Fixed Income Strategy Market Update

May 31, 2018

Intended for Institutional Investors Only – See Important Disclosures Below

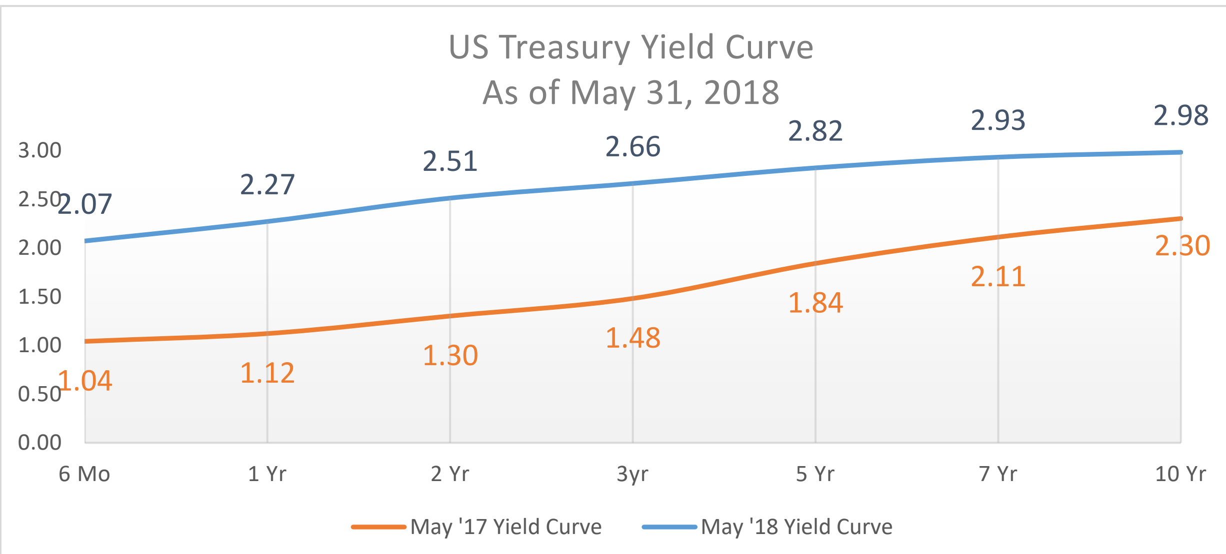
Domestic Rates: Government

United States Treasuries, Agencies, and Municipals

Tenor	US Treasury		US Gov't Agency		SC Municipal		
6 Mo	Const Mat 6M	2.08%	USD Govt Ag 6M	2.09%	SC Muni BVAL	6M	1.55%
1 Yr	Const Mat 1Y	2.23%	USD Govt Ag 1Y	2.26%	SC Muni BVAL	1Y	1.67%
2 Yr	Const Mat 2Y	2.40%	USD Govt Ag 2Y	2.50%	SC Muni BVAL	2Y	1.81%
5 Yr	Const Mat 5Y	2.68%	USD Govt Ag 5Y	2.78%	SC Muni BVAL	5Y	2.04%
7 Yr	Const Mat 7Y	2.78%	USD Govt Ag 7Y	2.93%	SC Muni BVAL	7Y	2.24%
10 Yr	Const Mat 10Y	2.83%	USD Govt Ag 10Y	3.12%	SC Muni BVAL	10Y	2.49%

Current Rates:

Source: Bloomberg indexes – Treasury H15T, Agency BVSUG, and GA Municipal BMSTSC as of 5/31/18



Current Yield Curve:

Source: St. Louis Federal Reserve FRED Database

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RATES COMMENTARY: FED PAUSE

On May 2, 2018 the Federal Reserve took a pause in its rate hiking cycle. The benchmark ten-year treasury rate rose during the two weeks following the FOMC meeting to a high of 3.115%, but has subsequently declined 2.822% at month end. We believe the rally was largely a result of the large spreads between German bunds and US bonds. The fed funds futures market anticipates that the Federal Reserve will once again raise rates, but at a slower rate with an implied rate of 1.822% rate for June and 2.10% by November and 2.41% by June 2019 before slowing still further to 2.60% in March of 2020 and 2.63% by December of 2021. We continue to view the fed funds rate as accommodative, but believe a move above 2% will proof restrictive over time. Current inflation measures are running well above 2% and have consistently registered above this threshold since the 2016 election, however, the 10-year realized inflation rate still clocks in at a paltry 1.5%. The Taylor Rule estimates argue that the neutral Fed Funds rate should be in the 4.90% region, however, we believe the low level of spreads suggests market participants anticipate that this tightening cycle should begin to bite at some point during 2019. In fact, 3 year rolling returns for most maturities are now below the 3 year rolling returns on T-Bills, which is a common feature towards the end of rate hiking cycles. From this point forward, we believe the risk to duration is lower than many market participants currently believe, particularly when viewed over the horizon of the security. **Over long periods of time, the Federal Funds rate and inflation rates have generally tracked each other. This relationship, which had broken down during the Federal Reserve's extended Q.E. policies has essentially normalized as of the end of February, and we believe will continue to normalize as the Fed chases shorter term inflation readings.** The market is currently forecasting just an additional 40 bps of tightening this year, whereas just a month ago the Fed and market participants were discussing at least three additional hikes in 2018. We are increasingly concerned that the political nature of the Fed is leading to a third asset bubble in the stock market.

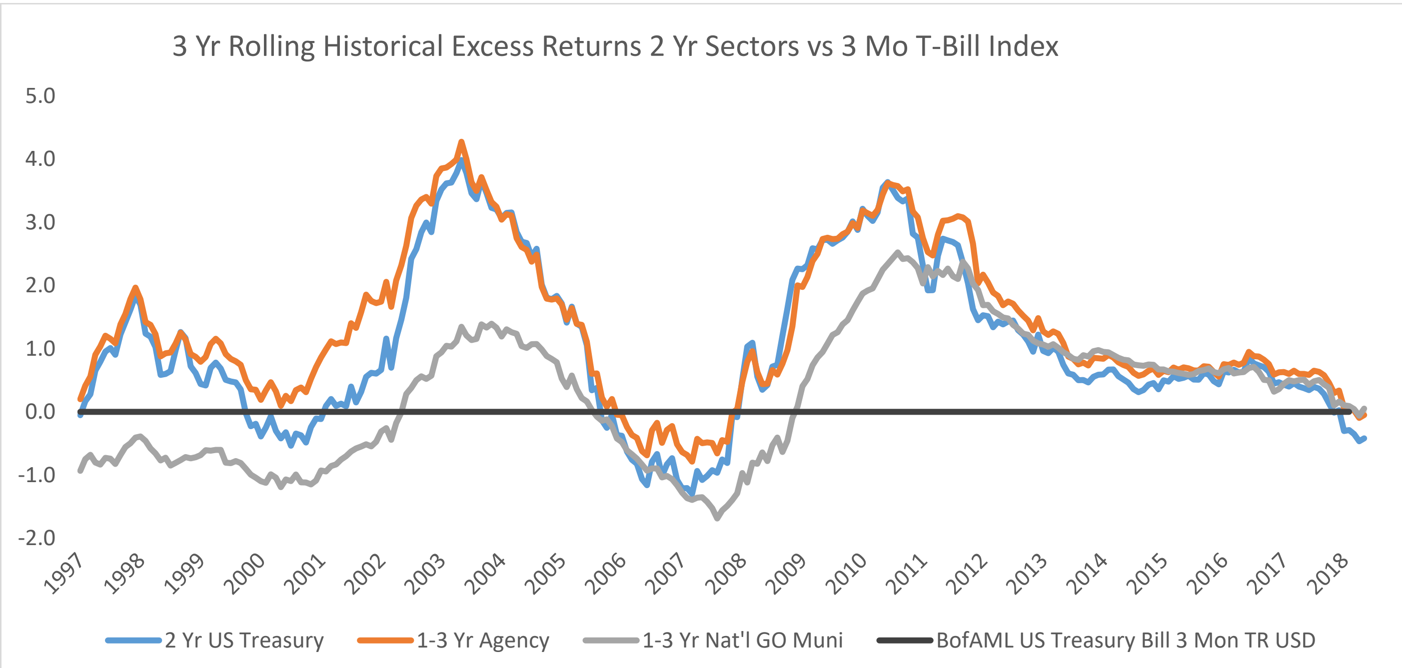
KEY RISKS:

Risk to our view include 1) higher than anticipated inflation 2) political risk 3) unexpected currency risk and 4) municipal credit risk.

2 Yr. Sector: Historical Returns and Spreads:

2 Year	Current Rate	Historical Return	Current Spread	Historical Spread	Current Spread as % of Return	Hist Spread as % of Return	Std Dev
2 Yr US Treasury Index	2.43%	2.96%	0.73%	0.92%	30.01%	31.12%	1.63
1-3 Yr Agency Index	2.44%	3.27%	0.74%	1.24%	30.27%	37.76%	1.42
2 Yr Nat'l AAA GO Muni	1.78%	2.43%	0.07%	0.39%	6.41%	16.18%	0.87
3 Month T-Bill Index	*1.46%*	*2.04%*	*0.00%*	0.00%	*0.00%*	*0.00%*	*0.62*

Source: Bloomberg as of 5/31/18



Source: Morningstar Direct as of 5/31/18

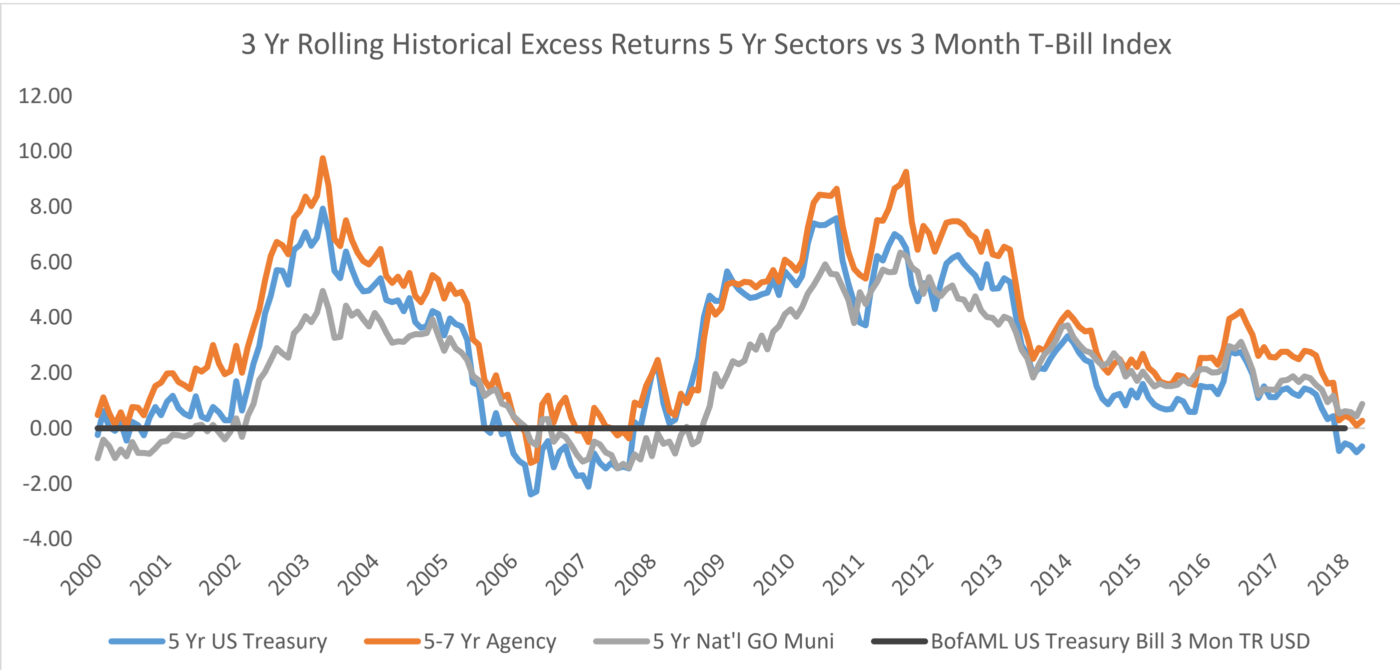
Comment:

With the 2 Year Treasury currently offering a yield of 2.43% and a spread of 73 bps to the 3-month, and the Fed not projected to reach 2.4% until June of 2019, we believe the 2-year sector is beginning to offer a compelling risk return relative to shorter term money market funds. The 2-year sector currently has 70 bps of tightening priced in and should rates unexpected decline the 2-year sector will offer some relative value. During the last two Federal Reserve rate tightening cycles, rolling 3 year returns on the two-year treasury index rolled below the rolling 3 year returns on the 3 Month T-bill Index, which happened in January on the 2 Year Treasury for the first time since 2008. While this underperformance could continue, we believe a strategy of rolling 2-year positions will begin to out earn money market funds from this point forward.

5 Yr. Historical Returns and Spread Information:

5 Year	Current Rate	Historical Return	Current Spread	Historical Spread	Current Spread as % of Return	Hist Spread as % of Return	Std Dev
5 Yr US Treasury Index	2.68%	4.25%	0.98%	2.21%	36.61%	52.01%	4.26
5-7 Yr Agency Index	2.75%	5.32%	1.05%	3.28%	38.09%	61.67%	4.18
5 Yr Nat'l GO Muni Index	2.17%	3.88%	0.47%	1.84%	21.66%	47.50%	3.01
3 Month T-Bill Index	*1.70%*	*2.04%*	*0.00%*	*0.00%*	*0.00%*	*0.00%*	*0.63*

Source: Morningstar Direct as of 5/31/18



Source: Morningstar Direct as of 5/31/18

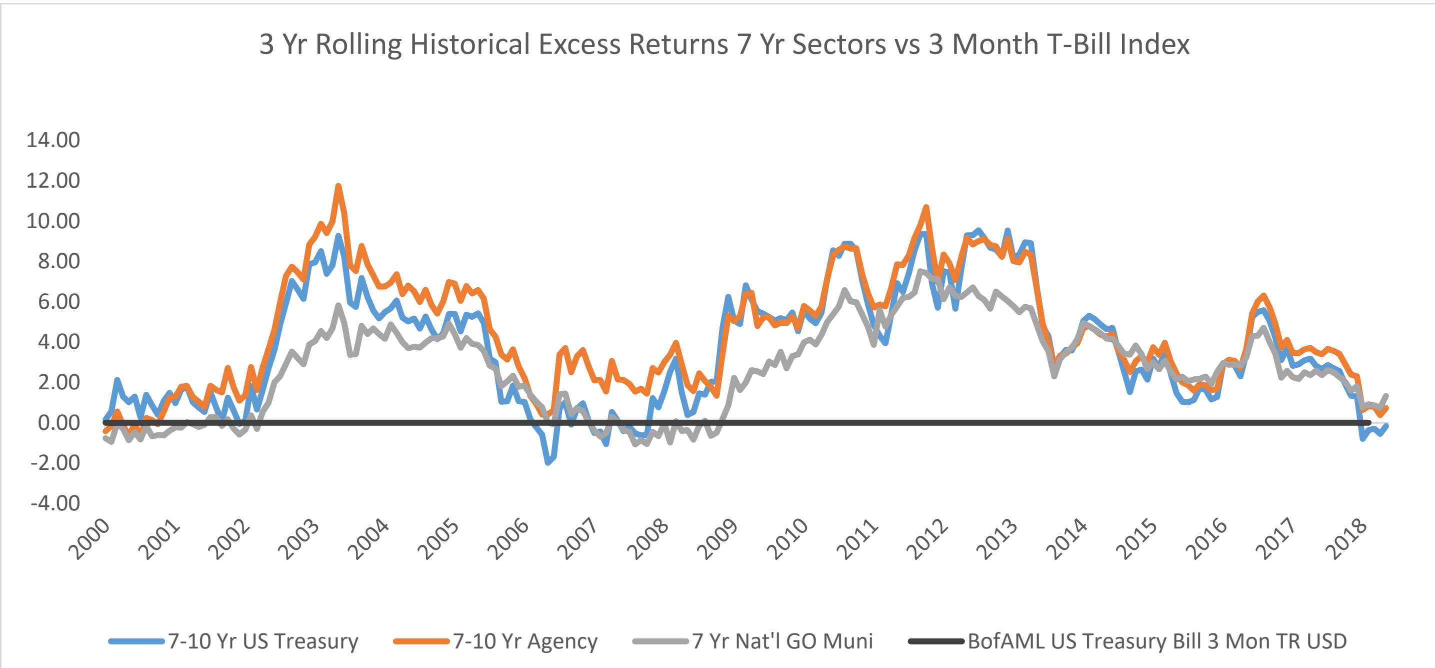
Comment:

Given the length of the current expansion, we believe the five-year sector might offer the most compelling value currently for buy and hold accounts, balancing near term and longer-term risk. The current 98 basis point spread against the 3-Month t-bill with it starting yield level of 1.70%, (which is above current long-term measures of inflation). Historically, the 5-year sector is the first to price in Federal Reserve activity. The five-year sector has now underperformed treasury bills on a rolling 3 year basis, but historically this statistically condition occurs toward the end of a Federal Reserve rate hiking cycle.

7 Yr. Historical Returns and Spread Information:

7 Year	Current Rate	Historical Return	Current Spread	Historical Spread	Current Spread as % of Return	Hist Spread as % of Return	Std Dev
7-10 Yr US Treasury Index	2.81%	5.23%	1.11%	3.20%	39.44%	61.08%	6.29
7-10 Yr Agency Index	2.88%	5.99%	1.18%	3.96%	41.01%	66.01%	5.49
7 Yr Nat'l GO Muni Index	2.19%	4.45%	0.49%	2.41%	22.37%	54.21%	3.91
3 Month T-Bill Index	*1.70%*	*2.04%*	*0.00%*	*0.00%*	*0.00%*	*0.00%*	*0.63*

Source: Bloomberg as of 5/31/18



Source: Morningstar Direct as of 5/31/18

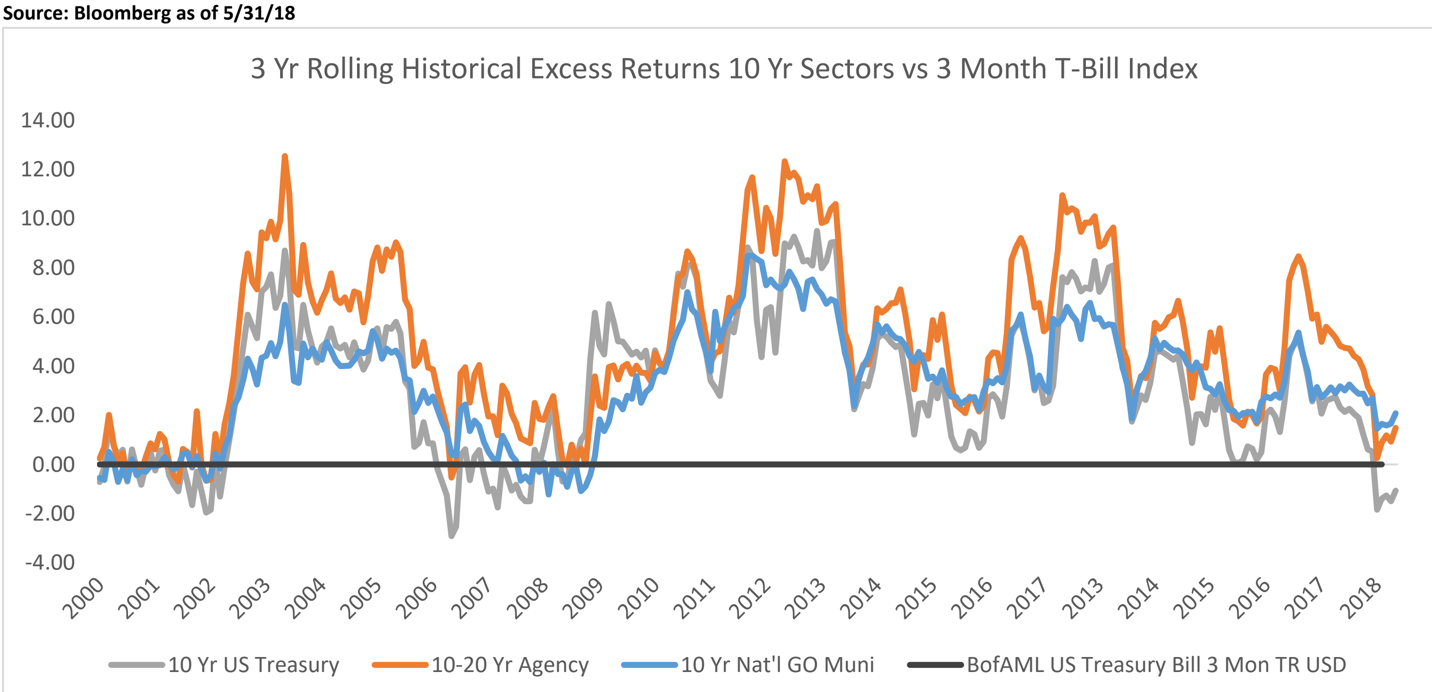
Comment:

While the current level of 2.81% absolute yield level is higher than current measures of inflation, the 14 basis point pickup over five-year treasuries does not justify the additional duration risk. Seven-year treasuries have now also underperformed bills on a rolling 3-year basis as of the end of January. While tempting, we still believe the low level of overall rates suggests investors will be better served with shorter maturities until the stock market begins to show signs of slowing.

10 Yr. Historical Returns and Spread Information:

10 Year	Current Rate	Historical Return	Current Spread	Historical Spread	Current Spread as % of Return	Hist Spread as % of Return	Std Dev
10 Yr US Treasury Index	2.86%	4.56%	1.16%	2.53%	40.54%	55.35%	7.26
10-20 Yr Agency Index	3.18%	6.28%	1.48%	4.24%	46.49%	67.56%	7.44
10 Yr Nat'l GO Muni Index	2.43%	4.87%	0.73%	2.84%	30.07%	58.20%	4.66
3 Month T-Bill Index	*1.70%*	*2.04%*	*0.00%*	*0.00%*	*0.00%*	*0.00%*	*0.63*

Source: Bloomberg as of 5/31/18



Source: Morningstar Direct as of 5/31/18

Comment:

The ten-year treasury rate at 2.86% is at the highest level in over 4 years. The yield now sits above the area of actual 10 year realized inflation measures plus its traditional spread (147 bps) to inflation measures**. The 10-year actual realized inflation number of 1.51% would imply a ten-year treasury rate of 2.99%.** We are also of the opinion that the lack of inflation is more of a cyclical phenomenon, which the market is treating as structural. In short, we think rates go higher over the long term, but with rates at current levels, the risk reward is beginning to be more balanced than last summer. We think the 10-year sector could be volatile around this center tendency, and will offer the best trading opportunities, as it has room to rally and decline as market perceptions about Federal Reserve activity change.

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