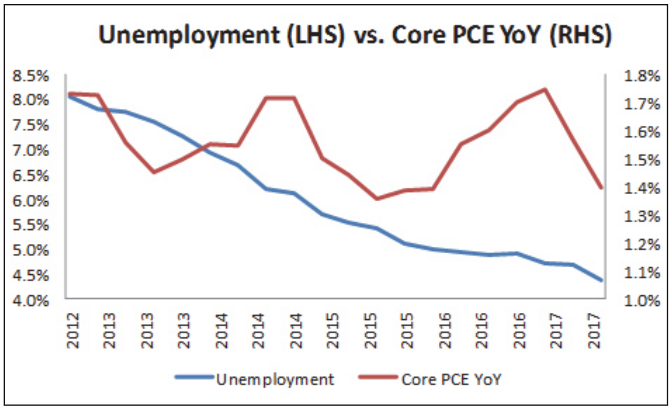
Looking ahead, assuming current health policy is unchanged, Deutsche Bank expects healthcare inflation to remain low in the near term, largely a result of the price caps and increased insurance coverage, among other factors. If the Centers for Medicare & Medicaid Services projections prove correct, rising healthcare services inflation could add a modest 0.2% to core PCE inflation in 2018. While odds of an ACA "repeal and replace" appear to have diminished of late, should this outcome be realized, the current bill before Congress suggests that healthcare inflation could continue to be repressed somewhat in the near term. The bill proposed so far appears to leave the ACA's price controls in place, presumably because of their restraining effect on the federal budget deficit.

Longer term, healthcare inflation will likely accelerate again. Government price controls, while restraining prices in the near term, could eventually impinge on supply. In addition, a more significant rollback of Medicaid as we enter the 2020s and the emergence of peak demands on the healthcare system from the baby boomer generation could put additional upward pressure on healthcare inflation. Despite the longer term pressure on inflation from healthcare, we do not anticipate Core PCE rising significantly above the Fed's 2% target any time soon.

Employment

Job growth has continued at a steady pace so far in 2017. Nonfarm payrolls have averaged monthly growth of approximately 176,000 for the first six months of 2017. This is close to the monthly average growth of 187,000 for the twelve months of 2016. The unemployment rate continues to decline, reaching 4.37% in June, at the lows reached prior to the last recession in 2008. Of note, however, the employment participation rate has stabilized at low levels, measuring 62.8% in June, just slightly higher than where we began the year.

If unemployment continues to fall and participation hasn't picked up significantly, why aren't we seeing more wage inflation? We believe demographics are mostly to blame as retiring baby boomers are being replaced in the workforce with lower earning millennials. Technology and productivity efficiency gains have also been contributing factors. While the Fed continues to assess disinflation as transitory, given the country's changing demographics, we believe it will take longer than expected for the historical relationship between unemployment and inflation to normalize.



Source: Bloomberg

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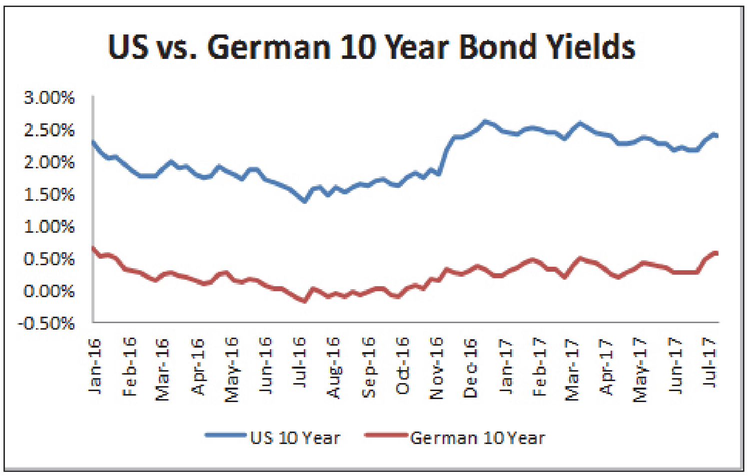
European Bond Sell-Off Ripple Effects

Recent comments by European Central Bank (ECB) President Mario Draghi set off a minor "taper tantrum" towards the end of the quarter, causing ripple effects on U.S. bonds and interest rates. While Draghi merely hinted at the possibility of the ECB being more hawkish and reducing its bond buying program, investors interpreted the comments as the first ECB step toward stimulus reduction. German 10-year bonds sold off and yields reached in excess of 0.5% for the first time since January of 2016. Yields on 10-year U.S. Treasury bonds increased to 2.39%. The removal of the "punch bowl" of bond buying and accommodation by both the Fed and ECB later this year is clearly a global tightening stance. Combined with additional rate increases this year as suggested by the Fed, global central banks may well be getting ahead of themselves by tightening too quickly. In our opinion, we wish the Fed would remain patient, measured, and data dependent before tightening too rapidly and choking off the modest expansion currently taking place.



Source: Bloomberg

It appears that Fed hawks are winning the ideological battle at this time and we suspect interest rates, in general, will drift higher in the short term. However, we anticipate that the U.S. Treasury yield curve will slowly flatten as short-end rates rise with continued Fed tightening and muted inflation expectations keep long-end yields from rising as much.

Another Good Quarter for Performance

Despite the Fed's on-going tightening policy discussed above, fixed income investors witnessed modest returns in the second quarter of 2017. The yield curve flattened as the 2-year U.S. Treasury yield rose to 1.38% from 1.26% during the quarter and the 10-year U.S. Treasury yield decreased to 2.30% from 2.39%. This curve flattening was the result of the Fed tightening with a lack of inflation evidence. The Barclays Capital U.S. Aggregate Index returned 1.45% in the second quarter. Corporate securities, as measured by the Bloomberg Barclays Corporate Index, returned 2.54% while Treasuries returned 1.19% in the quarter. Bonds with longer maturities performed better than those with shorter maturities and lower-quality securities outpaced higher-quality securities. The BofA/Merrill Lynch High Yield Master II Index gained 2.14% in the quarter.

Our strategy of carrying an overweight to corporate securities once again helped performance in the second quarter of 2017. All of our composites posted strong performance versus their respective benchmarks in the quarter. Our clients know we have structured all of the accounts with an overweight to the corporate sector as we want to take advantage of the slightly higher coupons offered in this sector as the economy slowly expands. We continue to believe this overweight in corporate bonds and the coupon advantage they offer remains the best opportunity in fixed income.

Ultimately, our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward tradeoffs in our portfolios. While market fluctuations can cause short-term underperformance, our long-only style of investing 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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