Fixed Income

Quarterly Market Commentary

Third Quarter 2017

Quarterly Market Summary

- The Fed continues to tighten monetary policy at a measured pace; its previously announced balance-sheet normalization plan launched in October.
- Labor market conditions support the Fed's outlook, as the unemployment rate reached a new cycle low. An acceleration in inflation remains elusive.
- Credit spreads are also at cycle lows, supported by historically low levels of volatility and strong performance across risk assets.
- Fiscal stimulus could be a catalyst for stronger growth, but would likely have implications for inflation, credit spreads, and overall yield levels.
- Structured product risk premiums are at or near historically tight levels, but relative value is increasingly attractive given the outperformance of credit.

Duration Positioning	Neutral	Maintaining a benchmark-like duration stance across strategies.
Credit Sector	Modest Overweight	Overweights focused in Financials and select BBB Industrials, concentrated in shorter-duration securities.
Structured Product	Mixed	At this point in the cycle, Asset-Backed Securities and agency Mortgage-Backed Securities provide increasingly attractive risk-return opportunities relative to credit.

Third Quarter Sector Review

U.S. Treasury rates were relatively unchanged during the third quarter, as the yield spread between 2-year and 10-year maturities narrowed by seven basis points (bps) to end the period at 84 bps. The Bloomberg Barclays U.S. Aggregate Credit Index generated a total return of 85 bps for the quarter. Spread sectors outperformed U.S. Treasury securities and accounted for 41 bps of excess return. Lower-quality and longer-duration portions of the investment-grade credit market outperformed. High yield generated a total return of nearly 2% and produced 160 bps of excess return during the quarter. Agency Mortgage-Backed Securities (MBS) recovered from weak performance during the first half of the year to generate 47 bps of excess return. Excess returns across Asset-Backed Securities (ABS) and agency debentures were modestly positive, but underperformed other risk assets.

We remain favorably disposed on credit fundamentals broadly across both investment grade and high yield, based on low defaults, good profitability, and healthy credit metrics. We continue to emphasize a more defensive position in our credit allocation, focused on shorter-duration securities (maturities of five years or less). We are overweight the Financial (banks and real estate investment trusts), Energy (including midstream), Utility, and Telecommunications sectors. Segments of the market, such as retail and cable/media, are experiencing disruption from changes in consumer distribution and spending behaviors, which could present opportunities to emphasize issuer and security selection in our process.

Regarding consumer ABS, overall performance of prime auto and credit-card collateral remains good, but has weakened modestly in the last several quarters. We have avoided the subprime space, as it has shown worsening fundamentals due to lax lending standards. The agency MBS market benefits from

Sector	Spreads (bps)	Excess Returns 3 Months	Excess Returns YTD
U.S. Agency	15.00	0.05	0.57
U.S. Credit	96.00	0.89	2.41
Industrial	105.00	0.85	2.40
Utility	100.00	1.05	2.09
Financial Institutions	93.00	0.86	2.53
Non-Corporate Investment Grade	71.00	0.98	2.34
U.S. Mortgage-Backed Securities	83.00	0.47	0.27
Asset-Backed Securities	44.00	0.14	0.68
Commercial Mortgage-Backed Securities: ERISA Eligible	71.00	0.34	0.77
U.S. Corporate High Yield	347.00	1.60	5.35

Source: Bloomberg Barclays

extremely low interest-rate volatility along with positive supply and demand dynamics. Risk premiums are at historic lows for the sector, while much uncertainty remains regarding the ultimate impact of the Fed's balance-sheet reduction. The outperformance of short-duration credit presents opportunities to rotate into higher-quality structured products and to continue to build a more defensive portfolio structure.

Federal Policy: Slow and Steady Wins the Race

With a continued firming in U.S. employment conditions, the Fed remains committed to its campaign of gradually tightening monetary policy. In early September, U.S. Treasury yields five years and longer reached 2017 lows due to a confluence of issues: elevated geopolitical risk, particularly from the Korean peninsula; encroaching federal budget and debt ceiling deadlines; and concerns surrounding the effects of three highly destructive back-to-back hurricanes in the U.S. At the time, the fed fund futures markets priced in just a one-in-four chance of a rate increase at the December meeting. However, relief and aid for those affected by the storms engendered improved dialogue in Washington, which helped alleviate near-term pressure from the debt ceiling and budget issues. Additionally, with increased optimism for broader tax policy changes, yields rose and risk assets resumed their rallies.

At its September confab, the Fed maintained its target policy rate in a range of 1% to 1.25%, as expected, and announced it would begin the balance-sheet normalization plan in October. Initial caps of $6 billion in U.S. Treasury securities and $4 billion in agency MBS will step up by like amounts on a quarterly basis until reaching a ceiling of $30 billion and $20 billion, respectively, in the fourth quarter of 2018. Based on projections for principal, interest, and amortization, it is expected the Fed will remain an active buyer of securities in both markets until at least late summer of next year. While not specifically addressed in the Fed's announcement, the terminal size of the balance sheet is expected to be far larger than it was pre-crisis and approach $3 trillion by 2020.

In the coming weeks, we expect President Trump to put forth a nominee for Fed chairman (as current Fed Chairman Janet Yellen's term ends in February 2018), which could have a material impact on policy decisions. Odds remain high for a December rate hike and Board projections suggest three additional increases over the course of next year.

Credit Markets: Valuation in Focus

During September, investment-grade credit spreads reversed August's weakness to end the quarter at 2017 lows, as measured by the Bloomberg Barclays U.S. Aggregate Credit Index. Investor demand for credit remains insatiable: Oversubscription for new issues remains high (multiples of targeted tranche sizes) and concessions to outstanding bonds remains modest. Corporate issuance breached $1 trillion in late summer and remains on pace with 2016, which was a record year. The calendar has been dominated by regulator-mandated issuance from domestic banks, as well as funding to support mergers and acquisitions and shareholder rewards in telecommunications, media, and technology.

The current low-volatility environment is reminiscent of the 2003 to 2007 period when the spread of the Bank of America Merrill Lynch (BAML) Corporate Index remained below 100 bps for more than 40 months, with an average spread of 93 bps. Market participants are questioning whether current conditions can persist and are looking to historical parallels for comparison. We would acknowledge elements of tax reform (e.g., interest deductibility and cash repatriation) could have a meaningful impact on supply and spreads. However, we believe key changes in the composition of the index would suggest that index spreads are at historically tight levels and credit valuations are rich.

BAML Corporate Index Option-Adjusted Spread

Source: BofA Merrill Lynch U.S. Corporate Master Option-Adjusted Spread[1]

The primary difference in the index today versus 12 years ago stems from a greater concentration in both BBB-rated and longer-maturity securities. In drawing this conclusion, we utilized a framework similar to our risk-optimization paper to analyze the the BAML Corporate Index. Our analysis below examines a breakdown of the composition, as well as the option-adjusted spread,

[1]Retrieved from FRED, Federal Reserve Bank of St. Louis: https://fred.stlouisfed.org/series/BAMLC0A0CM, October 19, 2017

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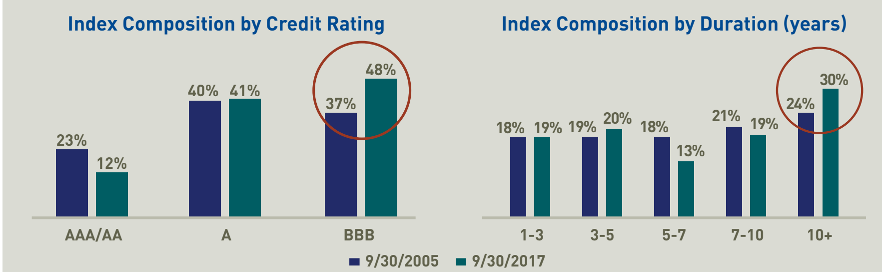
yield-to-maturity, and duration profiles of the index at the end of the third quarter in 2005 and in 2017. Given the increase in BBB issuers (to comprise nearly half of the total index) and the longer maturity profile, we expect the index will exhibit greater volatility due to changes in yields and spreads. These characteristics help to inform our more cautious positioning in credit given the historically low level of risk premia.

When considering the 17 bps increased spread of the BAML Corporate Index at the end of the third quarter of 2017 relative to 12 years ago, we make several observations:

Index Composition

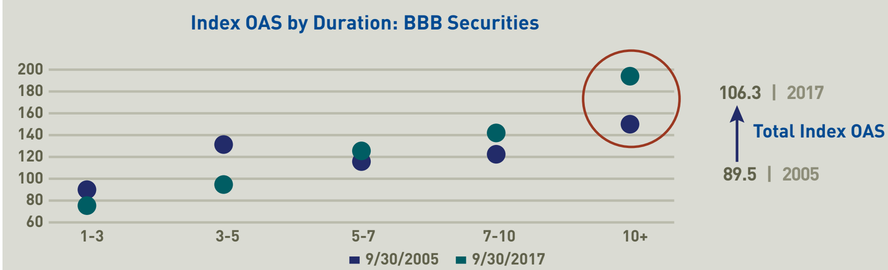
We attribute 8 bps of the difference to the increased concentrations in BBB-rated and longer-duration (10-plus years) securities.



Source: Bank of America Merrill Lynch U.S. Broad Market Index Series, PNC Capital Advisors analysis

Option Adjusted Spread (OAS) Levels

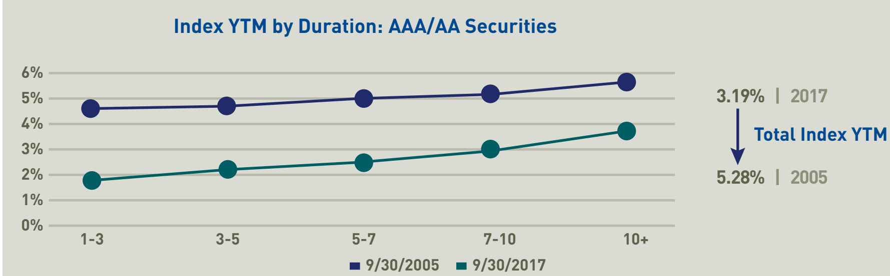
Across the ratings spectrum, today's index constituents have spreads wider than 12 years ago for maturities greater than 10 years. For long-duration BBB securities, spreads today are 46 bps wider, accounting for 6 bps of the total difference.



Source: Bank of America Merrill Lynch U.S. Broad Market Index Series, PNC Capital Advisors analysis

Yield-to-Maturity (YTM)

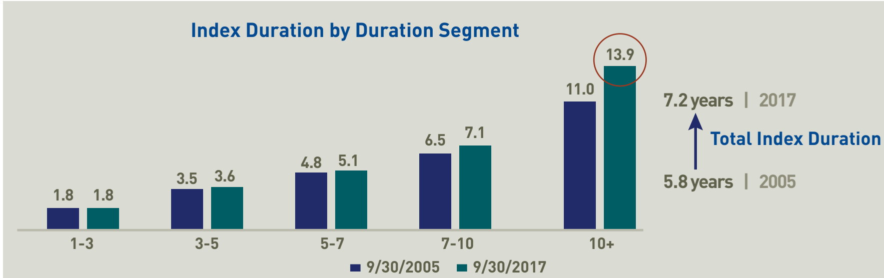
At the end of the third quarter 2017, the index yield was more than 200 bps lower than at the same time in 2005. The yield impact is particularly meaningful for longer-duration, higher-quality securities.



Source: Bank of America Merrill Lynch U.S. Broad Market Index Series, PNC Capital Advisors analysis

Duration

Due to the persistent low-yield environment, the index duration is 1.4 years longer and the 10-plus years duration portfolio of the index is approaching 14 years.



Source: Bank of America Merrill Lynch U.S. Broad Market Index Series, PNC Capital Advisors analysis

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Outlook

We are reminded of the old adage that sometimes "the best offense is a good defense." As shown above, credit spreads have narrowed to arguably record-tight levels when considering changes in the index composition. Inside of five years, we are finding better relative value opportunities in higher-quality structured products and will continue to focus on building more defensive portfolios. From our perspective, there is growing optimism in the market for potential fiscal stimulus through increased spending and/or tax reform. In addition, Fed policy is anticipated to remain accommodative, as further policy tightening is expected to proceed in a gradual manner. Risks from both domestic issues (debt ceiling and budget) and geopolitical challenges, as well as the attendant volatility we witnessed in late August/early September, have receded for the time being. However, we believe even minor policy errors along any of these fronts could be a catalyst to remind investors of the inherent risks currently being discounted in the market.
