ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

JANUARY, 2017

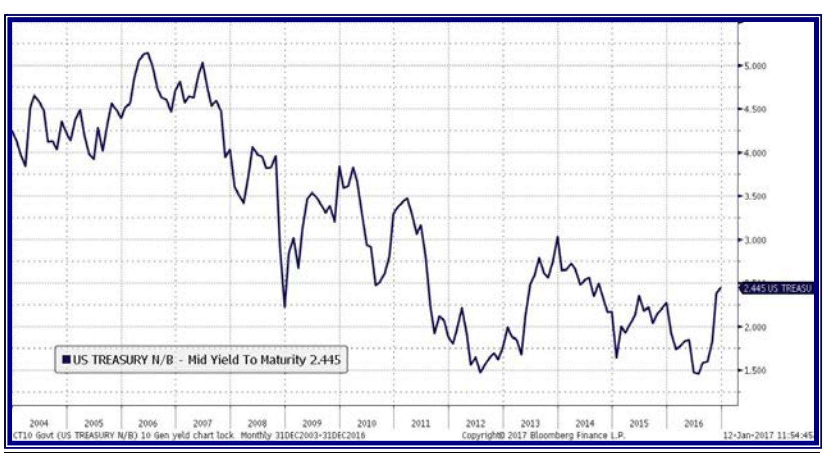
IN BRIEF: The U.S. Fixed Income Markets

Although the Federal Reserve was on hold, it was a very different tone this time around as the hawkish sentiment was blatantly obvious with three "nay" votes. It was the first time this has happened since December of 2014, with the first hike coming in 2015. One of the sticking points for the Fed is that it wants to see inflation closer to 2.00% before a second hike is justified. Interestingly, the committee does not see that level being reached until 2018 and has also decreased its GDP growth estimate to 1.80% from 2.00%. As a reference point, the post-crisis GDP estimate has steadily declined from 2.65% to the current 1.80%. Fed Chair Yellen noted that, "we are generally pleased with how the U.S. economy is doing", despite their estimates consistently being revised downward and/or stretched further out. For now, it appears the "hawkish hold" is one that continues to encourage data dependency and will be patient in both the timing and frequency of any future rate hikes.

Meanwhile, although the Treasury market continues to garner strong focus from both investment professionals and the media, it would be apt to remind readers how the credit markets are faring. U.S. domestic corporate credit continues its strong performance with impressive year-to-date gains, more than making up for September's back-and-forth. Spreads are roughly in line month-over-month and remain significantly lower than their levels from a year ago. Much of the performance in bonds is attributed to the duration effect (longer-dated bonds have outperformed shorter-dated) with the remainder due to the decline in overall credit spreads.

Despite the electoral-college victory for Donald Trump as the 45th President of the United States, markets could be at an interesting crossroads. We're watching as markets reconsider the post-election Trump rally, given the possibility that any benefits from new policy have already been priced into markets around the world. In the immediate aftermath of the election, domestic stocks rose alongside bond yields as many around the globe anticipated that Trump's mix of fiscal stimulus, tax cuts and other pro-growth policies would bolster the U.S. economic situation and lead to further prosperity. As is often the case, Wall Street strategists are recommending "buy the rumor, sell the news". The stock market now seem to be questioning Trump's ability to deliver on his promises. Recent confirmation hearings have given little evidence on this administration's agenda alongside some conflicting rhetoric from Trump himself. The catalysts for the recent rally are clear: tax cuts, regulatory rollbacks, infrastructure spending, inflation and job creation. There are many promises, and yet just a single press conference or negative geopolitical headline could derail market enthusiasm. We have taken the position that the markets could be volatile and the imbedded bullishness in equity markets could show signs of faltering and capping the downside risk of a 35-year bond market rally.

Ten-Year Generic Treasury Yield



Source: Altman Investment Management Research and Bloomberg

CLOSE-UP:

➢ Government Bonds

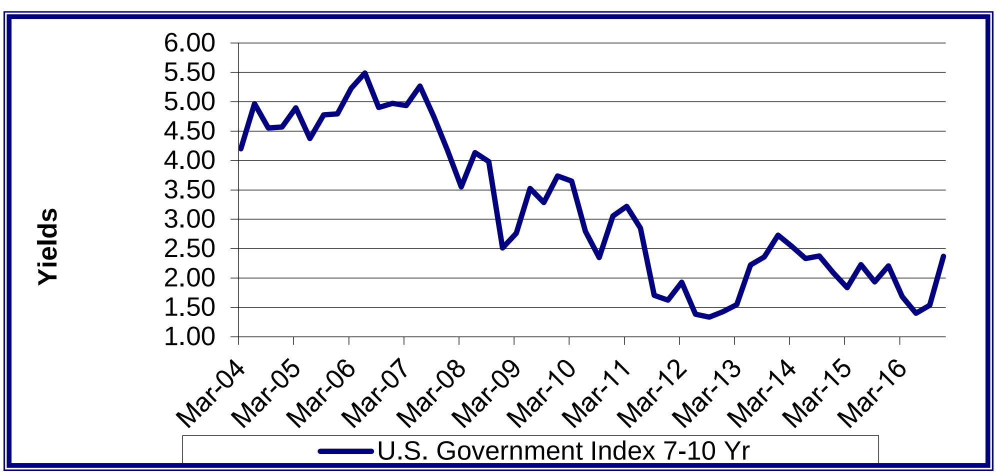
- Yields declined during the first half of 2016 in response to sluggish domestic growth in the first quarter, tepid global growth and uncertainty over Brexit and its impact on the European Union, Middle East unrest, terrorist attacks in Europe and ambiguity regarding the pending U.S. election. As depicted in the attached chart of ten-year Treasury yields, rates bottomed about midyear and then began a moderate reversal. The move to higher levels accelerated after President-Elect Trump's victory in November. The perceived prospect of a loosened regulatory environment, lower taxes and a pro-growth agenda developing under Republican leadership stimulated the equity market rally and a sharp rise in interest rates. The ten-year Treasury yield closed the year at 2.45%, up from a 1.37% low in mid-July.

- Despite uncertainty regarding the Trump administration's impact on the upcoming economic landscape, continued employment growth and a 4.6% unemployment rate emboldened the Fed and prompted a 25 basis point increase in the targeted Federal Funds rate at the December FOMC meeting. Combined with a prior 25 basis point move a year earlier in December 2015, the targeted Fed Funds range is now 0.50% – 0.75%, up modestly from the near zero level that prevailed for seven years from late 2008 to 2015.

Portfolio Strategy

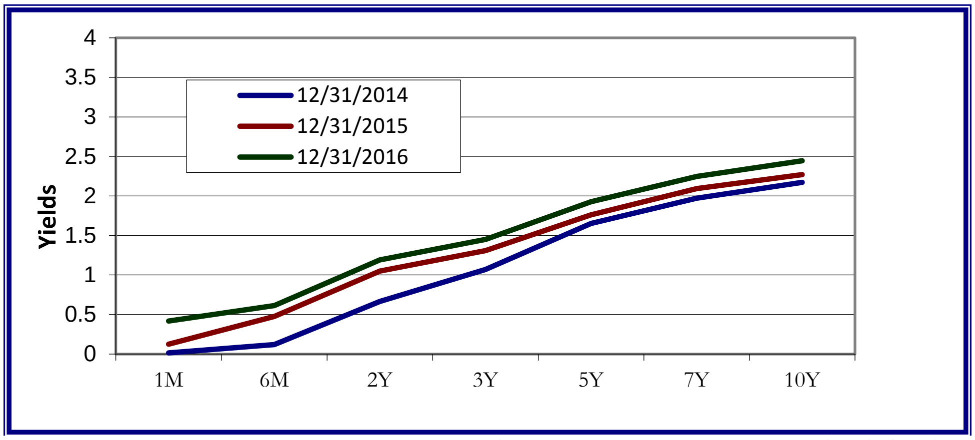
The environment we foresee in 2017 is a flattening curve and modestly rising rates. Our average maturity of 3.5 years in our fixed income portfolios results in a low relative duration and serves to dampen the impact of rising interest rates and typically produces strong relative returns compared to market indexes. Our exposure to longer term securities has been limited during the low rate environment over the past few years but we might be encouraged to take a second look along the curve to take advantage of higher prevailing yields as the year progresses. Portfolio durations are currently targeted at 2.5 years but still significantly (20%) below neutral. Keep in mind that the Barclays 5 Year GO Municipal Index had a negative 0.52% return.

U.S. Government Index 7-10 year



Source: Altman Investment Management Research and Bloomberg

Active Government Yield Curves



Source: Altman Investment Management Research and Bloomberg

Fixed Income Sector Performance – Q4 2016

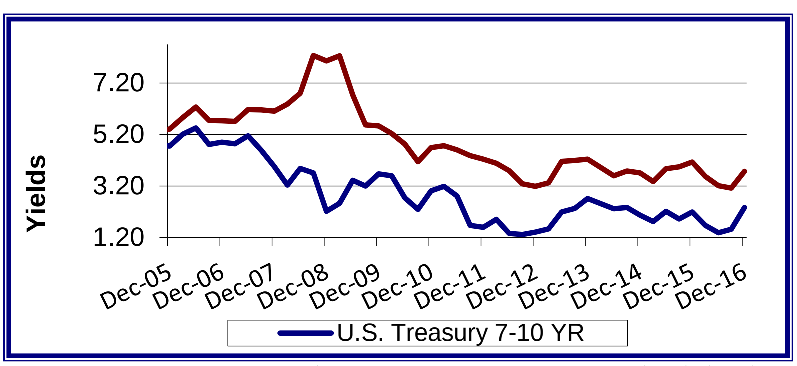
Fixed Income Sector Performance – 2016 Q4 - Sector	**Rating**	**Maturity**	**Duration Mod Adj**	**Yield**	**Spread**	**Price**	**Trailing1 12 Month Total Return**
Treasury	Aaa/AAA	8.7	6.2	1.9%	N/A	$102.5	1.1%
Agency	Aaa/AA+	4.9	3.8	1.8%	N/A	$104.5	1.5%
MBS	Aaa/AAA	6.4	5.4	2.8%	90	$103.7	1.7%
Municipal	Aa3/A+	4.6	3.5	1.9%	0	$109.2	(.1)%
Corporate (Intermediate)	A2/A-	4.9	4.2	2.9%	100	$102.0	4.2%
High Yield	B1/B	6.3	3.9	6.1%	420	$99.6	17.5%

Source: Altman Investment Management Research and Bloomberg

➢ Investment-Grade Corporate Bonds

As we continue through earnings season, companies continue to take advantage of the current "stable spread" environment. As spreads have remained fairly consistent since the beginning of January, companies that are willing/able to borrow are doing just that. Current month-to-date IG issuance sits at ~$194 billion, putting us on pace for a potential record-setting month. As with Treasury auctions, these primary market offerings dictate where corporate markets are priced.

U.S. Corporate 7-10 year versus U.S. Treasury 7-10 year



Source: Altman Investment Management Research and Bloomberg

➢ Municipal Bonds

Tax- free municipals trailed Treasuries in the third quarter after printing their first negative performance since June 2015, amid a heavy new-issue calendar and the seasonal transition to net-positive supply. Issuance of $35.7 billion represented the largest September supply on record. September supply was up over 50% versus 2015 and close to 30% higher than the 10-year average. The recently elevated supply, in our view, pulled deals forward to avoid uncertainty around the U.S. presidential election and the potential Fed rate hike in December. Meanwhile, demand for the asset class remained largely positive, though softer than the robust levels seen throughout most of the year. It was estimated that more than $51 billion was raised year-to-date (YTD). We would expect somewhat weaker flows are likely attributed to the turn in performance (as muni demand follows performance) and the unfounded fears of imminent rate hikes. The impact of the Fed's tightening is reflected in the rise in short rates in the fourth quarter and the recent flattening of the yield curve. The early December 240 basis point spread between one and thirty year prime tax-exempt yields (3.37 – 0.97) has subsequently narrowed to 198 basis points, as short rates have ticked higher while longer rates declined.

We continue to be positive on the asset class for its ability to provide tax-exempt income, low volatility and diversification away from equity and equity-like risk. We are also cognizant and cautious of weaker technical factors, with issuance likely to remain elevated following the election and demand muted if market performance is lackluster. That said, with the recent repricing of the market, any deluge of issuance may well represent a buying opportunity, as these negative dynamics are likely to fade as the first quarter matures. We maintain a shorter duration stance and a preference for A-/A3 or better credit quality.

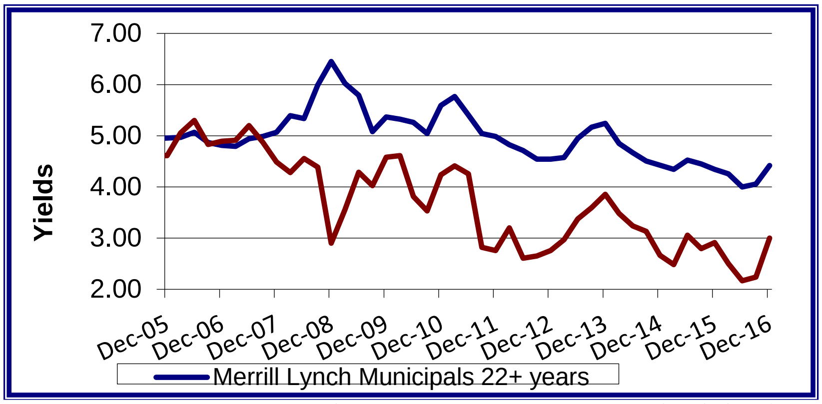
Interest rates in 2017

The year begins with the prospect of Mr. Trump's aggressive agenda combined with a Republican-controlled Congress eager to implement changes. We anticipate that governmental action early in the year will focus on reform/repeal of the Affordable Care Act, a Supreme Court justice nomination to replace Antonin Scalia, regulation reduction, immigration control and trade negotiations. Tax reform is anticipated to become a priority a bit later in the year with legislation clearing Congress in the fall.

Despite a flurry of legislative activity, the impact on the economy in 2017 is likely to be limited. We anticipate that 2.0%+ real GDP growth will continue for the most of the year and possibly longer. Labor costs are advancing in the low unemployment rate environment (plus 2.9% in 2016) and we anticipate additional modest increases. Energy costs should be reasonably contained, but inflation rates could drift somewhat higher. However, a sharp rise in the CPI appears unlikely in an environment of moderate global growth. Market volatility is likely to be with us and possibly some slight upward pressure on longer interest rates, but we doubt that the yield on the ten-year Treasury will exceed 3.0% on a sustained basis over the course of the year.

The short end of the yield curve will, as always, be impacted by Federal Reserve policy. Fed Chair Yellen has suggested that additional rate increases are on the table with as many as three moves over the course of this year. We anticipate that perhaps two tightening moves will take place. Federal Reserve action could pressure longer yields to some extent, but the primary impact of Fed tightening will likely be additional curve flattening.

Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

Tax Reform

As noted above, we expect that tax reform legislation will emerge from Congress sometime later in the year. President-elect Trump and House Speaker Congressman Ryan, with House Ways and Means Chairman Kevin Brady, have each provided outlines and consider tax reform a priority. Both plans would reduce the number of tax brackets from seven to three and a top 33% rate, down from the current 39.6%. Capital gains and qualified dividends would be taxed at lower rates in the three brackets under the Trump plan while the Ryan proposal has effective rates slightly higher. Both plans eliminate the 3.80% surtax on investment income and the alternative minimum tax. To compensate in part for lost revenue, both plans restrict deductions. The Trump plan limits deductions to $100,000 for single payers and $200,000 for joint filers. Mr. Ryan's plan eliminates all deductions except for mortgage interest and charitable gifts.

The tax reform proposals that have been put forth are unlikely to resemble ultimate legislation. Although some lowering of the maximum personal rate is likely, the resultant level is hard to predict. A few reasons are related to municipal budgetary constraints and municipal tax exemption implications on Federal government revenues. On the corporate side, lower tax rates would reduce corporate appetites for municipal ownership translating into somewhat higher rates, increased retail ownership of municipal securities and an increase in market volatility.

IN SUMMARY:

We maintain a cautious stance toward U.S. government bonds. First, we believe that inflation expectations are likely to increase over the next several months, especially if energy prices stabilize and health care cost continue to rise. Although it may take a few months for the trailing effects of the historical low rates to roll off, the Consumer Price Index (CPI) is likely to move higher and possibly even punch through the 2.0% threshold over the next several months. In addition to rising inflation expectations, any proposed infrastructure plans will likely be financed by long term debt.