May 19, 2017

Centre Funds Insight – Spring/Summer 2017 Market Review & Outlook – U.S. Fixed Income

The Institute for Supply Management (ISM) Reports on Business for the Manufacturing and Non-Manufacturing sectors show improvement in key components such as new orders, production, employment and delivery times. Based on Labor Department data, new hires have averaged approximately 180,000 over the six month period ending March 31, 2017, which suggests a strong labor market and the possibility of some "overheating". According to the Chicago Federal Reserve Bank, the top end of estimates for a sustainable rate of employment of new hiring is 110,000. John Williams, President of the San Francisco Federal Reserve Bank, believes the sustainable pace of new hires is only 80,000. The official unemployment rate, also known as U3, of 4.5% is currently below most estimates of NAIRU (Non-accelerating Inflation Rate of Unemployment). Additionally, the Kansas City Federal Reserve Bank's Labor Force Momentum indicator recently hit an all-time high reading. The Hornstein-Kudlyak-Lange Non-Employment Index delivers a message, consistent with the U3 level and the Labor Force Momentum indicator, that labor forces are likely fully employed which creates the potential for higher inflation and wage pressures in the near future.

Inflation has improved lately due to rising energy prices and a slowing in the appreciation of the U.S. dollar relative to foreign currencies. The price deflator for Personal Consumption Expenditures (PCE), the Federal Reserve's preferred gauge of inflation, is currently at an annualized run rate consistent with the Federal Open Market Committee's (FOMC) 2% target. In addition, the "trimmed mean" version of PCE, a preferred measure by some FOMC members, is also running at an annual rate in line with the 2% target. Furthermore, the median and trimmed mean calculations of the actual Consumer Price Index (CPI) and Core CPI used by the Cleveland Federal Reserve Bank are all at or above the 2% target. Moreover, the Atlanta Fed's Sticky-Price CPI and its Wage Growth Tracker also support the view that inflation has finally reach the Fed's optimal level. There continues to be support for overshooting the 2% inflation target in order to make sure that all resources are fully employed since the capacity utilization rate remains below its long-term average. Chairwoman Yellen indicated a willingness to let the labor market "overheat" and to allow inflation to move above 2% for a temporary period. The FOMC seems likely to increase the target for the funds rate twice (0.25 point move each time) by the end of 2017 and perhaps three times if forecasts suggest upside risk. The Atlanta Federal Reserve Bank's Taylor Rule Facility suggests that the FOMC is already 1-2 moves behind its normalization process. In addition, recently released Fed minutes indicate that the Fed may begin the process of bringing its balance sheet assets back from the present level of $4.5 trillion to the 2008 pre-crisis level of $850 billion by allowing its securities to mature. Chairwoman Janet Yellen has suggested in speeches and testimony that she believes the Federal Reserve's "dual mandate" of achieving full employment and price stability has been fairly successful. The Federal Reserve began its long awaited monetary policy "normalization" process in December 2016, and increased its target for the federal funds rate again in March 2017. During that period, interest rates exhibited volatile behavior but generally moved higher as the yield on the benchmark Constant Maturity 10-year Treasury note increased from 1.6% to 2.4%.

From a long term perspective, interest rates exhibit a significant and positive correlation with the economy's nominal growth as evidenced by the fact that rates have a real and inflation premium component just as nominal growth has a real and inflation component. The current real potential growth estimate of 1.8%

from the Congressional Budget Office and the Fed's 2% inflation target would imply an eventual 3.8% yield on the 10-year note. In actuality, rates have a tendency to overshoot at both peaks and troughs. Consequently, yields could reach a level of 4% or higher if President Trump's proposed growth policies are successfully implemented. Assuming continued economic expansion and higher inflation, an upward trajectory in rates is to be expected though the trend will not be smooth. The likelihood that President Trump could deliver pro-growth tax reform and infrastructure spending on a timely basis was likely diminished by the apparent focus on immigration policy and healthcare reform. Globally, political events, including those in the U.K. and France, created uncertainty regarding the stability of the European Union and the nature of Brexit. Political and military situations in North Korea and Syria also added to global uncertainty. In times of concern about any type of risk, the U.S. Treasury market serves as a safe haven. Policy uncertainties will likely lead to more frequent volatility and of greater magnitude and, as a result, there will be opportunities to profit from neutral as well as bullish calls even in a rising rate environment allowing the Fund to benefit, hopefully, from our flexibility and active duration management decisions.

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Definitions

1. Hard Data is defined as data in the form of numbers or graphs, as opposed to qualitative information.
2. Soft Data includes non-quantifiable data such as business or consumer sentiment based on survey results.
3. Overheating occurs when there is pressure to raise wages due to a strong labor market.
4. Hornstein-Kudlyak-Lange Non-Employment Index is an alternative to the standard unemployment rate that includes all non-employed individuals and accounts for persistent differences in their labor market attachment. It provides a more comprehensive reading of labor market health and is based on research first published by Richmond Fed economist Andreas Hornstein, San Francisco Fed economist Marianna Kudlyak, and McGill University economist Fabian Lange.
5. Personal Consumption Expenditures is the primary measure of consumer spending on goods and services in the U.S. economy. It accounts for about two-thirds of domestic final spending, and thus it is the primary engine that drives future economic growth.
6. Trimmed Mean is a method of averaging that removes a small designated percentage of the largest and smallest values before calculating the mean. After removing the specified observations, the trimmed mean is found using a standard

arithmetic averaging formula.

7. Consumer Price Index is an index of the variation in prices paid by typical consumers for retail goods and other items.
8. Core CPI is equal to CPI minus energy and food prices and is used to measure core inflation. The reason behind excluding energy and food prices is because the prices of these goods can be very volatile.
9. Sticky-Price CPI is calculated from a subset of goods and services included in the CPI that change price relatively infrequently. Because these goods and services change price relatively infrequently, they are thought to incorporate expectations about future inflation to a greater degree than prices that change on a more frequent basis.
10. Wage Growth Tracker is a measure of the nominal wage growth of individuals.
11. Capacity Utilization Rate measures the proportion of potential economic output that is actually realized. Displayed as a percentage, capacity utilization levels give insight into the overall slack that is in the economy or a firm at a given point in time.

Disclosures

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

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Diversification does not eliminate the risk of experiencing investment losses.

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