

# Multi-Sector Low Duration Core Strategy

## Key Takeaways

### MARKET

During the first quarter, post-election expectations of faster economic growth and rising inflation dimmed with the new administration's struggle to act on its legislative agenda. The Fed raised rates another quarter of a percentage point on the strength of the U.S. economy, the Brexit process formally began, and critical European elections loomed closer.

### PERFORMANCE

The strategy's underweight to U.S. Treasuries added value during a period in which most spread sectors outperformed government securities. Allocations to corporate high yield, asset-backed securities, and non-agency residential mortgage-backed securities contributed positively to returns.

### OUTLOOK

With strong demand by investors and a supportive environment for fixed income, spread sectors continue to offer attractive opportunities to investors searching for total return and yield.

## Important Developments this Quarter

**Overview:** Post-election expectations of faster economic growth and rising inflation continued into the first quarter as optimistic investors waited for clarity on President Trump's fiscal policies. As the quarter progressed, support for the "Trump trade" weakened as the new administration experienced bumps in the road with its aggressive agenda and visible opposition. In March, the Federal Reserve raised rates for the second time in three months, the Brexit process formally began, and crucial European elections loomed closer.

**Europe:** Political and economic developments in Europe captured attention during the first quarter. On March 29, nine months after voting to leave the European Union, Prime Minister Theresa May triggered Article 50 of the Lisbon Treaty to start the two-year process for the U.K.'s exit from the 60-year-old alliance. As the U.K. embarks on a path of complex and surely contentious negotiations, other European nations (and the Continent as a whole) are bracing for elections that will test the strength of right-wing populism and euro skepticism. While the Netherlands rejected its anti-European candidate in March, the more consequential French polls follow in late April/early May, and German elections will take place in September. Against this backdrop of political uncertainty, economic recovery in Europe is underway. The fear of deflation has diminished and positive economic data are emerging, albeit unevenly across the eurozone. The European Central Bank (ECB) held rates steady in March and announced no additional stimulus. There is a growing conviction that the end of quantitative easing is in sight, especially because the ECB is running out of options in terms of bonds it can buy.

**Federal Reserve:** While accommodative monetary policy persists in Europe, as well as in Japan, the Fed acted on its stated "confidence in the robustness of the economy" by raising its benchmark rate another quarter of a percentage point to a range of 0.75% to 1.0%. The probability of the move reached nearly 100%

as the Fed's March meeting drew closer. Labor market conditions and inflation both are approaching the decision-making body's target levels. Chair Janet Yellen continued to emphasize a gradual approach to rate hikes with two more projected in 2017.

**U.S. Economy:** The U.S. economy has indeed been resilient over the past few months. GDP increased at an annual rate of 2.1% during the fourth quarter of 2016, ahead of expectations though short of its 3.5% level in the third quarter of 2016. Labor market conditions remain firm, with 4.7% unemployment at the end of February. Though long-term inflation expectations have eased as a result of lowered expectations for fiscal stimulus, realized inflation measures have been trending higher. Core PCE (personal consumption expenditures ex food and energy), the Fed's preferred gauge, reached 1.8% in February and is approaching the 2% goal. Consumer confidence and the housing sector remain supportive.

**Treasuries:** The yield curve flattened over the quarter, with rates higher on the front end of the curve and relatively unchanged on the long end. The yield on the 10-year U.S. Treasury ended the quarter at 2.39%, modestly below the 2.45% yield at year-end 2016. Having surged in the aftermath of the presidential election, the benchmark yield was in a holding pattern for much of the first two months of 2017 as investors reevaluated the pace and likelihood of Trump's growth-oriented fiscal policies. Rising expectations of a March rate hike pushed the 10-year bond to

### U.S. TREASURY YIELDS

	12/31/15	12/31/16	3/31/17
2 year	1.05%	1.19%	1.26%
5 year	1.76%	1.93%	1.92%
10 year	2.27%	2.45%	2.39%
30 year	3.02%	3.07%	3.01%

Source: Bloomberg L.P.

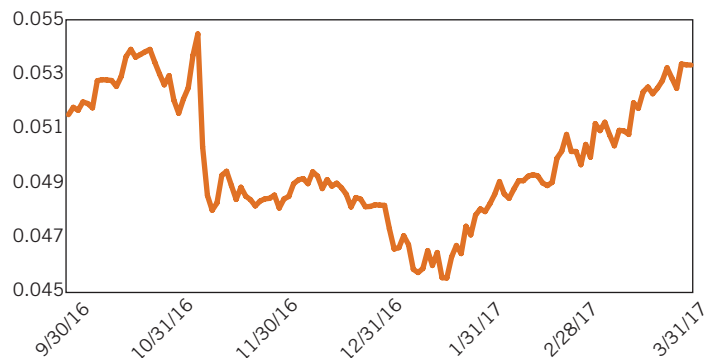
a three-year high of 2.63%. Yields subsequently retreated on the Fed’s message of gradual hikes. This was reinforced by the failure of Congress to repeal Obamacare, and its implications for accomplishing other items on Trump’s pro-growth agenda. The attractiveness of the U.S. bond market relative to other developed markets like Germany, Japan, and the U.K. has helped to keep a lid on U.S. yields. The demand for safe-haven assets amid the ebb and flow of political risk in Europe, namely France, has also benefited U.S. yields.

**U.S. Dollar:** The U.S. dollar declined steadily over the quarter in the wake of falling bond yields, disappointment with the progress on Trump’s fiscal stimulus plans, and the Fed’s dovish posture on future rate moves. The Bloomberg Dollar Index (a basket of 10 leading currencies against the U.S. dollar) ended the quarter at 1223.05, modestly above its pre-election level and well below its post-election high on January 3 of 1277.53. Perhaps most

symbolic of the new administration’s struggle to actualize its campaign pledges was the strengthening of the Mexican peso versus the U.S. dollar. During the election season, the peso rose and fell with candidate Trump’s standing in the polls. This reflected his hardline stance on tariffs, immigration, and the future of NAFTA. At the end of the first quarter of 2017, the peso was the top-performing currency in the world (+10.8%) and had recouped its losses against the dollar.

**Oil:** Until early March, oil had hovered around \$55 per barrel following OPEC’s November 30, 2016 agreement to curb output in support of prices. Reports of record-high levels of U.S. output, however, reignited worries of an oil glut. Despite a drop in production and strong compliance with the OPEC accord among participating countries, fears that U.S. oil production could overwhelm OPEC’s cuts drove prices down. On May 25, OPEC will decide whether to extend the agreement, which went into effect for six months on January 1. Brent crude, the international benchmark, touched a low of \$49.92 per barrel before rising at quarter-end to \$52.71 on encouraging signals of an extension from the cartel.

U.S. DOLLARS PER MEXICAN PESO



Source: Bloomberg, L.P.  
Performance data shown represents past results.

**Global Fixed Income Performance**

The broader U.S. bond market, as represented by the Bloomberg Barclays U.S. Aggregate Bond Index, returned 0.82% for the first quarter of 2017. Most spread sectors outperformed U.S. Treasuries during the quarter and spreads tightened. Longer duration assets and lower quality within each sector were key drivers of performance.

Emerging markets was the best performing sector for the quarter as fears of the impact of a Trump presidency on these markets subsided. The sector benefited from a weaker U.S. dollar,

**HOW THE STRATEGY PERFORMED**

**Contributors**



- U.S. Treasuries and Agency Mortgage-Backed Securities:** Our underweight benefited performance as most spread sectors outperformed the government sector.
- Corporate High Yield:** The sector was the primary contributor to performance during the quarter as the risk-on rally continued. Negative net issuance, improving fundamentals, and global accommodative central bank policy contributed to the sector’s outperformance.
- Asset-Backed Securities:** Fundamentals in the sector remain positive with low unemployment supporting our consumer focus. Technicals are strong. Supply is running ahead of last year’s level, but the market is easily absorbing it and the demand for subordinated credit product is ravenous. Issue selection within the sector was a positive contributor to performance.
- Non-Agency Residential Mortgage-Backed Securities (RMBS):** Allocation to the RMBS sector was a positive contributor to performance during the quarter. Fundamentals remain strong based on continued housing stability and solid mortgage credit performance. Technicals are also favorable due to the negative net supply overall with pockets of new issuance.

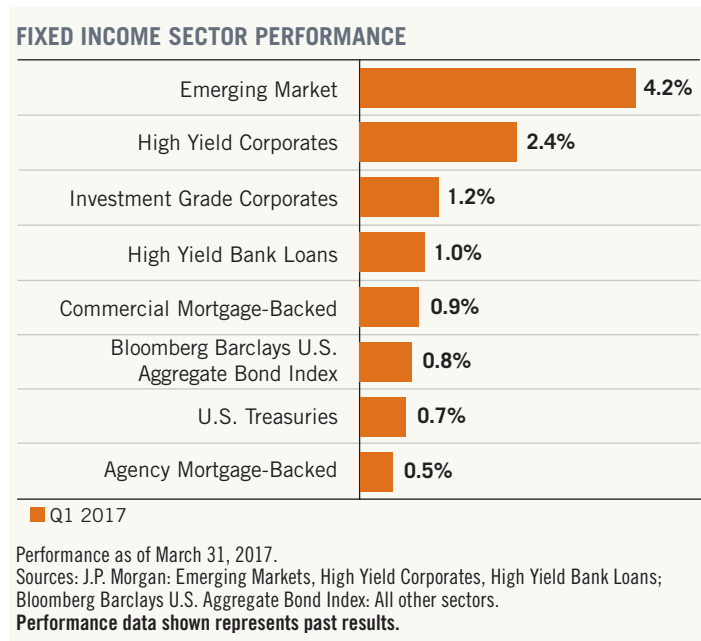
**Detractors**



- Higher Quality Bias:** Though exposure to corporate high yield contributed positively to the strategy’s overall performance, our higher quality bias detracted from returns in a period in which lower quality outperformed.

expectations of gradual rate hikes by the Fed, and the failure to materialize (or delay) of Trump's protectionist policy pledges. Relative stability in commodities and in China also contributed to the positive sentiment. External factors aside, emerging market fundamentals in the aggregate have been improving, and growth may be returning.

High yield corporates also generated strong performance for the quarter, benefiting from the risk-on rally that has prevailed since the election. The sector also got a boost from negative net issuance, improving fundamentals, and global accommodative monetary policy. Within the high yield sector, the best performers over the quarter were cable & satellite, healthcare, and chemicals. In a reversal from last quarter and full-year 2016, metals & mining and energy were among the laggards. Retail was the only sector to post a negative return. Lower quality continued to outperform higher quality.



## Current Strategy Positioning

**Reduced Exposures:** We have reduced our weightings to agency and non-agency mortgage-backed securities. We redeployed the sale proceeds primarily into corporate high quality and U.S. Treasuries.

**Overweights:** We continue to overweight corporate high yield, high yield bank loans, RMBS, and asset-backed securities (ABS), specifically out-of-index/non-traditional ABS.

**Securitized Product:** Our allocation to the securitized product sectors continues to play an important role in the strategy. Valuations remain attractive in the areas in which we invest, and

this segment of the market offers diversification to sectors more sensitive to global macroeconomic concerns. Securities in this sector also offer diversification to the corporate credit allocation within the strategy.

- > CMBS have benefited from the strengthening U.S. economy and demand for U.S. real estate. Underlying commercial real estate fundamentals have softened but remain solid.
- > Our consumer focus within the asset-backed sector has been helpful to performance as a result of the continuing ability of the U.S. consumer to lift the domestic economy.
- > Non-agency RMBS have benefited from the continuing improvement in the housing market and demand for mortgage credit.

Overall, the strategy maintains its higher quality focus and short duration to limit both spread and interest rate volatility.

## Looking Ahead

Our outlook for spread sectors is positive. Modest growth in the economy, with the potential for upside, provides a supportive environment for credit. A continuation of still-low interest rates and expectations for gradual rate increases by the Fed may push out the credit cycle, extending a credit environment that is supportive for high yield in particular. Against this backdrop, our overweight to spread sectors is based on sound and modestly improving fundamentals, strong technicals, accommodative central banks, and attractive valuations in certain areas of the fixed income markets.

Beyond the unfolding of Trump's policies, we continue to closely monitor and anticipate global areas of concern. These include U.S. dollar strength, the path of oil prices, global economic growth, critical political elections, Brexit, and the eventual winding down of quantitative easing by the most influential central banks.

We continue to look for opportunities in all sectors of the bond market, striving to uncover any out-of-favor or undervalued sectors and securities. With strong demand for fixed income and a supportive environment, spread sectors continue to offer attractive opportunities to investors searching for total return and yield. Some of the specific sectors where we see value are: out-of-index/off-the-run ABS, non-agency RMBS, corporate high yield, high yield bank loans, and emerging market bonds.

Uncertainty in the current market environment creates opportunity. As our long-term performance record demonstrates, our time-tested process positions us well to take advantage of challenging situations.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.

The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

The commentary is the opinion of the subadviser. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

### Risk Considerations

**Credit & Interest:** Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **ABS/MBS:** Changes in interest rates can cause both extension and prepayment risks for asset - and mortgage-backed securities. These securities are also subject to risks associated with the repayment of underlying collateral. **Foreign Investing:** Investing internationally involves additional risks such as currency, political, accounting, economic, and market risk. **High Yield-High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities.

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