2018 AAM OUTLOOK

ECONOMIC OVERVIEW

United States economic growth during the fourth quarter of 2017 revealed strong underlying domestic demand. Although the overall real U.S. Gross Domestic Product (GDP) growth rate at 2.6% came in below forecasts due to weaker than expected inventory investment and higher imports, consumer spending and business investment increased at very healthy paces of 3.8% and 7.9%, respectively. On an annual basis (q4/q4), real GDP in the U.S. increased by 2.5% for 2017.

2017 Returns by Asset Class

Investment Grade	
Bloomberg Barclays US Aggregate	3.07%
Treasuries	2.31%
Corporates	6.42%
CMBS	3.35%
MBS	2.47%
Tax Exempt Municipals	5.45%
Surplus Growth	
High Yield	7.48%
US Equities	20.48%
Convertibles	21.54%

Source: *Bloomberg Barclays Index Series, S&P 500, Barclay's Global High Yield Index, VOA1 (Merrill Lynch IG Convertibles Ex-Mandatory)*

Looking ahead to 2018, the consensus forecast is calling for GDP to increase at a similar 2.5% pace with business spending/investment expected to be the main driver of growth. We are starting the year with high optimism on both the business and consumer sides, lower corporate and individual taxes and a weak U.S. dollar, all of which could provide a tailwind for growth. On the other hand, rising geopolitical risks, rising commodity prices and the potential for a major correction in the markets, are all downside risks for growth in 2018. AAM is calling for above-consensus growth in 2018 as we view the risks to growth being skewed to the upside.

Inflation and inflation expectations we believe will be the main driver of Fed policy and interest rates in 2018. Even though inflation expectations are higher to start the year, we expect inflation to increase only modestly in 2018. With a modest rise in inflation, we expect the Federal Reserve to increase rates three times this year, or a total of 75 basis points. With the Fed increasing rates, coupled with a benign inflation outlook, we think that will lead to a continued flattening of the yield curve. We're calling for the 10-year Treasury yield to end the year modestly higher but below 3%. The Exhibit below lists our risks to GDP Growth, Inflation, and Rates.

Risks to GDP Growth, Inflation & Rates

	GDP Growth	Inflation	Rates
Upside	– Strong business and consumer optimism – Tax reform – Weak U.S. dollar	– Rising energy and commodity prices – Rising wage pressures – Weak U.S. dollar	– Increasing debt issuance – Normalization of the Fed's balance sheet – Decreasing monetary accommodation from other central banks
Downside	– Rising geopolitical risks – Major correction in financial markets – Rising commodity prices	– Improving technologies – Rising U.S. dollar	– Lower inflation expectations – Increasing volatility – Slowing US growth

FIXED INCOME

The markets have reacted strongly to the corporate tax cuts which will result in higher earnings. Also affecting the growth outlook is the expectation of repatriation of cash and heightened corporate investment within the US. The equity markets are higher, and high yield and investment grade corporates are at very tight spreads. In isolation, the tax cuts should be enough to spur the economy onward, its easy to foresee growth in wages and spending and investment as a result.

On the other hand, we have the Federal reserve (which has been very accommodative since 2008) raising rates and reducing MBS and Treasury holdings held on its balance sheet. Typically, when the Fed raises rates the Treasury curve flattens as investors see the economy slowing in the face of higher short rates. The yield curve is almost always flat to slightly inverted at about the same time that the Fed stops raising rates—which coincides with a clearly slowing economy.

For 2018, we have tax cuts which will stimulate growth and investment and the Fed raising interest rates which will impede growth. We expect that the economy is in a strong enough position that the effect of the tax cuts will overwhelm the Fed actions. With GDP growth at 2.5% or above we think that it will be another good year for Corporates, CMBS and ABS and Taxable Munis. However, we stress that with spreads at current levels the upside will be limited therefore caution in security selection is warranted. Additionally for Insurers, pending changes to the Risk Based Capital calculations should also be considered when investing during 2018 (see RBC note at the bottom of the Outlook.) We expect Tax-exempts to perform well but given the change in the corporate tax rate for P&C insurers we view tighter trading levels as selling opportunity. Given our benign outlook, the performance of Treasuries and Agency MBS will lag other sectors.

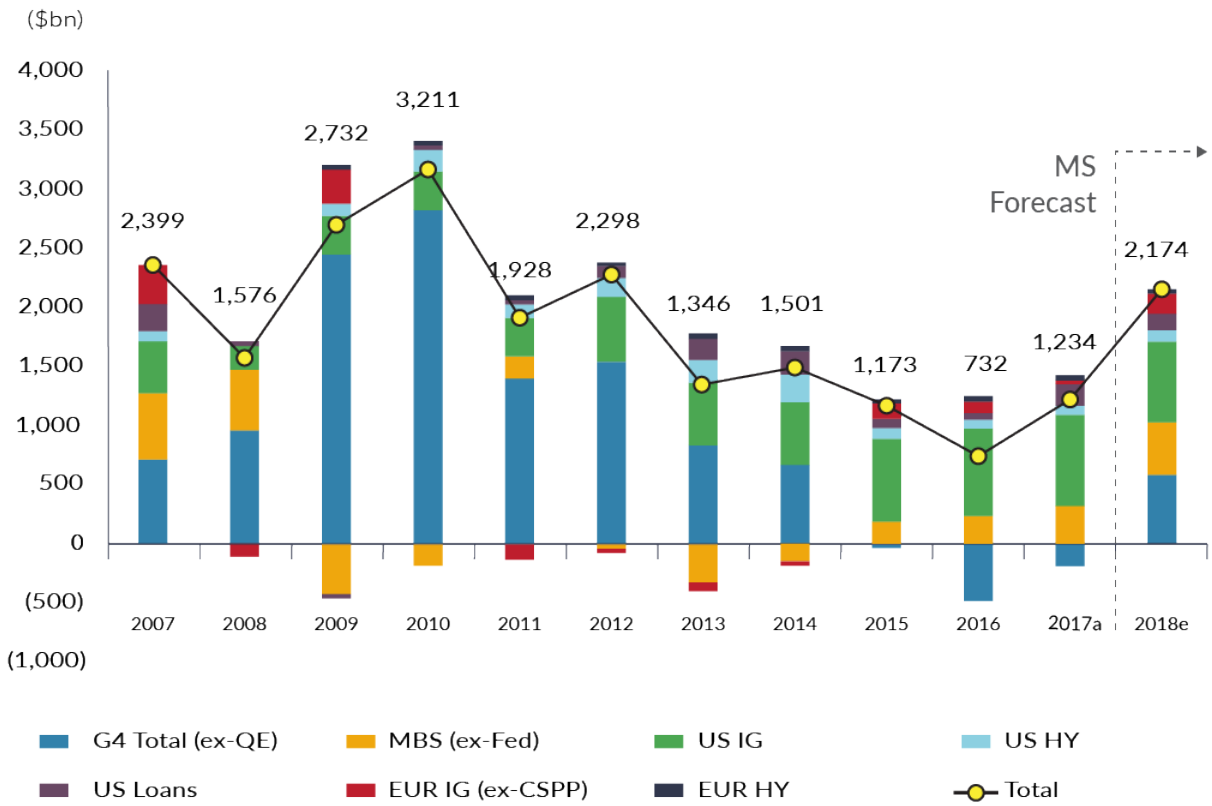
CORPORATE CREDIT

For 2018, we expect continued worldwide growth to support corporate fundamentals, with corporate tax reform in the US enhancing cash flows for many Investment Grade (IG) companies. While we expect most of the benefits to accrue to equity holders, there will be companies that will use the tax savings to deleverage (i.e., weak BBB rated companies). We expect Sales growth to be around 5% with EBITDA growth approaching 10% on average in 2018. Capital spending is expected to return to the levels experienced before the commodity correction.

We expect M&A activity to remain elevated, as technology and other catalysts drive companies to vertically or horizontally consolidate. Counter to market consensus, we are not expecting a material reduction in debt leverage over the medium term despite positive fundamental trends unless the cost of debt increases. While companies may temporarily reduce debt leverage, we anticipate shareholder demands to intensify. Given the number of companies with elevated debt leverage relative to other cycles, the credit market remains vulnerable to an unexpected shock to revenues or cash flows.

The demand from investors for corporate credit remained very strong in 2017. Inflows into IG bond funds and ETFs was two to five times higher than the annual flows of the last three years respectively. In addition, demand from foreign investors remained elevated, as yields net of hedging costs remained attractive in USD denominated IG bonds. For 2018, we believe corporate credit will remain attractive to investors seeking yield (pension, insurance), but with higher hedging costs, increased supply of alternatives related to QE unwinds (see graph below), and the likelihood of lower prospective total return given the expectation for higher rates, the risks are skewed to the downside.

Net Developed Market Fixed Income Supply



Source: *Morgan Stanley Research, Dealogic, S&P LCD, Federal Reserve, Bank of Japan, Bank of England, ECB*

With spreads starting the year at historically low levels reflecting the expectation for fundamental improvement and strong technicals, it will be difficult to match the strong performance of 2016-2017. Therefore, we expect more modest returns in 2018 (75-125 basis points). In this environment, we believe identifying idiosyncratic risk at the sector and credit level will be very important to portfolio returns in 2018.

The risks to the upside include: (1) better than expected fundamental improvement for credits over the medium term due to more rapid deleveraging or stronger than expected economic growth (2) prolonged central bank support and thus, investor demand for yield.

The risks to the downside include: (1) rise in inflation expectations which causes central banks to begin tightening more than the market currently expects, choking off economic growth (2) higher than expected debt issuance due to M&A and/or companies maintaining current levels of debt leverage (3) softer than expected economic or sector level growth (4) weaker than expected demand for IG bonds (likely from funds, foreign investors).

STRUCTURED PRODUCTS

As we look to 2018, we believe some caution is warranted. Spread sectors have performed exceedingly well over the past few years and valuations within structured products are relatively compressed. While we still recommend over weighting most sectors relative to Treasuries, sticking with less volatile subsectors and senior securities makes the most sense.

As in prior years, we begin the year with the view that there is very little value in agency mortgage backed securities. Despite having generated their best relative performance to Treasuries in three years, they continue to lag behind the other spread sectors. Ongoing reinvestment activity by the Fed has compressed spreads to multi year lows leaving little margin for error should interest rate volatility increase. In addition we forecast that the Fed should conclude its reinvestment program as early as the 4th quarter of this year. The absence of those purchases along with organic growth in the market place will require banks and asset managers to absorb an additional $400 billion in supply this year. We don't see the market being able to maintain current spread levels in light of this supply leaving us to favor other spread sectors and maintain our underweight relative to Treasuries.

Non-agency mortgaged backed securities still presents the best opportunity within the sector. A combination of solid home price appreciation, exceeding 6% this past year, and conservative underwriting underpin the exceptionally strong credit performance experienced to date. With large levels of credit enhancement relative to current delinquencies, the yield on senior, non-agency securities are very attractive relative to other alternatives.

Commercial mortgaged backed securities were the best performing subsector within the structured product universe last year as spreads narrowed relative to Treasuries, keeping pace with single A rated corporate bonds. Underlying property appreciation, as with residential properties, has supported credit fundamentals helping drive spreads tighter. From a technical perspective, a limited number of loans from 2008 requiring refinancing will help keep overall supply at modest levels helping to support valuations. There remain transformative forces in the market place that could disrupt underlying fundamentals, most notably with regional malls and other retail properties. Careful analysis needs to be conducted during security selection to help avoid those problems when they invariably crop up. With proper security selection we do expect CMBS to outperform Treasury and Agency mortgage backed securities and track single A corporate bonds closely in the year ahead.

MUNICIPAL MARKET

We are constructive on the outlook for the tax-exempt sector for 2018. An extremely favorable technical cycle is expected to develop during the year, which should lead to outperformance relative to taxable alternatives. This positive outlook is in stark contrast to the elevated levels of volatility that the market experienced in 2017. Most of last year's instability originated from the concerns surrounding tax reform and its potential impact on the institutional and retail investment base. Those concerns were well-founded, as the new tax legislation reduced the corporate tax rate to 21% from 35%, which effectively reduced tax-adjusted yields by 50 basis points (bps) for banks and property and casualty (P&C) investors. The new tax reform measures also capped the deduction for the combination of state and local taxes and property taxes at $10,000, effectively increasing the effective tax rate for individuals in high-tax states. However, the tax change that provided the most impact on yields and relative valuation levels was the elimination of tax-exempt issuance of advance refundings (i.e., refinancing bonds issued more than 90 days before the redemption date of the refunded/refinanced bonds). With this refinancing technique no longer available after 2017, issuers rushed a total of $144 billion into the market during the 4th quarter, which also produced a record of $62 billion of issuance during the month of December.

This rush to market during the final months of 2017 effectively pulled forward approximately $35 billion in supply that would have come during the first quarter of 2018. Additionally, advance refunding supply has historically provided between 15% to 20% of overall new issuance. The combined effect of its elimination from the tax-exempt market, along with the surge in 2017 fourth quarter issuance, is expected to result in a 23% drop in 2018 issuance to $331 billion. That's down over $100 billion from 2017's level.

Demand technicals are also expected to be very supportive of relative performance during the year. With the record pace of refinancings that have occurred over the last 3 years, the sector is once again expected to absorb a sizable amount of reinvestment flows of coupons/calls/maturities. Demand flows this year are expected to come in at approximately $450 billion, which is almost in line with 2017's $447 billion. However, the major difference this year is that the new issue cycle will not be heavy enough to absorb these flows. Net issuance is expected to hit an 11-year low of negative $121 billion, which is approximately $40 billion lower than the next closest year of 2011, when net supply came in at negative $81 billion.

In looking at the various investor segments, most of them are expected to remain firmly entrenched within the buying base. Mutual fund flows have been supportive over the last two years and, absent any sizable shocks in interest rate levels, should remain positively steady during the course of 2018. Fund inflows in 2017 came in at $24.4 billion, which was down 14% from 2016.

The household sector is also expected to remain fully engaged. Tax reform has made only marginal changes in the highest individual tax brackets, reducing the top bracket from 39.6% to 37%. The new legislation also retains the Affordable Care Act's Medicare surtax of 3.8%. Additionally, the new limits on the deductibility of state and local taxes and property taxes also makes tax-exempt income even more desirable to wealthy investors in high-tax states.

However, one area of concern is the drop in tax-adjusted yield levels for P&C firms and banks. With the new corporate tax shaving 50bps from tax-adjusted or grossed-up yield levels, these investors are expected to shift their focus to taxable alternatives. Although there's some uncertainty as to whether these investors will avoid the liquidation of their tax-exempt holdings in order to avoid reducing portfolio book yield, there's little contention to the expectation that these investors will seek to optimize their after-tax returns going forward and reduce their appetite for the sector in favor of taxable alternatives.

Although these institutional investors make up approximately 25% of the sector currently, the sizable retail-oriented demand will provide plenty of support for the market during the current year. That demand should help absorb any potential liquidation cycle that may develop from institutional investors going forward. Additionally, with this year's expected favorable level of building dislocations in the supply/demand dynamic, relative valuation levels look compelling to start the year. Municipal–to-Treasury yield ratios in the 10yr maturity stood at 82% and are expected to grind to lower levels over the course of the next few months.

Additionally, volatility is also expected to be subdued. State and local governments have seen slow but consistent growth in their economies, which has led to a generally stable credit profile. Moreover, now that tax reform has been finalized and is now behind the market, headline risk is expected to be fairly muted and that should help keep demand firmly entrenched in the sector.

In looking forward to our strategy, the constructive outlook for the tax-exempt sector should allow our P&C portfolios to reduce tax-exempt exposure into building outperformance over the course of the year. Our focus will be to wait for the compelling dislocations in supply and demand to develop and use the expensive relative valuations as a liquidity source to sector rotate into more advantageous after-tax yield opportunities within the taxable sectors.

The risks to the upside include:

- Stronger than consensus growth in the economy that would further improve the credit profile of state and local governments.

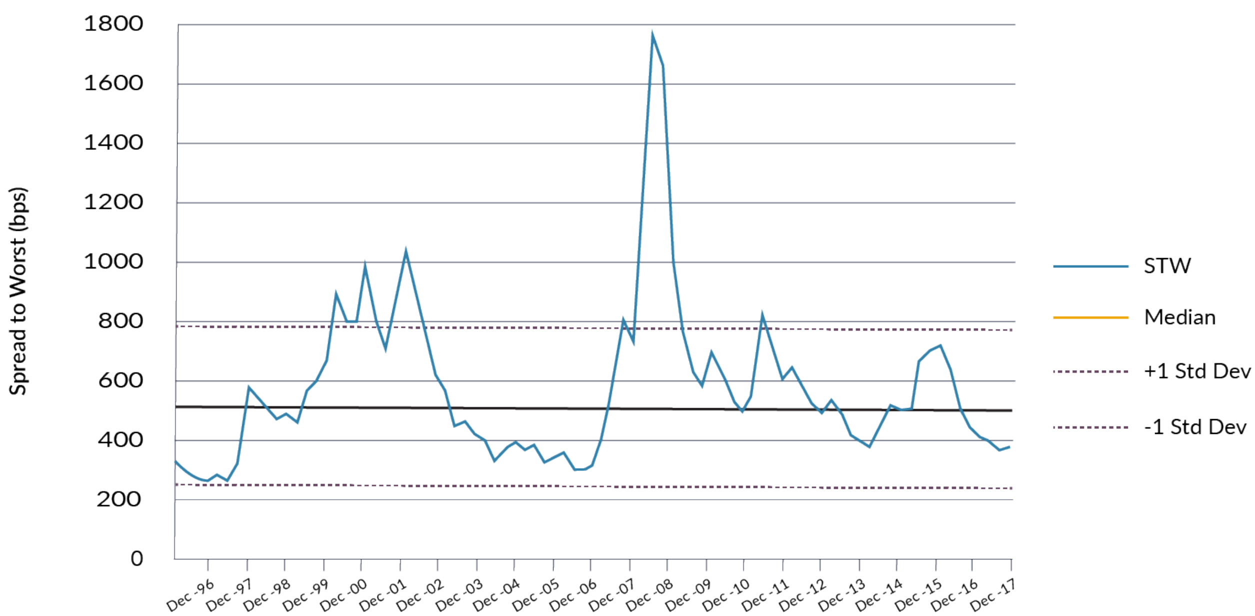
The risks to the downside include:

- Sharply higher Treasury rates, which could lead to heavy mutual fund outflows.
- Passage of fiscal stimulus for infrastructure spending that leads to a higher than expected new issuance cycle.
- P&C insurers and banks liquidate their tax-exempt holdings at a much faster pace in search of higher after-tax yield opportunities.

HIGH YIELD

2017 was a strong year for US High Yield credit as spreads tightened almost 60 basis points which resulted in total returns of 7.48% for the sector.

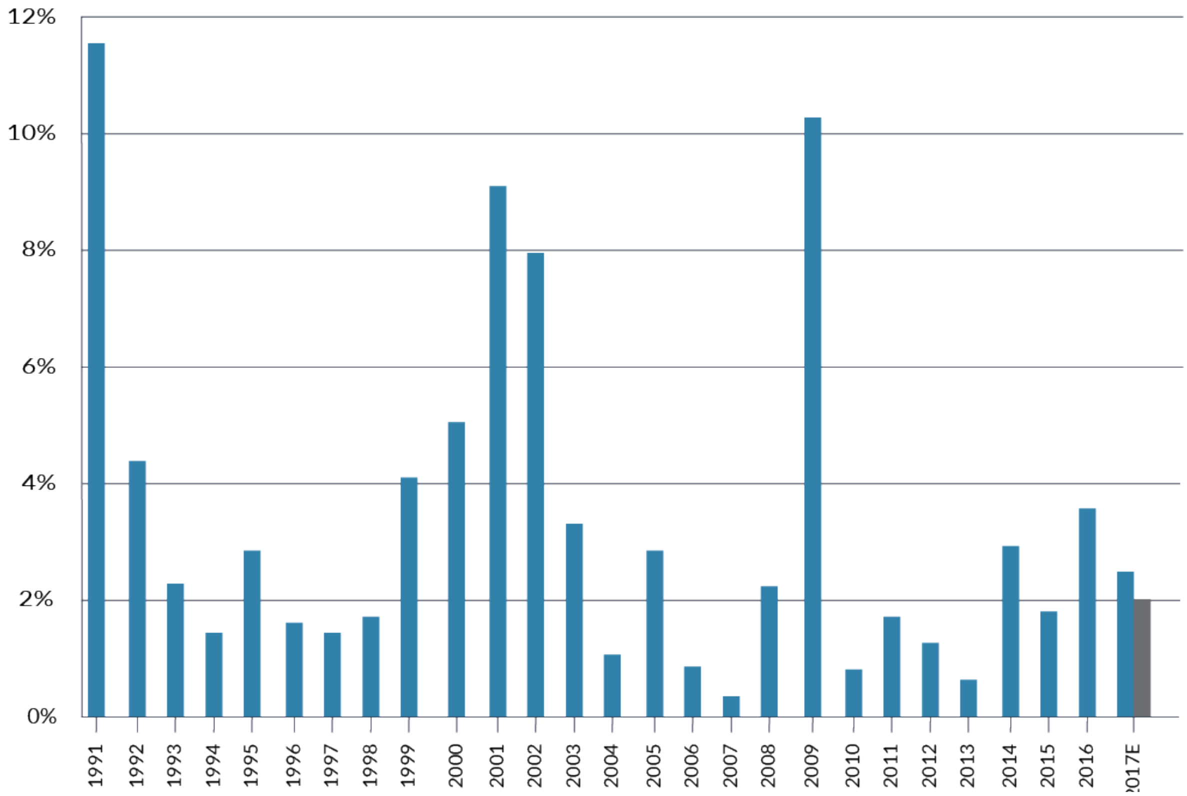
Long-Term High Yield Spreads



Source: *JP Morgan, as of November 2017. 2017 blue line rate, dark line = expected*

Fundamentally, balance sheet leverage in high yield has improved as the energy sector was forced to restructure in early 2016 which has benefited the asset class by purging weaker issuers. The average credit quality of universe has risen with BB rated issuers comprising around 55% of the US High Yield market and interest coverage has also improved above its long-term average. Accordingly, default expectations are lower for 2018 and remain below the long-term average.

US High Yield Market Default Rate



Source: *ICE Bank of America Merrill Lynch High Yield Index – actual default*

Future high yield supply is likely to be impacted by corporate tax reform which now caps the deduction of net interest expense. In the near term the effect is negative for highly leveraged companies' free cash flow, while longer-term it's likely to be a positive technical for the market by limiting the appetite to finance leveraged operations through debt, and ultimately bond supply. The lack of a strong merger and acquisition/leveraged buyout pipeline has left most of the primary market activity focused on refinancing, limiting new issue activity.

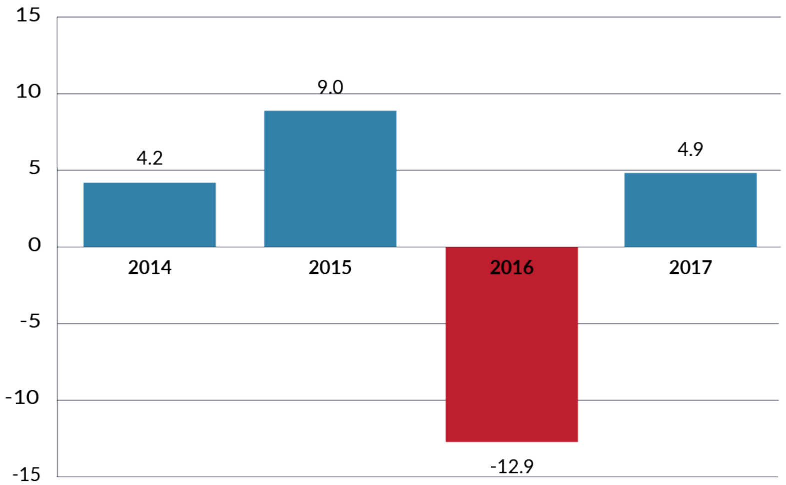
Overall, a solid growth trajectory should lead to a constructive environment for high yield credit with strong technicals and fundamentals offsetting tighter valuations. Accordingly, we expect returns to be muted from last year and range from 3.5%-4%. Downside risks include any increased volatility due to unexpected geopolitical or monetary policy moves, and the correlation between credit and duration becoming less predictable.

The US loans market expanded materially in 2017 as US corporations rebalanced their financing in favor of loans over bonds, and the CLO market continued to be a source of demand in an environment of positive credit migration and reduced appetite for duration. Re-pricing in 2017 has lowered the margin on loans materially and we would expect this to stabilize at current levels. A continued rise in US LIBOR would ensure solid investor demand with expected returns for 2018 to range from 4.5%-5%. We expect this trend to persist in 2018 with a possible increase in M&A transactions being a potential headwind for the sector.

CONVERTIBLES

Convertibles performed strongly in 2017, driven primarily by the broad rally in global equity markets. Large Cap and Growth names led the market over Small Cap and Value names. The dramatic equity rally, especially in those outperforming areas, caused segments of the convertible market to become very equity sensitive and created sector and issuer concentrations, most notably within Technology. New issuance was robust, especially when excluding mandatories, expanding the size of the market and providing ample investment opportunities in both primary and secondary. Portfolio activity focused on managing equity risk and maintaining sector and issuer diversification.

US Net Convertible Issuance in Billions



Source: *Deutsche Bank US Convert Market Summary Stats 2014-2017*

New issuance is off to a fast start in 2018, as GDP growth, tax reform, and deregulation have spurred corporate activity. We may see additional convertible issuance from high yield credits due to relative advantages under new tax policy. As the extended equity bull market continues, we believe balanced convertibles remain an attractive asset class uniquely positioned to participate in global equity advances while protecting from a reversal in market sentiment. Typical duration of under two years means any continued rise in interest rates is only a minor headwind. While perceived equity market risk remains near all-time lows, valuations in the asset class uniquely benefit from any uptick in volatility.

NAIC PROPOSED RBC ADJUSTMENTS

The NAIC continues to develop its plans to adjust the RBC treatment of insurer bond portfolios, adding more granularity to the ratings structure and adjusting the RBC factors applied to each rating to better reflect underlying risks. At the latest estimate these changes are expected to go into effect for year-end 2019 reporting. AAM expects that these changes could lead to meaningful investment strategy changes for insurers sensitive to increases in their RBC required capital (especially Life companies).

These changes include reductions in 'A' and 'BBB' rated securities and corresponding increases in 'AAA' and 'BB' holdings, due to significant changes in the relative required capital for bonds in these ratings buckets. Additionally, bond portfolios could become more granular, as the new portfolio adjustment formula strongly incentivizes a high issuer count (and penalizes a low one). AAM will continue to monitor this project and provide periodic updates as warranted.

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