Fixed Income

Quarterly Market Commentary

First Quarter 2018

Quarterly Market Summary

- During the quarter, the Federal Open Market Committee (FOMC) raised the federal funds rate, bringing the target rate to 1.50% to 1.75%.
- The FOMC increased its economic projections to now show a total of eight cumulative hikes in the policy rate from 2018 to 2020.
- Credit spreads continued to compress during January, but reversed course in February. Spreads ultimately widened 14 basis points (bps) during the quarter, which is 23 bps from the February 1, 2018 low.
- Fiscal policy, as it relates to tax reform, and a two-year budget deal continued to provide tailwinds for markets, but newly announced trade tariffs and increasingly antagonistic trade rhetoric introduced new headwinds.
- Structured products outperformed corporates during the quarter, as they experienced more modest spread widening.
- The yield curve temporarily steepened in the first half of the quarter, as concerns related to inflation and surging fiscal deficits took priority. However, as risk assets came under pressure in the second half of the quarter, the yield curve continued its multi-year flattening trend, with the 2-Year/10-Year U.S. Treasury curve reaching new post-recession lows.

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 underweight non-corporate credit.
Structured Product	Defensive carry, less compelling alternative to credit at current valuations	At this point in the cycle, Asset-Backed Securities and Agency Mortgage-Backed Securities are a defensive alternative to credit.

First Quarter Sector Review

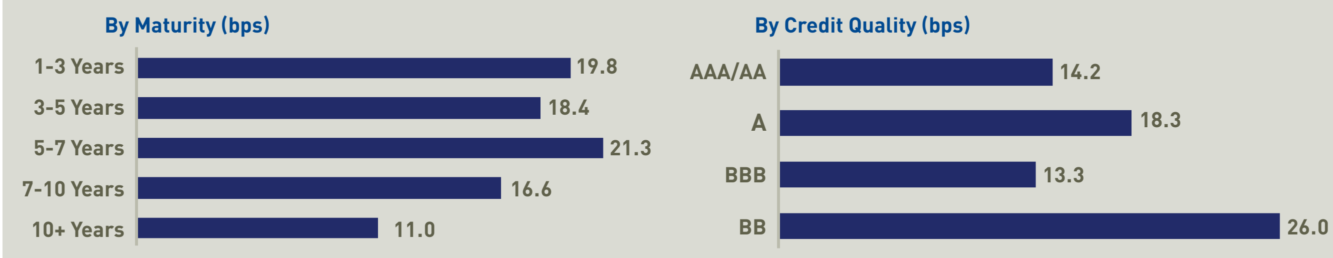
The first quarter began much like the fourth quarter ended, with volatility at multi-year lows and continued spread compression across most fixed income sectors. Then, in early February, equity market volatility surged and a pronounced pullback in the demand for short-duration corporates emerged. Credit spreads, as measured by the Bloomberg Barclays U.S. Credit Index, continued to compress during January, but reversed course in February. Spreads widened 23 bps from trough to peak, but rebounded somewhat to end the quarter 14 bps wider. The Bloomberg Barclays U.S. Aggregate Bond Index produced a total return of -146 bps during the quarter; spread sectors accounted for -31 bps of excess return during the period. March was a particularly challenging month for investment-grade credit, as the -81 bps of excess return was the weakest monthly return since January 2016. Interestingly, high yield outperformed investment grade during the quarter, as the uptick in volatility was less pronounced in weaker-rated credits. Agency Mortgage-Backed (MBS) and Asset-Backed Securities (ABS) also outperformed investment-grade credit, but did experience modest spread widening given the weak tone across spread sectors.

Sector	Option-Adjusted Spread (OAS) (bps)	Excess Returns 3 Months (%)	Excess Returns YTD (%)
U.S. Agency	12.00	0.14	0.14
U.S. Credit	103.00	(0.66)	(0.66)
Industrial	111.00	(0.67)	(0.67)
Utility	104.00	(0.87)	(0.87)
Financial Institutions	106.00	(0.99)	(0.99)
Non-Corporate Investment Grade	70.00	(0.01)	(0.01)
U.S. Mortgage-Backed Securities	29.00	(0.39)	(0.39)
Asset-Backed Securities	48.00	(0.19)	(0.19)
CMBS: Erisa Eligible	67.00	(0.06)	(0.06)
U.S. Corporate High Yield	354.00	(0.17)	(0.17)

Source: Bloomberg Barclays

Fixed Income

Much of the softness in corporate spreads during February and March can be attributed to weakening technicals. We believe the dynamics of the technical environment were influenced by changes in companies' ability to repatriate foreign earnings, per the revised tax rules of December 2017's Tax Cuts and Jobs Act (TCJA). In our view, increased foreign earnings repatriation has led to decreased demand for short-duration fixed income securities by corporate cash investors. These investors have shown a diminished presence in the new-issue market and have been selling holdings outright in the secondary market. Strong market technicals were one of the primary drivers of the outperformance of Credit in 2017, as valuations became increasingly less attractive. As we discussed in our outlook last quarter, market conditions can change abruptly, particularly coming out of a prolonged period of low volatility. While we remain cautious given the tenuous technical environment, stable credit fundamentals and improved valuations lead us to a continued overweight in the Credit sector.



Change in Option-Adjusted Spread (OAS) — December 31, 2017 - March 31, 2018

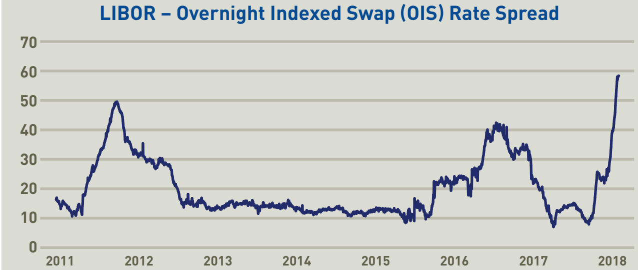
OAS	12/31/2017	3/31/2018
1-3 Years	47.2	67.0
3-5 Years	64.5	82.8
5-7 Years	80.4	101.7
7-10 Years	101.0	117.6
10+ Years	136.6	147.6

OAS	12/31/2017	3/31/2018
AAA/AA	50.1	64.3
A	72.5	90.8
BBB	120.8	134.1
BB	211.0	237.0

Source: Bloomberg Barclays, PNC Capital Advisors analysis

The re-pricing of spreads was most evident in short-dated credit, which has created some attractive opportunities as we look to optimize portfolios based on relative valuations. In the fourth quarter of 2017, we reduced some A-rated short-duration corporate holdings at spreads that were comparable to AAA-rated structured products. As we enter the second quarter, we are modestly reversing that trade by adding select credits that have experienced meaningful spread widening and now offer attractive relative value.

These factors extend all the way down the yield curve to money markets where they are particularly noticeable in the LIBOR-Overnight Indexed Swap (OIS) spread, which has reached post-crisis highs. The present widening is similar to the 2016 technical event related to money market fund reform, but has managed to surpass the 2011 fundamental event related to the European debt crisis. The current environment is the result of a confluence of events, led by a surge in Treasury bill issuance, which crowded out other money market alternatives, as well as various tax reform ramifications. This has created a plethora of opportunities for ultra-short investors, as these dynamics have caused credit



LIBOR – Overnight Indexed Swap (OIS) Rate Spread

Source: Bloomberg

curves to flatten and in many cases invert. There are many instances where spreads are wider on zero to 1-year maturities than they are on 1- to 3-year maturities for high-quality corporate and ABS securities.

While ABS and MBS were not immune to the effect of rising volatility and softening demand, they did outperform Credit in the quarter. Prime ABS fundamentals remain stable. And despite rising debt burdens among consumers, solid economic growth and a robust labor market should provide support for the sector in the near term. We expect new issue supply for 2018 to be broadly in line with 2017 levels (more than $200 billion). Even with a weaker technical environment, investor demand should be able to easily digest new offerings.

Our view on MBS continues to be somewhat bifurcated, as we remain constructive on short-duration alternatives, such as CMO's and 15-year pass-through securities for our shorter-dated strategies, but are somewhat cautious on 30-year collateral for longer aggregate styles. We believe the continued acceleration in the Fed's balance sheet tapering program will foster a supply headwind over the coming quarters. Coupled with valuations that remain rich on a historical basis and renewed interest-rate volatility, we remain modestly underweight the sector in our longer strategies. We believe the less volatile structures that we own in our shorter strategies present limited extension risk and therefore continue to offer a source of additional spread income in a defensive fashion.

Monthly Pace of the Fed's Balance Sheet Reductions by Quarter

	2017	2018			
$ in billions	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Terminal Cap
U.S. Treasuries	$6	$12	$18	$24	$30
Agency Debt and Agency MBS	$4	$8	$12	$16	$20

Source: Federal Open Market Committee

Monetary Policy: New Leadership, Stable Strategy

While the FOMC's economic projections were broadly revised higher on both future policy rate expectations and economic forecasts, we believe it is representative of recent macro developments and positive economic data, rather than a hawkish shift within Fed leadership. The March FOMC post-meeting press conference gave investors an opportunity to judge new chair Jerome Powell's approach versus his predecessor, Janet Yellen. In our view, despite the continued upbeat tone, the FOMC will continue to be cautious in setting future monetary policy. Expectations for inflation reaching and maintaining the Fed's 2% objective seem plausible given a labor market that will likely continue to overshoot full employment.

Fiscal Policy: Still Supportive, but Headwinds Forming

During the quarter, we gained insight into corporate America's views of the TCJA, as management teams across industries hailed the benefits of tax reform during their fourth-quarter earnings announcements. They outlined a variety of uses for these tax savings, including reinvesting in their businesses, returning capital to shareholders, issuing employee bonuses, making pension contributions, and paying down debt. Financial, manufacturing, and telecom companies were some of the businesses that benefitted most from the steep drop in the corporate tax rate. We believe most of these initiatives should prove favorable, or at least neutral, to bondholders, and the overall impact should be supportive for continued global growth. Alternatively, the recently announced U.S. trade tariffs on steel and aluminum imports, as well as increasingly antagonistic rhetoric from the president on trade policy, have raised concerns over the potential for possible trade wars and the impact to future growth. However, the likelihood of actual implementation of these proposed policies is still unknown and could be part of the negotiating process. Our expectation is that whether or not these particular trade issues are resolved quickly or linger on for some time, they will likely continue to be near the top of the president's agenda and serve as a source of volatility.

Outlook

Arguably, the January payrolls report was a primary catalyst that led to increased volatility in both equity and fixed income markets. Subsequent wage inflation data has moderated, and both survey- and market-based forward inflation indicators have fallen. We believe the continued tightening of labor markets, on-going strength in the housing sector, weakness in the U.S. dollar, and stability of commodity prices should provide tailwinds for inflation over the near term. In addition, we expect the impact of cellular plan price erosion in 2017 to roll off and no longer impact year-over-year comparisons. We maintain a modest allocation to U.S. Treasury Inflation Protected securities (TIPs) in longer-duration strategies; changes in near-term TIPs break-evens are more affected by commodity prices and risk appetites.

With respect to risk assets, we remain overweight Credit given good fundamentals and expectations for better economic growth, both in the U.S. and globally. Our overweight is concentrated in shorter-duration securities (inside of five years) and BBBs across both Industrials and Financials. We acknowledge that the extended period of low volatility, supported by coordinated, accommodative central bank policies in the U.S., Europe, and Japan, has come to an end. We expect periods of episodic volatility and the low level of spreads relative to history to moderate excess return potential. We have used recent market dislocations stemming from TCJA-related activity to swap out of short-duration ABS into 1- to 3-year Credit, which we believe has attractive risk/return characteristics. We have a more neutral position further out the curve (10 years and greater). We are concerned that crowding out from growing fiscal deficits, contraction in the Fed's balance sheet, and increased dollar hedging costs for foreign investors could pressure the technical support for Credit that has been prevalent for much of the last two years.

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 **LIBOR-Overnight Index Swap** (OIS) spread enables one financial institution to swap an obligation at floating overnight rates with another institution holding a short-term fixed-rate obligation.

Important Disclosures