SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

FINANCIAL CONDITIONS, INFLATION AND CENTRAL BANK SHIFTS

JAMES F. KEEGAN
Chairman and
Chief Investment Officer

PERRY TROISI
Senior Portfolio Manager
U.S. Government/Securitized

SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up focused, top-down aware process. Seix employs multi-dimensional approaches based on strict portfolio construction methodology, sell disciplines and trading strategies with prudent risk management as a cornerstone.

REVIEW OF FIRST HALF OF 2017

The last year has been interesting to say the least with the first half of 2017 a continuation of the "expect the unexpected" theme. From Brexit and the Trump election to the snap election in the UK earlier this year, things have not transpired as the consensus had anticipated. The financial markets have also followed this pattern as the consensus view coming into 2017 called for the Trumpflation/Trumponomics pro-growth agenda of tax reform/cuts, fiscal/infrastructure spending, and regulatory reform to engender a global reflation that would result in higher long-term interest rates, a steeper yield curve, and a stronger dollar (remember the consensus calling for the euro to head to parity versus the dollar?) that would facilitate the baton being passed from central banks, thereby allowing policymakers to "normalize" monetary policy. The removal of ultra-accommodative emergency monetary policy was expected to tighten financial conditions and increase volatility. As you know, the consensus is usually wrong, but this year the inaccuracy of the consensus is one for the record books. In fact, long-term interest rates are lower, the yield curve is much flatter, the dollar is significantly weaker, financial conditions are looser in spite of two rates hikes, and stock and bond market volatilities have hit record lows.

The message from Exhibit 1 is the remarkable lack of negative return numbers witnessed in the capital markets in the first half of 2017. The Trump reflation trade was the primary theme driving risk assets as we entered 2017 and much to our surprise, despite any major legislative victories, risk asset prices have continued their upward trajectory. Repeal and replace: looks dead for now. Infrastructure spending, tax reform, and trade reform: pending for now. Quite frankly, using the term "pending" is arguably a bit generous, having seen the ongoing dysfunction that is ubiquitous in Washington, DC. The degree to which the market assumed the Trump administration was going to hit the ground running with its pro-growth agenda and put an end to a multitude of policy "disasters" candidate Trump admonished on his way to victory has been grossly overestimated. Knowing how legislative calendars work, significant parts of this new agenda are now slipping to 2018, a midterm election year that may prove even more challenging for passing any significant legislation than witnessed thus far in the albeit limited Trump Administration tenure. The capital markets have not missed a beat, let alone found this lack of legislative success even moderately unsettling. Stocks apparently are not bothered at all, considering that since election night through June 30th, the S&P 500® and Russell 2000® indices have total returns of 14.8% and 19.5%, respectively. Certainly more muted but still impressive, the Bloomberg Barclays High Yield Bond Index delivered 6.8% in total return over that same period. Exhibit 1 illustrates the return data for the past two quarters for select Bloomberg Barclays (BB) indices as well as a few other specific risk proxy measures.

EXHIBIT 1: RISK ASSETS RALLY WITHOUT PRO-GROWTH AGENDA LEGISLATION

	Q1 TOTAL RETURN	Q1 EXCESS RETURN	Q2 TOTAL RETURN	Q2 EXCESS RETURN	H1 TOTAL RETURN	H1 EXCESS RETURN
BB Aggregate	0.82	0.11	1.45	0.30	2.27	0.42
BB Treasury	0.67	n/a	1.19	n/a	1.87	n/a
BB Agency	1.13	0.60	0.93	0.20	2.07	0.80
BB RMBS	0.14	-0.17	0.87	-0.04	1.35	-0.20
BB ABS	0.54	0.22	0.60	0.32	1.14	0.54
BB CMBS	0.86	0.08	1.31	0.34	2.18	0.42
BB Corporate	1.22	0.38	2.54	1.12	3.80	1.51
BB High Yield Bonds	2.70	2.14	2.17	1.46	4.93	3.65
HY - Ba/B	2.27	1.69	2.22	1.48	4.54	3.22
HY - Ba	2.06	1.45	2.68	1.88	4.79	3.38
HY – B	2.53	1.98	1.71	1.04	4.28	3.05
HY – Caa	4.66	4.19	1.85	1.28	6.59	5.55
HY - Ca-D	8.87	8.48	2.39	1.92	11.47	10.60
BB Emerging Market	3.28	2.59	1.77	0.72	5.11	3.36
CS Instl Lev Loans	0.99	n/a	0.89	n/a	1.90	n/a
S&P 500	6.07	n/a	3.09	n/a	9.34	n/a
Russell 2000	2.46	n/a	2.46	n/a	4.98	n/a

Source: Bloomberg, Bloomberg Barclays, Credit Suisse.

Past performance is not indicative of future results.

Not all markets have been as willing to ignore the lack of legislative follow-through from the new administration. The interest rate spike that accompanied the early Trump rally retraced a bit. The 10-Year Treasury briefly eclipsed the mid-December 2.60% high in mid-March near 2.63%, only to see rates come back down to 2.13% in mid-June before ending the quarter at 2.30%. Recall, the 10-Year closed at 1.86% on Election Day. In addition to the Treasury market, commodity prices have also softened in 2017 with crude oil (West Texas Intermediate -14.3% in 2017) weighing particularly heavily on the complex, while in the currency market the dollar strength that initially accompanied the Trump victory has seen a complete retracement. The U.S. dollar index (DXY) declined by 6.4% over the first half of the year, returning to levels of last September when a Trump victory was still a very out-of-consensus wager. This dollar weakness is even more surprising given the backdrop of two additional rate hikes the Federal Open Market Committee (FOMC) delivered thus far in 2017. We have now seen a rate hike in each of the past three quarters, a development that historically (as in barely a year ago) would have incited significant dollar strength due to central bank divergence, as both the European Central Bank (ECB) and the Bank of Japan (BoJ) continue to expand their respective balance sheets through asset purchases. But alas, 2016's fears are barely a footnote to potential risks in 2017.

FINANCIAL CONDITIONS/STABILITY HOLD THE KEY

In order to understand where we are on this journey, it is important to know how we arrived at the most current destination along the way. The Fed is removing emergency ultra-accommodative stimulus by beginning the interest rate normalization process against a backdrop of a still-anemic economy and weakening reported inflation that some believe will result in a policy error (raising rates too much and too soon). As we have written previously, there have been many policy errors committed by policymakers and politicians in their quest to put Humpty-Dumpty back together again that will become obvious as the cycle evolves. At the top of this long list should be the Fed taking rates to zero and leaving them at zero for seven years at the same time that our central bank was quintupling the size of its balance sheet to an unprecedented $4.5 trillion as the velocity of money plumbed new lows throughout this balance sheet expansion experiment.

> *There have been many policy errors committed by policymakers and politicians in their quest to put Humpty-Dumpty back together again.*

This emergency ultra-accommodative monetary stimulus was originally put in place to prevent the financial system from seizing up after the policymakers facilitated (via easy money/credit creation coupled with lax underwriting and securitization vehicles) the largest debt, credit, and housing bubble that was then either dismissed, misjudged, or misdiagnosed by these same policymakers resulting in the Great Financial Crisis. The rationale for this extraordinary unconventional monetary stimulus was to force people out of safe assets (cash, money markets, and Treasury securities) into riskier assets (equities, investment grade and non-investment grade bonds and loans, emerging market debt, and alternatives). This would drive asset prices higher, engendering a wealth effect, which was supposed to put the debt-financed, consumption/finance-dominated economy back together again effecting the rebirth of the virtuous economic cycle. However, the structural forces (excessive debt/unfunded liabilities, aging demographics, excess global capacity, and low productivity) got in the way and, as such, the dynamic stochastic equilibrium models that drive central bank policy decisions have come up short once again. To be fair, the Fed has succeeded in resurrecting the finance-dominated economy as the "too big to fail" banks are even larger now, but many of the well-paying jobs have either disappeared, been off-shored, or replaced by technological advances.

Fast-forward to today and a logical question to ask is why then is the Fed raising short-term interest rates when inflation is below its 2% target? The Fed is raising short-term rates for the following reasons:

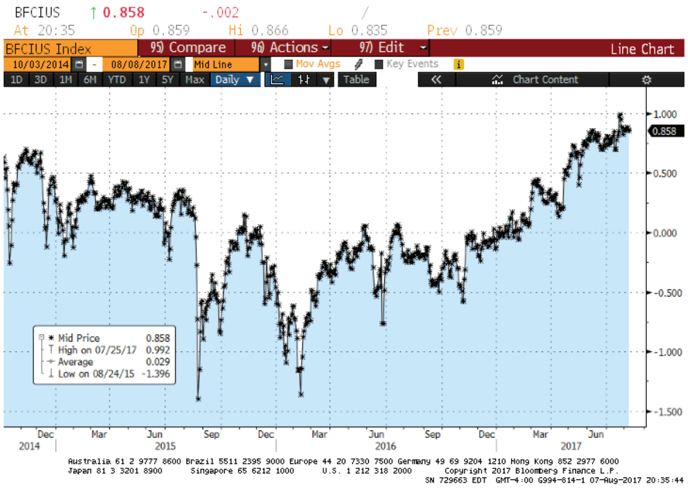
1. The Fed's belief that the softer inflation readings recently are at least partially transitory in addition to expecting wage inflation to accelerate as the economy approaches full employment (data dependency and the Phillips curve)
2. The age of the economic cycle (eight years and approaching the second longest in the post-war period)
3. The desire to have more conventional policy (short-term interest rates) available to fight the next recession
4. The fact that financial conditions are much looser now than they were when the Fed embarked on the initial rate hike in December 2015 (financial conditions are actually the loosest they've been since November 2014 and you will remember that the Fed ended QE3 in October 2014)

Financial conditions are a function of interest rates, stock prices, credit spreads, and the value of the dollar on currency markets. There are several indices that measure whether financial conditions are being broadly tightened or loosened. Below is a table that lays out the level of each component (stock prices, interest rates, credit spreads, and the dollar) on the date that the four rate hikes occurred going back to the initial hike in December 2015:

DATE OF HIKE	S&P 500	10YR UST/2S-10S	IG/HY OAS	DXY
12/15/15	2043.41	2.28%/130 bps	166/667	98.22
12/14/16	2253.28	2.54%/127 bps	124/401	100.73
3/15/17	2385.26	2.51%/118 bps	118/392	100.74
6/14/17	2437.92	2.15%/80 bps	112/361	96.32

As you can see in the table above, stock prices as indicated by the S&P 500 are higher (looser), 10-Year UST yields are lower (looser), credit spreads for both the investment grade and high yield indices are much lower (looser), and the dollar index, as measured by the DXY, is lower (looser). Despite four 25 basis point rate hikes that have taken the fed funds target from 0-0.25% to 1.00-1.25%, financial conditions have actually become looser/easier. Possible explanations for the aforementioned are: S&P 500 profits were strong in the first half of the year (stock prices), economic growth remains anemic and reported inflation soft (10-Yr. UST yields), rates are extremely low in the U.S. and negative in some European and Asian bond markets so the insatiable demand for yield remains strong, and the currency markets are pricing in a more dovish Fed and improved relative growth outside the U.S. (DXY). Money markets are pricing in less than two 25 basis point rate hikes through the end of 2018 versus the Fed's DOT plot where the median forecast is implying four additional 25 basis point rate hikes. Moreover, there is less concern that President Trump will be appointing more hawkish members to the Board of Governors of the Federal Reserve Board (currently there are two vacant seats in addition to the Chair's four-year term expiring in February and Vice Chair's term expiring in June 2018).

FIGURE 2: BLOOMBERG FINANCIAL CONDITIONS INDEX



Source: Bloomberg

The ultra-accommodative monetary stimulus was expected to create inflation and it has, but the Fed and most others are looking for inflation in the wrong places. Most participants, including the Fed, talk about inflation only in terms of the price of goods and services that are calculated in such metrics as the consumer price index (CPI) and/or the personal consumption expenditure deflator (PCE). Instead of just focusing on goods and services inflation metrics that have been recalibrated/redesigned through the use of hedonic and substitution effect adjustments in order to keep reported inflation statistics low (to minimize cost-of-living adjustments in such programs as Social Security), the Fed should consider the insidious inflation of asset prices that puts financial stability at risk. There has been massive inflation created by ultra-accommodative emergency stimulus and it is reflected in asset prices across the board. Central banks tell us that they created inflation targets to guard against the destructive nature of goods and services price deflation. But rather than be alarmed by small declines in the prices of goods and services, the deflation that is more pernicious and likely to occur given elevated valuations is a deflation in asset prices that have become massively distorted and disconnected from reality as a result of excessive central bank stimulus/liquidity. Asset price deflation risk is the real reason that Fed policy will likely never be fully normalized unless the Fed is willing to wrest control back from the financial markets and risk the price discovery that has been missing for much of this cycle should the excessive liquidity/stimulus be withdrawn from the system.

Asset price deflation risk is the real reason that Fed policy will likely never be fully normalized unless the Fed is willing to wrest control back from the financial markets.

The Fed is going to find itself in a dilemma of its own making if it does not get out in front of the asset price deflation risk which only increases with every upward move in asset prices. Financial stability can give way rather quickly to financial instability if and when volatility increases. But, for the moment, both stock and bond market volatilities are close to all-time record lows. In fact, the S&P 500 has gone more than a year without so much as a 5% peak-to-trough decline. Furthermore, equity valuations are very high, credit spreads are approaching the cycle tights, while political uncertainty and geopolitical risks seem to increase with every passing day. It seems like it is just a matter of time before Minsky's financial-instability hypothesis (long periods of stability ultimately breed instability) kicks in again.

The timing and catalyst(s) that change behavior remains "a known-unknown." If you wait for the catalyst to occur, you will likely be forced into a game of musical chairs where the risk is not just fewer chairs but no chairs when the music stops.

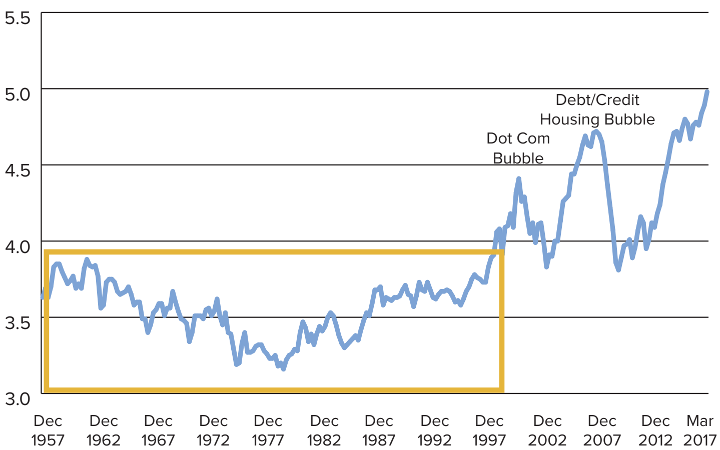
Algorithms dominate trading activity in many asset classes, money flows unabated into ETFs and passive strategies where momentum is more important than valuations, and a significant amount of capital is being invested/speculated in volatility selling strategies where leverage increases as volatility decreases. We may be early, but it sure seems like the table is being set for potential financial instability should volatility increase, momentum reverse, and/or the global central banks' aggregate balance sheet stops expanding. As always, an important caveat to remember is that the timing and catalyst(s) that change behavior remain "a known-unknown." If you wait for the catalyst to occur, you will likely be forced into a game of musical chairs where the risk is not just fewer chairs but no chairs when the music stops.

AN ASSET BUBBLE IN THE MAKING

As readers know well, it has rarely paid to talk about, much less try to identify, asset bubbles, wherever they may be lurking. The limits of our own prognostication recently to declare a bubble in complacency (a trend that remains in full force as various measures of volatility continue to probe new lows as the third quarter is getting underway) is premature at best. But with each passing quarter higher valuations become further disconnected from the real economy as risk asset performance carries valuations to seemingly unsustainable levels. Faced with the prospect of a near zero return from the risk free rate for nearly eight years, investors of all different stripes invariably sought some incremental return beyond their traditional comfort zone. To our way of thinking, the actions of global central bankers, and the Fed in particular, have induced many investors to take more risk as the valuation cycle extends rather than take profits as valuations become more and more stretched. Exhibit 3 illustrates in fairly simple terms the consequences of such policy induced behavior.

The actions of global central bankers ... have induced many investors to take more risk as the valuation cycle extends rather than take profits as valuations become more and more stretched.

EXHIBIT 3: RATIO OF HOUSEHOLD NET WORTH TO GDP



Source: Bloomberg, Bureau of Economic Analysis, Federal Reserve

This net worth-to-GDP ratio is instructive as it shows how asset values relative to the size of the economy exhibited a fairly stable relationship for nearly 40 years. From the late 1950s to the late 1990s (highlighted rectangle in Exhibit 3), this ratio stayed comfortably within the 3x to 4x range. Starting in the late 1990s, a breakout occurred that has come to be known as the Dot Com bubble, where the ratio hit 4.4x in March 2000 before correcting back down to 3.8x by September 2002. As quickly as that correction ended thanks to ultra-accommodative policy, another acceleration began that would take the ratio to an even higher level, peaking at 4.7x in March 2007. This was the peak before the Great Financial Crisis (GFC) that everyone remembers as the housing bubble. The GFC quickly brought the ratio back down, returning to 3.8x again by March 2009. The period since represents the most lethargic economic recovery in the post-war period with real economic growth averaging a little over 2% despite massive accommodation from the Fed that persists to this day. The ratio has responded to ultra-accommodative policy once again and continues on its uptrend to date. The most recent quarterly data available is through Q1 of this year and the ratio has essentially hit 5x, a new record high that eclipses each of the prior two asset bubbles. Of course, this time is different, and multiples need to be higher given that the risk free rate is so low, so don't be alarmed...said no one at Seix Investment Advisors. This is a picture that keeps us up at night and leaves us curious as to why more are not equally bothered by such a distorted relationship, given the relatively long and stable history illustrated in Exhibit 3.

The last time we included this exhibit was over three years ago in our review of the second quarter of 2014. At that point the ratio was just below the 4.8x peak that matched the housing bubble. The three years since then has allowed for another surge upward and into uncharted waters. Knowing that both stock markets and housing prices rose since Q1, the Q2 update for this ratio in September will set yet another record.

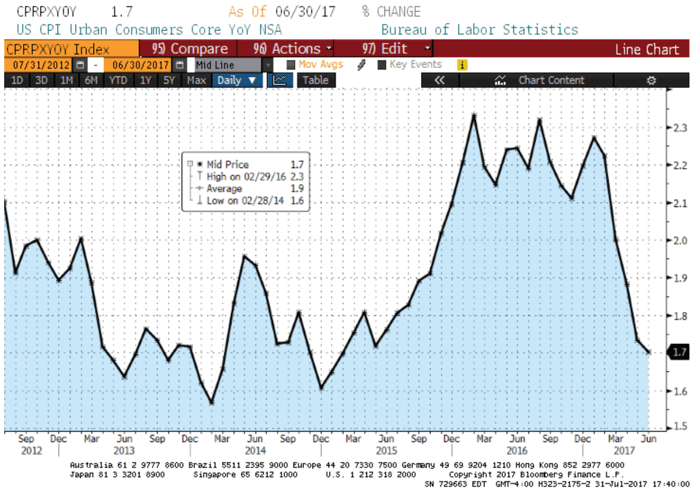
At the heart of this latest distortion is the very same monetary policy (error) that was a prime contributor to the prior distortions. The Fed was exceptionally cautious in reining in the monetary policy accommodation it used to offset the economic slowdown that accompanied the Dot Com market correction. The removal of said ultra-accommodation (Fed target rate at 1%) started in June 2004, but the Fed never tightened by more than 25 bps at each meeting for two full years, a measured pace that was exceptionally gradual and extended relative to prior monetary policy tightening cycles. This extended and unprecedented cycle essentially kept rates too low for too long, thereby contributing significantly to the subsequent debt, credit, and housing bubble that peaked in 2007. Rather than learn from this policy error, the Fed instead delivered another exceptionally long period of overly accommodative policy that has again recreated this asset value/economic distortion. The arrival of the third quarter marks the eight-year anniversary of the economic recovery, but the Fed has only tightened four times thus far, reversing barely a quarter of the traditional easing that began back in the summer of 2007 when the Fed's short-term target rate was at 5.25%. The Fed talks and talks about the need to return to its inflation target, but it conveniently ignores the other inflation (asset) its policy errors have delivered all too frequently over the past fifteen years.

> ***The Fed ... talks about the need to return to their inflation target, but they conveniently ignore the other inflation (asset) their policy errors have delivered all too frequently over the past fifteen years.***

A BENIGN INFLATION TARGET?

Given the backdrop of three consecutive rate hikes from the Fed, it would make sense for an investor (without Bloomberg, TV, or internet access) to assume that perhaps there is an inflation problem at hand. With history and their hard fought credibility on the line, central bankers are inherently the front line defenders of price stability. Ironically, the inflation problem of 2017 is not of the ilk that three rate hikes would imply. There has not been any surprising uptick on the inflation front this year. Rather than an uptick, this year has witnessed a shortfall of inflation relative to expectations and the Fed's 2% inflation target, a level it has deemed to equate to price stability. Core inflation measures are followed closely by most, as the Fed is prone to focus its efforts on core inflation outcomes rather than the more volatile headline rate due to the heavy influence of energy prices. You need not trade oil futures to understand that price volatility, as the ever changing price of gas at the local service station offers sufficient evidence regarding the uncertain and volatile nature of the energy complex. Coming into 2017, it was understood by most that there would be an uptick of year-over-year headline inflation due to the base effects of lower energy prices in early 2016. This came to pass as the year-over-year rate for headline CPI moved from 0.8% in July 2016 to 2.6% by February 2017. Since February, the headline year-over-year rate has fallen to 1.6%. On a year-over-year basis, the core CPI rate was far more stable and spent all of 2016 in a 2.1% to 2.3% range before declining over the past four months to 1.7%. Exhibit 4 illustrates the core CPI measure over the trailing five years. This decline in the core component is what has suddenly alarmed some market participants and analysts. As a consequence, much ink has been spilled over whether the drivers of this core inflation decline are transitory or a reflection of broader disinflationary trends that may persist.

EXHIBIT 4. CORE CPI YEAR-OVER-YEAR



Source: Bloomberg, Bureau of Labor Statistics

For some context, the year-over-year core CPI has spent the last five years in a 1.6% to 2.3% range with a 1.9% average. The low was hit on two occasions in 2014 while the high was hit on two occasions in 2016 and once this year in February. The merits of the transitory argument lie primarily in what occurred in early 2017 in the wireless telecom sector — another price war between AT&T and Verizon with the reintroduction of unlimited data plans. While this is not by itself an overly large sector within the core CPI calculation, the year-over-year price decline for wireless telecom now exceeds 13%, thereby contributing about 26 basis points of drag to the core calculation. Absent this unique and clearly unsustainable influence, the core CPI year-over-year rate would be 2%. The backdrop of the inflation discussion would be very different with a 2% annual core rate. But the wireless price war did happen. Concurrently, there were more moderate readings from some of the larger and more persistent sectors within core CPI like housing and medical care. The moderation seen in these sectors is what has led some analysts to conclude that the Fed is embarking on a policy error by tightening amidst a "worrisome" slowdown in core inflation. That an alarm goes off for some because of these shifts, particularly as it relates to the Fed's interpretation of both the data and its inflation target, is where we depart from the mainstream interpretation.

> ***The natural question that falls out of this analysis is why does our central bank accept, let alone target, a 2% inflation target?***

The Fed began referencing a formal 2% inflation target back in early 2012 as part of their introduction of a more expansive summary of economic projections (SEPs, as the market has taken to calling them). This was also when the Fed introduced the "dot plots" used to illustrate the broad opinion of Fed target rate projections from the full Board of Governors and Regional Bank Presidents. What the Fed has never offered since introducing this formal target is a rational explanation for why 2% inflation represents price stability. To our simple way of thinking, price stability is an inflation rate of approximately zero. This is a topic we've discussed before in a Perspective from early 2011, about a year before the Fed adopted its formal target, but it is worth repeating again.

What are the consequences of a 2% inflation target? The number sounds low enough so as to not alarm anyone, but the mathematics of compounding make for a less benign outcome. The concept of compounding is part of most introductory finance courses. In its simplest form it can be illustrated as follows. A 2% nominal return compounded annually for 20 years actually delivers a 48.6% return, not simply 40% (20 * 2%). The difference is the concept of "interest on the interest" and that component offers the saver the incremental 8.6% return on their original principal (48.6% - 40%). Pretty simple stuff, but now let's apply the same math to calculating the impact of a 2% inflation target on an individual's purchasing power.

> ***That seemingly benign 2% inflation target over 20 years results in cumulative price gains that wipe out nearly half of an individual's current purchasing power ... In barely 35 years, that compounded 2% inflation rate will wipe out an individual worker's entire current purchasing power!***

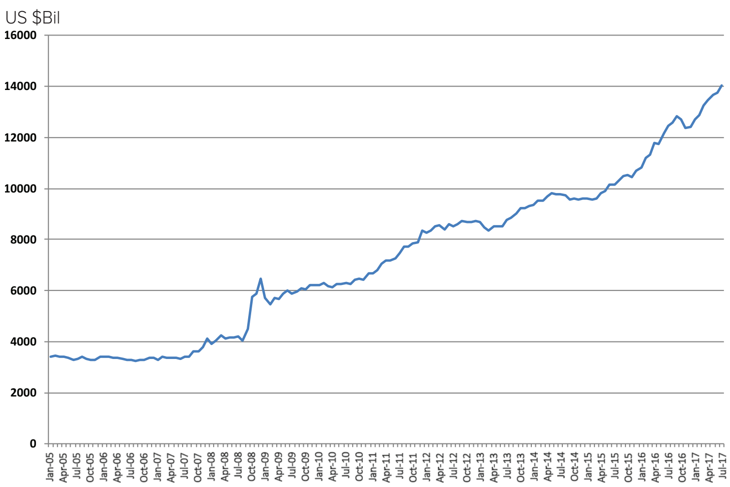
The compounding of the 2% inflation target over the same 20-year period results in a decrease of our purchasing power by that same 48.6%. That seemingly benign 2% inflation target over 20 years results in cumulative price gains that wipe out nearly half of an individual's current purchasing power. Let's go even further and consider a 35-year period, something that more closely resembles a full working career (at least before ZIRP, or zero interest rate policy). Yes, you guessed it, in barely 35 years that compounded 2% inflation rate will wipe out an individual worker's entire current purchasing power! Regardless, the Fed still believes this is a reasonable and defensible target. From the average worker's perspective this does not remotely resemble "price stability" and most hard-working Americans likely agree that such an outcome is totally unacceptable. The natural question that falls out of this analysis is why does our central bank accept, let alone target, a 2% inflation target? The answer is debt, or, more precisely, excessive debt. As our economy has become more "financialized" and credit more "democratized," both the public and private sector have taken on too much debt. Inflation under these circumstances is no longer just a stealth tax on purchasing power, but also a stealth form of deleveraging. It allows debtors, particularly the U.S. Government, to pay off current debt with "cheaper" dollars in the future. This may sound a bit conspiratorial, but it is hardly a new concept. In the post-war period a considerable amount of government deleveraging was achieved via this inflation channel and we discussed it at length in our Perspective that reviewed the second quarter of 2011. The section on page three titled "Repression Not Depression" discusses that post-war deleveraging period in greater detail.

Part of the Fed's inflation focus is centered on its desire to put its multiple policy channels on two separate tracks. Additional rate hikes (the more traditional monetary policy tool) are now subject to data dependency. Should the inflation data return to trend as the Fed anticipates (à la the Phillips curve), thereby supporting its "transitory" assessment of the recent core CPI slowdown, additional rate hikes should be forthcoming. Likewise, a pause in the rate hike cycle will be justified by a continuation of this slowdown as a fundamental change in the inflation dynamic supports caution by the Fed. The other policy channel, balance sheet policy (or the proposed reinvestment taper) that is commencing "relatively soon" per the July Fed statement, is now on more of an auto-pilot that the Fed plans on running uninterrupted "in the background." It would seem at this stage that only an unforeseen exogenous shock will derail the reinvestment taper. This traditional (rates) versus unconventional (QE/balance sheet) policy distinction is a new wrinkle from the Fed and only time will tell if it has the discipline to really leave the latter on auto-pilot. Given its track record over the duration of this cycle, there are reasons to be skeptical.

THE AGGREGATE CENTRAL BANK BALANCE SHEET

While our focus in the U.S. is on the Federal Reserve, its policies/reaction function and balance sheet, as investors we operate in a global financial marketplace where liquidity is fungible and excess liquidity tends to flow into markets with the highest return potential. Therefore, it is important to not only monitor the Fed's balance sheet, it is critical to monitor the global central bank balance sheet in the aggregate. Exhibit 5 is a snapshot of the aggregate balance sheet of the Fed, European Central Bank (ECB), and the Bank of Japan (BoJ) at various intervals. The Fed has only been reinvesting coupons, maturities, and prepayments from the mortgage-backed securities (MBS) and Treasury portfolios so its balance sheet has remained fairly constant since the end of 2014. The ECB and the BoJ on the other hand have been expanding their balance sheets by purchasing sovereign bonds, covered bonds, and corporate bonds in the case of the ECB, while the BoJ has been buying JGBs, REITs, and ETFs.

EXHIBIT 5: GLOBAL CENTRAL BANK BALANCE SHEET



Source: Fed, ECB, and BoJ

DATE	FED/ECB/BOJ B/S (USD)	CUMULATIVE GROWTH
12/31/08	$6.47 Trillion	
12/31/11	$8.33 Trillion	29%
12/31/14*	$9.62 Trillion	49%
12/31/16	$12.40 Trillion	92%
7/31/17	$14.03 Trillion	117%

**Fed ended third round of Quantitative Easing on 10/31/2014.*

The aggregate central bank balance sheet was $14.03 trillion on 7/31/17 and is 46% larger since the Fed ceased QE3 and is increasing at a 24% annualized rate in 2017. The liquidity created as a result of the expansion of the aggregate central bank balance sheet has corresponded, if not correlated, to the increase in asset prices. Going forward, a critical question for investors to contemplate is the timing of the inflection point at which the aggregate central bank balance sheet is no longer expanding and is actually contracting. It remains to be seen whether central banks will step away and allow the financial markets to find the clearing prices for all asset classes without the support of the major global central banks that has been ever present since 2008.

PORTFOLIO POSITIONING & OUTLOOK

Changes to portfolio weightings thus far in 2017 have been modest and allocations to spread/risk assets have been pared as a result. Within the corporate credit sleeve, our positioning entering this year was just slightly overweight with a 1.1x the benchmark weighting. Early-year activity saw this increase temporarily to about 1.3x before reversing direction and lowering it to essentially a neutral or near neutral posture. Spreads within corporate credit have stayed in relatively tight range, but the trend remains in a tightening mode. The Bloomberg Barclays Corporate Bond Index Option Adjusted Spread (OAS) began the year at +123 and never traded wider before ending the second quarter at +109. This spread is rich from a historical valuation standpoint over short and intermediate-term intervals. The technical backdrop for the credit sector remains the primary driver of performance, with consistently strong demand for any incremental yield from many corners of the globe. This has led to a new issue market where spread concessions (the degree to which a new issue is priced cheaper or wider to where existing issuer or comparable issuer bonds currently trade) have all but evaporated. Fundamentally, the credit cycle peaked a few years ago, as issuers continue to leverage balance sheets for more shareholder friendly initiatives such as dividends and buybacks. Overall corporate leverage remains near its peak as the business cycle nears its latter stages, a particularly important distinction as this expansion is already aged well beyond the typical cycle and is fast approaching the second longest on record. Typically, at this point of the cycle with profits near a peak, leverage is relatively far from its peak. Given the atypical nature of this cycle, it seems less remarkable that this leverage/business cycle relationship has departed from historical norms, yet another reason to be taking profits with valuations disconnected from fundamentals. For the balance of 2017, we anticipate lowering spread risk within the corporate credit sleeve even further, preferring instead to position for more volatile markets that should improve the risk/reward skew. Having dry powder later this year may offer more substantial alpha generating potential opportunities should volatility pick up from all-time lows.

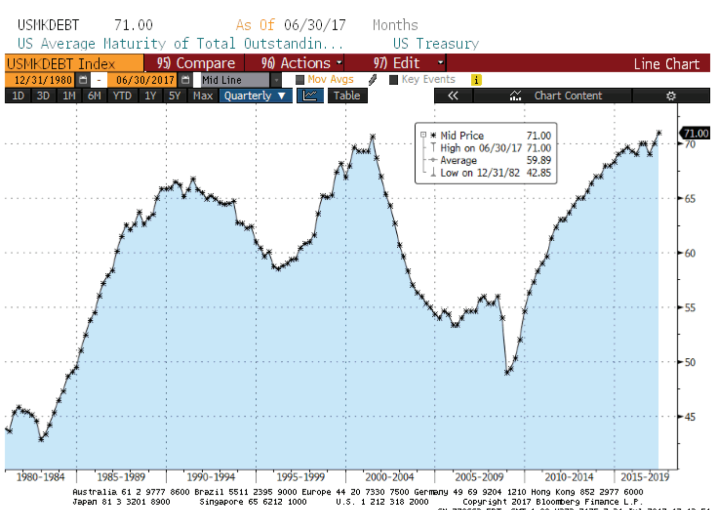
> ***Going forward a critical question for investors to contemplate is the timing of the inflection point at which the aggregate central bank balance sheet is no longer expanding and is actually contracting.***

Residential mortgage-backed securities (RMBS) exposure was already slightly underweight at 0.9x the benchmark weighting to start the year. By the mid-point of the year, RMBS exposure was approaching 0.6x the benchmark weight. Valuations have been less than compelling for some time in RMBS, a consequence of the Fed's past QE initiatives, and this influence continues given that all prepayment/income generated by the Fed's RMBS portfolio is still reinvested in the asset class. Surprisingly, even the advent of the reinvestment taper, which the Fed has projected to begin "relatively soon," has failed to manifest itself through wider RMBS spreads. The market consensus for "relatively soon" is a September announcement for the taper to commence in October. Barely two months away, valuations have barely budged. Granted, the initial taper for RMBS portfolios is small, but the market has been under the thumb of the Fed for many years and must now transition to a declining Fed role. Given the relatively rich valuations the sector possesses, there should be more market anxiety as this change nears. The remarkable complacency of market participants with RMBS is fittingly emblematic of a generic complacency across the capital markets today. Many measures of volatility across various asset classes continue to decline, leaving more than a few investors, ourselves included, befuddled by the degree of indifference many other investors continue to exhibit despite a less than compelling relative value proposition. Spreads will be forced to adjust in the near/intermediate term and we are positioned to capitalize accordingly.

Position shifts have been varied within the smaller spread sectors, commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS). Similar to the aforementioned changes, CMBS exposure was also reduced slightly, with the benchmark relative weighting going from just over 2x to about 1.5x. As for ABS exposure, it actually increased via a few new issue offerings that allowed for this tactical shift. It's worth noting the size of these relatively small sectors, where the actual allocation to both sectors totals about 10% in market value terms. That compares to over 40% in market value terms for the corporate credit and RMBS sleeves combined. CMBS and RMBS strategies have been a continuation of our "safe income at a reasonable price" strategy, primarily in the short to intermediate part of the yield curve.

Yield curve positioning for 2017 has been mostly neutral. The yield curve has flattened this year, given a modest uptick in short-end yields and moderate declines in the longer end of the curve. Using the more popular two-year to ten-year maturity relationship as a yield curve proxy, the first half of the year witnessed about 34 bps of flattening, with a larger 21 bps of the move occurring in the second quarter. Flattening is more typical in a tightening cycle and given that the Fed hiked rates over the past three consecutive quarters, the move is consistent with such a backdrop. The reinvestment taper is at hand now with the Fed about to embark on a shrinking of its balance sheet for the first time since the crisis, which may distribute the impact of this policy tightening initiative more evenly across the yield curve. This will be determined by both the degree of taper the Fed actually executes going forward versus what it has proposed to date, as well as the decisions made by the Treasury, as it will be forced to issue additional public debt to finance what the Fed will no longer purchase through its reinvestment. The Treasury has been extending the average maturity of the public debt since the financial crisis. At the end of 2008, the average maturity of outstanding Treasury debt was 49 months and as of June 30th it stands at 71 months, matching a record high last seen in 2001. Exhibit 6 presents the average maturity history since the advent of the data from Treasury.

EXHIBIT 6: AVERAGE MATURITY OF OUTSTANDING MARKETABLE TREASURY DEBT



Source: Bloomberg, US Treasury

Talk of ultra-long issuance with potential maturity points of 40 or 50 years remains under consideration by the Treasury. Currently, the longest maturity Treasury debt offered is 30 years and information regarding the Treasury's plans should be forthcoming in the second half of 2017. This added variable will introduce greater curve volatility, hence our mostly neutral curve position. Potential opportunities are likely going forward as these varied cross currents weigh on different parts of the curve.

Our core plus mandates remain void of any strategic non-investment grade exposure. Given that the high yield sector continued to produce respectable excess returns year to date, as illustrated in Exhibit 1, this positioning had an implied opportunity cost, particularly against peers positioned more aggressively this year. This is hardly a new development as we have chosen to forgo a broad strategic allocation due to rich valuations that have only gotten richer. Similar to the investment grade credit sleeve, spreads remain rich and fundamentals have peaked. The driving force again remains the technical bid of very strong demand for any incremental yield. For several years, that demand has persisted regardless of just how much incremental yield is offered and persistently low risk free rates continue to push more investors beyond their traditional risk tolerance in search of any additional yield regardless of the underlying risk. Any way you cut it, with the High Yield Index offering a 5.62% yield to worst on June 30th (OAS +364), the sector fails to offer ample reward for the risk being assumed. Caveat emptor…

A final word as it relates to the Federal Reserve, it is important to put the current phase of the policy cycle in perspective. While the Fed has indeed raised rates four times in 25 basis point increments since its initial move in December 2015, the target remains very low in the 1.00-1.25% range. Recent comments from Fed officials, including Fed Chair Yellen (at her semi-annual Humphrey Hawkins testimony in July), have stated that rates will not have to rise much further to get to neutral—implying the Fed is close to the neutral rate. Our base case view has been that the neutral rate is closer to 2% or less and, as such, taking rates from zero to 1-2% hardly constitutes a "tightening'" cycle. From our perspective, it is more appropriate to frame this action on the part of the Fed as an "unloosening" cycle rather than a "tightening" cycle since all that the Fed has done to this point is remove a very small part of the emergency ultra-accommodative monetary stimulus that has been in place since November 2008.

Our base case following the Trump victory was that the new president's agenda would take some time to pass and implement and that the initial reaction would manifest itself in improved confidence and increased "animal spirits" while the actual economic impact would likely not emerge until sometime later, possibly 2018 or 2019. The aspects of President Trump's agenda that require congressional cooperation are stalled for now and the resistance to any legislative accomplishments is coming from within his own party, which is risky as it could put the House in play in the 2018 midterm elections. The president has been successful in rolling back the onerous regulatory burden through executive orders as well as agency actions. Should President Trump get some degree of tax reform/cut/repatriation (higher probability) and infrastructure/fiscal spending (lower probability) through Congress, long-term interest rates will likely come under short-term pressure and the bond bears will come out of the woodwork heralding another premature declaration that the secular bull market in bonds has ended again. While one never really knows whether the next 25 or even 50 bps is going to be higher or lower as short-term movements tend to be driven by positioning and psychology, our base case is that the 10-Year will remain range bound (2.00-2.50%) in the near term. Tax reform and fiscal stimulus could pressure long-term yields to break above the upper end of that range, but our intermediate/longer term view remains that the low in long-term interest rates is still ahead of us due to the structural forces/ headwinds already mentioned. Our "lower for longer" thesis envisions a scenario where 10-Year U.S. Treasury yields could approach 1% and even lower while 30-Year U.S. Treasury yields may approach 2% and possibly lower before the secular bond bull market is over.

Our "lower for longer" thesis envisions a scenario where 10-year U.S. Treasury yields could approach 1% and even lower while 30-year U.S. Treasury yields may approach 2% and possibly lower before the secular bond bull market is over.

INDEX DEFINITIONS

The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and nonagency).

The **Bloomberg Barclays U.S. CMBS Investment Grade Index** measures the market of US Agency and US Non-Agency conduit and fusion CMBS deals with a minimum current deal size of $300mn.

The **Bloomberg Barclays U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.

The **Bloomberg Barclays U.S. Corporate High Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt.

The **Bloomberg Barclays Emerging Markets USD Aggregate Index** is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers.

The **Bloomberg Barclays U.S. Government Bond Index** is comprised of the U.S. Treasury and U.S. Agency Indices. The index includes U.S. dollar-denominated, fixed-rate, nominal U.S. Treasuries and U.S. agency debentures (securities issued by U.S. government owned or government sponsored entities, and debt explicitly guaranteed by the U.S. government).

The **Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index** tracks agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The **Bloomberg Barclays U.S. Treasury Index** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting.

Credit Suisse Institutional Leveraged Loan Index is a subindex of the Credit Suisse Leveraged Loan Index which contains only institutional loan facilities priced above 90, excluding TL and TLa facilities and loans rated CC, C or in default. It is designed to more closely reflect the investment criteria of institutional investors.

The **Russell 2000® Index** is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies.

The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies.

The indexes are calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

For more information, please contact:
Seix Investment Advisors LLC / Tel: 201.391.0300 / cdegae@seixadvisors.com / www.seixadvisors.com

Basis point (bp): One basis point is equal to 1/100th of 1%, or 0.01%.

Yield to worst: The yield to worst on a bond represents the lowest potential yield that an investor would receive on a bond with embedded optionality if the issuer does not default. The yield to worst is calculated by making worst-case scenario assumptions on the issue by calculating the returns that would be received if provisions, including prepayment, call, or sinking fund, are used by the issuer.

All investments involve risk. Bonds offer a relatively stable level of income, although bond prices will fluctuate providing the potential for principal gain or loss. Intermediate term, higher-quality bonds generally offer less risk than longer-term bonds and a lower rate of return.

There is no guarantee a specific investing strategy will be successful. Individual investors are advised to consult with their investment professional about their specific financial needs and goals before making any investment decisions. Investment process, strategies and procedures detailed in this brochure are intended to be general guidelines, subject to market conditions and client-specific investment guidelines and restrictions, and are measured at the time of purchase. Seix Investment Advisors LLC may deviate from these guidelines if market conditions warrant, or if the investment professionals deem doing so would be in clients' best interests. Guidelines do not guarantee any reduction of risk or loss.