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Centre Funds Insight – Spring/Summer 2018 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. Our view is that over the next few years - barring recession and/or exogenous shocks to the economy - steady real growth, the waning of special factors (e.g. Medicaid payments) exerting downward pressure on inflation and continued monetary policy normalization should push interest rates higher. As of now, the U.S. economy seems to be continuing to be in an expansionary phase, is entering the ninth year of economic recovery and will soon be the second longest expansion in American economic history.

Research suggests that expansions do not "die of old age", so we are of the opinion that we are not "due" for a recession. Over 2 million jobs were created in 2017 and the level of labor market activity remains strong with positive momentum which has taken the unemployment rate below the level that is sustainable, NAIRU, over time based on population growth and the labor force participation rate. The official unemployment rate is 4.1% and current estimates place NAIRU at around 4.7%. Additionally, our research indicates that the shape of the Treasury yield curve[1], currently viewed by some as a recession warning sign, is not troubling. We agree with the assessment of former FOMC (Federal Open Market Committee) Chairman Alan Greenspan that it is the level of the federal funds rate relative to the "Natural Rate" consistent with full employment and target inflation that changes the pace of economic activity.

Labor market strength is further 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. Besides continuing the process of policy normalization at its most recent meeting, FOMC members have increased their expectations for real growth in 2018 from 2.1% to 2.5%. According to participants in the Survey of Professional Forecasters from the Philadelphia Federal Reserve Bank, real growth over the next two years is projected to be even higher than the FOMC's forecasts, at 2.8% and 2.5% in 2018 and 2019, respectively. Survey participants have also materially reduced their estimates of experiencing negative growth in any quarter out through the end of 2018.

The increases in real growth forecasts are consistent with the view that current tax legislation changes could boost near term real growth by up to 0.5% per year over the next two years and with improving growth overseas. However, both FOMC members and Survey participants accept the Congressional Budget Office's (CBO) estimate of potential real growth of around 1.8% longer term. We believe that real growth will be higher than projections from both the FOMC and professional forecaster longer term and will likely be in the 2.75% range starting in 2019. Our outlook assumes that the current regulatory environment will continue to be more pro-growth oriented through legislative action or executive orders, that the recent tax restructuring will increase incentives to both work and invest, that infrastructure spending to facilitate growth will take place, that expanding energy exports can generate additional income and that a trade of significance can be avoided.

While inflation has run below the desired 2% target of the FOMC since 2012, the shortfall appears attributable to transitory factors and to a recovery that has been slow relative to past expansions until

[1] A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.

recently. The slower expansion reflects a debt overhang, now eliminated in both household and business balance sheets, and an increased aversion to risk. The slow pace of inflation has caused investors' inflationary expectations to be well anchored at a rate below the Fed's 2% target. Expectations are critical to achieving the inflation target as they are built into the pricing decisions of manufacturers and service providers and the spending decisions of consumers. Presently, most policy makers and forecasters expect the 2% goal to be attained and maintained in the next two years. FOMC Chairman Jerome Powell has seemingly accepted Janet Yellen's argument to let the labor market "overheat"[2] and allow inflation to move "somewhat" above 2% for a "temporary" period. While inflation expectations have not yet "broken out", recent data from the Philadelphia Fed suggests they are beginning to increase.

Furthermore, there are currently, among monetary policy makers, an increasing number of advocates for "price-level" targeting[3]. Given the shortfall since 2012, this approach would require an inflation rate well above 2% for an extended period of time in order to bring the price level to a value consistent with 2% increases since 2012. Our view is that inflation will likely exceed 2% this year causing inflation concerns to become unanchored and putting additional upward pressure on rates beyond that due to simply achieving the FOMC's target rate.

As a result of continued real growth and the expectation that inflation will reach the specified target in the "near term", the FOMC will likely continue its programs of policy normalization regarding both further target rate increases and Federal Reserve Balance Sheet decreases. FOMC policy makers believe the Federal Funds Rate will average 2.1% for all of 2018 and reach an average level of about 2.7% in 2019. The Taylor Rule Analysis at the Cleveland Federal Reserve Bank "Seven Simple Monetary Policy Rules" indicates a median value of the federal funds rate of 2.6% in the first quarter of 2018 and 2019. Additionally, research on the Natural Rate of interest (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. These forecasts/analyses imply three to four more target rate increases (assuming 0.25% moves) within eighteen months.

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. Unemployment is already well below estimates of NAIRU and inflation seems to reflect transitory and temporary factors. If our own projections for real growth and inflation prove accurate, the equilibrium value for the fund's rate will be at least 3%. In fact, the median forecast from the FOMC is for a 3% fund's rate in 2020. As a result, the tendency for policy to lag behind will, we believe, require target rate increases of 50-75 basis points[4] at least once or twice before December 31, 2019 as policy makers are forced to play "catch-up".

Historically, the spread between the 10-year yield[5] and the funds rate has been 150 basis points. A 2.5% funds rate would be consistent with a 4% 10-year yield. John Williams, President of the Federal reserve Bank of San Francisco and a voting member of the FOMC, has suggested that a 1% spread may be normal going forward, which would put the 10-year rate at 3.5%. However, it is not clear why the Treasury term

[2] An overheated market is one that is expanding at an unsustainable pace.
[3] Price-level targeting is a monetary policy framework that can be used to achieve price stability. Price-level targeting establishes targets for a price index like the consumer price index.
[4] Basis points, otherwise known as bps, are a unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100th of a percent) or 0.0001 in decimal form.
[5] The 10-year yield is the interest rate that the U.S. government pays to borrow money over 10 years.

premia[6] should be permanently lower unless the Fed can control inflation volatility better going forward than they have accomplished historically. 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.

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 3.0% and 4.0% over the next twelve months. Given the tendency historically of policy makers to foster overshooting of the unemployment and inflation rate targets, our view is that rates will actually break through the 4% level before December 31, 2018.

Risks to the interest rate forecasts described above are more likely to the upside rather than the downside. 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 above where it stands today. Such an achievement 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, or, if price-level targeting becomes accepted policy. Once currently well anchored inflationary expectations break free, actual inflation could spike higher, as business and household expectations become embodied in pricing and spending decisions.

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% area 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 accurate, 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 likely reflect political, economic, and demographic related issues more so than monetary policy. The real growth projection based on the "New Normal" for the U.S. economy from the San Francisco Federal Reserve Bank is 1.75% while the 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".

Our own long term outlook and its implications for rates rest on the following assumptions. The educational process has not plateaued. While the number of opportunities for middle manager type jobs may have decreased, there are ample job opportunities if workers have the necessary skills. Increasingly, the

[6] An asset's risk premium (or premia) is a form of compensation for investors who tolerate the extra risk, compared to that of a wholly risk-free asset.

educational process must focus on technical/vocational type studies and apprenticeships in order to eliminate any skills mismatch between available jobs and those seeking employment. Provided proper incentives, the labor force can grow despite the demographics of an aging population. The employment-to-population ratio for prime-age workers is 1% below its pre-crisis level and the participation rate for 65+ workers is already increasing. The extent to which capital deepening can enhance productivity remains to be seen. A legal and regulatory framework that encourages new business formation should, in addition to spurring new hiring, be a source of new innovations that lead to increased productivity. Finally, there is a lag between the development of new technologies and their utilization in the production and distribution of goods and services. To argue that current technologies are not as impactful as earlier ones may be overlooking the time to achieve maximum benefit.

The downside to our more optimistic longer term forecast comes from the increasing size of the federal deficit. If it grows at the current pace it will likely reach $20 trillion in five years. If interest rates were to rise to 5% (our view) instead of the Trump administration's prediction of just under 3.5%, the interest cost alone would be $1 trillion. Thus, more than half of all personal taxes would be needed to pay bondholders, potentially crowding out expenditures on the infrastructure needed to facilitate growth. Recent research has highlighted the significant negative correlation between increasing deficits and the potential real growth rate. An increasing deficit is also the cause of a worsening trade deficit. If domestic spending exceeds domestic saving, capital must be imported. Positive capital inflows are funded by negative trade flows. So, addressing the deficit also has implications for the trade balance.

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 to 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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About The Fund

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. Natural unemployment, or the Natural Rate of unemployment, is the minimum unemployment rate resulting from real, or voluntary, economic forces.
2. Basis point refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to $1/100^{th}$ of 1%, or 0.01% (0.0001), and is used to denote the percentage change in a financial instrument.
3. Duration is a measure of the sensitivity of the price of a fixed-income investment to a change in interest rates.
4. Taylor's rule is a proposed guideline for how central banks, such as the Federal Reserve, should alter interest rates in response to changes in economic conditions. Taylor's rule, introduced by economist John Taylor, was established to adjust and set prudent rates for the short-term stabilization of the economy, while still maintaining long-term growth.
5. The "New Normal" is a business term referring to economic conditions following the 2007–2012 financial crisis.
6. 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.
7. "NAIRU," or non-accelerating inflation rate of unemployment, refers to a level of unemployment below which inflation rises.
8. 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.
9. 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.

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