Stephens
Capital Management

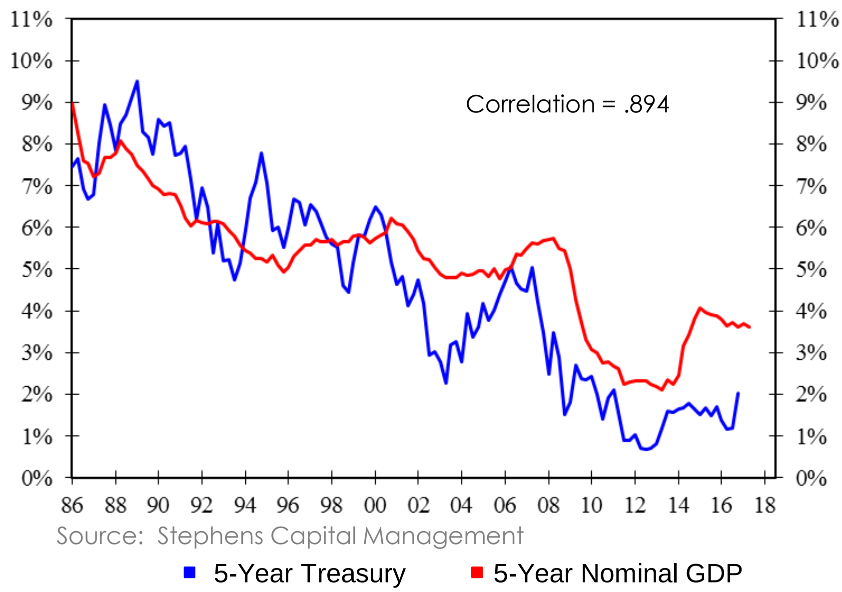
FIXED INCOME STRATEGY

Quarterly Commentary
December 2016

The conclusion of 2016 stood in stark contrast to the first half of the year. The first six months were characterized by the continued slump in the price for oil while political uncertainty abroad led to plunging interest rates and fears of global economic stagnation. Immediately following the surprising Brexit vote in late June, the U.S. 10-year Treasury interest rate hit a historic low of 1.35%. Since that time, however, the yield on the 10-year has risen over 100 basis points to close the year at 2.45% as economic data in the second half of the year pointed to a recovery in growth and oil prices rebounded off early 2016 lows. The rise in interest rates was particularly acute after the surprise election of Donald Trump as the next President of the United States as optimism surged on hopes for a pro-growth agenda of fiscal expansion as well as regulatory and tax relief. The breakeven inflation rate rose from 1.61 to 2.01, which meant 40 basis points of the rise in interest rates were attributed to expectations of rising inflation as a result of expected higher economic growth.

As the chart to the right clearly shows, nominal interest rates are highly correlated with nominal GDP. Nominal GDP is the sum of Real GDP plus inflation. So what are the prospects for each of these components as we move through 2017?

5-Year Treasury vs.
5-Year Nominal GDP Growth Rate

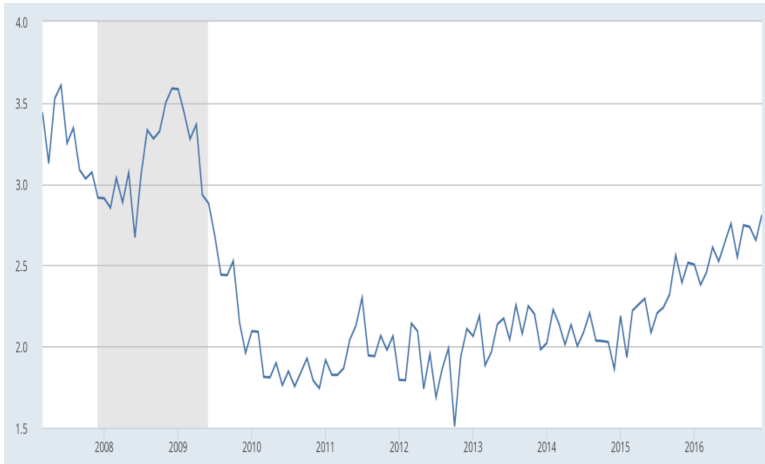


<u>Real GDP</u>

Tepid economic growth has been the hallmark of the economic recovery since the conclusion of the financial crisis and associated recession. The initial reports put Real GDP growth at 1.9% for the fourth quarter, matching the rate of growth achieved the previous year. However, there are reasons to be more optimistic about our growth prospects moving forward. Immediately following the election, small business and consumer confidence shot up markedly on hopes of a more business friendly administration coming to Washington. The National Federation of Independent Businesses publishes the Small Business Optimism Index which increased to 105.8 in December, up 38 points from the previous month, to the highest level recorded since 2004. The University of Michigan Consumer Sentiment survey closed the year at a high not seen in almost 12 years!

The combination of a continued strong housing market, relatively low interest rates and increasing wages and have boosted consumers' financial prospects as well. Stagnant wage growth has been one of the major reasons so many Americans feel as though they are no better off than before the financial crisis despite the fact that the recession ended over seven years ago. In 2016, the tight labor market finally generated meaningful wage inflation which is a positive precursor of consumer spending. According to the Atlanta Federal Reserve's Wage Tracker Index, wages were up 3.5% in 2016. The more widely followed average hourly earnings, published by the Bureau of Labor Statistics, shows in increase of 2.9%, the largest gain in over seven years.

Average Hourly Earnings of All Employees



Source: St. Louis Federal Reserve

The Institute for Supply Management publishes its Purchasers Management Index (PMI), which measures economic activity in the manufacturing sector. The PMI is based on a survey of 350 purchasing and supply executives in 18 different industries. A reading above 50 50 indicates expansion whereas below 50 equals contraction. The latest results show that manufacturing increased further in January to 56, the highest level in over two years. For a basis for comparison, the PMI has averaged 52.1 for the latest 12 months.

Manufacturing at a Glance

Index	Series Index		% Change	Direction	Rate of	Trend
	Jan	Dec			Change	(Months)
PMI®	56.0	54.5	+1.5	Growing	Faster	5
New Orders	60.4	60.3	+0.1	Growing	Faster	5
Production	61.4	59.4	+2.0	Growing	Faster	5
Employment	56.1	52.8	+3.3	Growing	Faster	4
Supplier Deliveries	53.6	53.0	+0.6	Slowing	Faster	9
Inventories	48.5	47.0	+1.5	Contracting	Slower	19
Customer's Inventories	48.5	49.0	-0.5	Too Low	Faster	4
Prices	69.0	65.5	+3.5	Increasing	Faster	11
Backlog of Orders	49.5	49.0	+0.5	Contracting	Slower	7
New Export Orders	54.5	56.0	-1.5	Growing	Slower	11
Imports	50.0	50.5	-0.5	Unchanged	From Growing	1
OVERALL ECONOMY				Growing	Faster	92
Manufacturing Sector				Growing	Faster	5

Source: Institute for Supply Management

Inflation

As we anticipated, inflation rebounded as the decline in the price of oil has finally abated. Through December, the consumer price index (CPI) registered an annual increase of 2.1%, up from 1.8% in November. The return of inflation is not strictly a result of oil however. Shelter, by far the largest component of the CPI at just over one-third, rose by 3.6% over the past 12 months. This shows no sign of slowing down. Over the past six months it has increased at an annualized 3.76% rate and the latest three months comes in at a slightly faster 3.86%. The fact that raw material prices are now up for 11 straight months is another development that suggests inflationary pressures may be building. Core inflation, which excludes food and energy, was up 2.2% through December. This extends its run of over 2% inflation to 14 consecutive months. With core inflation holding firm, a continued stabilization in the price of oil will likely push headline inflation higher during the first half of the year. While we never try and put a number as to exactly how high inflation may go, we feel confident that the time when the market was worried about too little inflation or even deflation is clearly behind us.

With the likelihood that both the economy and inflation will firm in the year ahead, we expect interest rates of all maturities to stay firm. With a new administration, there is always the risk of a change in economic or foreign policy that could upset the forecast. Taking this into consideration, we intend to continue with the defensive posture we have had for some time.

Adam B Tedford   Bill Tedford

Important Disclosures

The views expressed in this commentary were those of the portfolio manager as of the publication date and are subject to change without notice. The performance data quoted does not reflect the deduction of advisory fees and other account expenses. Our advisory fees are available in Part II of our ADV or the appropriate brochure. Performance results represent past performance and do not guarantee future results. Market volatility can significantly impact short-term performance. Actual results of an investment made may differ from the composite results, depending on the size of your account, the duration of the account, the investment objectives and/or restrictions, the time at which your investments are made, and other factors.

William Tedford has developed and uses a proprietary model designed to forecast inflation. The model reflects past and historical relationships of inflation to monetary base and oil prices. The future behavior of inflation is influenced by many factors (many of which are themselves unpredictable) and will not necessarily continue to follow historical patterns. The model, by itself, cannot guide an investor as to what securities should be bought or sold nor as to when to buy or sell.

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