Fixed Income

Quarterly Market Commentary

Fourth Quarter 2017

Quarterly Market Summary

- The Federal Open Market Committee (FOMC) raised the federal funds rate for the third time in 2017 during the fourth quarter, bringing the target rate to 1.25% to 1.50%.
- Labor market conditions continued to improve as the unemployment rate moved to a new cycle low; an acceleration in inflation remains elusive.
- Credit spreads closed the year at the tightest levels since 2007, supported by strong investor demand, stable fundamentals, and low volatility.
- Tax reform passed, providing a tailwind for markets. However, some of the benefits were already priced in to current valuations.
- Structured product risk premiums were at or near historic tights, but relative value was increasingly attractive given the outperformance of credit.
- Flattening yield curve drew attention as investors debated implications.

Duration Positioning	Neutral to slightly short	Maintaining a benchmark-like duration stance across strategies, with a modest underweight to the front end in longer strategies.
Credit Sector	Modest Overweight	Overweights focused in Financials and select BBB Industrials. Remaining under-weight non-corporate credit
Structured Product	Defensive carry, increasingly favor relative to credit	At this point in the cycle, Asset-Backed Securities and and Agency Mortgage-Backed Securities are a defensive alternative to credit.

Bloomberg Barclays U.S. Aggregate Yield To Worst Less Bloomberg Barclays Global Aggregate Yield To Worst

Source: FactSet

Fourth Quarter Sector Review

The yield differential between the 2-year and 10-year U.S. Treasury contracted by an additional 33 basis points (bps) during the quarter and is now at a roughly 10-year low of 52 bps. This was primarily driven by a reaction across shorter maturities to increasing expectations for Federal Reserve tightening, while longer maturities remain range-bound due to benign inflation and low global yields. The Bloomberg Barclays U.S. Aggregate Index produced a total return of 39 bps during the quarter, as spread sectors once again outperformed U.S. Treasury securities and accounted for 36 bps of excess return during the period. Investment-grade credit capped off a solid 2017 by generating 89 bps of excess return in the fourth quarter. High-yield returns were less robust in the fourth quarter, but still managed to produce 72 bps of excess return for the period and 610 bps for the year. Agency Mortgage-Backed (MBS) and Asset-Backed Securities (ABS) trailed other spread sectors by each providing 24 bps of excess return during the quarter.

Heading into 2018, we continue to overweight corporate securities given stable credit fundamentals and an improving global growth backdrop. Credit valuations remain full and have exhibited very low levels of spread volatility given strong demand from investors. A brief period of modest spread widening

Sector	Spreads (bps)	Excess Returns 3 Months (%)	Excess Returns YTD (%)
U.S. Agency	14	0.12	0.69
U.S. Credit	89	0.89	3.35
Industrial	98	1.02	3.49
Utility	92	1.23	3.41
Financial Institutions	85	0.86	3.43
Non-Corporate Investment Grade	68	0.43	2.78
U.S. Mortgage Backed Securities	69	0.24	0.52
Asset-Backed Securities	36	0.24	0.92
Commercial Mortgage-Backed Securities: ERISA Eligible	62	0.78	1.58
U.S. Corporate High Yield	343	0.72	6.10

Source: Bloomberg Barclays

Fixed Income

in the first half of November was largely due to market indigestion from a surge in new-issue supply. As issuance tapered toward the end of the year, spreads resumed their grind to tighter levels and reached new post-financial crisis lows, with the Bloomberg Barclays U.S. Aggregate Index moving below 90 bps for the first time since June 2007. Given the strong fundamental and technical environment, coupled with increasing tailwinds from passage of a favorable corporate tax policy, we have modestly added to our corporate exposure. Financial institutions appear likely to benefit from both the lower corporate tax rates, as well as continued efforts to decrease industry-specific regulations. At the same time, issuance by Financials – banks in particular – seems likely to fall from 2017 levels. We have looked to capitalize on these favorable conditions by extending the duration of our holdings in Financials across strategies. Tight valuations and the prolonged period of subdued volatility does give us some pause in our overall credit allocation and therefore we maintain a defensive posture as we continue to favor shorter-duration and slightly more defensive issuers in the Industrials sector.

Similar to credit, asset-backed security spreads have compressed throughout the year and are now at the tightest levels in years. Fundamentals (as measured by the performance of prime auto and credit-card collateral) remain stable and have not shown any meaningful signs of deterioration: unlike the subprime space, which continues to show stress. Our view remains that markets will continue to differentiate between prime and subprime ABS securities and we remain overweight the highest-quality issuers.

Agency MBS fundamentals continue to benefit from extremely low levels of interest-rate volatility, which has driven valuations tighter on the year. This has occurred despite the initiation of the Fed's tapering of reinvestments earlier this quarter. While the initial pace of purchase reductions by $4 billion MBS a month was small enough to avoid any meaningful impact, we remain cautious that as the pace picks up in the second half of 2018 there may be some impact to valuations, particularly if coupled with an increase in the volatility of U.S. Treasurys.

Update on Monetary Policy – Fed Still Cautious, But Looking To Pick Up The Pace

The FOMC achieved its forecasted three rate hikes for 2017, despite the fact that inflation readings spent much of the year below expectations. The primary explanation was a healthy labor market, which continued to bring the unemployment rate to new cycle lows and now stands near levels last seen in 2000. Also aiding the Fed's move to tighter policy were highly favorable financial conditions, which eased throughout the year as a result of a strong stock market, tightening credit spreads, low interest-rate volatility, and a weakening dollar. Questions remain as to when and if tightness in the labor market will translate to higher inflation via faster wage growth. Similar uncertainty exists as to the FOMC makeup, which undergoes notable changes, highlighted by Jerome Powell assuming the Fed chairmanship from Janet Yellen in February 2018. Our expectation is that the FOMC led by Chair Powell will largely resemble Yellen's regarding cautious monetary policy, but may be slightly more hawkish as a whole and more open to relaxed financial regulations. January will bring an increase in the pace of balance-sheet normalization for the Fed as it doubles the reinvestment caps to $12 billion for U.S. Treasurys and $8 billion for Agency MBS from $6 billion and $4 billion, respectively. While these amounts are still very small relative to the size of these markets, we continue to watch for the potential impacts in the second half of 2018.

Goldman Sachs Financial Conditions Index

Source: Bloomberg

Update on Fiscal Policy – Tax Cuts and Jobs Act Provides Stimulus

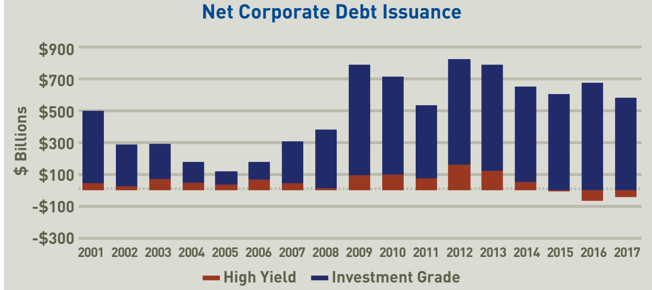
As the fourth quarter progressed, expectations steadily increased that a tax package would successfully make its way from Congress to the president. While the finer details of the tax plan varied over time, the newly enacted Tax Cuts and Jobs Act was consistent with expectations that corporations would enjoy drastically lower tax rates. Along with the tax cut benefits to the household sector, the cumulative impact should be supportive of a small boost to GDP growth in 2018. Credit markets have largely priced in the associated benefits of tax reform, but we do believe that the positive tailwinds from this fiscal stimulus should continue into the new year.

Fixed Income

Update on Credit Markets – The "F and T" of Fundamentals, Valuation, and Tactics in Focus

In our third-quarter commentary, we analyzed how corporate valuations are expensive on a historical basis, particularly when factoring in index composition, which has migrated to a higher concentration of lower-quality and longer-duration credits. While this remains the case and continues to drive our defensive positioning, we are cognizant of how the fundamental and technical environment for credit securities may continue to provide investors with positive, but muted excess returns. Fundamental analysis is the foundation of our credit process and looking at the corporate market as a whole shows a story of improving leverage as measured by the debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio. Despite another $1 trillion-plus year of corporate issuance, continued solid earnings growth, higher commodity prices, and generally stable policies related to balance-sheet management resulted in an overall decrease in leverage in 2017. Global growth that continues to trend higher, coupled with a new stimulative corporate tax policy should continue to favor these trends absent an external economic shock.

On a technical basis we continue to see robust demand for corporate securities from both domestic and foreign investors, who are attracted to the higher relative rates in U.S. markets. New-issue supply on both a gross and net basis will likely be on par with the record issuance seen in 2017, but could see lower levels of supply from banks, which have made significant strides in meeting their regulatory capital requirements. Repatriated foreign cash and unforeseen merger-and-acquistion activity will also influence issuance trends that may bring greater variability by sector given the relative impacts.



Source: Barclays Capital

Outlook

As spreads across sectors tightened in 2017, we have looked to position portfolios more defensively given our focus on providing clients with attractive risk-adjusted returns. We continue to balance less-favorable valuations with factors that remain supportive and could set up an environment in 2018 for a prolonged period of tight spreads. Compressed levels of volatility both in terms of interest rates and broader risk measures are also of concern, as there are many dynamics that could potentially upset the highly complacent environment. Any factor that distresses the balance could portend an abrupt adjustment to market conditions, as pricing across numerous asset classes has reached cycle highs. While this is not our base case, we think that reaching for yield is not the appropriate strategy in the current environment and that disciplined risk management is key when determining sector allocations.

Fixed Income

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