Fixed Income

Quarterly Market Commentary

First Quarter 2017

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- Rising uncertainty over the timing and extent of economic benefit from fiscal stimulus on heels of the failed Affordable Health Care Act (AHCA) vote has tempered the market's implied growth expectations.
- With unemployment around 4.5% and inflation trending to 2%, the Federal Reserve's resolve to normalize policy should continue to strengthen. The balance sheet may be addressed in 2017 ahead of membership changes to the Federal Open Market Committee.
- The U.S. rate curve is arguably bound by a floor at the short end, by the projected path of Fed policy, and by a ceiling at the long end due to comparatively attractive yields relative to international equivalents.
- Volatility in both equity and fixed-income markets remains low. Geopolitical tensions could present episodic shocks.

Duration Positioning	Neutral	Maintain benchmark-like duration positioning across strategies
Credit Sector	Modest Overweight	Focused in financials and select BBB issuers. Opportunities in short-duration credit overall.
Structured Product	Mixed	Asset-backed securities overweight. Mortgage-backed securities underweight in Aggregate styles.

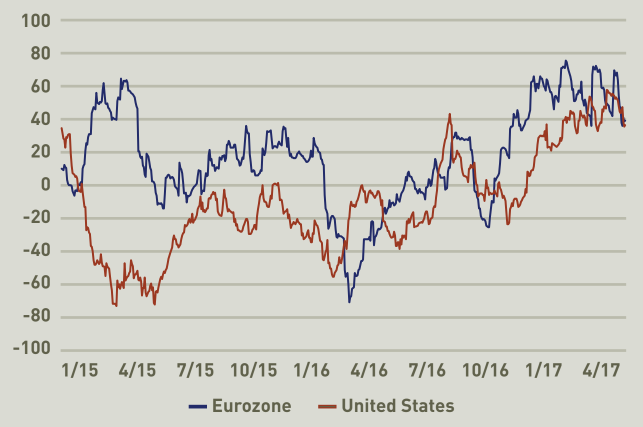
Economic and Market Update

The trend of generally positive economic data continued in the first quarter. Sustained improvement in the labor market, robust consumer sentiment, and continued progress on inflation measures toward the Fed's 2% target set the stage for further normalization of monetary policy. Additionally, encouraging data in the industrial sector suggests that capital investment should provide a positive tailwind for the U.S. economy in 2017. It appears likely that inventory adjustments and weaker retail sales weighed on first-quarter growth. However, the impacts should be transitory in nature and allow growth to trend toward 2% over the full year.

Expectations for large-scale fiscal policy measures to further boost growth have been steadily dialed back after overly optimistic scenarios on both the size and implementation schedule were recalibrated. While it still appears more likely than not that the Trump administration will eventually succeed in some measures of their bold policy agenda, the impact on the domestic economy looks to be pushed further into the future.

The global economic picture is showing some encouraging signs as well: Ongoing quantitative easing from the European Central Bank (ECB) and Bank of Japan support improvements in both economic growth and a moderation in disinflationary pressures. While the ECB seems interested in pivoting away from extreme accommodation, significant hurdles remain. The force of global populism increased political risk in 2016 and the upcoming French elections look to be the next test.

Citi Economic Surprise Index – U.S. and Eurozone



Source: Citigroup ©FactSet Research Systems

Key Themes

Our strategies outperformed their respective benchmarks in the first quarter through the sectors we emphasized, particularly within Credit. While the spread on the Bloomberg Barclays Credit Index narrowed by only 6 basis points (bps), lower-quality materially outperformed higher-rated issuers, while financials bested their industrial counterparts. Our overweights on a contribution-to-duration basis were concentrated in BBB-rated issuers and in the banking, health care and technology, media, and telecom sub-sectors. Mortgages underperformed again in the first quarter, albeit only modestly. Given narrow spreads and

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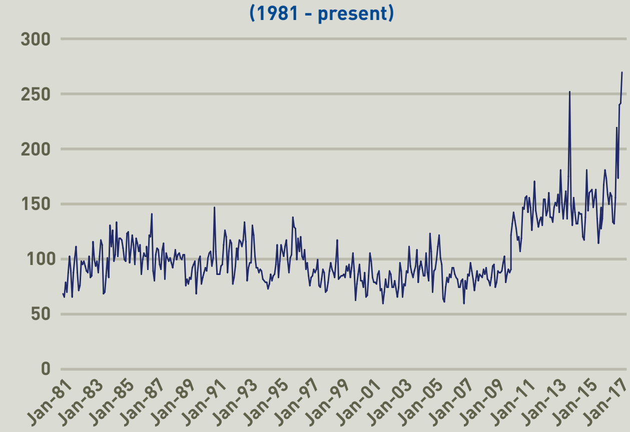
concerns about the Federal Reserve unwinding its balance sheet, we shifted to an underweight position in March. We remain overweight short-duration, high-quality, asset-backed securities as a means to enhance yield through a low-volatility sector.

❶ The new administration's "panem et circenses" is increasing uncertainty over the timing of policy implementation; geopolitics presenting early challenges

Expectations for stimulative fiscal policy were a key driver of financial markets in the fourth quarter. Capital markets adjusted to the anticipated policy initiatives of the new administration. The rise in both growth and inflation expectations led to a steeper yield curve and an increase in real yields, while risk assets generally outperformed. In March, House leadership was unable to rally sufficient support for a vote on the AHCA, and near-term prospects for health-care reform/repeal appear limited. We believe other cornerstone legislation regarding broad-based tax reform and infrastructure spending may be challenged by heightened partisan politics. We have a near-term test with the looming government shutdown on April 28, 2017.

At the same time, geopolitical issues in the Middle East, Europe, and Asia have the potential to present significant diplomatic challenges. This could lead to greater global unrest and potentially impact trade and growth. Both fiscal and foreign policy are potential sources of volatility over the course of 2017.

Philadelphia Fed Partisan Conflict Index (1981 - present)



Source:

❷ Fed rhetoric suggests policy changes to its balance sheet in advance of board member changes

Beginning in late February, the Fed's more hawkish commentary acted to reorient market expectations toward a March increase in the fed funds rate. Financial markets remained resilient and the Fed capitalized on the opportunity for an additional policy tightening at its March 15, 2017 meeting. The Fed left much of its forward guidance and economic projections unchanged from its December meeting, which was initially interpreted as a "dovish hike." However, Federal Open Market Committee participants still expect on average two more rate increases in 2017. Despite supportive economic fundamentals and financial conditions, the fed funds futures market at quarter-end implied a 45% chance the Fed will hike less than 50 bps for the remainder of the year.

Equally notable is the discussion and speculation about a change in the reinvestment strategy for the Fed's $4.5 trillion balance sheet of Treasuries, agencies, and mortgage-backed securities (MBS). The market lacks clarity around the timing and strategy for implementing what we would expect to be a gradual reduction in the scale and scope of their investment portfolio. With the Fed's $1.8 trillion in MBS holdings representing almost 25% of the overall market, any significant change could impact market technicals. We expect the Fed to proceed cautiously to avoid a repeat of the market's "taper tantrum" in mid-2013.

Lastly, upcoming changes to the Fed's membership will become a focal point for the market in light of evolving monetary policies. Both Chair Yellen's chairmanship and Vice Chair Fischer's term expire in the first half of 2018; with three additional board vacancies (including that of Tarullo who recently resigned), President Trump could dramatically alter the Fed's composition.

❸ Credit spreads are tighter but relatively stable; late cycle but still opportunities for outperformance

Credit markets continue to show tremendous U.S. resiliency as the first quarter saw record corporate new-issue supply, often pricing with little if any concession or discount to existing secondary securities. This is particularly impressive given that spreads are now approaching the tight levels seen in the summer of 2014. We would attribute this to relatively stable credit fundamentals and favorable market technicals. Flows into high-grade mutual funds remain positive and demand from international investors, who now own nearly 30% of the market, is robust. The yield gap between the Bloomberg Barclays U.S. Aggregate Corporate Index and the ex-U.S. global equivalent of 208 bps remains near the highest levels since the financial crisis and has widened 30 bps since the election.

❹ Market-based inflation indicators moderating; cross currents in the hard data

Driven by increased energy costs, during the first quarter, headline inflation measures of the consumer price index at 2.7% and personal consumption expenditures (PCE) at 2.1% reached the highest year-to-year rates of change in five years. Measures of core inflation have increased in a broad-based manner, with core PCE (1.8% year over year) approaching the Federal Reserve's 2% target rate. Longer-term inflation expectations per the Treasury inflation-protected securities market were steady during the first quarter and implied 10-year expectations ended March at 1.98%. Going forward, there are competing forces in the inflation data. Consumer and small-business sentiment surveys paint an optimistic picture and continued improvement in various labor market indicators have lifted expectations for upward wage pressure. However, this optimism is offset by weakness in used-car sales, softening shelter inflation, and concern that the tailwind from last year's jump in oil prices will continue to dissipate.

Outlook

We maintain our overweight to the Credit sector. With aggregate spreads low on a historical basis, selection (both issuer and sub-sector) is increasingly important and recently our preference has shifted to favoring shorter-duration securities. As shown in our recent Thought Leadership paper Optimizing Risk-Return Outcomes in Core Fixed Income, this sector offers compelling risk/return characteristics over longer time periods. We moved to an underweight position in agency mortgage-backed securities for aggregate benchmark strategies. This reflects our concern that, with valuations relatively rich, interest-rate volatility combined with changes in the Fed's reinvestment policy could negatively impact the sector. Security selection opportunities in 15-year pass-throughs and collateralized mortgage obligations support allocations in shorter-duration strategies.

We still lack meaningful clarity around key fiscal programs that would support an acceleration in economic growth and balance the impact of tightening financial conditions from Fed policy normalization. For now, we believe the economy should continue to expand at a moderate pace akin to the Fed's projected 2% rate. Increasing geo-political tensions and difficulty in quantifying the reaction function for Fed policy relative to fiscal stimulus has flattened the U.S. Treasury curve with the spread of 2-year to 10-year securities approaching 100 bps. The domestic yield curve is anchored by the projected path of Fed policy at the short end and low global yields at the longer end. We continue to maintain a neutral duration position relative to respective benchmarks. Our strategies continue to focus on emphasizing the sectors that offer the best risk-return attributes based on our macro outlook. We maintain high quality, liquid portfolios that allow us to both protect client portfolios from episodic volatility and capitalize on the opportunities that may arise.
