Potential Opportunities For Income

- Emerging Market Corporate Bonds
- High-Yield Corporate Bonds
- High-Yield Municipal Bonds

Weaker Opportunities For Income

- International Sovereign Bonds
- Treasurys

MARKET REVIEW

Recession in the Rear View Mirror

The foreign developed markets, as measured by the MSCI EAFE Index, increased by 3.44% in December, ending the year on a positive note. These markets outperformed U.S. stocks, as measured by the S&P 500, and the Emerging Markets, as measured by the MSCI EM Index, which increased by 1.98% and 0.05% respectively. Generally speaking, bonds continued their slide down, as measured by the Bloomberg Barclays Global Bond Aggregate Index, which declined by 0.46%. Bonds with more credit sensitivity, as measured by the Barclays US Corporate High-Yield Index, held up better increasing by 1.85% during the month of December.

The release of the Fed's Federal Open Market Committee (FOMC) increased the Federal Funds Rate by 0.25% in December and signaled that there are likely three or more hikes coming in 2017. In addition, the JPMorgan Global Purchasing Manager's Index increased for the third month in a row to 52.1. Numbers above 50 indicate that the economy is likely expanding and the index has been generally heading higher since March of 2016.

Both of these facts indicate that the global economy appears to be getting stronger and the likelihood of a recession is low. Additionally, an expanding economy will likely begin to generate inflation which will help Europe and Japan justify the slowing of quantitative easing and perhaps even lead to increases in interest rates.

STOCKS vs. BONDS

A Bolder Case for Stocks

A combination of rising rates and a strong economy create an environment that is accommodative for stocks. While we would currently be underweight stocks we would continue to grow this position and will likely move into an overweight position over the next couple of months.

Investor sentiment is very high which is made obvious in the extremely low price volatility for stocks. When this is coupled with high valuations in the form of earnings multiples it is hard to get excited about stocks. There is very little evidence to support a bearish outlook. However, in the longer-term it is probably safe to say we are closer to the end of this bull market cycle than the beginning.

OUTLOOK

Rising Rate, Expanding Global Growth

Assuming you believe the case for economic growth highlighted above then which markets should benefit? As of right now, the least expensive markets are in the emerging markets including Russia, China, South Korea and India. Additionally, many of these same countries have the wind at their back with strong momentum. Meanwhile, some of the most expensive markets are developed countries such as the United Kingdom, France, Canada, Italy and Spain. Which are also exhibiting very weak momentum. A combination of poor valuation and a lack of investor enthusiasm usually spells trouble.

Additionally, it may simply just be time for emerging market outperformance. For the first time since 2013, the MSCI

EM outperformed the MSCI World for the year. In the past, these types of cycles can be long in duration and very profitable for investors.

As indicated previously, rates are going up, and this is probably not just for the U.S. either. On the margin, the European Central Bank and Bank of England have started to slow down asset purchases so it is probably safe to assume that while the U.S. will lead the way in rising rates, the rest of the world will probably be dragged along. One of the best ways to reduce the impact from rising rates is to find safety in higher levels of income. The high level current income will help reduce the impact of capital loss due to falling bond prices.

Given this, high-yield bonds and emerging market corporates are one good option. Deregulation in the United States in energy and financials seems likely given the current political environment. These two sectors make up a large component of the high-yield bond space and fiscal policy appears to be putting some wind at the back of high-yield bonds. Additionally, the deregulation in energy could be a boon for oil prices which will benefit emerging market corporations as well. When coupled with a low probability of recession, these are probably relative winners among bonds.

FUN FACT

Raspberry Daiquiris

Astronomers at the Max Planck Institute for Radio Astronomy have discovered that the center of the Milky Way galaxy is made up in part of chemicals that give raspberries their smell and rum its flavor.

So it appears that the center of our galaxy is just a raspberry daiquiri and maybe we are along for the ride in a giant galactic blender.

Methodology

To learn more about the methodology visit the Salient Partners Income Investing blog series Part 1 and Part 2. You can also follow us on Twitter @nrowader and @NicMillikan for live updates on the Income Report Card.

Asset Class Key

Bonds

U.S. Treasurys	Bloomberg Barclays U.S. Treasury
U.S. Investment Grade Credit	Bloomberg Barclays U.S. Credit
Municipal Bonds	Bloomberg Barclays Municipal Bond
High-Yield Municipal	Bloomberg Barclays Muni High Yield
U.S. High-Yield Corporate	Bloomberg Barclays U.S. Corp High Yield
Emerging Market Corporate	CS Emerging Markets Corporate Bond
Emerging Market Sovereign	Bloomberg Barclays EM Sovereign
International Sovereign	Bloomberg Barclays Global Treasury ex USD
Mortgages	Bloomberg Barclays U.S. MBS
Short Term Treasurys (Cash Proxy)	Bloomberg Barclays US Treasury 1-3 yr

Stocks

U.S. Stocks	S&P 500 Index
International Stocks	MSCI EAFE
Emerging Market Stocks	MSCI Emerging Markets
US Real Estate	Dow Jones US Real Estate
MLPs	Alerian MLP Infrastructure
Preferred Stocks	BofA Merrill Lynch Fixed Rate Preferred Securities
Utilities	S&P 500 Utilities Sector
International Real Estate	Dow Jones Global Select ex US Real Estate Securities
EM Infrastructure	MSCI EM Infrastructure

U.S. Stocks

Yield: 2.09% **Risk:** 8.56%

TREND B CARRY D

In terms of income, we believe U.S. Stocks are pretty middle of the road but that income comes with a very reasonable level of risk. In fact recent market volatility has been near all time lows which means we should view this asset class with some skepticism as low volatility tends to predict a correction but deregulation could favor this asset class.

International Stocks

Yield: 3.19% **Risk:** 9.77%

TREND D CARRY B

Renewed strength in the U.S. dollar is putting pressure on Europe and Japan and this is reflected in the weak trend. However, when carry is good and trend is bad, it usually signals a reversal in fortune. Keep an eye on this one especially with the recent improvement in trend.

Emerging Market Stocks

Yield: 2.55% **Risk:** 14.05%

TREND A CARRY F

Emerging markets aren't offering much in terms of income right now but it is one of the most reasonably valued equity asset classes in terms of earnings and has had tremendous performance in the past several months following years of relative underperformance. This could potentially be the beginning of a long term cycle of outperformance.

U.S. Real Estate

Yield: 4.59% **Risk:** 16.55%

TREND C CARRY B

The positive correlation with bonds should be taken seriously especially for any investor with a large position in fixed rate bonds. This is probably a good speculative position on the basis of a rebound off the recent lows but not a good long term core position for now.

Master Limited Partnerships (MLPs)

Yield: 7.09% **Risk:** 18.31%

TREND A CARRY A

MLPs have bounced back from their 2016 lows and erased much of the losses from 2015. There is still a fair amount of price volatility but the income and growth potential makes this a good position for growth oriented investors that have little exposure to bonds. In other words, we think of this as a high yield proxy in the stock portfolio and deserves a position.

Preferred Stocks

Yield: 5.28% **Risk:** 6.94%

TREND F CARRY A

This is the asset class to own for safe U.S. based income. It does have a positive correlation to bonds but the higher income stream should help protect it from changes in rates. Plus as bank stocks rallied, the bank heavy preferred market declined. This could be a good way to play financials as they start their recovery.

Utilities

Yield: 3.56% **Risk:** 18.40%

TREND C CARRY D

Like real estate, utilities sold off as investors weighed the impact from rising rates. This provides an attractive way to get low volatility U.S. based income. However the earning multiples of this space and long term growth prospects are fairly weak signals. We think investors may want to look to Preferred Stocks instead of Utilities.

International Real Estate

Yield: 3.67% **Risk:** 13.67%

TREND D CARRY C

We believe this is an expensive and volatile asset class when compared to the other options out there. However, we see that the yield is starting to look fairly attractive and maybe there is a short term play here in the near future.

EM Infrastructure

Yield: 3.33% **Risk:** 14.03%

TREND B CARRY D

If EM Stocks are too volatile, we believe this is a great way to access to the economic growth of the Emerging Markets with some decent income and lower volatility. Additionally most of these stocks are backed with hard assets and good cash flow.

Grades: Quintile rankings of asset classes
Downgrade Upgrade No Change

Trend: 12 month momentum
Carry: Current Yield / Current Std. Deviation

Risk: Based on 60-day std. deviation

Sources: Bloomberg, Salient Partners L.P., as of 12/31/16. The performance quoted represents past performance, does not guarantee future results and current performance may be lower or higher than the data quoted.

U.S. Treasurys

Yield: 1.89% **Risk:** 4.04%

TREND	CARRY	
F	F	Treasurys may be the purest way to express an interest rate position. As a result, this asset class represents the tip of the spear on the future of interest rates. The recent collapse in trend and carry demonstrate the sharp reversal in fortune for any interest rate sensitive asset class.

U.S. Investment Grade Credit

Yield: 3.29% **Risk:** 4.06%

TREND	CARRY	
B	C	The trend is improving for investment grade and for some investors this might be a place to find some safe, quality cash flow. However, barring a recession, we think investors should feel comfortable taking more credit risk.

Municipal Bonds

Yield: 2.65% **Risk:** 4.06%

TREND	CARRY	
F	D	Following the election there was a feverish sell-off of muni bonds on the idea that tax rates were going down. Investors overreacted in the asset class and there was a slight bounceback in December which took care of any mispricing of the asset class. Again, we believe investors should be willing to take a little bit more credit risk.

High-Yield Municipal

Yield: 6.42% **Risk:** 5.89%

TREND	CARRY	
C	B	Again there was a sharp sell off in this asset class following the election. This asset class is riskier than rated muni bonds, but barring a recession (which seems unlikely at this juncture) this is a good alternative to any investment grade holding. If you are looking for safe cash flow, this is your best bet.

U.S. High-Yield Corporate

Yield: 6.12% **Risk:** 3.74%

TREND	CARRY	
A	A	This has been one of our favorite asset classes based largely on very compelling valuations in early 2016. However, the level of defaults and expectations have reached parity and we don't expect to earn the same level of return in 2017. Given the stable economy and the likelihood of upward rate pressure, high-yield is likely to be a relative outperformer.

Emerging Market Corporate

Yield: 6.78% **Risk:** 3.80%

TREND	CARRY	
A	A	This was also one of our favorite asset classes in 2016 and, like high-yield, may have reached fair value. But the low price volatility still makes it very attractive. We don't expect this to deliver total return like it has over the past year but rising oil prices and higher income will offset any increased rates.

Emerging Market Sovereign

Yield: 5.42% **Risk:** 8.97%

TREND	CARRY	
B	D	This is also another great asset class for income seeking investors. Given the risk/reward profile, investors would likely be better off with Emerging Market Corporates, but if the investor prefers the safety of government bonds then this may be a good alternative. However, it is subject to changes in foreign policy which might increase volatility.

International Sovereign

Yield: 0.63% **Risk:** 12.85%

TREND	CARRY	
C	F	We warned about this asset class last year and think 2017 won't be much better as slowing of asset purchases in Japan and Europe will put upward pressure on rates and possibly bring to a close the idea that negative interest rates were a long term policy tool.

Mortgages

Yield: 0.63% **Risk:** 3.30%

TREND	CARRY	
D	B	Mortgages are a tough asset class in a rising rate environment. There has been some bounceback here as the course of interest rate increases is starting to become a little more visible. In general though, the macro trend is against this asset class so it probably does not belong in an income portfolio.

Short Term Treasurys (Cash Proxy)

Yield: 1.19% **Risk:** 0.82%

TREND	CARRY	
D	B	Cash is starting to look better these days on an income basis as the yield curve is beginning to flatten. We believe shortening duration or increasing credit exposure are really the best ways to get income in a rising rate environment. Barring a recession though, we'd suggest credit over short duration.

Grades: Quintile rankings of asset classes
Downgrade Upgrade No Change

Trend: 12 month momentum
Carry: Current Yield / Current Std. Deviation

Risk: Based on 60-day std. deviation

Sources: Bloomberg, Salient Partners L.P., as of 12/31/16. The performance quoted represents past performance, does not guarantee future results and current performance may be lower or higher than the data quoted.

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Definition of Terms

Emerging market is a country that has some characteristics of a developed market but does not meet all of the standards to be a developed market.

Max drawdown is the percentage of loss that an asset incurs from its peak net asset value to its lowest value.

Sharpe ratio is a ratio developed by Nobel laureate William F. Sharpe to measure how a fund performs relative to the risk it takes.

Standard deviation measures the degree to which a fund's return varies from its previous returns or from the average of all similar funds.

Yield is the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost or on the U.S. government's debt obligations.

Index Definitions

Alerian MLP Index is the leading gauge of large- and mid-cap energy master limited partnerships (MLPs). The float-adjusted, capitalization-weighted index includes some of the most prominent companies and captures approximately 75% of available market capitalization.

Bloomberg Barclays 1-3 Year U.S. Treasury Index is an unmanaged index of public obligations of the U.S. Treasury with a maturity between one and up to (but not including) three years.

Bloomberg Barclays EM Sovereign is a rules-based market-value weighted index engineered to measure the fixed-rate local currency sovereign bonds issued in emerging markets as identified by Bloomberg.

Bloomberg Barclays Global Treasury ex USD is an unmanaged index composed of those securities included in the Bloomberg Barclays Global Aggregate Bond Index that are Treasury securities, with the US excluded while hedging the currency back to the US dollar.

Bloomberg Barclays Municipal Bond covers the USD-denominated, long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are U.S. domestic, taxable and dollar denominated. The index covers the U.S. investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

Bloomberg Barclays U.S. Corporate High-Yield Bond Index covers the USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Bloomberg Barclays U.S. Credit is an index composed of corporate and non-corporate debt issues that are rated investment grade (Baa3/BBB) or higher.

Bloomberg Barclays U.S. MBS tracks the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC).

Bloomberg Barclays U.S. Municipal Bond covers the USD-denominated, long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

Bloomberg Barclays U.S. Treasury is an unmanaged index of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

BofA Merrill Lynch U.S. Preferred Stock Fixed Rate Index consists of investment-grade, fixed and fixed-to-floating rate U.S. dollar-denominated preferred securities.

Credit Suisse Emerging Market Corporate Bond Index consists of U.S. dollar-denominated fixed-income issues from Latin America, Eastern Europe and Asia.

Dow Jones Global ex-U.S. Select REIT Index measures the performance of equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded globally, excluding the U.S.

Dow Jones U.S. Real Estate Index measures the performance of the real estate industry of the U.S. equity market.

JPMorgan Global Manufacturing Purchasing Managers Index is a composite index that serves as a global economic indicator by measuring different business conditions in 24 countries, including global manufacturing output, new orders and employment across the global manufacturing sector.

MSCI EAFE (Europe, Australasia and Far East) Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI Emerging Markets Infrastructure Index captures the global opportunity set of companies that are owners or operators of infrastructure assets.

MSCI World Index is a free float-adjusted market capitalization index designed to measure equity market performance in the global developed markets.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy.

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