Potential Opportunities For Income

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

Weaker Opportunities For Income

· International Sovereign Bonds
· Treasurys
· International Real Estate

MARKET REVIEW

It's Just a Flesh Wound

U.S. stocks led global markets in February with the S&P 500 Index increasing by 3.97% and the Russell 2000 Index gaining 1.93%. This disparity could mark the end to a period of very strong relative performance for small-cap stocks versus large-cap stocks, or it could just be a lull in an otherwise strong trend. Emerging markets (EMs) increased 3.06%, continuing their stretch of outperformance over international developed stocks, which increased by 1.43% in February. However, the strong equity performance didn't keep the bond markets down as global bonds increased by 0.47%, led by strong performance in U.S. high-yield corporate bonds, which increased by 1.46%, and emerging market corporate bonds, which increased by 1.40%.

No matter how you look at the bond market today, it is facing an uphill battle. Rates are near all-time lows across the globe at a time when global economic activity is on the rise and even inflation appears to be back in the game. For example, the U.S. Consumer Price Index (CPI) is at 2.5% as of the March 2017 release. Thus, many intelligent people are calling it the start of a new bear market for bonds. This refrain should sound familiar since it has basically been the argument since 2011. Yet, despite all the evidence, interest rates have declined since 2011. So why is this time different? First off, the Federal Reserve is broadcasting its intent to increase rates while concurrently the European Central Bank and Bank of Japan have officially begun to slow their respective quantitative easing programs. Additionally, Europe is showing signs of sustainable economic growth and notable increases in profits. This environment is very different from 2011, when many global markets were saddled with deflation and weak bank balance sheets.

Given all this data, February was something of a "Rubicon" moment for the bond market as it appears to have avoided slipping into an official bear market by keeping within the range established in last November's sell-off. The early part of February saw a substantial increase in rates among 30-, 10- and 5-year Treasurys, but those rates failed to break out above the December high and, in the case of the 30- and 10-year Treasurys, failed to break out above the January high as well. We think in March those same bonds will likely retest the December, January and February price lows, which, if they hold, will once again set up a pattern to test yields and set the table for another bear market test in the next few weeks.

STOCKS vs. BONDS

What, Me Worry?

Since the election, the CBOE VIX Index has been tame. In fact, in January and February, it nearly reached its 10-year low. The lower volatility indicates that investors are extremely complacent with the state of the market. Many market observers have pointed out the paradox of this complacency, especially at a time when political policy seems to be in flux and valuations are at levels that do not support higher long-term returns. All this information is accurate, but this type of market can continue to grind higher despite these concerns. On the bullish side, the shift toward a reflationary theme, which supports generally undervalued sectors like energy, materials and industrial stocks; meanwhile disinflationary sectors, like utilities and consumer staples, are the primary contributors to high market valuations. Bonds perform well in deflationary periods while stocks perform well in inflationary periods. The past several years has seen hand over fist buying of bonds, so perhaps this shift is just a rotation back into stocks on the expectation of higher rates. Regardless of the reasons, it does pay to be cautious. We think investors should diligently adhere to their risk management protocols, but, in the meantime, enjoy the ride.

OUTLOOK

Buyers Flood the Market

Over the past few years of the bull market, many pundits have highlighted that the increase in U.S. stock prices has occurred during a period of historically low volume. This dynamic is an oddity in any type of open market where the price of a stock goes up for everyone even if only one person bids that stock higher. Low volume bull markets are generally considered risky because the price of shares traded is not widely validated by many investors. Therefore, the actual value could be shaky, especially if many investors show up to sell at the same time. However, the low volume argument is a bit weaker these days as the volume of buyers has increased significantly over the past three months. In fact, the volume of buyers versus sellers has increased at a rate greater than 1.35 standard deviations. That is a significant move and is yet another factor supporting the current bull market.

In the annual outlook, we noted that we do not want to be bullish, but we can't find a reason to be bearish. Our two main themes were an expectation that emerging market stocks will outperform global stocks and that higher income bonds will outperform global bonds. So far, this outlook is stable and, furthermore, it is bolstered by the recent decline in the U.S. dollar relative foreign currencies, particularly in the emerging markets. This decline puts pressure on Treasurys and the relative performance of U.S. stocks versus emerging market stocks. The reversal of the U.S. dollar is further supported by the uptick in volume for emerging market bonds and currencies. While this trade is looking a bit extended, we would expect it to survive what will likely be a small correction in what should be a good overall year.

FUN FACT

139 Years and Going Strong

This month was the 139th Westminster Kennel Club Dog Show, making it the second oldest U.S. sporting event, behind only the Kentucky Derby. To date, it has showcased over 300,000 dogs and has been hosted in all four versions of Madison Square Garden. During its lifetime, there have been 25 presidents and the lightbulb, the automobile and basketball have all been invented. The show is older than 12 states and the proceeds from the event helped establish the American Society for the Prevention of Cruelty to Animals (ASPCA). Finally, in the era of alternative facts, of course a German Shepherd named Rumor won Best in Show in 2017.

Methodology

To learn more about the methodology visit the Salient Partners *Income Investing* blog series Part 2. You can also follow us on Twitter at @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
U.S. 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

Income Report Card: Stocks

U.S. Stocks

Yield: 1.99% **Risk:** 6.63%

TREND	CARRY	
A	D	Strong performance of U.S. stocks is eroding the income. Stocks now have the worst absolute level of income. The low volatility and possible changes to the regulatory environment still make this a good total return option. Plus, it is a good hedge against inflation and rising rates.

International Stocks

Yield: 3.12% **Risk:** 8.85%

TREND	CARRY	
B	C	The general slowdown in bond purchases by the ECB and BOJ are viewed positively by stock investors and, so far this year, developed foreign markets are benefitting. Plus, the U.S. dollar has slowed relative the euro and yen, which is also benefitting this asset class. Now might be a good time to rotate some assets from the hot emerging markets.

Emerging Market Stocks

Yield: 2.44% **Risk:** 9.44%

TREND	CARRY	
B	F	Emerging market stocks still prodcue low income, but the asset class offers strong diversification away from the U.S. economic environment. The strong trend, valuation and possible change in the long-term cycle all favor this asset class. The recent shift in trend, however, might signal a short-term reversion, which is worth watching.

U.S. Real Estate

Yield: 4.40% **Risk:** 11.98%

TREND	CARRY	
C	B	The positive correlation with bonds should be taken seriously, especially for any investor with a large position in fixed-rate bonds. This asset class 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: 6.84% **Risk:** 14.96%

TREND	CARRY	
A	A	Despite the higher level of price volatility, MLPs have continued their strong 2016 performance into 2017. Growth investors with less exposure to bonds should look at this asset class as a high-yield proxy within their stock portfolio.

Preferred Stocks

Yield: 4.80% **Risk:** 3.56%

TREND	CARRY	
D	A	Preferred stocks are 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. It appears that the asset class is starting to improve on a relative performance basis.

Utilities

Yield: 3.38% **Risk:** 12.41%

TREND	CARRY	
C	D	Like real estate, utilities sold off as investors weighed the impact from rising rates. This asset class 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:** 11.75%

TREND	CARRY	
F	C	Unfortunately, this asset class's strong January was met with a weaker February and the high volatility of the asset class doesn't make it a great source for income. Foreign stock investors should look to more broadly diversified asset classes.

EM Infrastructure

Yield: 3.08% **Risk:** 8.23%

TREND	CARRY	
D	B	If EM stocks are too volatile, we believe this asset class 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 positive 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 02/28/2017. The performance quoted represents past performance, does not guarantee future results and current performance may be lower or higher than the data quoted. This material is distributed for informational purposes only and should not be considered as investment advice, a recommendation of any particular security, strategy or investment product, or as an offer or solicitation with respect to the purchase or sale of any investment.

Income Report Card: Bonds

U.S. Treasurys

Yield: 1.87% **Risk:** 3.54%

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. If you must hold Treasurys, we believe short duration/cash-like is best.

U.S. Investment Grade Credit

Yield: 3.18% **Risk:** 3.84%

TREND	CARRY	
B	D	Things are looking a bit bleak for this asset class as volatility picked up slightly in February. This change just reinforces our belief that high-yield corporates are better in the current environment.

Municipal Bonds

Yield: 2.44% **Risk:** 2.82%

TREND	CARRY	
D	D	Muni bonds offer an attractive yield relative Treasurys and the trend does appear to be improving. However, the low likelihood of recession favors taking more credit risk. Look to high-yield municipal bonds instead. But, if you must have a high-safety asset class, we think this asset class is your best bet over Treasurys.

High-Yield Municipal Bonds

Yield: 6.13% **Risk:** 3.96%

TREND	CARRY	
C	B	This asset class is riskier than rated muni bonds, but barring a recession (which seems unlikely at this juncture) we believe high-yield municipal bonds are a good alternative to any investment grade holding. If you are looking for safe cash flow, we think this asset class may provide a good opportunity.

U.S. High-Yield Corporate Bonds

Yield: 5.58% **Risk:** 1.82%

TREND	CARRY	
A	A	Given the stability of the economy and the likelihood of increasing interest rates down the road, U.S. high-yield corporate bonds are one of our favorite asset classes. We expect this asset class to be a relative outperformer for the year.

Emerging Market Corporate Debt

Yield: 6.10% **Risk:** 1.73%

TREND	CARRY	
A	A	EM corporate debt is also one of our favorite asset classes for 2017. The low price volatility and high current income makes this asset class very attractive. We don't expect this asset class 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 Debt

Yield: 5.11% **Risk:** 3.85%

TREND	CARRY	
B	C	The strength in the U.S. Dollar has stalled a bit in the first two months of the year and this has helped control the risk of this asset class and improved the risk adjusted yield. If you absolutely need government bonds, this is your best bet. However, we prefer emerging market corporate debt of this asset class.

International Sovereign Debt

Yield: 0.67% **Risk:** 12.58%

TREND	CARRY	
F	F	Japan officially slowed the buying of government bonds. This change, coupled with the low yield of the asset class, make it our least favorite asset class. We believe this asset class should currently be avoided.

Mortgages

Yield: 2.85% **Risk:** 3.26%

TREND	CARRY	
D	C	Mortgages are a tough asset class in a rising rate environment. There has been some bounce back 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: 1.22% **Risk:** 0.88%

TREND	CARRY	
C	B	Right now we would prefer credit risk over short duration, but in the event of recessionary environment, cash is starting to look very attractive.

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

Definition of Terms

Alerian MLP Infrastructure 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 EM Sovereign Bond Index 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 Index is an unmanaged index composed of those securities included in the Barclays Global Aggregate Bond Index that are Treasury securities, with the U.S. excluded while hedging the currency back to the U.S. dollar.

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

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

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

Bloomberg Barclays U.S. Treasury Bond 1-3 Year Term 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.

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

Brexit a term for the potential or hypothetical departure of the United Kingdom from the European Union.

Consumer price index (CPI) is an index number measuring the average price of consumer goods and services purchased by households. The percentage change in the CPI is a measure of inflation.

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.

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.

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

Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 3000 Index represents approximately 98% of the investable U.S. equity market.

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

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.

Valuation is the process of determining the value of an asset or company based on earnings and the market value of assets.

VIX (the ticker symbol for the Chicago Board Options Exchange Volatility Index) is a popular measure of market risk and is constructed using the implied volatility of S&P 500 index options.

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.

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