Fixed Income

Quarterly Market Commentary

Third Quarter 2018

Quarterly Market Summary

- The Federal Open Market Committee (FOMC) raised the federal funds rate in September, bringing the target rate range to 2.00% to 2.25%.
- The FOMC has now raised rates for four consecutive quarters. Both FOMC projections and market estimates indicate an additional hike is expected in the fourth quarter.
- Investment grade credit spreads compressed in the third quarter, producing positive excess returns. Excess returns are now back to nearly unchanged for the year.
- Financial conditions remained favorable and investor risk appetites remained strong despite a continued move higher in Treasury yields.
- A modest deceleration in GDP from second quarter to third quarter is possible, but domestic economic growth remains on solid footing.
- Episodic volatility seen in the first half of the year was largely absent in the third quarter, but potential sources of volatility remain (trade policy uncertainty, Fed policy normalization, mid-term elections, Italian political instability, and emerging markets weakness, among others).

Duration Positioning	Neutral to slightly short	Maintaining a benchmark-like duration stance across strategies, with a modest underweight to the front-end maturities that are directly influenced by Fed policy.
Credit Sector	Modest Overweight	Overweights focused in Financials and select BBB Industrials. Remaining underweight non-corporate credit.
Structured Product	Remain overweight, particularly in short-duration portfolios.	At this point in the cycle, Asset-Backed Securities and Agency Mortgage-Backed Securities are a defensive alternative to credit.

Third Quarter Sector Review

Strong economic growth, solid corporate earnings, and robust risk appetites set the stage for a healthy rebound in credit markets during the third quarter. The Bloomberg Barclays Aggregate Index produced a total return of 2 basis points (bps) during the quarter. Spread sectors accounted for 53 bps of excess return during the period, helping to offset the impact of rising Treasury rates. U.S. Credit produced 157 bps of excess return during the quarter, as the Option-Adjusted Spread (OAS) of the Bloomberg Barclays U.S. Aggregate Credit Index compressed by 16 bps over the quarter. Once again, high yield outperformed investment grade, although unlike the first two quarters of the year, there wasn't a material variation in performance between BB and B/CCC credits. Agency Mortgage-Backed (MBS) and Asset-Backed Securities (ABS) also provided positive excess returns for the period, but trailed credit for the first time this year.

Bloomberg Barclays Aggregate Bond Index Sector	Option-Adjusted Spread (OAS) (bps)	Excess Returns 3Q18	Excess Returns 2018 YTD
U.S. Agency	12	0.10	0.10
U.S. Credit	100	1.57	(0.01)
Industrial	108	1.90	0.07
Utility	106	1.44	(0.79)
Financial Institutions	102	1.35	(0.32)
Non-Corporate Investment Grade	69	0.94	0.48
U.S. Mortgage Backed Securities	28	0.17	(0.07)
Asset-Backed Securities	38	0.31	0.29
CMBS: Erisa Eligible	60	0.77	0.70
U.S. Corporate High Yield	316	2.48	3.27

Source: Bloomberg Barclays

Credit spreads rallied sharply in July, modestly weakened in August, and then continued to tighten in September. The market's attention pivoted away from second quarter concerns about hostile trade policy and emerging market volatility and instead focused on the continued tailwinds provided by strong economic growth. Also factoring into the outperformance was a more favorable technical backdrop associated with a reduction in new issue supply over the summer months relative to what was seen in the second quarter.

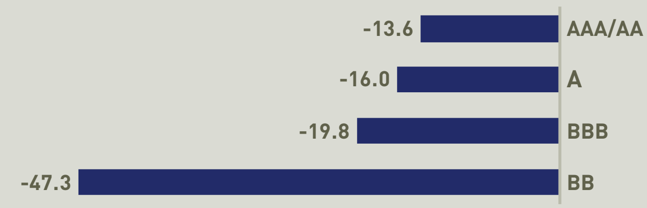
Fixed Income

This supply/demand dynamic continues to exert a notable influence on the direction of credit spreads so far in 2018. Tax reform enabled large technology companies to repatriate cash, and this has restricted longer-duration, higher-quality supply in the market. While an uptick in merger and acquisition activity could lead to higher issuance at some point, continued economic growth of 3% to 4% should drive solid free cash flow generation and support corporate fundamentals.

Given this upbeat tone, spread compression was more pronounced in lower rated investment grade credits, as investors were comfortable extending further down the ratings spectrum to garner additional yield.

Change in Option-Adjusted Spread (OAS) of the Bloomberg Barclays Aggregate Bond Index
June 30, 2018 – September 30, 2018

By Credit Quality (bps)



Quality	6/30/2018	9/30/2018	Change
AAA-AA	69.6	56.0	-13.6
A	101.9	85.9	-16.0
BBB	152.8	133.0	-19.8
BB	253.2	205.9	-47.3

Source: Bloomberg Barclays, PNC Capital Advisors analysis

Monetary Policy: Gradual Means Quarterly

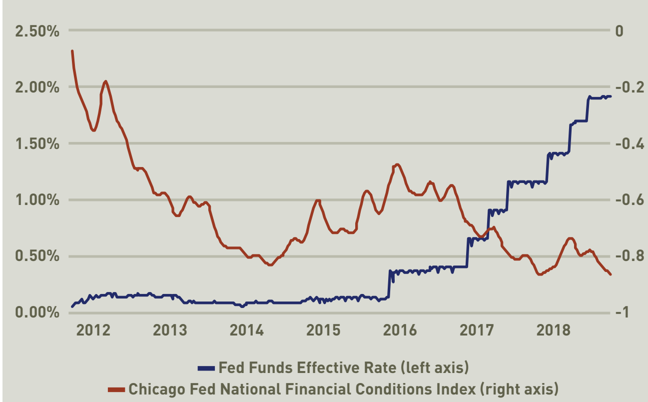
For the fourth consecutive quarter, the FOMC raised the federal funds rate, as economic conditions remained favorable. Labor markets remain at full employment and appear likely to show robust employment trends into the fourth quarter. Similarly, inflation has now settled in at the Fed's 2% target, allowing the Fed to continue to gradually raise rates by 25 bps per quarter, as has been the case since the fourth quarter of 2017. The Fed generally maintained its previous projection for the path of the policy rate in coming quarters, and subsequent speeches led the market to reprice a higher probability that the Fed will execute on its forecasts. As a result, yields moved higher and the U.S. Treasury curve steepened modestly. The start of the fourth quarter also brings the final increase in the pace of the Fed's monthly balance sheet reduction to $50 billion per month.

In our view, financial markets have continued to take the increasing fed funds rate and the reversal of quantitative easing in stride, as both have had little influence until recently. We believe increased funding needs from rising fiscal imbalances may exert more pressure on U.S. Treasury markets than the Fed's reduced activity. The pace of agency MBS tapering (now at $20 billion per month), along with rising yields, could lead to spread widening in the agency MBS market, as it is unlikely the Fed will be an active purchaser going forward, due to the expected pace of mortgage pay-downs.

Volatility Less of a Factor, as Financial Markets Remain Sanguine

At the end of 2017, we highlighted our concern about the low levels of realized market volatility despite a multitude of potential sources of increased risk. While volatility did increase, and in some cases spiked higher in the first half of the year, during the third quarter, most measures retraced to the placid levels that we saw throughout most of 2017. Rising rates and the continued normalization of Fed policy, increased trade and geopolitical tensions, and continued weakness in emerging markets have led to increased "risk-off" sentiment so far in this early part of the fourth quarter. The domestic mid-term elections bring a new element that could change the status quo should the Democrats be successful in reclaiming control of the House. The Republican majority in both the Senate and the House has allowed the president to enact a bold policy agenda with little resistance. In addition to this possible outcome, unresolved political issues in Italy, as well as economic stress in several emerging market economies, could resurface quickly and

Financial Conditions vs. Fed Funds Rate



Source: Bloomberg, PNC Capital Advisors analysis impact financial markets. Lastly, as already discussed, the steady tightening of monetary policy has had little adverse impact on risk markets over the last couple of years. As the Fed continues to gradually normalize policy in advance of other developed nations, it seems likely financial conditions will begin to tighten.

Outlook

We have emphasized in recent quarterly summaries our desire to position client portfolios more defensively given the potential for volatility to create market disclocations, particularly in credit. Our focus on relative risk/return opportunities at the sector and sub-sector level is a core tenet of our investment process and informs our portfolio construction. At the sector level, we are always mindful of where we can effectively utilize AAA-rated structured products as a surrogate for highly rated credit.

As valuations in credit oscillated this year, we frequently adjusted allocations to favor whichever sector represented a better risk-adjusted return profile. At the sub-sector level, our overweights remain in banking, energy, and autos, while our underweights are focused in capital goods and consumer non-cyclicals. As always, this positioning is a reflection of both our fundamental outlook and current valuations for the respective sub-sectors.

We have maintained a modest short (2% to 3%) in the duration positioning of our strategies for the last couple of years. Tactically, we've adjusted duration to the lower end of our target range (5% of the benchmark) when Treasury yields materially underprice the pace of the Fed's projected hikes. We concentrated our short-duration position at the front end of the curve, which should be more responsive to changes in the Fed policy rate. We employed this strategy from August through September leading up to the Fed meeting.

As we began preparing to enter the fourth quarter, we became increasingly skeptical that the "risk-on" posture of capital markets was sustainable. We lowered our corporate credit exposure overall, specifically in 7+ year maturities, based on rich valuations. We maintain our overweight in shorter-duration segments of the corporate market, but selectively extended 1- to 3-year paper into higher-quality, AAA-rated consumer asset-backed securities.

The recent sell-off in U.S. rates, along with a re-steepening of the U.S. Treasury curve, has led to modest pressure in the agency MBS market. We still believe valuations are rich, but the attractiveness of MBS relative to corporate credit is improving. This may present opportunities for broader sector rotation in the near term, as the historical risk/return profile of structured products is attractive, particularly if we are entering the latter stages of a credit/economic cycle.

Indexes

The **Bloomberg Barclays U.S. Credit Index** measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market.

The Chicago Fed's **National Financial Conditions Index (NFCI)** provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.

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