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2017 Mid-Year Review and Market Outlook

So here we are at mid-year 2017 and what do we know? Frankly, we do not know much more than we did back at the start of the year. The markets (that being all markets, including equities, fixed income, commodities, currencies, etc.) continue to be primarily influenced by the actions (or lack thereof) of the world central banks (Federal Reserve, ECB, BOJ) and a Trump Administration that seems committed to doing anything only one way…the hard way.

Let's start with the Federal Reserve, although there can be plenty of overlap between the two. While the Federal Reserve initiated its tightening cycle in December 2015, it chose to stray from its projections on the number of rate hikes for 2016 and again so far in 2017; at least one more rate hike is expected later in 2017. Keep in mind that the Fed has at its disposal the huge resources of an entire analysis apparatus, and its ability to accurately project anything remains questionable. That said, the chatter surrounding further actions on rates has settled recently into a discussion of the Fed's $4.5 trillion balance sheet, and whether it is time to undertake "QT" (i.e. "qualitative tightening") and initiate a process of reducing balance sheet holdings. At its June meeting, talk centered on the Fed potentially reducing its holdings by $10 billion per month. In the now ninth year of economic expansion, the Fed has maintained its policies of reinvesting maturing agency debt and agency MBS in agency MBS and of rolling over maturing UST at auction, rather than allowing a "roll-off" of its balance sheet, let alone initiating any outright "sale" of securities. But the chatter is now being described as "no big deal" for the Fed to change course and initiate a "rolling off" of the balance sheet. This will be perfect. A Federal Reserve that has repeatedly taken guidance from the equity markets as confirmation that its policies unquestionably were correct will now take no guidance from the fixed income markets regarding its balance sheet reduction policies. Whether it is hiking rates or removing accommodation by engaging in the sale of fixed income securities on its balance sheet, the Fed is surely engaged in tightening, and has been since the day Ms. Yellen became Chair, thereby having a dampening effect on domestic economic growth. So we will likely continue to plow ahead with an economy of sub-2% growth and sub-2% inflation. When did 2% average annual growth get labeled as "moderate"? Why not "modest", "slight" or even "crappy"? We note that inflation has been below the Fed's 2% inflation target for the past five years; but the Fed "projects" that the trajectory for inflation remains consistent with the 2% target. And thus they conclude it's time to tighten monetary policy because we may achieve 2% inflation within the next five years? We all know the history. In response to the Financial Crisis and ensuing Great Recession, the Fed and ECB became huge buyers of fixed income securities across the markets as they promoted "qualitative easing" policies to support nascent economic growth. Where might rates need to go to find the clearing rate where potential buyers are willing to replace central bank purchases? That's where the Trump Administration comes in.

The equity markets have been transfixed since the November election on Trump Administration initiatives to "fix" healthcare, energy, tax, trade, and regulatory matters that had held back economic growth during the Obama Administration. While the Federal Reserve does not quantify what such fixes could mean to the economy, it certainly seems to take some measures into account when formulating its economic projections. Unfortunately, the mass majority of these "fixes" require Congressional legislation and heavy amounts of political capital to get done. As time passes without movement on these various initiatives, we expect market makers will grow weary and the loss of market enthusiasm will likely have a negative impact on equity prices and dampen the likelihood of future Fed rate hikes.

What does this tell us about rates? At year-end 2016, the yields on 10-year and 30-year US Treasury securities were 2.44% and 3.06% respectively; these rates spiked in mid-March with yields at 2.62% and 3.20% respectively. At June 30, the yields on 10-year and 30-year USTs were 2.30% and 2.83% respectively. Municipal rates largely followed this same pattern. At year-end 2016, the yields on 10-year and 30-year "AAA" rated municipal bonds were 2.33% and 3.05% respectively; rates spiked in mid-March to 2.49% and 3.25% respectively; and at June 30, the yields were 1.99% and 2.79% respectively. We note that long rates are actually lower during the period that the Fed has raised short term rates. This flattening of the yield curve should not go unnoticed. Flatter yield curves historically precede economic weakness. So unless "it's really different this time", the bond and equity markets are sending distinctly different signals. Which one is right? This disconnect is being fueled in part by continued monetary stimulus by the ECB and BOJ, keeping overseas rates artificially low (i.e. negative), thus creating demand for both safe assets (US dollar assets, i.e. US Treasuries) and risk assets (i.e. equities). Unless there is a meaningful and believable shift in central bank policies, we expect rates will largely remain range-bound.

Last year, the Brexit vote served as a market catalyst, but we argued it was merely one data point, and that it would take some time for the "implementation strategy" to take effect and in turn, enable market participants to assess outcomes. We noted that the UK comprised less than 4% of the world economy and that many market participants anticipated GDP growth in the rest of the world to slow by only 0.2% over the ensuing 12 months. Our view is unchanged; on balance, we project that US securities, which tend to be our primary focus, should remain largely insulated from any "Brexit contagion". That said we will continue to monitor the various currency, commodity, fixed income and equity markets for any signs that may provide credit opportunities; either long or short.

Investing Performance. Interestingly, the above observations serve to once again provide "validation" for "long/short credit" investing strategies. Utilizing a "long/short credit" strategy in today's world serves to augment and complement any fixed income portfolio, let alone serve as an important core diversifying holding for equity minded investors. It is not by accident that as Investment Managers, we maintain exposures across the municipal bond, corporate bond, high yield, preferred, and US Treasury markets.

While our funds have maintained a modest underweight long position in municipal bonds throughout Q1 and Q2, we have continued to manage the portfolio on a "defensive" basis. For readers, our concerns with the macro economic landscape are well known; when combined with the specifics of US domestic policy dysfunction, we have tended to utilize less leverage, opted for liquidity over yield, and maintained an overall shorter duration for the portfolio. By managing the portfolio on this basis, we have been able to run a "less hedged" book, reducing our volatility and relying on our short corporate bond positions rather than our typical rates hedging through short exposure to the US Treasury market.

We should emphasize that despite calls to the contrary, we will continue to run short positions in our fund portfolios. We are not long-only managers. And given the low overall level of interest rates, there remains a likelihood that rates will trend higher over time, rather than continuing to move lower. We expect to modify hedge ratios on a dynamic basis and we are prepared to endure the costs associated with our "long/short credit" strategy despite the fact in the current environment it seems at times that rates may never rise again! Throughout our history we have navigated periods of rising rates quite effectively, and particularly out-performed long-only managers during such periods. It does get maddening at times to hold short positions, but our convictions are that the Federal Reserve will not ultimately get it exactly right and any number of events could also cause rates to move higher; at any time.

According to Bloomberg-Barclay's, through June 30, the Municipal Bond Index returned 3.57%; the High Yield Municipal Bond Index returned 6.13%; the US Credit Index returned 3.68%; the Aggregate Index returned 2.27%; and the US High Yield Corporate Index returned 4.93%.

Fixed Income Market Commentary- Municipal Market Comment. June new issue volume totaled $39 billion, up 8% over May but down 19% year over year. Gross year-to-date new issuance for the municipal market stood at $195 billion at June 30, down about 13% over the same period in 2016. The 30-Year Municipal Market Data Index (MMD Index) ended June at 2.79% (down from 3.05% to start the year). We note that since municipal bonds enjoy tax-exempt status, historically the "Municipal/ US Treasury" ratio in 30 years has averaged about 86%, although the ratio has remained elevated over the recent past. At June 30, the 30-year Municipal/ US Treasury ratio stood at about 98.58%, down from 99.67% at year-end 2016.

We started the year by observing that the municipal bond market appeared to be in very good shape as technical factors appeared particularly favorable throughout Q1 and Q2. On the demand side, we have had January 1 and June 1 coupon interest payments and bond redemptions, coupled with continuing positive inflows into municipal bond funds. According to EPFR, municipal inflows have aggregated $14.06 billion through the week ended July 5. In addition, anecdotal evidence has shown significant buying interest from both Asian and European investors as a result of "negative interest rates" in many host countries; such flows are not being counted in the weekly inflows statistics. On the supply side, we had assumed a static to slightly increasing rate environment and in turn projected the new issue volume for 2017 would fall at the lower end of the range of $300 to $340 billion. The forward calendar is currently at lows not seen since December 2014. And the likelihood of a new Trump- sponsored infrastructure program seems well down the Congressional agenda. The levels of rates in Q3 and Q4 will almost certainly impact the amount of debt refundings to be undertaken by issuers. New money issuance so far 2017 is actually running ahead of 2016 levels; but we question whether this statistic will standup for the balance of the year. We will continue to pay close attention to municipal flows and new issue volume during the remainder of the year as a sign of continuing positive technical factors for the sector.

From a fundamental perspective, municipal credits as a whole are improving, as tax collections continue to rise and cost cutting measures remain in focus. Regarding specific credits, the municipal market has continued to be keenly focused on the State of Illinois. The Illinois General Assembly passed a budget relying on increases in both the individual and corporate income tax rates as well as 10% across the board spending cuts. Included in the overall plan is a $6 billion general obligation bond issuance designed to cover a portion of the State's $15 billion of unpaid bills. While the

Illinois House and Senate passed the bill with the required 60% vote, it was promptly vetoed by Governor Rauner. Subsequently the Senate and the House both voted to override the veto. Matters relating to the State of Illinois also impacted market perceptions and market evaluations for other related credits including the City of Chicago and Chicago Board of Education.

Readers will recall that the US Congress followed through on its promise to pass legislation in June 2016 to provide The Commonwealth of Puerto Rico with a process to undertake some form of debt restructuring of its outstanding indebtedness and institute a moratorium on creditor litigation between December 2015 and the later of February 15, 2017 or potentially a different date. The legislation, known as PROMESA, brought into existence the Financial Oversight and Management Board ("Oversight Board") to oversee the Commonwealth's budgetary, revenue and expense matters and provided a process for implementing debt relief through negotiations with bondholders. The negotiated transaction for restructuring of the debt of the Puerto Rico Electric Power Authority ("PREPA") that was reaffirmed earlier this year was not expected to be affected by the legislation or the Oversight Board. The negotiated restructuring for PREPA was set at a price of $85 on its outstanding bonds.

Readers will recall that we have outlined that bonds issued by the Commonwealth of Puerto Rico and its instrumentalities need to be assessed on the basis of individual credits, rather than lumped as a whole into one "bucket". We have largely chosen to concentrate holdings of Puerto Rico bonds in the revenue bond obligations of essential services providers including PREPA and Puerto Rico Aqueduct and Sewer Authority ("PRASA"). That said, the Oversight Board, having earlier submitted a Title III bankruptcy filing under PROMESA for a number of Puerto Rico credits including The Commonwealth's general obligation bonds and the indebtedness of the Sales Tax Authority ("Cofina"), chose to reject the Restructuring Support Agreement ("RSA") among PREPA, the Ad Hoc Bondholder Group, the mono-line bond insurers and certain other lenders. As a result, the Oversight Board has now submitted a Title III bankruptcy filing under PROMESA on behalf of PREPA (that in turn led to PREPA's failure to pay its July 1, 2017 debt service). Creditors are understandably perturbed (an understatement) by these actions. The RSA had been negotiated and amended multiple times over a more than two-year period and most recently had been amended at the request of the newly elected Puerto Rican Governor Rosello. At issue, is not so much the substance of some revisions requested by the Oversight Board --- but rather whether the Board's action was even legal under the PROMESA enabling legislation. The creditors maintain that the PREPA RSA is a consensual restructuring specifically contemplated under PROMESA which the Oversight Board had no right to reject and creditors believe that the Oversight Board has "… chosen to disregard the rule of law …". As a result, weakness in Puerto Rico credits has been seen during the past month, and the market awaits further guidance on the Oversight Board's intentions regarding PREPA bonds. Despite the failure of the PREPA RSA, we are confident in our rights as secured creditors and ultimately expect significant recovery on PREPA bonds from current price levels. In addition, we continue to view the bonds of PRASA as providing total return opportunities as well. To date, PRASA has made all scheduled debt service payments and is not the subject of any Title III filing under PROMESA.

Fixed Income Market Commentary- Corporate Credit Market Comment. With market prices for US Treasury securities moving higher as rates fell during the first half of the year, and in spite of spread volatility, the corporate credit markets had positive first half performance, with the Bloomberg-Barclay's US Aggregate and US High Yield Indices up 2.27% and 4.93% respectively.

According to EPFR, through the week ended July 5, year-to-date fund flows for US Investment Grade and US High Yield funds were a positive $150 billion and negative $7.6 billion, respectively. First half new issuance of investment grade corporate bonds was $706 billion, up 2% from the record levels of 2016. High Yield new issuance was $145 billion, up a solid 23% from the first half of 2016. Credit spreads have remained range bound and seeking direction from oil prices, Fed policy, corporate earnings, and anywhere else it might be found. Progress, or lack thereof, on Trump Administration policy initiatives would also have an impact on sentiment, risk, and spreads. S&P 500 companies are sitting on $1.9 trillion of cash, offering substantial potential firepower to be unleashed by repatriation and/or other measures. Freeing up these resources could inspire confidence for companies to ratchet-up capital expenditures and/or motivate mergers and acquisitions.

Investment grade spreads are at recent cycle tights and only 35 bps away from their all-time lows of 2005. Non-financial investment grade company leverage of 3.0x is above the 2009 cycle highs, and while energy company leverage has declined from the 2015 peak, ex-energy leverage is steadily rising. Q1 revenues and earnings were the strongest they have been in several years and exceeded expectations; we shall see if Q2 can meet or exceed lofty expectations. For the last several years, companies have continued to spend more cash on capex, M&A, dividends and share buybacks than they have earned in operating cash flow. Low market interest rates combined with tight credit spreads and a domestic corporate tax scheme that favors borrowings have allowed companies to fund this shortfall at historically low all-in borrowing costs, and without a meaningful change in rates, spreads and/or taxes, we fully expect this trend to continue. There is $3.3 trillion of IG debt maturing over the next five years, so any increase in rates or hiccup in spreads may be exacerbated by issuance needs. Duration risk sits at an all-time high given the tenor profile and absolute low level of rates. For these reasons, we are cautious on investment grade credit spreads.

High yield spreads are 142 bps away from their 2007 tights. Corporate default rates declined earlier in the year from 7.9% at year-end 2016 to 3.9%, and are now below the long term average of around 4.4%. At the same time, the distressed ratio has come down substantially from its peak of 31.6% last year to only 5% currently, with much of that remaining distressed debt concentrated specifically in the retail and energy sectors. While overall levels of leverage and cash flow have been relatively stable, this is masking a divergence where certain sectors are improving and others are deteriorating significantly. This divergence provides long and short opportunities that are ripe for our picking and we think the current market in High Yield sets up quite well for our long/short credit strategy.

We believe the corporate credit markets continue to exhibit mid-to-late stage statistics and behavior. While this may continue for some time, we are positioning accordingly, continuing to identify long and short opportunities, run relatively low net exposures, seek asset coverage and downside protection in our long positions, and the opposite in our shorts, and find idiosyncratic and process-driven special situation investments that are less correlated with the broader markets.

Last But Not Least-Crude Oil Commentary. In the past, we have highlighted our views regarding the crude oil markets and the economic impact of crude oil prices. At December 31, 2016, crude was trading at $53.72, down almost 50% from the $107.26 peak in June 2014. At June 30, 2017, crude was trading at $46.04, down about 14.3% year to date. In Q1 and Q2 crude oil traded in a range of $42.53 to $54.45. At various points, we have observed that there can appear to be a fair amount of "hysteria" and likely short selling associated with the oil markets. Notwithstanding the absence of consensus on production quotas by OPEC and continued marginal non-OPEC production, we believe the market itself is not coming completely unhinged, although volatility and uncertainty is to be expected. In early 2016, we observed we would not be surprised to see the $30.00 level hold as a market bottom, with the prospects for somewhat higher prices by mid-2016. This rang true throughout 2016 and into the first half of 2017. As a point of reference, after posting the 2003 lows, oil prices rose substantially over the next four years to about $77 in August 2006. Certain market observers are now calling for crude oil prices to breach the $54.45 peak of late February, with a projection from current levels to something like $60.00 (this would represent about a 30% increase from the June 30 level). We closely track the level of crude oil prices because a continued recovery in the price of crude oil will likely have a direct positive influence on the equity markets and may consequently have a negative impact on rates; while at the same time having a positive impact on credit spreads.

Summary. As always, we appreciate your confidence in us and continued participation in our investment programs. Please call us with any follow-up comments or questions or if you prefer, you may send e-mail to us at info@cedarridgepartners.com.

Sincerely,

CEDAR RIDGE PARTNERS, LLC