Potential Opportunities For Income

- Emerging Market Corporate Bonds
- High-Yield Municipal Bonds

Weaker Opportunities For Income

- International Sovereign Bonds
- Treasurys

MARKET REVIEW

A Weak Dollar Continues to Propel Foreign Stocks

May was another positive month for international stocks, which increased by 3.75%, driven by the increasing value of the euro relative the U.S. dollar. In fact, the MSCI Europe Index increased by 4.79% in U.S. dollars, but only 1.65% in euros. Emerging markets (EM) also posted gains, with an increase of 2.97%, although this growth was as bit more organic as currency movement detracted from performance. U.S. stocks increased by 1.41%, bucking the typical “sell in May” mantra. International and EM sovereigns increased by 2.28% and 0.76%, respectively, while U.S. Treasurys increased by 0.83%. Currency also played an important role for international sovereign bonds, as the increase in the value of the euro accounted for nearly 1.50% of the monthly gains. Credit-sensitive sectors gained, but trailed the robust gains in global sovereign markets. U.S. corporate high-yield bonds increased by 1.03% and EM corporate bonds increased by 0.11%.

May was somewhat unusual as the implied volatility of the S&P 500 Index reached a near 30-year low, indicating very low levels of price volatility. This level seems to contrast with the uncertainty in politics, foreign affairs and even some choppy numbers in the economy. While the exact reason for low volatility is probably impossible to figure out, we believe that many investors have become good at digesting the volatile news cycle over the past 10 years. In other words, there doesn’t appear to be any mechanical reason for investor complacency, but rather investors just aren’t that shaken by the daily headlines promising a coming apocalypse.

Overall, leading economic indicators continue to show a synchronous expansion of the global economy and emerging market countries continue to surpass expectations. The JPMorgan Global Manufacturing Purchasing Managers’ Index increased from 53.6 to 53.7, indicating that the global economy is still in a state of expansion.

STOCKS vs. BONDS

Beware the Rotation Discussion

Interest rates and their related inflation have been one of the key discussion points we have highlighted over the past few months. This discussion has focused on fiscal policy, where policies like lower taxes, the potential end of the Affordable Care Act and a major infrastructure spending plan were all expected to increase inflation and rates alongside it. Immediately following the election, the 10-year U.S. Treasury increased by 1.25%, but started to drift back down as turmoil in the White House appeared to indicate the possibility that the anticipated aggressive policymaking may take longer to unfold. We felt that the trend of interest rates was a good indicator for the likelihood of major policy changes. For most of the year, the 10-year U.S. Treasury oscillated between 2.30% and 2.60%. The range broke down following the collapse of the healthcare reform bill and established a new range between 2.20% and 2.30%, which appears to have collapsed again following the termination of FBI Director James Comey. It may be safe to say that many investors have decided that major policy changes that could drive growth and inflation are no longer as certain. With that said, this pattern of rates may no longer serve as the guide we hoped it would. For now, let’s hit the pause button.

Many investors continue to favor stocks over bonds, which appears to be prudent positioning going forward. Foreign stocks and tech stocks have outperformed this year with international stocks rising 14.37%, emerging market stocks rising 17.32% and the NASDAQ-100 Index rising 19.64%. This performance may spark a conversation regarding a rotation from current leaders into current laggards. However, current laggards are mostly energy and financials stocks that were poised to benefit from changes in policy. This potential rotation may happen alongside a typical push and pull between leaders and laggards, but the macroeconomic environment favors the current leaders. Emerging markets are reasonably valued at 15x earnings while the S&P 500 sits at a much higher valuation of 22x earnings. We think international stocks are benefitting from an improved political environment as traditional parties in certain countries have beat back the threat of populist parties. This shift helps keep in place many of the policies aimed at improving the economies of Europe and Japan, which are just now starting to bear fruit. Finally, the higher valuations in the U.S. require higher growth, hence a preference for high-growth tech stocks. In conclusion, despite the talk of rotation we think the current leaders appear to be well-situated for continued growth.

OUTLOOK

International Sovereign Bonds Soar

Our outlook this year remains unchanged. We prefer credit in the bond space, which has favored EM corporate bonds, U.S. high-yield corporate bonds and high-yield municipal bonds. On the stock side, we favor the emerging markets due to their valuation. More recently, the income per unit of risk for international stocks and real estate has been improving and warrants further consideration

However, international sovereign bonds have been an outperformer recently due largely to the increasing value of the euro relative the U.S. dollar. Given the low yield of 0.67% and high volatility of 6.03%, we think this asset class continues to be a very risky position for income investors. Any investor considering it must understand that it is essentially a currency play and may not be a safe source for income. Last year, the asset class fell 13.14% from 08/18/16 to 12/15/16. That type of correction is unusual for any income investment, so it should be viewed with caution.

As global sovereign bonds have increased in value, the credit sector has lagged as of late (see the comments in the market review section for specific returns). The credit sector tends to benefit on a relative basis when rates increase and on an absolute basis in slow economic environments. These two well-known macroeconomic factors remain dominant in today's markets, so despite positive sovereign performance, there is no reason to expect the view on the credit sector to change.

FUN FACT

NBA Championships

Once again, the Golden State Warriors and Cleveland Cavaliers are facing off in the NBA Championships. However, today's game of basketball is very different than the first game played in 1892 (it was invented in 1891). The court was half the size it is today, the game lasted 30 minutes and they played with a soccer ball. The soccer ball remained until 1894 when Spalding produced the basketball, which became the official ball of the NBA in 1983. The original hoop was a peach basket that required the referee to climb up a ladder and retrieve it. Fortunately, there was only one point scored in the first game. While these are humble beginnings, basketball has come a long way. Today the average NBA team is worth $1.25 billion.

Methodology

To learn more about the methodology visit the Salient Partners blog posting at www.salientpartners.com. 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: 1.97% **Risk:** 7.37%

TREND	CARRY	
B	D	Strong performance of U.S. stocks is eroding the income they offer. Stocks now have the worst absolute level of income. The promise of an improved regulatory environment is eroding as well, which could drag down prices.

International Stocks

Yield: 3.09% **Risk:** 8.80%

TREND	CARRY	
A	C	The general slowdown in bond purchases by the European Central Bank and Bank of Japan are viewed positively by stock investors. So far this year, developed foreign markets are benefitting. Plus, the U.S. dollar has slowed relative to 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: 2.39% **Risk:** 10.31%

TREND	CARRY	
A	F	Emerging market stocks still produce low income, but the asset class offers strong diversification away from the U.S. economic environment. Strong trends, valuations and possible changes in the long-term cycle all favor this asset class. We think this asset class is still one of the best stock assets to hold.

U.S. Real Estate

Yield: 4.17% **Risk:** 9.89%

TREND	CARRY	
D	B	U.S. real estate's positive correlation with bonds should be taken seriously, especially for any investor with a large position in fixed-rate bonds. The trend of rate sensitive assets is breaking down, so this is probably not the best asset class to hold right now.

Master Limited Partnerships (MLPs)

Yield: 7.05% **Risk:** 15.42%

TREND	CARRY	
B	B	Oil is under pressure as a result of political discord in the Middle East, which is making MLPs not as attractive in the short term. However, it is one of the few asset classes left with a reasonable valuation and cash flow that is 2x any other stock asset class.

Preferred Stocks

Yield: 2.72% **Risk:** 2.75%

TREND	CARRY	
F	A	Preferred stocks are the asset class to own for safe U.S.-based income. The asset class does have a positive correlation to bonds, but the higher income stream should help protect it from changes in rates. The trend for rate-sensitive assets is definitely breaking down, so this asset class is something to keep an eye on. The lower income as a result of some strong gains isn't great.

Utilities

Yield: 3.32% **Risk:** 9.30%

TREND	CARRY	
C	C	Utilities have had a good year, bucking the trend of other rate-sensitive assets. However, income investors can get more bang for their buck elsewhere without the same rate exposure or the high levels of debt held by utility companies.

International Real Estate

Yield: 3.68% **Risk:** 7.83%

TREND	CARRY	
D	A	The future is looking better for international real estate alongside other international asset classes thanks to improving currency values. On the risk/reward spectrum, this asset class could be a good complement to an international stock position.

EM Infrastructure

Yield: 3.11% **Risk:** 10.60%

TREND	CARRY	
C	D	If broad EM stocks are too volatile, we believe this asset class is a great way to access 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. However, the trend has been weaker here, so it is important to note the lower potential return.

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

Income Report Card: Bonds

U.S. Treasurys

Yield: 1.80% **Risk:** 3.05%

TREND	CARRY	
F	F	Treasurys have posted a strong couple months, but little has changed for this asset class, especially if you think interest rates are on the rise. Many short-duration options are close to the same yield as Treasurys, so investors don't need to take the duration risk. However, we would still suggest credit risk over low duration at this point.

U.S. Investment Grade Credit

Yield: 3.06% **Risk:** 3.39%

TREND	CARRY	
B	D	Along with strength in Treasurys, credit is improving. However, investors can still get more income by taking more credit risk. Right now, investors can look toward more credit sensitive options.

Municipal Bonds

Yield: 2.14% **Risk:** 1.58%

TREND	CARRY	
D	C	Muni bonds offer an attractive yield relative to 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: 6.05% **Risk:** 2.89%

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: 5.48% **Risk:** 2.56%

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. However, this asset class is sensitive to oil prices and political issues in the Middle East are putting pressure on oil. We don't think there is a reason to worry just yet, but high-yield municipals may be a better choice.

Emerging Market Corporate Debt

Yield: 6.12% **Risk:** 2.33%

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 higher levels of income will help protect against rising rates.

Emerging Market Sovereign Debt

Yield: 4.93% **Risk:** 3.23%

TREND	CARRY	
B	C	The U.S. dollar has been very weak as of late, which has benefitted EM sovereign bonds. As a result of the increase in price, the yield isn't looking as attractive per unit of risk. We think investors would do better with EM corporate bonds.

International Sovereign Debt

Yield: 0.67% **Risk:** 6.03%

TREND	CARRY	
F	F	This asset class has benefitted from a rising euro, but it is really a currency play and is therefore speculative. We think income investors should avoid this asset class.

Mortgages

Yield: 2.73% **Risk:** 2.84%

TREND	CARRY	
D	D	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: 1.29% **Risk:** 0.72%

TREND	CARRY	
C	B	Right now we would prefer credit risk over short duration, but in the event of a 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

Source: Bloomberg, Salient Partners, L.P., as of 05/31/2017. 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.

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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. Municipal High Yield Index measures the noninvestment-grade and nonrated U.S. dollar-denominated, fixed-rate, tax-exempt bond market within the 50 United States and four other qualifying regions (Washington D.C., Puerto Rico, Guam and the Virgin Islands).

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.

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 Europe Index is a free float-adjusted market capitalization index designed to measure developed market equity performance in Europe.

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.

NASDAQ-100 is a modified capitalization-weighted index that includes the largest nonfinancial U.S. and non-U.S. companies listed on the NASDAQ stock market across a variety of industries, such as retail, healthcare, telecommunications, wholesale trade, biotechnology and technology.

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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