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Everett School Employee Benefit Tr.
Darla Van Duren
PO Box 2098
Everett, Washington 98213

Dear Darla:

The bond market provided moderate returns in the second quarter. The broad intermediate investment grade taxable market returned about 0.93%, that's an annualized rate of 3.8%. The historical average for this sector of the market has been 5.9%. Bonds performed better earlier in the quarter but interest rates began to rise (and prices subsequently fell) in late June.

The late sell-off can be attributed to several factors. Inflation expectations, which had been declining since mid-March, began rising, US employment statistics continued to improve, the US economy continued to grow at a moderate pace, overseas economies began to improve and the Federal Reserve reiterated its desire to "normalize" interest rates after increasing the funds rate in June.

The improvement in foreign economies, particularly in Europe, prompted the European Central Bank (ECB) to openly discuss pursuing a less accommodative monetary policy. This caused rates to rise. In Germany, for example, the ten-year government bond rate had been as low as 0.23% in mid-June but closed the month at 0.47%. On June 30, the US 10-year rate, at 2.30%, was considerably higher. Nevertheless, higher German rates made their bonds more attractive and pressured the US market. The ECB's comments placed them more in line with the Federal Reserve and prompted concerns of a global rise in interest rates.

Here at home, the Federal Reserve has been candid about their desire to normalize rates. They have increased the funds rate twice this year and have indicated that one more increase is likely in 2017. At first, the market discounted the possibility of a third increase. But lately, the market is building in this additional increase. Another rate hike will take the target funds rate to 1.25% to 1.50%; still very low when compared to our nominal growth rate of about 4.0%. The Fed believes the neutral rate is 3.0%. Their projected pace to reach the neutral rate is slow and steady and they do not anticipate being there until the end of 2019. In addition to rate increases, the Fed is planning to gradually shrink their balance sheet, meaning they are going to decrease their portfolio of securities. This will take money out of the economy and more bonds will have to be purchased by the private sector. This should influence a move to higher rates.

During the quarter, bonds with longer maturities tended to outperform shorter bonds. Investors also continued to search for better yielding opportunities. This favored corporate and municipal bonds and caused these sectors to outperform US Treasuries.

Your portfolio returned 0.30% in the second quarter; in line with its benchmarks. The activity in the account has centered on raising cash to meet your liquidity needs. The duration of your portfolio is 1.8 years while your benchmark's duration is 2.2 years. Your portfolio is therefore slightly more conservative than your benchmark.

Most of the factors influencing bond yields are lined up to push rates higher. We believe the bond market risks still outweigh the rewards and we are conservatively managing your fixed income assets.

As always, we appreciate your business and invite your questions and comments. Please feel free to contact any of us here at Becker Capital.

Sincerely,

Keene Satchwell