FIRST PRINCIPLES CAPITAL MANAGEMENT

Monthly Market Observations

August 2017

Themes

Volatility – both actual and implied from options prices – continued to drop in July, with both VIX (equity) MOVE (bond) indices at all-time lows. Over the second week of August we saw a small reversal of this exuberance sparked by escalating, threatening rhetoric with North Korea.

Employment & Inflation

The torrid pace in US employment continued in July with non-farm payrolls up by 209K – positive for a record 82nd straight month – averaging +195K per month over the past 3 months. The unemployment rate ticked back down to 4.3% – a 16-year low. June US job openings moved up to 6.16 million – the highest reading since the measure's inception in 2000.

Inflation measures continue to be subdued with both core CPI and PCE coming in closer to 1.5% year-over-year (YoY). In fact, headline rates of inflation have converged with core inflation as the effect of lower oil has dissipated.

The latest readings on wage inflation are still mild, with July Average Hourly Earnings up 0.3% for July (+2.5% YoY), and the June Atlanta Fed Wage Tracker at 3.2% YoY – the lower end of the range over the past 18 months. Many economists, surprised that sustained, robust job growth has not pushed inflation higher, are now predicting that inflation will pick up in Q4 for a variety of reasons (sub-4% unemployment, lower dollar, etc.), but the bond market is not buying that story. Frankly, lower inflation helps prolong growth in the real economy, two-thirds of which is driven by the consumer.

Central Banks

As expected, the Fed left things unchanged in its July meeting, but did indicate that it would begin slowing its reinvestment soon – likely meaning an announcement following the September FOMC meeting and commencement in October. Janet Yellen indicated that the Fed would take both actual and expected inflation data into account when deciding whether to raise the fed funds rate. The futures market prices less than a 50% chance that the Fed will raise the rate by 25 basis points in December.

Mario Draghi will be in attendance for the Fed's annual Jackson Hole conference in August, but it is unlikely that he will discuss the ECB's €60 billion per month bond purchase program. The Governing Council will likely make a statement at its September meeting on changes to the pace of purchases in 2018.

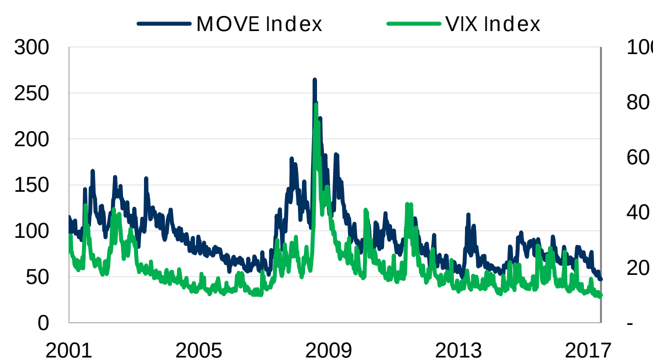
Debt Ceiling

The T-Bill market began to reflect nervousness over the debt ceiling with the Treasury announcing that the government will run out of money by the end of September. Bills maturing in October are yielding more than November and December maturities. Congress returns in September with only a couple of weeks to begin discussions on resolving the debt ceiling and agreeing on a 2018 budget. The Freedom Caucus may insist on tying domestic budget cuts or new military spending to any increase in the debt ceiling, which would require 60 votes in the Senate. President Trump may even choose not to sign a bill that raises the debt ceiling, thus shutting the government down. Any breach of the debt ceiling will likely be short-term, and lead to prioritization of payments, a downgrade by (at least) Moody's, and possibly a small delay in redeeming T-Bills.

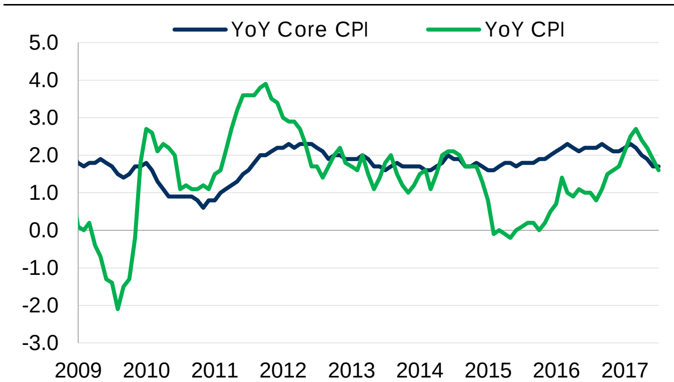
Financial Asset Inflation

Both investment grade corporate credit spreads and AA municipal yield ratios (relative to Treasuries) approached their tightest levels in years in July as investors continued to pile into high grade US fixed income. The theme is consistent – historically low option implied volatilities and credit spreads, with the stock market at all-time highs. Financial asset inflation (bonds, stocks, private equity, commercial real estate, etc.) is pushing investors to take more risk for less return. The prevailing market view is that the US economy (and the world economy for that matter) is in sound fundamental shape, US banks are well capitalized, central bank-driven depressed real yields are too low, and there is a surfeit of investor cash to put to work – including a significant growth in passive investing in stock index ETFs, where stocks are purchased based upon their market capitalization, without regard to whether they represent good value.

Merrill Lynch Option Volatility Estimate vs VIX



CPI YoY vs. Core [%]



FIRST PRINCIPLES CAPITAL MANAGEMENT

Monthly Market Observations

August 2017

Observations

- The Treasury yield curve has flattened 20 bps since the beginning of Q3. Many are of the view that long yields can rise. We believe the curve has the potential to flatten further with continued demand from retirement related flows.

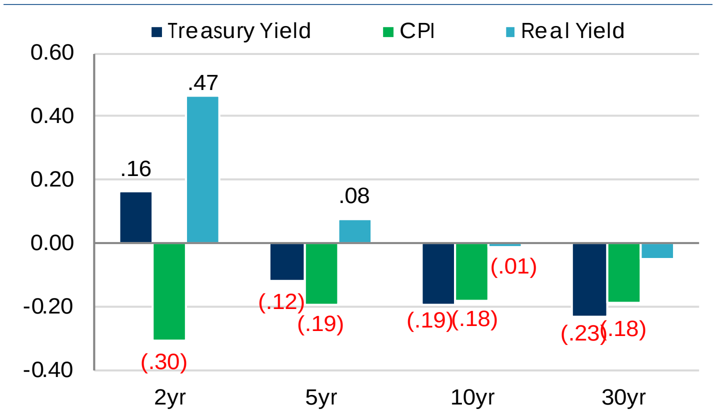
- The probability of another Fed hike on December 13, 2017 has continued to decline. Since the beginning of Q3, market expectations have moved from a 60% probability to just under 40%.

- We've pointed out the meaningful impact of declining yields and the shape of the yield curves on public and private pensions. In his latest white paper entitled, "Carry On," First Principles CEO Richard Dolan discusses the impact of the yield curve and carry on US pension plans.

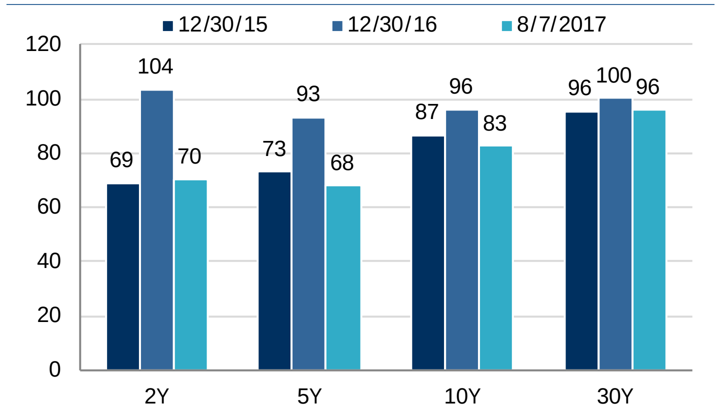
- With the recent deterioration in several state GO municipal debt ratings, we've observed increased volatility on state credit spreads. This highlights the importance of continuous and reliable financial information on municipal issuers. In many cases, municipal issuers below investment grade do not have robust financial information normally available in corporate credit markets.

Monthly charts

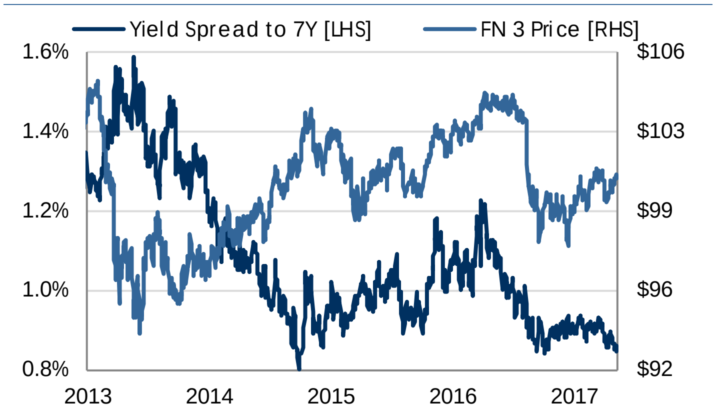
US rates shift [%], 12/30/2016 through 8/7/2017



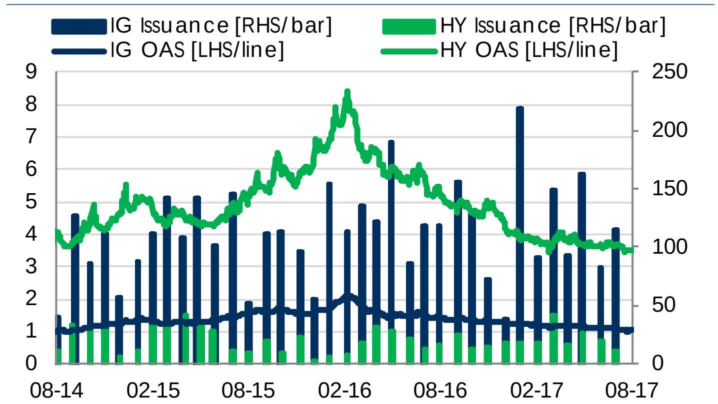
Ratio of AAA GO muni yields vs USTs [%]



MBS TBA spread to UST vs. FN 3 price



Corporate issuance [$BN] and spreads [%]



Author:

Stephen R. Miller is a Managing Director at First Principles Capital Management, LLC (FPCM). FPCM is a wholly owned subsidiary of American International Group (AIG).

Disclaimer

The information contained herein has been prepared solely for informational purposes and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security.

First Principles Capital Management, LLC ("FPCM"), or any of its affiliates, do not make any representation or warranty, express or implied, as to the accuracy or completeness of the information contained herein, and the information contained herein should not be relied upon as a promise or representation whether as to the past or future performance. The information contained herein includes estimates and projections that involve significant elements of subjective judgment and analysis. These statements are not purely historical in nature, but are "forward-looking statements". They may include, among other things, projections, forecasts, targets, sample or pro forma investment structures, portfolio composition and investment strategies. These forward-looking statements are based upon certain assumptions. Actual events may differ from those assumed. FPCM or any of its affiliates do not make any representations as to the accuracy of these forward-looking statements or that all appropriate assumptions relating thereto have been considered or stated and none of them assumes any duty to update any forward-looking statement. Accordingly, there can be no assurance that estimated returns or projections can be realized, that forward-looking statements will materialize or that actual results will not be materially lower than those presented.

FPCM and its affiliates disclaim any and all liability as to the information contained herein or omissions here from, including, without limitation any express or implied representation or warranty with respect to the information contained herein.

The information contained herein is confidential and proprietary to FPCM and its affiliates. This material and information should be treated as strictly confidential and cannot be disclosed to any other party other than the recipient and its advisers. Notwithstanding anything to the contrary contained herein, the recipient (and each employee, representative, or other agent of the recipient) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transactions described herein and all materials of any kind that are provided to the prospective investor relating to such tax treatment and tax structure (as such terms are defined in Treasury Regulation section 1.6011-4). This authorization of tax disclosure is retroactively effective to the commencement of discussions with prospective investors regarding the transactions contemplated herein. By accepting this information, the recipient agrees to be bound by all of the limitations described herein.