ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

OCTOBER, 2017

IN VIEW: The Economic Landscape

Through the third quarter, the bond market has traded in a tight range with relatively low volatility all year. However, the economic variables and world events continue to aggravate investor anxiety. Longer term factors that are potentially impacting overall global economic growth - such as demographics or technological innovation - have been marginalized against conspicuous headlines associated with geopolitical fears of an imminent crisis. As governments deal with appropriate policies associated with what appears to be limitless radical or extremist elements coming from groups in Yemen, Syria, Iraq, Turkey and North Korea, coupled with radical Islamic fundamentalists and hate groups, investors have desensitized themselves to these headlines.

Our government seems to personify the divide between the establishment and the outsiders. This has had the effect of hindering the legislative agenda by either party. The central banks have not relinquished their hold either by ballooning balance sheets 5-fold and showing little appetite to address the long-term potential of crowding out investment. This story continues to be written by the world's G4 central banks: The Federal Reserve Bank, The European Central Bank, The Bank of Japan and The People's Bank of China. Since the U.S. Great Recession of 2007-2008, money has been created and has materially affected demand for financial assets. In 2005, the total assets of all four of these central banks combined was about the same as the current Fed balance sheet at $4.4 trillion. Today, the combined central banks' balance sheets (according to Bloomberg data) are roughly $19.4 trillion, a result of their quantitative easing programs. Three of these central banks continue to purchase assets on the open market at around $300 billion/month, with the Federal Reserve's balance sheet now the smallest of this group.

The FOMC's program of normalizing rates has been restrained in light of economic data that vacillates from growth to contraction. Concerns of a "bond bubble" with little inflationary pressure against a Fed balance sheet reduction program has added to investor uncertainty. And despite the noise, interest rates continue to appear directionless.

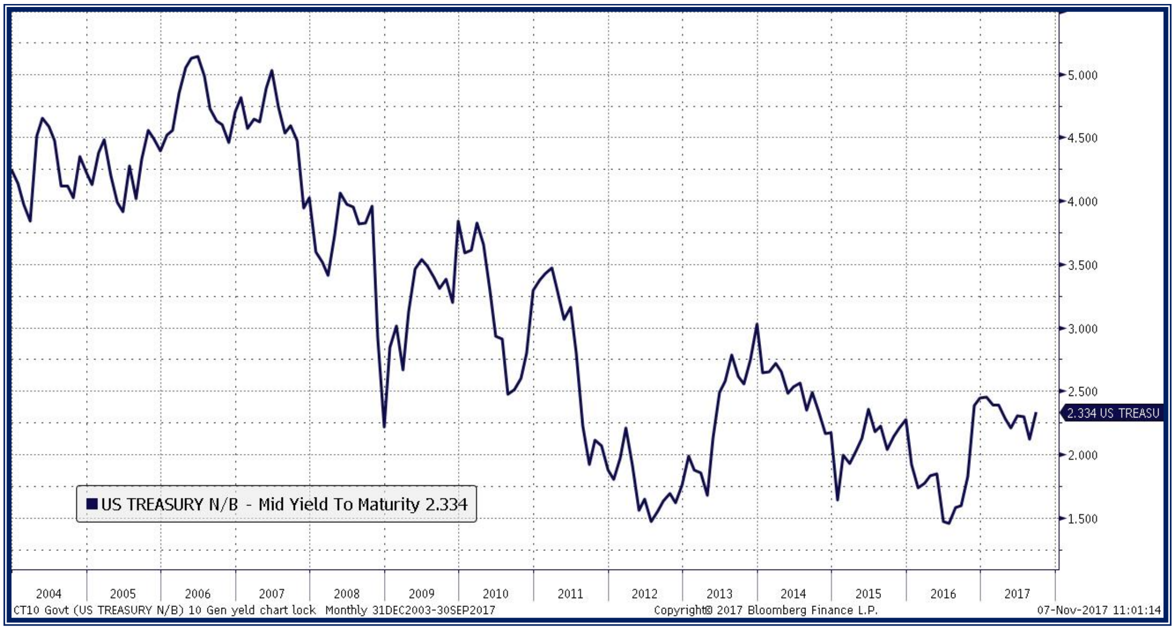
IN BRIEF: The U.S. Fixed Income Markets

Earlier in 2017, we thought that the U.S. Treasury yield would begin normalization, rising slowly absent any exogenous shocks, and that the Federal Reserve would hike rates at least two more times following an interim pause at mid-year. As we complete the year, the possibility that 10-year Treasury rates reach 2.45% appears likely. That would result in an essentially unexpected flat year for rates. This begs the question if interest rates are still in the process of normalization within a more typical economic cycle - or will they remain lower as a result of global deflationary forces overwhelming traditional supply and demand imbalances.

The biggest event during the third quarter affecting the fixed income markets was when the Federal Reserve announced the plan to unwind their 4.5 trillion balance sheet with the month of October as the implementation date. We would expect a strong correlation with higher rates on the shorter end of the yield curve and expanding balance sheet negatively impacting risk assets. Yet equity markets have risen almost in tandem with this phenomenon. One might easily surmise that if quantitative easing was good for risk assets in the past, then any attempt at tightening would be followed by a negative response in the equity markets as valuations (PE ratios) contract. However, investors do not seem to share these concerns because the plan is expected to be so gradual that the natural demand for government debt remains relatively strong, for both U.S. and foreign investors. The transparency of the Fed has alleviated much of the anxiety and uncertainty as to the path the Fed will follow in the rate normalization process.

We will continue to monitor markets, underlying inflation expectations and valuations in long duration assets. While we are not expecting a recession, any disappointments in economic policy, unexpected surges in interest rates or further evidence of subpar growth both domestically or globally could agitate risk premiums and warrant a defensive approach to fixed income markets.

Ten-Year Generic Treasury Yield



Source: Altman Investment Management Research and Bloomberg

CLOSE-UP:

Government Bonds

The movement in the U.S. Treasury during the third quarter was largely flat. The benchmark reached its highest level of 2.39% in early July, and then slid to as low as 2.04% before ending the quarter at 2.34%. The declining yield was fostered by low inflationary numbers, a potential government shut down and geopolitical tensions particularly with North Korea. September culminated with Fed rhetoric that was more hawkish increasing the likelihood of another hike in rates by year end. This resulted in a sharp selloff in the UST, and spreads between the 5-year and 30-year flattening to under 100 basis points.

The largest yield declines were in early September, coincident with Hurricane Irma and North Korea continuing to flex its muscles by launching another round of missile. The biggest yield increases were followed by the absence of downgrades associated with damage caused by Hurricane Irma, lack of follow through by North Korea, and the announcement by the GOP of an imminent tax cut plan being introduced before year end.

The fourth quarter has begun with a continuation of yields increasing across the Treasury curve. Since December of 2016, the Fed has hiked interest rates 25 basis points (bp) three times: December, 2016; March and June, 2017. Despite the 75bp net move, even the short-end of the Treasury curve has only mustered a 60bp year-to-date increase while the long-end of the curve still remains slightly down in yield. (One basis point = 1/100th of a percent)

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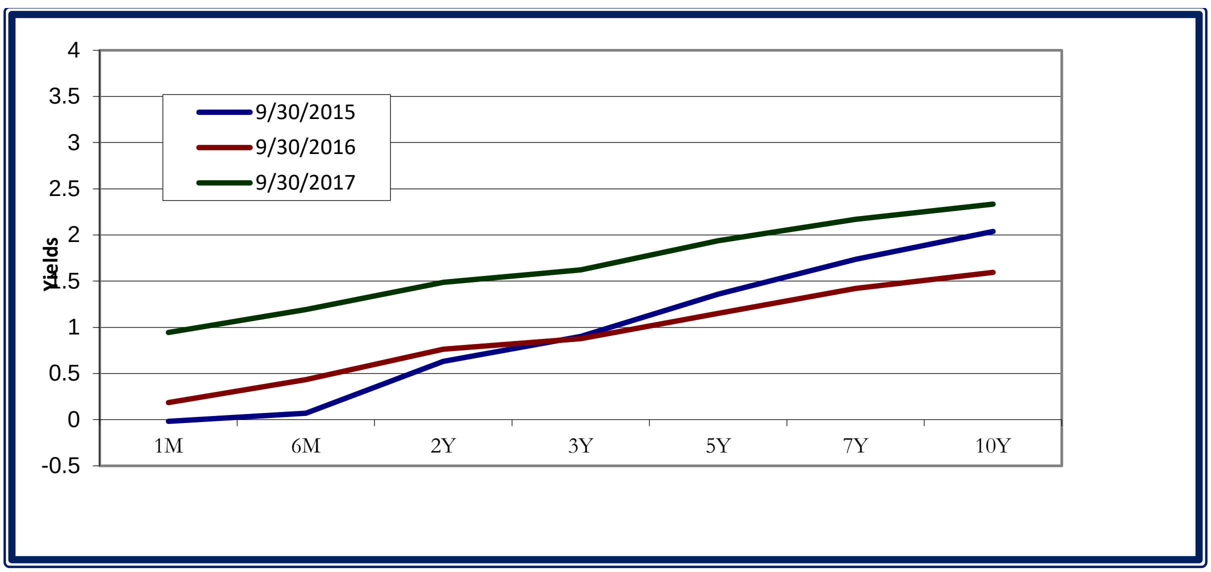
U.S. Government Index 7-10 year

Source: Altman Investment Management Research and Bloomberg

Active Government Yield Curves



Source: Altman Investment Management Research and Bloomberg

Investment-Grade Corporate Bonds

The U.S. Investment-grade market continues to be supported by strong technical and improving fundamentals. Spreads tightened (Bloomberg Barclays U.S. Credit Index) as much as 100 basis points relative to similar durations in the Treasury market. The Index was up 1.35% in the quarter, but sold off in September as higher yields offset tighter spreads.

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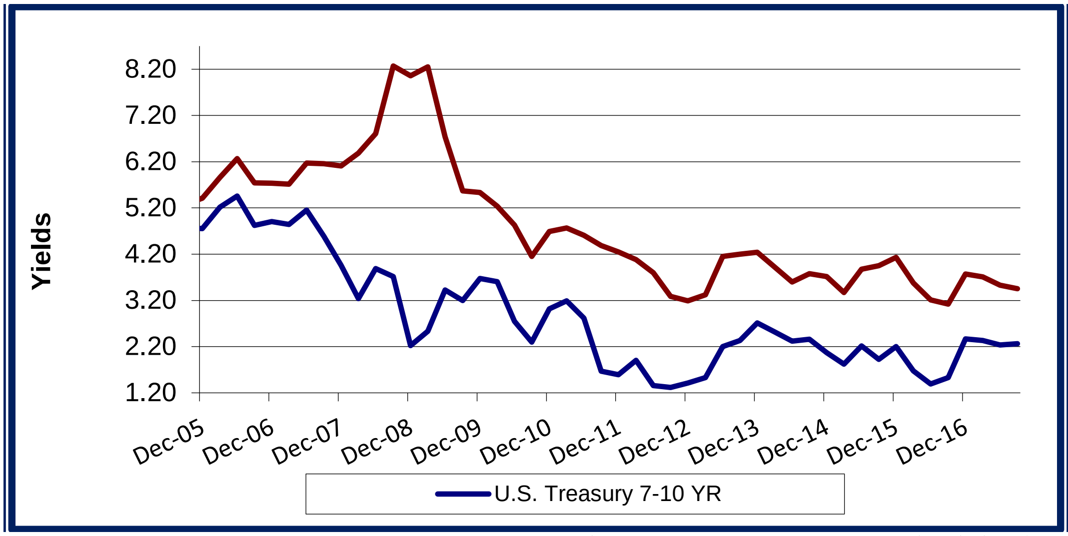
U.S. Corporate 7-10 year versus U.S. Treasury 7-10 year



Source: Altman Investment Management Research and Bloomberg

Municipal Bonds

Following the pattern of the first half, tax-exempt new issuance was again muted in the third quarter. Year to date supply totaled $280 billion, down approximately 16% from last year. Some increase in supply is anticipated in the fourth quarter, but with limited refunding activity we expect new issuance to continue to lag 2016 levels.

Hurricanes Harvey and Irma resulted in serious damage to the Houston area and many parts of Florida. Despite the severity of these storms, most areas should recover in the coming months as federal relief funds coupled with state support and insurance payments provide funding for rebuilding. The price impact on strong Houston area and Florida municipal bonds has been minimal.

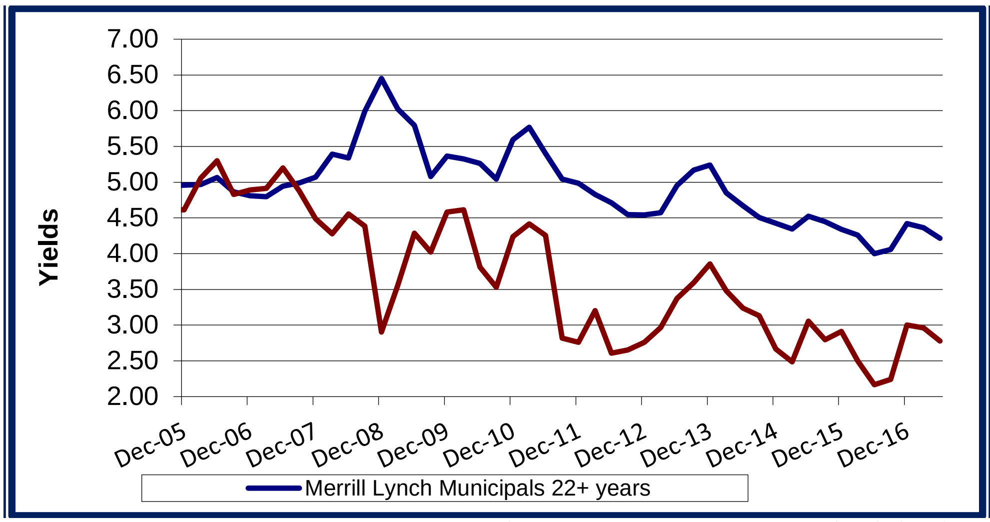
The extent to which casualty insurance companies are impacted by claims related to these storms remains to be seen. These providers may be prompted to shed some municipal holdings in their investment portfolios in response to reduced profitability. Given limited municipal new issuance, any incremental supply in the secondary market should likely be absorbed.

The impact of Hurricane Maria on Puerto Rico is a different story. Most of the island remains without power and many areas without fresh water. Destroyed homes, and wrecked bridges, mud slides, etc. will require massive funding to rebuild. FEMA and the military are providing relief efforts but recovery is expected to be extremely protracted and encumbered by Puerto Rico's limited financial reserves and lack of access to the capital markets. The population in Puerto Rico has declined an estimated 11% since 2004, and that rate of exodus is expected to accelerate as residents migrate to the continental U.S. It has been estimated that an additional 500,000 residents, out of 3.4 million, might opt to relocate.

On the financial side, creditor/debtor issues in Puerto Rico will be set aside for an extended period as recovery efforts take precedence over consideration of the island's debt obligations. With creditor negotiations on hold, Puerto Rico securities have been hardest hit. It was recently reported that the Commonwealth's benchmark 8.0% general obligation bonds due in 2035 traded in the low 30s. After visiting the island, President Trump suggested that Puerto Rico's debt should be "wiped out". We believe the feasibility of such action is questionable.

Demand remains strong as the fourth quarter unfolds. Mutual fund inflows have been robust as has buying by individuals. In addition to investor demand for income and safety, strong stock market gains have skewed equity/fixed portfolio ratios prompting allocations to bond investments as accounts are rebalanced. Divergence from Treasuries on the intermediate end of the curve led to lower muni-Treasury ratios, which now sit at 82.5%. The new issue market remains active. Recently, the following issues in the investment grade space have come to market successfully: NYC Water Finance Authority (Aa1/AA+/AA+) had a $400 million combined water and sewer revenue bond issue; The Illinois State Highway Authority had a $300 million toll-backed senior revenue deal, with ratings of Aa3/AA-/AA-. Both deals were oversubscribed. On the competitive front, Washington State plans to sell $505 million of general obligation refunding bonds --- rated Aa1/AA+/AA+.

Long Term Municipal to Treasury Spreads



Source: Altman Investment Management Research and Bloomberg

THOUGHTS ON PROPOSED TAX PLAN:

The new tax reform framework should ultimately bode well for municipal bond performance. The proposed elimination of the exemption for advanced refunding and private activity bonds would limit future municipal issuance, while an unchanged top individual tax rate of 39.6% and fewer tax shelters should broadly increase demand for the asset class. Additionally, the curtailment of the deductibility of state and local taxes would further increase state-specific municipal demand from investors in states with high tax rates.

A lower corporate rate would reduce the incentive for banks, casualty insurers and other corporate entities to hold tax-exempt securities. Any diminished demand from these buyers would likely be absorbed by mutual fund and ETF portfolio managers and by individuals. However, lower personal rates could prompt modest upward yield adjustments on tax-exempt securities to recalibrate comparisons with taxable rate levels.