Fixed Income

Quarterly Market Commentary

Second Quarter 2017

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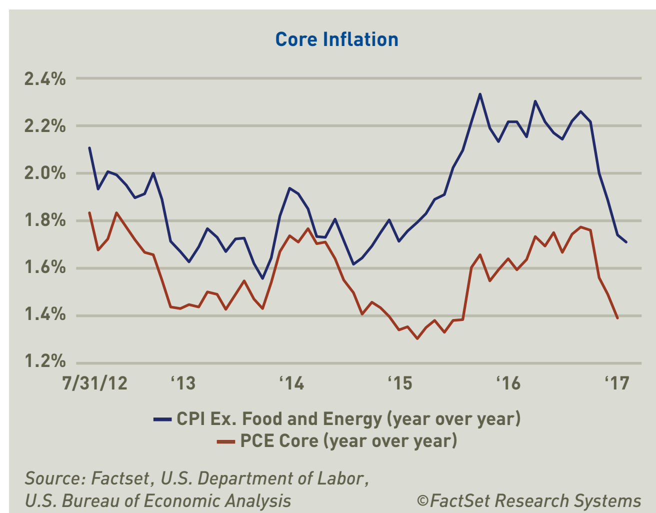
- The Federal Reserve raised rates for the third time in nine months in June and is looking to hike rates again later this year and possibly initiate its recently announced balance-sheet reduction strategy.
- Labor markets continue to meet the Fed's mandate, as the unemployment rate moves to a new cycle low, while continued soft inflation data raises questions.
- Spread sectors continue to drive positive excess returns in investment-grade fixed income. Valuations are tightening and are accompanied by historically low levels of volatility.
- Broad-scale fiscal policy continues to elude the Trump administration and Congress. Attention may soon need to shift to the budget and the debt-ceiling resolution.

Duration Positioning	Neutral	Maintain benchmark-like duration positioning across strategies.
Credit Sector	Modest Overweight	Overweights focused in financials and select BBB industrials. Increasing allocations in short-duration credit.
Structured Product	Mixed	Asset-backed securities overweight. Mortgage-backed securities underweight in Aggregate styles. Adding to 15-year mortgage-backed securities and collaterized mortgage obligations in short and intermediate strategies.

Second-Quarter Fixed-Income Market Landscape

The second quarter was characterized by reports of economic statistics that routinely fell short of expectations, particularly inflation. A dip in the March inflation data was initially thought to be temporary (blamed on weakness in wireless pricing), but the trend continued, as core consumer price index and personal consumption expenditure readings fell 0.6% and 0.4%, respectively, from their January highs. Similar drops in headline inflation were less surprising given the recent softness in oil prices, especially when compared to the energy price recovery we saw around this time last year. The labor market told a brighter story, as the weak March payroll report proved temporary and solid job growth resumed. The May report, while far from spectacular, showed the unemployment rate fell to 4.3%, marking a new low for both the current economic expansion and the one that followed the 2001 recession. Despite continued stability in job creation, wage growth remains below policy makers' expectations, as average hourly earnings growth retreated to 2.5% year over year in June, after peaking at 2.9% at the end of 2016. First-quarter GDP, which was initially estimated at 0.7%, has been revised higher twice, finally settling at 1.4% as of the third revision. Most indicators suggest the second quarter will show an acceleration in GDP to between 2% and 3%, a rate we believe could continue during the second half of the year.



Source: Factset, U.S. Department of Labor, U.S. Bureau of Economic Analysis ©FactSet Research Systems

Key Themes

1. **The Federal Open Market Committee (FOMC) remains committed to policy normalization, while other global central banks consider less accommodation**

   Despite softening inflation data over the course of the quarter, the Federal Reserve continues to believe the current economic dip is temporary. While the increase of the Fed's benchmark interest-rate range to between 1% and 1.25% came as no surprise, the Fed's commentary casting weak inflation data as short term was considered slightly hawkish.

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Additionally, we believe the recent release of details for its planned balance-sheet reinvestment initiatives illustrates the Fed's commitment to methodically reversing its hyper-accommodative monetary policy. As has been recognized by several FOMC members, financial conditions support further tightening, as long as economic data continues to indicate progress on the Fed's dual mandate. As we move closer to the possible inception of the balance-sheet runoff, markets will look closely at how the Fed uses balance sheet adjustments in conjunction with policy rate increases.

Abroad, continued progress in European economic activity may lead policy makers toward reducing additional monetary policy stimulus. Financial markets interpreted recent comments from European Central Bank President Mario Draghi and Bank of England Governor Mark Carney as surprisingly hawkish. This led to a swift sell-off of European government bonds during the last week of the quarter, which influenced domestic rates to move higher as well. While the recovery in the Eurozone continues to trail that seen in the U.S., European risk assets continue to perform well given the region's improving economic fundamentals.

❷ Investment-grade spread sectors continue to outperform and exhibit little volatility

Investment-grade credit spreads tightened in the second quarter, with the Bloomberg Barclays U.S. Aggregate Credit Index compressing 9 basis points (bps) to close June at 103 bps. Similar to the first quarter, spreads exhibited minimal volatility, as credit fundamentals remained solid across most sub-sectors and market technicals remained robust. Strong demand for corporate securities continues unabated, as flows into investment-grade products have been unrelenting during the first half of the year. New-issue supply continues to be prolific, but did cool toward the end of the quarter as we enter the seasonally slower summer months. This technical factor, along with some near-term stability in oil prices, provided the necessary tailwind for credit to begin the third quarter on a positive note. Financials have had the highest excess returns year to date, followed by industrials and then utilities.

Sector	Spreads (bps)	Excess Returns 3 Months	Excess Returns YTD
U.S. Agency	15.00	0.24	0.52
U.S. Credit	103.00	0.99	1.48
Industrial	112.00	1.15	1.51
Utility	110.00	1.03	1.00
Financial Institutions	103.00	1.06	1.63
Non-Corporate Investment Grade	77.00	0.38	1.32
U.S. Mortgage Backed Securities	93.00	(0.04)	(0.20)
Asset-Backed Securities	46.00	0.32	0.54
CMBS: Erisa Eligible	74.00	0.34	0.42
U.S. Corporate High Yield	364.00	1.46	3.65

Source: Bloomberg Barclays

Similar to investment-grade credit, consumer asset-backed security spreads have tightened with minimal volatility. Although collateral performance for prime auto and credit-card securities has weakened modestly from historically strong levels, overall performance remains good. Meanwhile, subprime has exhibited deteriorating fundamentals, due mainly to lax lending standards. Agency mortgage-backed securities (MBS) was the lone investment-grade sector that did not deliver positive excess returns in the second quarter. Agency MBS posted a modest negative excess return of -0.04 bps, as MBS spreads remained stable, but prepayments accelerated. While we expect to see the Fed reduce its MBS purchases once the balance-sheet reduction efforts begin, it will likely be a gradual approach. This was welcome news to the market, as this measured strategy is expected to prevent significant near-term volatility in the MBS market. However, much uncertainty remains regarding the ultimate market impact once the purchase reduction begins

❸ Reflationary impacts of fiscal policy promises continue to deflate

The Treasury curve flattened, as the likelihood of impactful fiscal policy faded on the heels of health-care reform failing to move through Congress. During the fourth quarter of 2016, the spread between the 2-year and 10-year U.S. Treasury curve steepened dramatically on expectations that various Trump initiatives would further stimulate economic growth and more than offset the effects of the Fed's tightening policy. While the loosening of various government regulations has proceeded, broad-scale tax

reform and infrastructure spending remain highly elusive given the challenges of D.C. politics. Regardless of the amount of progress (or lack thereof) on fiscal policy initiatives over the summer months, attention will soon need to shift to raising the nation's debt limit. The Treasury began "extraordinary measures" in March once the debt ceiling was reached and flexibility is expected to run out by sometime in early fall. We believe it is highly unlikely congressional Republicans drive policy through hard negotiations with the president. But given the frustratingly slow pace of other legislation, we expect they will be loath to raise the limit without some form of tax or spending reform. Fortunately, the U.S. economic backdrop appears fully capable of handling continued Washington gridlock.

Outlook

There has been a persistent lack of volatility across fixed-income and equity markets so far this year. The CBOE Volatility Index (a common measure of stock market volatility) reached multi-decade lows in early June and interest-rate volatility, as measured by the Merrill Lynch Option Volatility Estimate Index, also touched lows not seen since early 2013. Solid underlying macroeconomic fundamentals and strong market technicals should remain supportive of current financial conditions. However, we believe the administration's eagerness to pass legislation, the debt-ceiling deadline, and a determined Fed, coupled with fully priced risk assets, sets the stage for increasing bouts of volatility.

As discussed previously, we have been gradually adjusting portfolios across our taxable fixed-income strategies toward a more cautious positioning. While we maintain an overweight position in corporates, we have continued to both shorten the duration of holdings and transition to more defensive and higher-quality sub-sectors. By opportunistically capitalizing on periods of improved liquidity in the secondary markets, we have effectively been upgrading the quality and liquidity of holdings, using both the primary and secondary markets.

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