Fourth Quarter 2017

The Strategist's Corner

Scouting for Yield

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Inside this Issue

"Most risky asset classes have had a nice run of continuing gains since the lows of the Great Recession."

It is the beginning of a new year and investors have harvested and are enjoying the bountiful crop of returns from 2017. Farmers will turn to the Old Farmer's Almanac to get a long-range weather outlook for the upcoming planting season. Investment professionals will commit to many interest rate and sector return projections to assist in navigating the upcoming investment environment. Brothers, Randolph and Mortimer Duke would be looking to get an early peek at the USDA Crop Production Report.

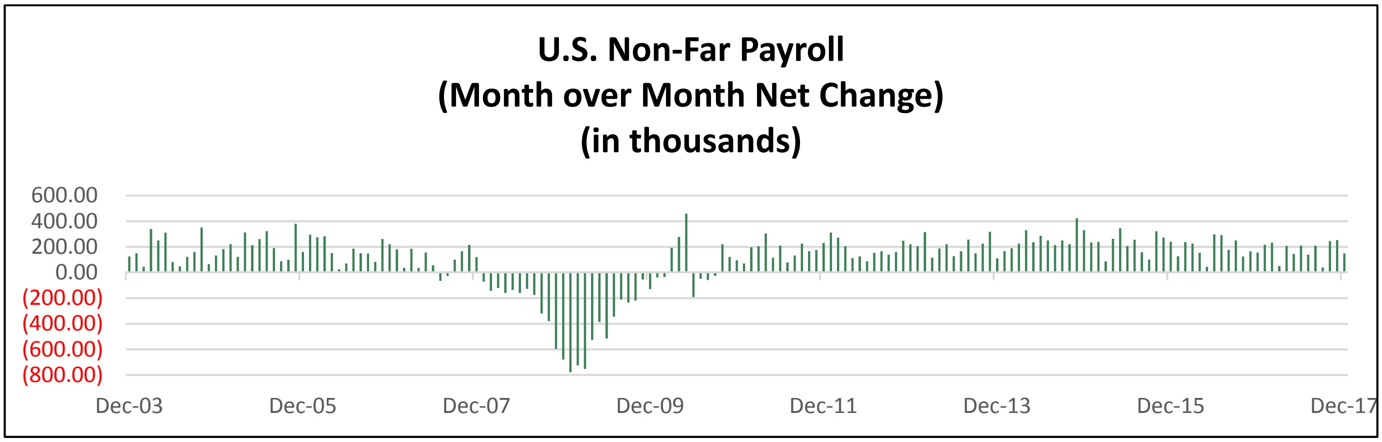
My grandfather was an eastern North Carolina farmer that planted corn, soybeans and tobacco. Also, my late father in-law was a farmer and cattle rancher. I enjoyed coming down from Maryland during my pre-teen summers to work on the farm, drive the tractors, go with him to the feed store and attend crop auctions. I did not enjoy cropping tobacco. Crop production is a massive investment for farmers. Protecting this investment requires keeping a close watch on what is going on in the fields throughout the growing season. This inspection process is called crop scouting. Yield losses resulting from chewed foliage, missing plants, weeds, or discolored foliage can be reduced by a carefully planned crop scouting process. Timely identification of insect or wildlife damage, effectiveness of herbicide treatments, and nutrient (fertilizers) deficiencies in plants is vital in reaching maximum yield potentials in row crops.

In the science and art of agronomy, it's important to understand the characteristics of the soil and how it interacts with the growing crop: what nutrients the crop needs and when and how to apply these nutrients; the ways that crops grow and develop; how climate and other environmental factors affect the crop at each stage; and the best way to control weeds, insects, fungi, and other pests.

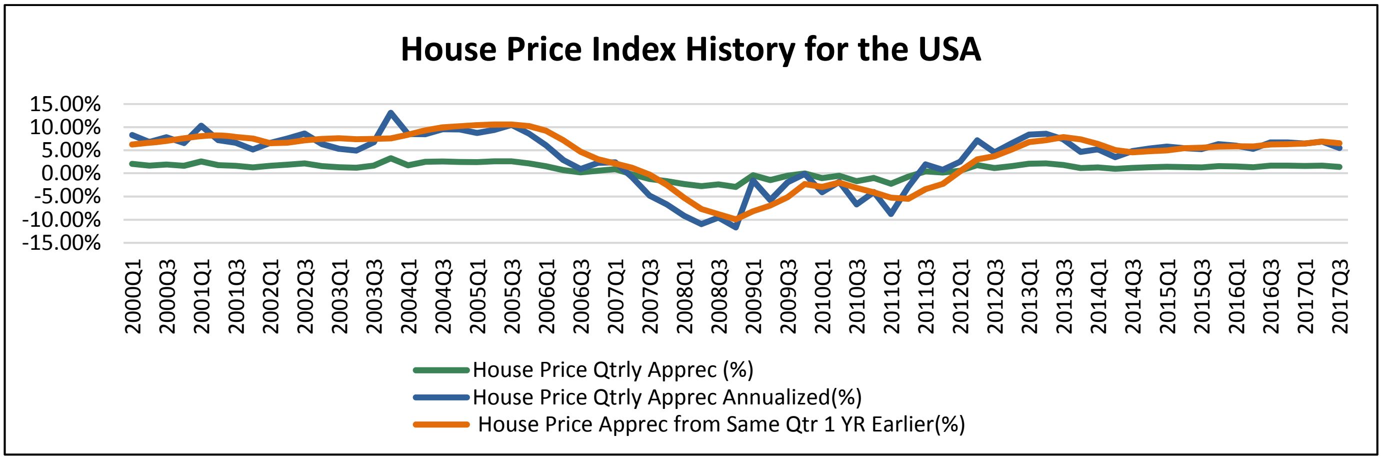
Growing high-yielding crops requires relationships amongst a vast number of fields, including the traditional soil, plant, and weed sciences, as well as related disciplines such as ecology, entomology, climatology and economics. Investment management is a collaboration of many related disciplines including finance, investments, mathematics, statistics, risk management and economics.

Most risky asset classes have had a nice run of continuing gains since the lows of the Great Recession. Stretched valuations leave little margin for error - be it on the economic, legislative, global, monetary, or earnings fronts. It is time to think about rotating into and out of various sectors and industries. Step-ups, floating rate and high yield securities are notable structures for rising interest rates.

Please see "Crop" on page 4



Source: Bureau of Labor Statistics



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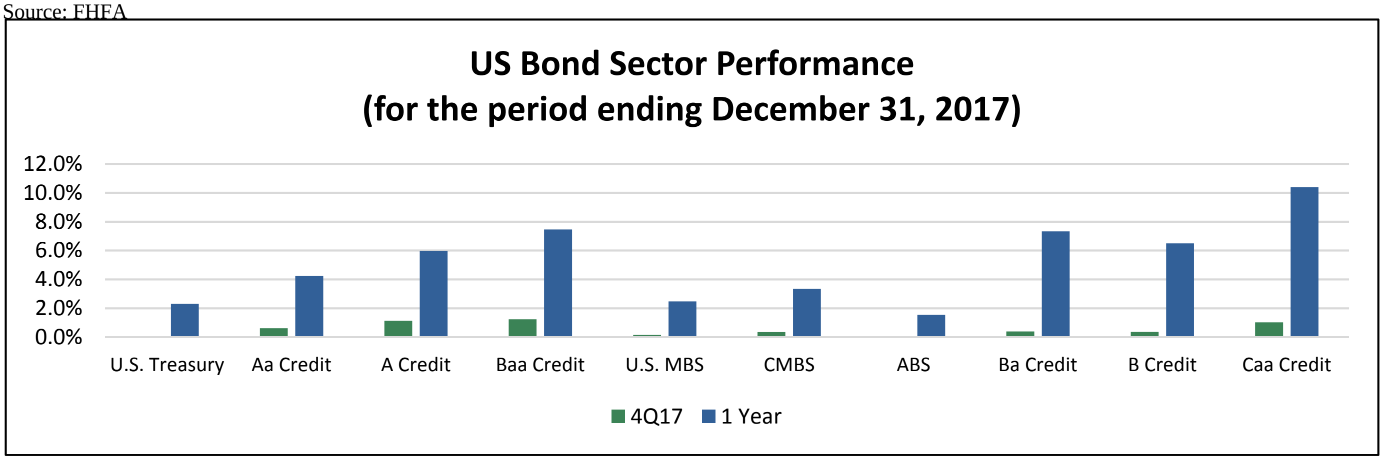
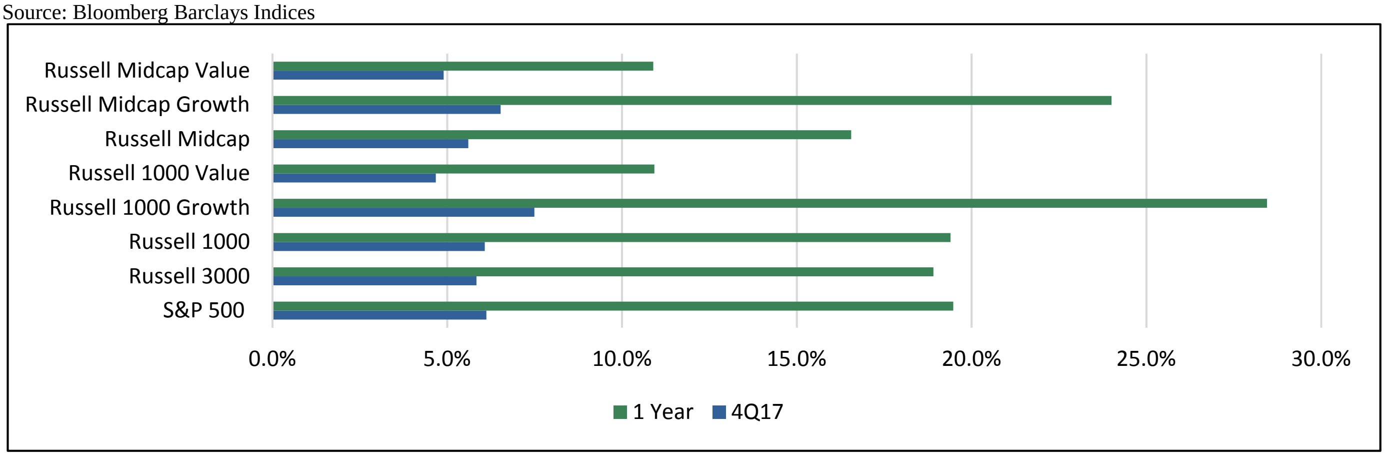


Source: Bloomberg Barclays Indices



Source: Bloomberg

Review and Outlook

The U.S. stock market concluded the year with a strong 4th quarter. The S&P 500 was up nearly 7% during the quarter, achieving its 9th quarterly advance. Information Technology was the best performing equity sector returning over 39% for the year and nearly 10% for the quarter. Recent stronger than expected data show that employment, manufacturing and non-manufacturing are doing well. Consumer confidence and new home purchase mortgage applications are solid as supply continues to struggle to keep up with demand.

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The Federal Reserve raised the target range for the federal funds rate 25 basis points to 1.5% in December, but left its outlook unchanged. It predicts the tax cuts will boost the economy next year, but with no lasting benefit. The Fed seemed to think that there will be minimal impact from the tax cuts, so they are keeping their forecast of three additional interest rate hikes in 2018 and 2019 unchanged. The Fed expects interest rates to reach 3.1% in 2020, slightly above the 2.8% "neutral" rate they expect to maintain in the long run.

The major domestic fixed income indices struggled to produce positive returns numbers for 4Q2017, given the 29-basis point increase in yield on the 5-year Treasury. The U.S. Aggregate index improved 0.24% during the quarter. High yield bonds posted positive returns while investment-grade debt also gained during the fourth quarter, according to Bloomberg Barclays Capital indices. The total returns from corporate high yield were 0.42% for the quarter, while returns from investment-grade corporate debt produced total returns 1.02%. High yield debt is rated below Baa3 by Moody's Investors Service and lower than BBB- by S&P.

The 2-year Treasury yield climbed 41 basis points while the 10-year Treasury yield increased 10 basis points during the quarter to yield 1.90% and 2.43% for the period, respectively. Utilities and Industrial were the best performing sectors within the U.S. Aggregate index. The two sectors returned 1.83% and 1.26%, respectively, for the quarter. U.S. Treasury bonds produced total returns of -0.13%. Baa bonds were the best-performing investment-grade credit quality during the fourth quarter, posting a 1.18% gain. Independent Energy, Oil Field Services, Refining and Electric Utility were the best performing industries within the high yield corporate sector.

The Bloomberg News monthly survey of bond yields – which includes input from more than 60 economists – forecasts that U.S. Treasury 10-year yields will decrease to 2.86% in 4Q2018 and then rise to 3.01% in 4Q2018. All the yields are less than the forecasted yields of the November survey. After putting up gains of 3.1% and 3.3% in the second and third quarters, respectively, economic growth seems positioned to top 3% in 4Q2017.

Future gains in the equity market will be more difficult to come by in the new year. Rising interest rates could make things more perplexing for the various bond markets. Investors should look for periodic selloffs despite a constructive outlook for the U.S. economy. We will continue to manage portfolios that tend to exhibit less volatility than their relative index and strive to deliver attractive risk-adjusted returns. Our portfolios are designed to perform over a full market cycle with a focus on downside risk, a style we believe will succeed over the long term.

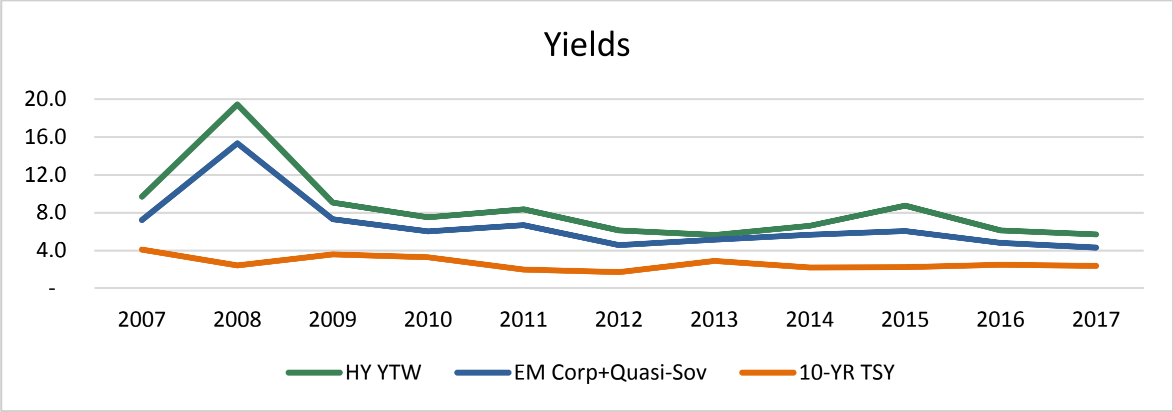
"Crop" from page 1

I like to follow the relationship between high yield credit in the U.S. and emerging market credit spreads when I think we are approaching a major turning point in the direction of the markets. In 2007, it was the widening of spreads from late September while equity and commodity markets were still rallying that would suggest underlying fragility and deteriorating economic conditions. This is my portfolio "crop scouting".

Corn is a superior rotational crop for peanuts, tobacco, cotton, soybeans, vegetables and other crops. It can be an important part of an integrated pest management program for several crops on a farm. Interestingly, we are now starting to see a similar separation surface between U.S. equity and U.S. high yield markets, and between EM debit and high yield markets as we saw back in 2007. Sector rotation is usually a good thing for a bull market. Over cropping is the reason for crop rotation; it can exhaust the soil and lead to unbalanced conditions that put future yields at risk. High yield bonds provide diversification and income to portfolios. It is a superior rotational asset class that provides some protection against rising interest rates.

"Generous excess yields for emerging market debt are not germinating."

Chart 1



Source: Bloomberg Barclays Indices

Chart 1 shows that the incremental yield over the 10-year treasury continues to decline. Generous excess yields for emerging market debt are not germinating. The continuing strength of participates joining in on the feast of previous performance is weathering the need for caution in participating in emerging market debt.

Table 1: Annualized Return from 2008-2017

	EM USD Aggregate	U.S. Treasury 1-3 Year	U.S. Aggregate	U.S. High Yield	Russell 2000	S&P 500
Annualized Return	6.56%	1.47%	3.99%	8.07%	8.83%	8.45%
Standard Deviation	10.25%	1.17%	3.25%	10.63%	19.98%	15.14%
Sharpe Ratio	0.61	0.97	1.12	0.73	0.43	0.54
Sortino Ratio	0.79	2.02	2.05	1.06	0.62	0.77
Range	-29.97%	-2.63%	-6.10%	-28.01%	-36.26%	-27.72%
Minimum-Monthly	-20.55%	-0.89%	-2.37%	-15.91%	-20.80%	-16.79%
Maximum-Monthly	9.42%	1.74%	3.73%	12.10%	15.46%	10.93%

Table 1 indicates that the annual returns for the high yield index is between the U.S. aggregate and the equity indices. High yield bonds typically exhibit equity-like returns with lower volatility than stocks.

Farmers know scouting for insects is an important part of best farm management practices and helps to minimize yield losses. But what do experts recommend in terms of the financial markets? Industry rotation, sector rotation and correlations are some of the tools of choice for harvesting fixed income returns. These tools are like a combine harvester, in that it combines several jobs into a single machine (process). A green thumb does not help much in managing money, but a Midas touch won't hurt!

Chart 2 shows how the percentage of each high yield industry weighting contributions have changed over time. Energy, technology and capital goods have systematically gained index weighting at the expense of utility, other industrial and transportation. The index asset shift could be a market move towards capital-appreciating growth investments. Growth categories are necessary if institutional investors want to meet return objectives in this low interest rate environment.

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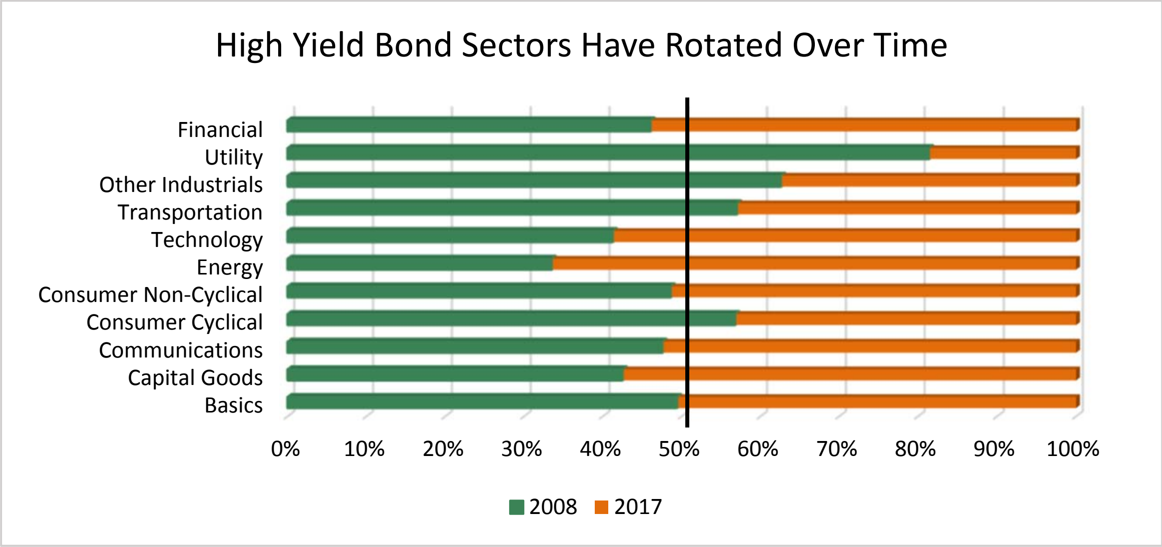
Chart 2



Source: Bloomberg Barclays Indices and PIA

Are your 2018 expectation projections reasonable? A bumper crop last season does not mean that one can plant the same crops or use the same asset allocation to obtain healthy yields and returns this year. A lower return environment can lead some to add more fertilizer or take on more risk. Public pension plans continue to reduce their assumed rate of return as the result of decreased future return expectations. Investors may want to consider a sizable plot allocated to high yield bonds over the next few years. I believe there is greater risk in the equity market than the bond market at current levels. This equity bull market (one of the longest in history) has removed a lot of nutrients from the soil. That is just one reason you don't want to plant a large amount of equities in the same place multiple years running.

Table 2 shows the asset correlations for various asset classes. High yield bonds do not look like other bonds. They don't necessarily act like other bonds. This insight can have important implications for how investors consider them in an overall portfolio. High yield performance patterns do not follow those of other fixed income sectors very closely over the long term. As with farming, these correlations aren't constant; they fluctuate markedly over time.

Table 2

Asset correlations for period 01/01/2008 – 12/31/2017 based on monthly returns

Name	ID	EM	TSY	AGG	HY	RUSS	S&P
Bloomberg Barclays EM USD Aggregate	EM	-	-0.03	0.56	0.80	0.53	0.62
Bloomberg Barclays U.S. Treasury: 1-3 Year	TSY	-0.03	-	0.54	-0.33	-0.37	-0.35
Bloomberg Barclays U.S. Aggregate	AGG	0.56	0.54	-	0.25	-0.06	0.04
Bloomberg Barclays U.S. High Yield	HY	0.80	-0.33	0.25	-	0.69	0.72
Russell 2000	RUSS	0.53	-0.37	-0.06	0.69	-	0.91
S&P 500	S&P	0.62	-0.35	0.04	0.72	0.91	-

Source: eVestment, Bloomberg Barclays Indices and PIA

"In such an ecosystem, companies issuing high yield bonds could see a continuation of the low default rate environment."

Table 2 illustrates the correlations between high yield, emerging markets, U.S. aggregate, Russell 2000, S&P500 and 1-3 year treasury indices. The high yield and emerging market indices are highly correlated. Those indices are also moderately correlated with the S&P 500. The U.S. aggregate is the most sensitive to changes in short interest rates.

A rapid increase in interest rates could cause high yield to underperform equities. Tighter spreads can make valuations less compelling, and might moderate returns in the short run. But they do not diminish a high yield strategy's ability to diversify portfolios and improve the consistency of returns over longer time frames.

Rising interest rates pose no major threat to high yield bonds. Rising interest rates can be beneficial. Interest rates rise in response to an improving economy, which boosts earnings for most corporates. In such an ecosystem, companies issuing high yield bonds could see a continuation of the low default rate environment.

According to the Old Farmer's Almanac 2018 Long Range Weather Forecast for the Southeast, winter will be warmer and rainier than normal, with below-normal snowfall. Temperatures will be near normal in the south and below in the north. Summer will be slightly hotter than normal, on average, with above-normal rainfall. Overall, September and October will be warmer and drier than normal. Watch for a tropical storm threat in early to mid-September. Changes in the weather gives farming its own economic cycles, often unrelated to the larger economy.

The latest United Nations Intergovernmental Panel on Climate Change report, stated that warming temperatures will reduce global agriculture yields more than 2 percent every decade, given current trends, as the world's population surges to 9 billion. This does not address the challenges of immigration and exporting policies. A farmer must be as nimble as a small asset manager regarding uncertainty about future farm and economic policies.

Whether we are impacted by flood or drought or by calm versus volatility, a higher impulsive economy driven by fiscal stimulus could generate greater dispersion in winners and losers and more relative value opportunities in farmland and high yield credits. Anticipating, nurturing, cultivating and preparing for what is to come is one of the most delightful things about managing money and farming.

To see things in the seed, that is genius. - Lao Tzu

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Credit risk. Credit risk refers to an issuer's ability to make payments of principal and interest when they are due. Bond prices typically decline if the issuer's credit quality deteriorates. Lower grade securities may experience high default rates, which could mean that an account may lose some or all of its investments in such securities. If this occurs, the account's value would be adversely affected.

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