Investor Insights & Outlook

October 2017 3rd Quarter Concorde Investment Management

Domestic Economic Overview

A Message from Concorde Investment Management

We are pleased to provide the following overview of the domestic and international economic backdrop and the financial markets that impacted our investment policy and strategy during the Third Quarter of 2017, as well as other articles of interest.

We mentioned a "Goldilocks economy" in our last letter and those characteristics are continuing. The 3rd quarter manufacturing activity is at a 13 year high, the service sector activity is at a 12 year high and the U.S. economy has lots of open jobs (that are tough to fill which is resulting in increasing wages in those sectors). In addition, wages in general are up 2.9% and the unemployment rate is at a 16 year low, workers are coming back into the workforce, home sales prices are rising, and optimism about the American economy is at a 10 year high. The Q3 GDP was announced October 27th and hit a 3% annualized number, in spite of the economic impacts of hurricanes experienced in Texas, Florida and Puerto Rico. The growth in the economy that will take place due to rebuilding activity after those same disasters will make for stronger numbers in Q4 and into 2018. Emotional impacts notwithstanding, rebuilding after hurricanes will likely add to growth as the 2016 Congressional Budget Office report found that federal spending after major hurricanes can add as much as .6% to GDP. The U.S. economy is healthy, synchronized with the rest of the world and the cycle still has some time to run if past expansions are a reasonable analog. We are hopeful that Congress will adopt some sort of constructive corporate tax reform that could push the growth numbers past even higher.

Good news notwithstanding, it's also important to recognize structural issues. The Q3 GDP headline number is strong, however, .7% of the 3% growth was related to inventory accumulation. There also was a decrease in domestic demand growth quarter over quarter. For the fiscal year end 2016, the federal government out spent its revenues by $668

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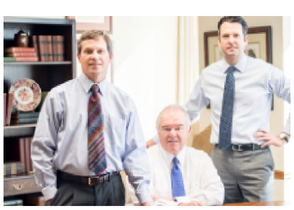
The Concorde Team



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Domestic Economic Overview (continued)

Billion and the gap was covered with more debt as the fiscal deficit rose to 3.5% of the nation's GDP. Controlling government spending is not a realistic expectation in Washington anytime soon, no matter who is elected. From a purely government spending view, the healthcare bills that were presented in the Senate were, in essence, entitlement reform bills more than anything else and the party of smaller government could not get 50 votes required to pass the legislation. Politics are local and the good Senators from Maine and Alaska proved that point again by voting for their own states best interest and not those of the country, as a whole. Other than reduction of spending, the only way to get the United States debt and deficits under control is to grow the economy. We've written constantly about growth rates in the 2-2.5% range and that is all fine but if our GDP does not grow faster than a rate that generates tax revenue sufficient to offset spending then the trajectory of the U.S. economy is unsustainable. The growing realization of that fundamental fact, and the fact that the GOP controlled congress needs some sort of legislative victory prior to the 2018 midterm elections, is why we remain optimistic of a passable tax bill that, at a minimum, will reduce the corporate income tax rate which should have multiple constructive and positive effects on economic growth.

The United States consumer (which accounts for 69% of the U.S. economy) remains strong. Household debt service ratios are lower than any time in the last 35 years and household net worth continues to increase, specifically as asset prices have been pushed up by easy monetary policy. Assets have been reflated which is why the Fed is in a position to begin shrinking its balance sheet going forward. It's hard to overstate how much of a positive impact a decade of low interest rates has been on consumer and corporate credit metrics and asset prices.

International Economic Overview

Currently there is a synchronized global expansion ongoing amid low inflation. This is giving central banks across the globe a window of opportunity to revert to monetary policy normalization rather than continuing the active economic support through expansionary monetary policy and low interest rates which has been ongoing for almost a decade. The Fed is beginning to "unwind" its balance sheet by reducing the amount of debt it holds and the European Central bank is expected to begin tapering its asset purchases next year. This could pose a liquidity challenge to markets. However, Global Purchasing Mangers' Index for manufacturing, a leading indicator of growth prospects, shows positive numbers for both the Developed and Emerging Markets. The Index for every single country, as of September, is above 50 (the indication of acceleration versus below 50 indicating deceleration of a country's economy) which suggests a continuation of the synchronized global expansion.

The Eurozone is on a cyclical upswing and is in mid-cycle expansion with consumer sentiment and expectations at multiyear highs. The issue on the horizon will be the actual Brexit (British exit from the European economic union) which was voted for by UK citizens in the summer of 2016.

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International Economic Overview (continued)

There was an initial negative reaction in equity markets to Brexit that lasted less than 48 hours before a general rebound, but as we move closer to an actual break from the rest of Europe, there is growing concern about the lack of progress being made in negotiations surrounding the specific mechanics of that separation. It is likely to be very messy. UK consumer's expectations for economic growth have deteriorated and the Country has rising inflation which impacts real income growth. Not a good combination.

Long term, which is the multiyear period over which we view investing, and how we encourage clients to view the world, our concerns have not abated. Mainly driven by demographics (the one variable that takes decades to change) long term growth rates of developed economies will continue to stay lower than the previous 20 years. We expect GDPs of emerging economies to grow faster than developed based on that fact and assuming they are successful in generating internal demand in their home economies. There will be short term volatility if only due to the central banks slowing fiscal support but longer term, the growth will come from economies supported by appropriate demographics, internal demand and rational economic policies. The overall observation by many thoughtful pundits is that while the current global economic environment is positive, such growth remains vulnerable to policy mistakes by governments and geo-political aberrations which might disrupt or end the synchronized economic growth "party".

WEB PRESENCE AND CLIENT LOGIN

Last year we launched our website www.concordeco.com. If you have not already done so, please take a few minutes to explore the website. On the site you will find information about our firm, services, certain literature, and access to client portals. Notice that our "Client Access" tab has a pathway to a "Concorde Login". To obtain your personal login information, please contact Greg Wood at gregwood@concordeco.com or 972-701-5412 and he will work with you to get your account set up.

Fixed Income

As the expectation that the U.S. Federal Reserve will increase the Fed Funds rate another 25 basis points near year-end and also begin a slow reduction in their inflated balance sheet consisting of primarily Treasury and mortgage securities, market yields have remained relatively flat most of the year. The fact that these changes have not sent market rates higher highlights the strength of balancing market forces. Continued low rates of domestic inflation and strong buying from international investors and sovereign funds are likely two of the stronger factors enhancing demand. In addition, it is possible that market participants are beginning to be slightly concerned about the longevity of the economic expansion, although fundamentals currently do not confirm this. Flows into registered funds for taxable and tax-free products has exceeded flows into U.S. and world equity products by a significant degree for 2016 and YTD 2017 through August.

Domestically, the best performing sectors have been in spread segments such as investment grade and high yield corporates, municipals and convertibles (which have benefited from rising equities). International fixed income returns denominated in U.S. dollars have generated good returns primarily from the short-term dollar weakness as generally rates have stayed in a narrow range.

Looking forward, we are maintaining a conservative duration approach as we can see multiple scenarios over the next several years where yields could rise modestly and want to limit any damage to principal that this could cause. We also continue to recommend and hold allocations in select corporate issues, non-agency mortgage backed securities and some exposure to targeted international markets in order to diversify and generate higher current income in this continuing low yield environment.

Equity Markets

The positive trends in domestic and international markets during the first half were continued in Q3. Domestically, growth stocks continued to outperform value and large caps exceeded small caps to a lesser degree. Internationally, most developed and emerging indices are still surpassing U.S. markets YTD. Domestically, a mix of sectors with no common theme have risen significantly, including healthcare, technology and materials. In international, Western Europe and global emerging markets have posted the best returns. At the current time we are increasing international exposure modestly as a percentage of total equity commitment as the recent outperformance is likely to have additional legs after multi-year weakness, and recent fundamental improvements are likely to continue. Regarding overall valuations, the same considerations have been in place over the last year or two.

Real earnings growth and continued moderate medium-term interest rates are supporting current levels with only a moderate amount of anticipation built into current prices. Reinforcing this observation is our experience of discovering a reasonable number of individual equities to continue to hold or purchase that are priced under or near a conservative fundamental valuation range. We believe some potential rise in yields are factored into equity valuations, however a more significant increase, say 10 year USTN yields at 4.00% within 2 years, could pressure equities. Also supporting equities domestically is incremental foreign demand resulting from currency diversification priorities and income generation greater than is available in many developed countries. With all this said, clearly global political and policy risks appear higher than we have seen in some time, warranting a more conservative asset allocation.

Making Sense of an Increasingly Tight Market for Bonds

by Alina Lamy, Morningstar Research

The first seven months of the year have been moderately generous to investors in intermediate-term bond funds. The Bloomberg Barclays U.S. Aggregate Bond Index returned a solid 2.3% from Jan. 1 through July 31, close to its gain for all of 2016.

Meanwhile, many funds that take a more adventurous approach to risk than the investment-grade index posted even better returns, thanks to gains in emerging-markets debt—peso-denominated Mexican debt was a particular standout—and junk bonds. But recent bond strength has made for an increasingly challenging market for fixed-income investors. Treasury yields remain low on an absolute basis, while corporate bonds have enjoyed a strong rally since early 2016. The Bank of America Merrill Lynch U.S. High Yield Index offered an option-adjusted spread (which measures how much investors are paid for taking on the credit risk inherent in junk bonds) of just 3.6% as of the end of July.

That level is close to postcrisis lows, meaning that there's not much compensation for the default risk inherent in junk bonds and suggesting that, at best, high-yield bonds are likely to see relatively muted returns.

For individual investors, it's important to have realistic expectations about bond returns (they are likely to be fairly modest for investment-grade bonds). It's also important to take a look at what's in your portfolio and make sure that you're comfortable with your risk profile—and, in particular, the level of credit risk your managers are taking. But how are fixed-income managers with a broad investment universe, including those who manage funds in the intermediate-term bond Morningstar Category, making sense of the current opportunity set?

A Mostly Cautious Approach to Duration

Given that the Federal Reserve has raised rates three times since last fall and seems poised to announce a scaling back of its balance sheet in September, it's not surprising that bond fund managers would be cautious on longer-term bond yields. Intermediate-term to long-term bonds have also rallied modestly year to date, although they still remain above their levels prior to the U.S. elections.

That said, even many managers with an underweighting to duration are not expecting a huge runup in rates. As of the end of the second quarter, for example, BlackRock noted that it was decreasing its underweighting to duration in one of its funds, citing softening economic growth and inflation and continued strong demand for fixed-income instruments. PIMCO, meanwhile, noted a 'modest' underweighting to duration in one fund, but a preference for U.S. duration over other developed-markets exposure.

Some are even bullish on U.S. rates, although again these bets also tend to be fairly modest. One team at Prudential noted that it was running their fund's duration slightly longer than the Bloomberg Barclays U.S. Aggregate Bond Index as of midyear, arguing that markets are pricing in an 'unrealistic' amount of central-bank tightening in the years to come.

While many managers are staying relatively close to neutral in their outlooks for nominal interest rates, we're seeing more enthusiasm for Treasury Inflation-Protected Securities, which have been one of 2017's biggest underperformers to date. Some managers are even arguing that the inflation expectations embedded in TIPS prices are too low.

Making Sense of an Increasingly Tight Market for Bonds (continued)

Credit Looks Less Attractive After a Strong Run

From the beginning of March 2016 through July 31, 2017, the broad U.S. high-yield indexes posted 25%-plus gains. With returns of this magnitude likely in the rearview mirror, many intermediate-term bond investors with the flexibility to hold junk bonds are turning cautious on credit. Some managers recently pointed out that on a loss-adjusted basis, yields on junk bonds aren't particularly attractive relative to investment-grade fare.

Meanwhile, they cited other late-credit-cycle dynamics, including poor underwriting standards, a flattening yield curve, and weak corporate profitability, as reasons to be careful when it comes to credit.

Other managers maintain an overweighting to credit but have nonetheless trimmed exposures, arguing that the U.S. economy could stay in the late stages of the credit cycle for a prolonged period of time.

Bullish on Securitized

Securitized credit offers one of the few opportunities that many managers agree on. PIMCO, Prudential, BlackRock, and TCW MetWest all have found ample opportunity in a mix of nonagency mortgages, commercial mortgage-backed securities, and asset-backed securities, focusing primarily on senior tranches that have a first claim on assets. These firms have also found value in AAA rated slices of collateralized loan obligations (CLOs), which are backed by floating-rate bank loans. Although these structures may sound alarm bells for investors who remember the difficulties suffered by collateralized debt obligations during the financial crisis, managers note that the senior tranches of CLOs actually held up well even as bank loans suffered massive losses; newer versions of these CLOs provide more protections for senior investors.

Investors are more cautious in their approach to plain-vanilla agency mortgage-backed securities, which account for close to a third of the index. Many investors cite potential pressures on valuations as the Fed is expected to start to slow its reinvestment in mortgages. PIMCO stands out as a firm that has been more sanguine about this risk.

A Mixed View on Emerging-Markets Debt

Over the years, many intermediate-term bond managers have increasingly found opportunities in emerging-markets sovereign debt, and many added to stakes in the sector following last year's post-election sell-off. As of mid-2017, enthusiasm for emerging-markets debt varied widely across firms. BlackRock falls in the 'bull' camp, citing strong developed-markets growth as a powerful support for the sector. TCW MetWest, meanwhile, was relatively bearish on emerging-markets debt. The firm has raised concerns about leverage in the Chinese financial sector and notes that any problems in China are likely to quickly spread to the rest of the emerging-markets universe.