November 1, 2017

Centre Funds Insight – Winter 2017/18 Market Review & Outlook – U.S. Fixed Income

Over the long run, interest rate behavior primarily reflects real economic growth, investors' inflation expectations or concerns, monetary policy, and bond market valuations. However, in short time periods, fundamentals can be overwhelmed by investors' fear or euphoria. After the presidential election the yield on the 10-year U.S. Treasury Note, the benchmark for the U.S. fixed income marketplace, increased by roughly 100 basis points based on the belief that the economy could return to its former glory days in terms of real growth and break out of its stagnant, "New Normal" shackles. However, as the realities of the delays associated with the prioritizing of political goals, defining policy proposals, and getting them through Congress became apparent, rates moved lower and reversed part of the November sell-off in bond prices. Rate behavior in the period also reflected concerns about the geopolitical situation, particularly in North Korea. As a result of these factors, rates fluctuated generally between 2.2% and 2.4% during the one year period ended September 30, 2017, although the 10-year yield briefly dipped below 2.1% at the height of political concerns and reflected the flight of capital to the global safe haven asset, U.S. Treasury Bonds.

The Fund portfolio manager's view (or "we") is that over the next few years - barring recession and exogenous shocks to the economy - steady real growth in the U.S. economy, the waning of factors exerting downward pressure on inflation (such as foreign labor costs), and continued monetary policy normalization should push interest rates higher. As of now, the U.S. economy continues to be in an expansionary state and is entering the ninth year of economic recovery. Labor market activity is strong and has positive momentum which has taken the unemployment rate below the level that is sustainable over time based on history. Labor market strength is confirmed by the Non-Employment Index, a measure designed to answer critiques of the "official" unemployment rate by evaluating the likelihood of a return to the labor force by those no longer counted as active job seekers. Additionally, research on "informal work hours" is consistent with the argument that the labor market slack created during the Great Recession has been eliminated. The Federal Open Market Committee ("FOMC") members are expecting real growth of 1.9%-2.1%, slightly above current estimates of the U.S. economy's growth potential. According to the Survey of Professional Forecasters from the Philadelphia Federal Reserve Bank, real growth over the next two years is projected to be even higher, at 2.2%-2.4%. Survey participants have also materially reduced their estimates of experiencing negative growth in any quarter out through the third quarter of 2018. We believe that real growth will be higher than projections from both the FOMC and professional forecasters, and will likely be in the 2.75%-3.0% range starting in 2019. Our outlook assumes that the current regulatory environment will become more pro-growth through legislative action or executive orders, the current tax structure will be simplified with increased incentives to work and invest, infrastructure spending to support growth will take place, and that further educational attainment, focusing on problem solving and critical thinking, will be achieved.

While inflation has run below the desired 2% target of the FOMC, the shortfall appears attributable to transitory factors. The Federal Reserve's ("Fed") 2% target is expected to be reached over the next two years as Chairwoman Janet Yellen has indicated in various speeches and testimonies before Congress a willingness to let the labor market "overheat" and allow inflation to move above 2% for a temporary period. As a result of continued real growth and inflation at or above target, the FOMC will likely increase the target for the Federal Funds Rate at least one more time before December 31, 2017. FOMC policy makers believe the Federal Funds Rate will average 2.1% for all of 2018 and reach an average level of about 3% in 2019. Analysis at the Cleveland Federal Reserve Bank "Seven Simple Monetary Policy Rules" indicates a

median value of the Federal Funds Rate of 2.24% in the third quarter of 2018 with a rate of 2.43% by the third quarter of 2019. Additionally, research on the Natural Rate (or "r*" as it has become known) by San Francisco Federal Reserve Bank President John Williams and others indicates an equilibrium funds rate of 2.5% based on full employment and target rate inflation suggesting the Federal Funds Rate will be increased five more times (assuming 0.25% moves) within eighteen to twenty-four months. In all likelihood, the Federal Funds target rate will be increased by a greater amount should one or more of these five events or assumptions occur. Historically, the FOMC's decision process has displayed an inertia that leads to a number of small target increases initially with larger ones later as policy makers realize that both the unemployment rate and the inflation rate have exceeded their sustainable unemployment or desired inflation goals. As unemployment has already reached below NAIRU and inflation concerns seem to reflect transitory and temporary factors, the tendency for policy to lag behind seems more probable. As a result, we believe target rate increases of 50-75 basis points will occur at least once or twice before December 31, 2019.

FOMC members seem confident that current policy remains accommodative and that the continued normalization of the target for the Federal Funds Rate and the beginning of the normalization process of the Federal Reserve's Balance Sheet remain appropriate policy goals. Several researchers both in the Federal Reserve system and in academia have hypothesized that Quantitative Easing ("QE") has reduced longer term yields by a little less than 1%. Therefore, unwinding the balance sheet may put upward pressure on longer term yields by a similar level. Historically, the spread between the 10-year yield and the funds rate has been 150 basis points. A 2.5% funds rate would be consistent with a 4% 10-year yield. Williams has suggested that a 1% spread may put the 10-year rate at 3.5%. According to Federal Reserve Board Governor Lael Brainard, the term premia on longer term rates (currently well below average) would move higher by 40 basis points even if short term rates were stable after the balance sheet normalization got in full swing. These various arguments place the 10-year rate between 2.75% and 3.75% over the next twelve months. Given our growth expectations and the tendency of policy makers to foster overshooting of the unemployment and inflation rate targets – based on history, our view is that rates will actually break through the 4% level before December 31, 2018. Further, as it is unclear how the aging of the population will impact investors' overall willingness to take on risk in order to gain return and the desire to save rather than spend, the long-run average risk premium demanded by investors is our best estimate. This should put the yield on the 10-year Treasury 1.5% above the Federal Funds Rate on average.

Risks to the interest rate forecasts described above are more likely to the upside than the downside. In fact, FOMC participants are currently placing greater weight on the upside risks to both their real growth and inflation projections than was the case in March. Like stock prices, rates tend to overshoot the level indicated by the fundamentals. Additionally, the Federal Reserve has never achieved a "soft-landing" in reaching its dual mandate of full employment and price stability, which is currently defined as an inflation rate of 2% and an unemployment rate roughly where it stands today. This may be even less probable given the expressed willingness to breach the 2% target by a "small amount" for a "temporary period" as neither "small" nor "temporary" were well specified. Once currently well anchored inflationary expectations break free, actual inflation could spike higher, creating a vicious cycle as business and household expectations become embodied in pricing and spending decisions. Additionally, continued progress of rolling back on the regulatory front vastly expanded under President Obama could create a more favorable climate for business and accelerate the pace of hiring and investment for plant and equipment. Furthermore, if investors become convinced that tax simplification and restructuring as well as growth facilitating infrastructure spending will occur, in addition to an improved regulatory environment, rates could again spike higher. Longer term, yields will likely settle in the 5%-6% range if our expectations for real growth are realized

and inflation, after a period of overshooting, settles at the Fed's 2% target. If this is true, we think investors will cause rates to move into this range sooner rather than later.

Moving forward, the inflation rate and real growth and, as a result, interest rate levels will reflect political, economic, and demographic related issues more so than monetary policy. Real growth projections based on the "New Normal" for the U.S. economy from the San Francisco Federal Reserve Bank are in the range of 1.5%-1.75% while the Congressional Budget Office (CBO) is projecting a 1.8% real growth through 2027. The arguments that form the basis for this significantly slower pace of growth relative to the 20th century average of around 3.0%-3.25% revolve around a reduced rate of technological advancement, less contribution from education, and slower growth in the labor force. In "The Rise and Fall of American Growth", Robert Gordon argues that the technology related ideas of today are much less dramatic in their growth impact than the innovations of the past, such as the steam engine. John Fernald of the San Francisco Federal Reserve Bank projects productivity growth in line with its "pace for most of the period since 1973" of about 1%. He assumes that any contribution from educational attainment (increased human capital) has "plateaued" and that capital "deepening" (increased capital per worker) will not spur labor productivity dramatically. The arguments for a reduced rate of growth in the future point to a slowing pace of labor force growth, which in turn reflects both slower population growth and the retirement of the "baby boomers".

Regardless of the eventual outcomes for growth and inflation rates, there is nothing in this debate to suggest that the business cycle has been tamed out of existence or that it will not be exacerbated by monetary policy, either conventional or unconventional, as has been true in the past. In fact, some suggest that business cycles may occur more frequently and potentially be of greater downside magnitude if a lower real Federal Funds Rate, consistent with slower trend growth, limits the Fed's ability to stimulate growth through conventional monetary policy. If true, this would increase opportunities to benefit from the eventual cyclical decline as policy makers move in to rein in accelerating inflation. If, on the other hand, real growth reverts toward its 20th century norm, there will be a great need to protect portfolio value against rising rates near term, but with an opportunity to benefit from the eventual cyclical decline as policy makers move in to rein in accelerating inflation. So, going forward, rate behavior seems most likely continue to be cyclical in nature and jagged or violent in pattern as both market participants and policy makers react and overreact to the impacts of changing economic conditions. The Interest Rate Scorecard is intended to anticipate rate moves and adjust portfolio duration tactically for the benefit of shareholders of the Centre Active U.S. Treasury Fund by taking advantage of rate declines and shielding value against rate increases.

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T. Kirkham Barneby is the portfolio manager of the Active U.S. Treasury Fund and Active U.S. Tax Exempt Fund. Mr. Barneby serves as Investment Director, Fixed Income of the Adviser. Prior to joining the Adviser in 2014, Mr. Barneby served as Senior Managing Director and Portfolio Manager at Hudson Canyon Investment Counselors, LLC, where he was responsible for managing private account clients in the Active Interest Rate Management strategy. Prior to that, Mr. Barneby held the title of Chief Strategist & Portfolio Manager, Taxable Fixed Income at American Independence Financial Services. Prior to AIFS, Mr. Barneby was a Managing Member of Old Iron Hill Capital Management, LLC employing quantitatively-oriented fixed income and multi-strategy investment approaches. Previously, he headed an investment group at UBS in New York that managed equity and bond portfolios with roughly $7 billion in assets. Mr. Barneby is a graduate of Southwest Missouri State College-now Missouri State University-with a Bachelor of Science Degree in Mathematics and Economics. Subsequently, he completed all course and exam requirements for a Doctorate in Economics at Oklahoma State University. He is a National Science, NDEA and Woodrow Wilson Fellow.

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<u>About The Fund</u>

The Fund is a nontraditional U.S. Treasury securities fund that seeks to maximize investors' total return through capital appreciation and current income through investments in primarily U.S. treasury securities. The Fund has the potential for capital appreciation/preservation in various interest rate environments through a proprietary interest rate forecasting process that aims to take advantage of interest rate changes through active duration and interest rate management.

The Fund's investment objective is to maximize total return through capital appreciation and current income. The Fund pursues this objective by using an active interest rate risk management strategy. In other words, when interest rates are expected to decline, the Fund extends duration and when interest rates are expected to rise, the Fund shortens duration. The portfolio's duration is adjusted based on a monthly assessment of the likely change in interest rates. Our fundamentally-driven active duration management strategy seeks the potential for capital appreciation and/or preservation in variable interest rate

environments by utilizing U.S. Treasury securities including bills, notes, bonds, inflation protected securities (TIPS), cash equivalents and, in certain market environments, futures contracts on U.S. Treasury Notes and Bonds.

The Centre Active U.S. Treasury Fund is intended to serve as a tactical (long, short or neutral duration relative to that of the Treasury market) fixed income investment by managing market exposure to achieve performance (i.e., managing interest rate beta to achieve alpha). Over time, it is intended to provide the same yield as the Treasury market with attractive diversification benefits given the underlying core portfolio of fixed income yielding bonds. In addition to its capital appreciation and current income generation objectives, the strategy is designed to accommodate both systematic and unforeseen cash needs, given the liquidity of the Treasury market. Furthermore, the utilization of Treasury securities within asset allocation is designed to provide attractive diversification properties, as the correlation between Treasury market returns and those of the U.S. equity market has historically been negative during recession related “bear” equity markets, particularly over the previous two decades. The Fund’s investment discipline is designed to identify the risks and opportunities of trends and short term deviations from those trends in interest rate behavior by incorporating the Federal Reserve’s policies, measures of real growth, inflation expectations, and market valuations. The Fund’s investment discipline is intended to preserve capital in periods of significant rate increases by decreasing the portfolio duration and provide the flexibility to extend portfolio duration when rates are likely to decline.

Definitions and References

1. Basis point refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001), and is used to denote the percentage change in a financial instrument.
2. Duration is a measure of the sensitivity of the price of a fixed-income investment to a change in interest rates.
3. The “New Normal” is a business term referring to economic conditions following the 2007–2012 financial crisis.
4. The Non-Employment Index is an alternative measure of the labor utilization that accounts for all non-employed individuals, distinguishing between groups like short-term versus long-term unemployed, discouraged workers, retirees, and disabled individuals, and adjusting for how likely each is to transition to employment.
5. “NAIRU,” or non-accelerating inflation rate of unemployment, refers to a level of unemployment below which inflation rises.
6. Quantitative Easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply.
7. Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. Beta is used in the capital asset pricing model (CAPM), which calculates the expected return of an asset based on its beta and expected market returns.
8. Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of a mutual fund and compares its risk adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha.

Disclosures

Investors should consider the investment objectives, risks, charges and expenses of the Funds carefully before investing.

To obtain a prospectus containing this and other information, please call 1-855-298 4236 or download the file from www.centrefunds.com. Read the prospectus carefully before you invest.

There is no assurance that this investment philosophy will consistently lead to successful investing. An investment in the Funds involves risk, including loss of principal. Fixed-income securities are subject to repayment risk and the risk of price volatility due to interest rate sensitivity, market perception of the issuer's creditworthiness and general market conditions. As interest rates rise, the value of fixed-income securities typically declines. TIPS are long-duration assets, sensitive to changes in interest rates and, in the short term, can experience substantial fluctuations in price.

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Diversification does not eliminate the risk of experiencing investment losses.

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