May 27, 2019

Centre Funds Insight – Spring/Summer 2019 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. The Fund portfolio manager's view is that over the next few years, barring a recessionary shock, steady real growth in the U.S. economy is likely to continue and that is likely to become the longest expansion in the post WWII period. Labor market activity has been and remains strong and has positive momentum. We believe this strength has taken the unemployment rate well below the level that is sustainable, NAIRU[1]. Current estimates of NAIRU, based on projected population growth and estimates of the labor force participation rate, are in the range of 4.5-4.7%. The unemployment rate is currently at 3.8%. Job openings reported by the Department of Labor continue at a high level as does the "quits" rate. The quits rate is an indicator of confidence on the part of workers as it indicates those leaving current employment to search for a better position. Labor market strength is further confirmed by the Non-Employment Index[2], 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, the lack of acceleration in the inflation rate as the unemployment rate has fallen to such a low level, the seeming failure of the Phillips Curve[3], may be indicative of some remaining labor market slack. The employment-to-population ratio for prime age labor market participants remains 1% below pre-crisis levels and may be evidence of such slack. So, as various FOMC[4] members have said, it seems likely that the Federal Reserve (Fed) is willing to support some overheating of the labor market and an inflation rate somewhat above target for a period. Finally, James Bullard, President of the St. Louis Federal Reserve Bank, has recently said that the FOMC must be sensitive to not "invert the yield curve". While our own assessment is that yield curve inversions do not have the predictive power typically attributed to them, many others including policy makers and academics continue to focus on them as indicative of recessions. Our own analysis focuses on the relation between the federal fund's target and the economy's neutral or natural rate. Currently, monetary policy is not restrictive. We believe the federal fund's rate target is likely ¼ of a percent below the natural rate and the Fed's balance sheet remains significantly larger than that required for the efficient implementation of monetary policy.

Historically, the spread between the 10-year yield[5] and the federal funds rate has been 150 basis points[6]. So, the Fund's current target range would be consistent with a 10-year yield in the 3.75-4% range. John Williams, newly appointed President of the Federal Reserve Bank of New York and now a permanent

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[1] The Non-Accelerating Inflation Rate of Unemployment (NAIRU) – also referred to as the long-run Phillips curve – is the specific level of unemployment that is evident in an economy that does not cause inflation to rise.

[2] 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.

[3] Phillips curve is an economic concept developed by A. W. Phillips stating that inflation and unemployment have a stable and inverse relationship. The theory claims that with economic growth comes inflation, which in turn should lead to more jobs and less unemployment.

[4] The Federal Open Market Committee (FOMC) is the branch of the Federal Reserve Board that determines the direction of monetary policy..

[5] The 10-year yield is the return on investment, expressed as a percentage, on the debt obligation issued by the U.S. government with a maturity of 10 years upon initial issuance.

[6] 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%, or 0.0001, and is used to denote the percentage change in a financial instrument.

voting member of the FOMC, has suggested that a 1% spread may be normal going forward, which would put the 10-year rate at 3.25-3.5%. However, we see no reason why investors should willingly accept lesser term premia[7] going forward unless the Fed proves to be a more stabilizing force than has been true in the past. Given our growth expectations and the indicated willingness of policy makers to foster overshooting of the unemployment and inflation rate targets, our view is that rates could be in the 3.5-3.75% range before December 31, 2019.

Risks to the interest rate forecasts described above are more likely to the upside than the downside. Like stock prices, rates tend to overshoot the level indicated by the fundamentals. Additionally, the Federal Reserve has very rarely achieved a "soft-landing[8]" in reaching its dual mandate of full employment and price stability, defined as an inflation rate of 2% and an unemployment rate somewhat above where it stands today. Upside risk may be even more 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.

Continued progress in rolling back growth hindering regulations could create a more favorable climate for business than anticipated 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 4-5% 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 becomes the generally accepted outlook, we think investors will cause rates to move into this range sooner rather than later.

Risks to the downside of our outlook come from those who argue that the best days for growth are behind us. Over time, inflation and real growth and interest rate levels will reflect political, economic, and demographic related issues. Our growth outlook, for the reasons mentioned above, resembles, though it is somewhat less than, the economy's potential growth during much of the 20th and early part of the 21st centuries. In contrast, real growth projections based on the "*New Normal*[9]" 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. Combined with the Fed's 2% goal for inflation, these growth projections would place the equilibrium value for the 10-year yield at roughly 3.5%-4% longer term, still higher than current levels. 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 (demographics).

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

[7] Term premia represent the additional yield bondholders require for holding long-dated bonds as opposed to short-dated paper.

[8] A soft landing, in economics, is a cyclical downturn which avoids recession. It typically describes attempts by central banks to raise interest rates just enough to stop an economy from overheating and experiencing high inflation, without causing a significant increase in unemployment.

[9] The term "New Normal" refers to a permanent downward departure from America's historic 3% growth rate. New Normal projections could be a response to the trauma of the financial panic, the European debt crisis, deleveraging, and downtrending demographics, summing to a suggestion of slower growth.

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".

Forecasting an ongoing lack of meaningful technological advancements and the failure of the educational system to adapt to changing skill requirements seems both problematic and pessimistic. And, to the extent that "capital deepening", more capital per worker, has an impact on productivity, the ongoing pace of business investment spending is encouraging. This investment reflects the attractive after-tax rate of return currently being earned which has been stable to increasing of late according to research at the St. Louis Federal Reserve Bank.

This research also calls into question the work concluding that a decline in the economy's natural rate of interest, the rate in real terms consistent with potential output growth and target rate inflation, has occurred. An explanation for why the real or natural rate of interest is below the return on capital may be an increased aversion to risk on the part of investors and a greater demand for the riskless asset[10], U.S. Treasury securities (as noted above). Increased risk aversion could reflect demographic changes, global political and economic policy uncertainty and the lingering aftermath of the global financial crisis. If investors become less concerned, they may be less willing to pay a higher premium for perceived safety.

Apart from the contrasting position noted above, there is a "stagflation[11]" scenario that merits concern. From the Hoover Institute: "if, for example, interest rates were to rise to 5%, instead of the Trump administration's prediction of just under 3.5%, the interest cost alone on the projected $20 trillion of public debt would total $1 trillion per year. More than half of all personal income taxes would be needed to pay bondholders. Such high interest payments would crowd out financing of needed expenditures to restore our national defense budget, our depleted domestic infrastructure, and other critical government activities." A reduction in outlays for infrastructure could slow the economy's potential for growth.

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 more frequently from cyclical declines in rates. If, on the other hand, real growth reverts toward its 20th century norm and inflation accelerates as policy makers delay too long in the normalization process, there may be a great need to protect portfolio value against rising rates. There may, of course, be an opportunity to benefit from the eventual cyclical decline in rates and changes in term premia as policy makers eventually act to rein in accelerating inflation.

Going forward and consistent with history, rate behavior seems 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, inflation and political conditions. Our investment process is designed for

[10] A risk-free asset has a certain future return. Treasuries (especially T-bills) are considered to be risk-free because they are backed by the U.S. government.

[11] Stagflation is a condition of slow economic growth and relatively high unemployment, or economic stagnation, accompanied by rising prices, or inflation. It can also be defined as inflation and a decline in gross domestic product (GDP).

such a world and is intended to anticipate rate moves and adjust portfolio duration[12] tactically for the benefit of shareholders of the 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. 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.

T. Kirkham Barneby is a registered representative of ALPS Distributor, Inc.

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 using 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 that aims to capture general cyclical interest rate trends while allowing for the potential to benefit from short-term deviations. This strategy involves the use of a proprietary fundamentally-driven interest rate forecasting process designed to forecast interest rates on a monthly basis. The Fund's duration is adjusted based on a monthly assessment of the likely change in interest rates. When interest rates are expected to decline, the Fund extends duration, and when interest rates are expected to rise, the Fund shortens duration. The Adviser's active duration management strategy for the Fund seeks

[12] Duration is a measure of the sensitivity of the price – the value of principal – of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Bond prices are said to have an inverse relationship with interest rates. Therefore, rising interest rates indicate bond prices are likely to fall, while declining interest rates indicate bond prices are likely to rise.

the potential for capital appreciation and/or preservation of capital in variable interest rate environments by utilizing U.S. Treasury securities, including bills, notes and bonds, Treasury inflation protected securities (TIPS), cash equivalents and, in certain market environments, futures contracts on U.S. Treasury Notes and Bonds.

The 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 Treasury securities. The Adviser's strategy for the Fund is also designed to accommodate both systematic and unforeseen cash needs, given the ample liquidity of the Treasury market.

The utilization of Treasury securities within an investor's portfolio asset allocation is designed to provide attractive diversification properties, as the correlation between Treasury market returns and those of the equity market has historically been negative during recession-related "bear" equity markets. The Adviser's investment discipline for the Fund is designed to identify the risks and opportunities of trends and short-term deviations from those trends in interest rates by combining measures of the Federal Reserve (Fed)'s policies, real growth, inflation expectations, and current bond market valuations. The investment discipline is intended to preserve capital in periods of significant rate increases by decreasing the Fund's portfolio duration and provide the flexibility to extend portfolio duration when rates are likely to decline.

Definitions

1. Treasury inflation protected securities (TIPS) refer to a treasury security that is indexed to inflation in order to protect investors from the negative effects of inflation. TIPS are considered an extremely low-risk investment because they are backed by the U.S. government and because the par value rises with inflation, as measured by the Consumer Price Index, while the interest rate remains fixed.
2. 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.
3. 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.
4. A fund with a long duration holds bonds that have longer maturities, typically 10 years or more.
5. A short duration strategy involves buying bonds with shorter-dated maturities and selling long-dated bonds in order to lower the overall price sensitivity to interest rate movements and, as such, minimize potential capital losses.

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.

The statements and opinions expressed are those of T. Kirk Barneby as of the date of this report. All information is historical and not indicative of future results and subject to change. Reader should not assume that an investment in the securities mentioned was or would be profitable in the future. This information is not a recommendation to buy or sell. Past performance does not guarantee future results.

Diversification does not eliminate the risk of experiencing investment losses.

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