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HJ Sims' 2018 Outlook

Bond Market

Our interest rate outlook this year differs from the conventional wisdom. We agree that the Federal Reserve will raise short-term interest rates 3-4 times this year. Most economists believe that long-term rates will rise slightly but not by as much as short-term rates will climb.

We believe that economists are underestimating the effects of the Tax Reform Act passed at the end of 2017. To us, tax reform will make the economy stronger, resulting in greater workforce participation and more inflation. At least in its initial year, tax reform should mean lower U.S. government tax revenues and higher deficits and begin a circular pattern of higher deficits leading to higher interest rates, which in term lead to higher deficits, etc.

The last major U.S. tax reform legislation was passed in 1986, and at least for a while after enactment, interest rates rose. Of course, this does not mean that rates will rise today, but this probability is much higher than is conventionally believed.

The tax-free bond market was also obviously affected by 2017 tax reform. It is very clear to us that this reform means that tax-free bond interest rates for senior living borrowers will drop relative to corporate bond rates. Here are some reasons why:

1) The supply of senior living bonds will be lower because of the prohibition on advance refundings.

2) A stronger economy will generally help the financial performance of senior living credits.

3) Today, the after-tax yield of BB rated tax-free bonds is 200+ basis points higher than BB rated corporate bonds.

Therefore, higher interest rates in the U.S. government and corporate bond markets will be moderated in the tax-free bond market.

Of course, everyone's predictions will be subject to unplanned events at home, in Korea, Iran or other places. International crises normally result in investors putting more money into U.S. government bonds, which, of course, would lower U.S. interest rates – both taxable and tax-free.

At the upcoming Sims Conference, you will have a chance to prove your interest rate forecasting acumen. We will have an interest rate predicting contest with fabulous prizes.

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Senior Living Industry

Overall, the operating environment for the senior living industry became more difficult in 2017. The growing economy, booming stock market and strengthening residential real estate market in many areas mean that seniors and their families have more resources to pay for increased fees at senior living communities. On the other hand, the stronger economy and more limited immigration mean more competition for staff and higher wages. Simultaneously, the growth of new communities in many locales results in holding back price increases while operating expenses rise.

According to the National Investment Center for Seniors Housing & Care ("NIC"), the third quarter of 2017 saw the independent and assisted living rental senior living occupancy rate holding steady at 88.8%. However, the number of units under construction and still in lease-up is over 10% of existing, stabilized supply – the highest rate in over 12 years. Entrance fee communities seem to be divided between great success (well over 90% occupancy) with modern physical plants and expansions into new services and additional units. The other side includes some struggling entrance fee communities (mid to lower 80% occupancy) with postponement of capital expenditures needed to remain competitive. Skilled nursing homes are being challenged by higher Medicaid participation, few Medicaid rate increases and lower managed Medicare revenue per patient day.

What are successful providers doing to overcome these challenges? Their solutions will be a focus of the upcoming Sims Conference at the Omni Orlando at ChampionsGate from February 28 – March 2. Some of the initiatives to be gone into detail at the Conference include:

- Reinventing the relationship among senior living communities, nursing homes and acute care hospitals.
- Building new communities downtown in urban areas.
- Targeting, valuing, pricing and financing strategic acquisitions.
- How to distinguish yourself from the competition by fueling your brand with the science of emotion.
- How you can use design to enhance the health of your residents, staffs and families and your reputation in the market.

In addition to these initiatives, four leaders from the proprietary and nonprofit segments of the senior living industry will describe what they are doing to stay ahead.

At Sims, we have seen many communities succeed with a wide variety of strategies. To us, the future looks bright.

Senior Living New Issue Rates as of 1/23/18

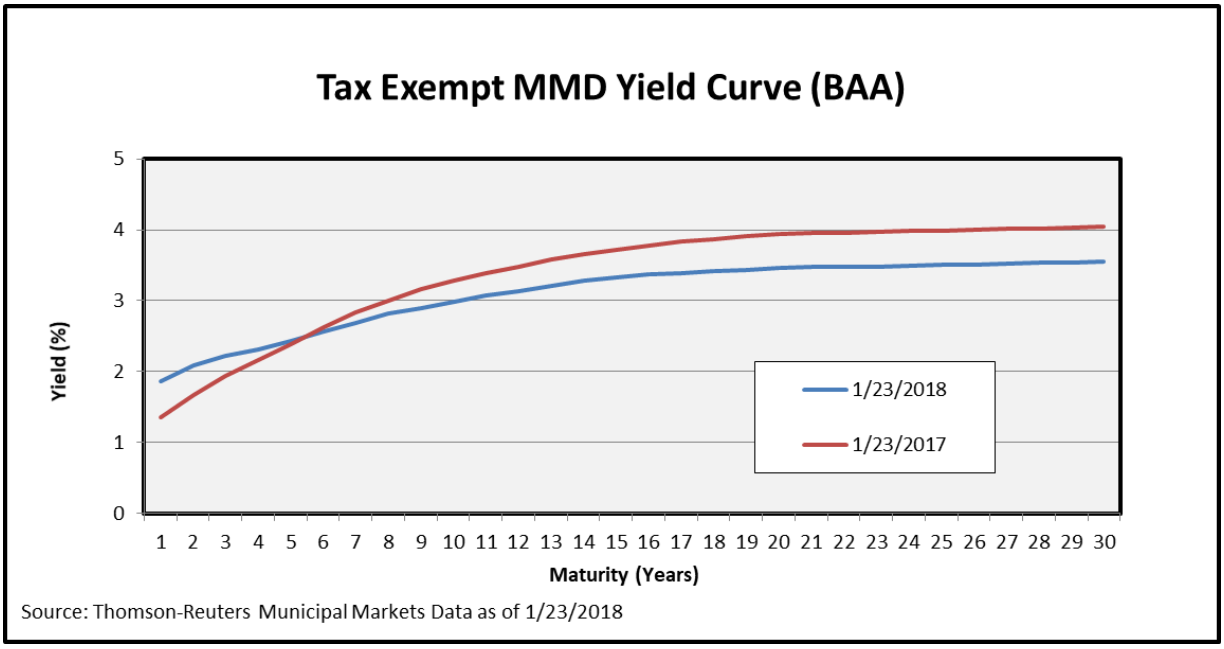
Maturity	Taxable Rates	Tax Free Rates					
	GNMA Taxable	FHA Tax-Exempt	A	BBB	BB	Refinancing & Expansion	Start-Up
5 yr.	NA	1.690%	2.350%	2.550%	2.70%	2.75-3.25%	4.00-4.50%
10 yr.	NA	2.460%	2.900%	3.200%	3.55%	3.50-4.00%	4.50-5.00%
20 yr.	NA	3.040%	3.450%	3.600%	4.05%	4.125-4.625%	5.25-6.00%
30 yr.	3.650%	3.260%	3.600%	3.750%	4.15%	4.25-4.75%	5.75-6.375%

Senior Living new issue rates for borrowers in specialty states are 20-30 basis points lower in yield.

SIFMA Index	LIBOR
1.23%	1.56%

Revenue Bond Index (RBI)	10 Year Treasury	30 Year Treasury
4.01%	2.613%	2.8940%

	1 Year	3 Year	5 Year	7 Year	10 Year
Weekly SIFMA Swap Rates	1.45%	1.72%	1.84%	1.96%	2.10%
Weekly LIBOR Swap Rates	2.04%	2.39%	2.51%	2.59%	2.67%



Market Commentary: Negotiating Law by Ultimatum

In what is always a humbling exercise for those deemed non-essential, the federal government shut down for 69 hours until an agreement on a temporary spending bill was reached. Some 800,000 federal workers deemed "non-excepted" were furloughed, including 95% of the Commodity Futures Trading Commission staff and 56% of the Internal Revenue Service, while members of Congress and senior White House officials negotiated terms on immigration, child health care, defense spending and a three week funding extension. A partial shutdown happens about every thirty months and has lasted for as little as a day and as long as three weeks. There is a good possibility that another one will happen again next month. With ultimatums and horse-trading, this is how our laws are made.

Averting fiscal crises a few minutes, weeks or months at a time has become a familiar practice in our healthcare system as well. Managers in both nonprofit and for-profit institutions often find themselves performing financial triage while physicians handle the human kind. In "Don't Hate the Player; Hate the Game", authors take a look at market conditions and other factors that have led to the proliferation of freestanding emergency departments. Dr. Brendan Carr, a co-author, will be a featured speaker at the Sims Late Winter Conference next month. He brings policy, business, provider and consumer perspectives to the healthcare discussion and proposes innovative approaches that can only come from having boots-on-the-ground. We hope that you will be able to join us for his remarks at the Omni Orlando at ChampionsGate where we convene from February 28 to March 2. For more information, please visit HJ Sims 2018 Conference.

The 10-year Treasury yield hit a 3-year high last week, fueled in part by overzealous media coverage of the partisan divide in Washington. In addition, it appears that investors are starting to adjust to the prospect of three rate hikes, inflation and a flood of government paper in the market as a result of Federal Reserve sales and a heavy slate of new Treasury issuance that JPMorgan forecasts at $1.42 trillion. The 10-year yield jumped 11 basis points from 2.54% to 2.65%. The difference in yields between 10- and 30-year maturities remains narrow: the long bond yield finished the week up 9 basis points and only 28 basis points wider. At 2.93%, this yield compares with the 30-year yield in Portugal at 2.90%, but is well above that of Germany, France and the United Kingdom at 1.29%, 1.75% and 1.84%, respectively.

Tax-exempts significantly outperformed governments last week, but municipal bond yields inched up too. The 10-year began the week at 2.12% and finished at a yield of 2.13%. The 30- year yield rose slightly from 2.71% to 2.73%. Municipal bond funds took in $1.1 billion of new money, including $207 million that flowed into high yield funds, but there was not much in the primary market to buy. New municipal issuance came in at $3 billion on the week, which was shortened by the Martin Luther King holiday. In the high yield sector, we saw a several special tax bonds issued in California and Florida at maximum yields of 4.80% in 2048. This week, we expect a $770 million non-rated special assessment deal in Mesa, Arizona on the $7.2 billion calendar. Also this week, the first ETF celebrates its 25th anniversary, corporate earnings season continues, sixty heads of state and hundreds of business leaders gather for the World Economic Forum in Davos, Switzerland and the European Central Bank and Bank of Japan hold policy meetings. There will be four days of Treasury auctions, and we expect releases on new and existing home sales, wholesale and retail inventories, durable goods and gross domestic product.

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