DuPont Capital

Fixed Income Market Review and Outlook

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Market Overview

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It is often said that one should generally avoid discussing religion, money, or politics. This quarter, I promise not to talk about religion, but it is very difficult to discuss the financial markets (money) without bringing up politics. The United States is going through a very unusual transition to the new Presidential administration. Numerous protests occurred immediately following the inauguration, talk of an investigation into the possibility of Russia's tampering with the election, delayed confirmation of many qualified cabinet selections, and an initial setback on changing the healthcare laws all led to intensified media coverage.

Happily, and surprisingly, despite the turmoil in Washington, the financial markets have been relatively calm and have performed well so far in 2017. Equity markets rose, U.S. interest rates were close to unchanged, and fixed income credit sectors marched higher. Investors still are leaning into the "Trump trade" in the belief that the President, in conjunction with a Republican Congress, will enact policies that would benefit economic growth and corporate earnings through tax reform, a more business-friendly regulatory environment, and a large increase in government spending on infrastructure.

For the 1st quarter, the Barclay's Capital Aggregate returned +0.82%, with corporates providing the highest returns and mortgages lagging the Index. All investment grade fixed income sectors ended with positive returns. High yield performed well, buoyed by the rising U.S. equity markets. Emerging Markets Debt (EMD) rebounded after a tough 4th quarter as the fears of protectionist policies subsided, at least for the time being. Local currency EMD rebounded even more strongly and was the top performing fixed income asset class.

The following tables show the returns for the various fixed income sectors and rating categories for the 1st quarter of 2017:

Sector	1st Quarter 2017 Return*
U.S. Treasuries	0.7%
Agencies	1.1%
MBS	0.5%
Inv. Grade Corporates	1.2%
High Yield	2.7%
Emerging Markets Debt	3.9%
EMD — Local	6.6%

Credit Rating	1st Quarter 2017 Return*
AAA	0.6%
AA	1.0%
A	1.0%
BBB	1.7%
BB	2.1%
B	2.5%
CCC	4.7%

* Returns are from Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures as of 3/31/2017.

Market Overview (Continued)

U.S. Treasuries

Treasury prices did not change materially during the quarter despite the 25 basis point increase in the Fed Funds Rate. The yield curve flattened, with shorter maturities rising in yield and longer maturity yields slightly lower. The Funds Rate is now at 0.75% to 1.00%. The Fed's comments after the rate hike in March were more dovish than expected, but it continues to forecast two more 25 bps hikes in 2017. Investors are believing the forecast at this point as markets are pricing in the additional two moves later this year.

The Fed did not materially revise its expectations for future GDP growth, with expectations of only 1.9% to 2.1% growth from 2017 through 2019. The Fed's expectations for inflation did not change, running from 1.9% in 2017 to 2% in 2018 and 2019. The Fed does not usually increase rates significantly when growth is close to 2% and inflation is at its target. In its forecasts for rate hikes, the Fed has consistently overestimated how soon and how many rate hikes it would announce. The Fed's credibility with investors is slightly improved, but is still low and the market has typically been pricing in fewer hikes than the Fed was predicting. It will take a longer period of increased accuracy in the Fed's forecasts to restore investors' confidence.

In the 1st quarter, yields increased for short maturities, with the two-year Treasury rising by 7 basis points, the five-year Treasury unchanged, and the ten and thirty-year Treasuries falling by 5 and 4 basis points, respectively. The yield of the ten-year moved as high as 2.62% in mid-March before declining later in the month. The yield of the two-year note closed at 1.27% while the ten-year Treasury finished at 2.40%.

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Spread Products

Spreads tightened slightly in investment grade corporates while high yield and emerging markets debt tightened more significantly during the quarter. High yield spreads were more volatile, starting the year at +442 and then moving as low as +376 on March 2 before widening in March (due to the decline in oil prices) to close the period at +412. Despite President-elect Trump's negative comments on Mexico and China before and immediately following the election, emerging markets debt spreads tightened by over 30 basis points in the quarter and ended at +310. An improved economic outlook in many EM countries helped offset Trump's comments. Below is a table that shows spreads for investment grade corporates, high yield, and emerging markets debt as of December 31, 2015, February 11, 2016 (the widest point), the day of the Presidential election, year-end 2016, and the end of this quarter:

Sector	12/31/2015	2/11/2016	11/8/2016	12/31/2016	3/31/2017
Investment Grade Corporates	+172	+220	+137	+127	+121
High Yield	+707	+897	+517	+442	+412
Emerging Markets Debt	+415	+507	+333	+342	+310

*Spread data are from Barclays' indices for IG Corporates and High Yield and from JP Morgan for Emerging Markets Debt.

Investment grade corporates tightened by 6 basis points during the 1st quarter to 121 basis points over Treasuries, and are trading slightly tighter than long-term averages. Financials and industrials performed better than utilities while longer duration corporates had higher returns than shorter duration corporates. In mortgages, CMBS spreads tightened and outperformed mortgage pass-throughs and ABS.

High Yield performed well despite the March decline in oil prices. As a reminder, energy represents over 13% of the high yield index and the huge oil price decline in 2015 and early 2016 led to high defaults in the energy sector. Spreads closed 30 basis points tighter while the average high yield price rose slightly and ended the quarter at $100.9. The current spread for high yield is much tighter than long-term averages, and the yield-to-worst decreased by 28 bps to 5.84%. Default activity was lower during the quarter and has improved over the last six months as oil and metal/mining prices rose. The twelve-month default rate declined significantly from 3.5% to 1.9% at the end of March. This is much lower than the historical average of 3.7%. The decline is due to the rise and stabilization of oil and metals/mining prices over the past year.

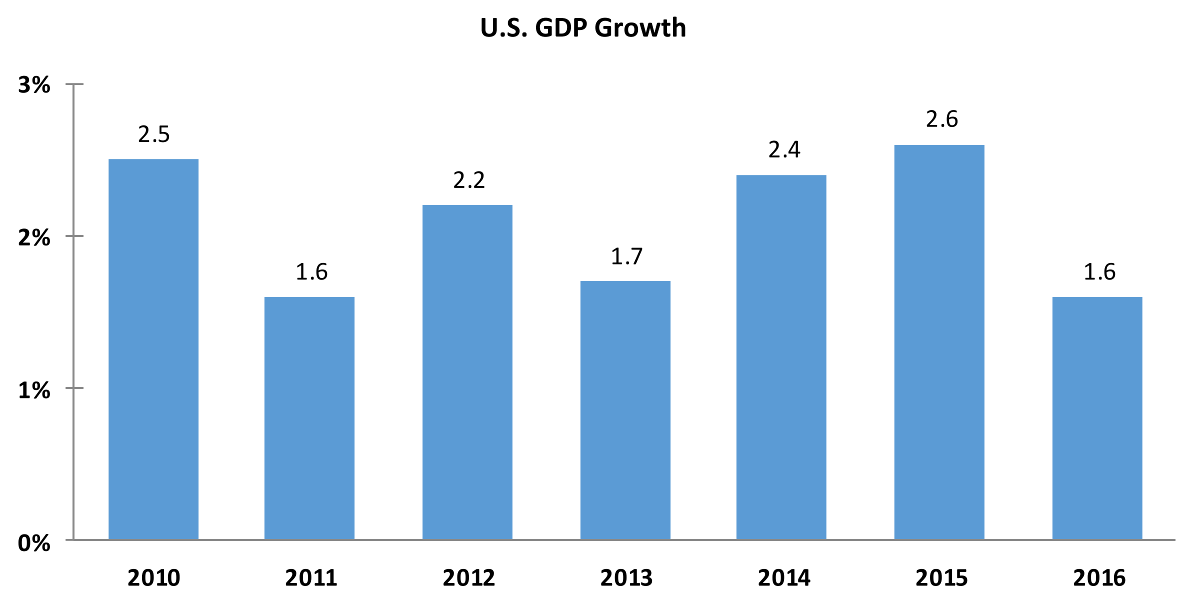
EMD performed very well with spreads tightening and yields falling. An improved economic outlook for several EM countries, fairly stable commodity prices, lower volatility in interest rates, and reduced fear about changes in trade policies combined to drive EMD prices higher, both for US Dollar and local currency bonds. EMD yields declined by 33 basis points to 5.47%. In US Dollar sovereigns, some of the best performing countries included Mongolia, Mexico and Brazil. Local currency EMD was the stand-out performer in fixed income globally. Mexico, Brazil, Russia, and South Africa all had double digit returns in the first quarter on their local currency bonds.

The Economy

The first official estimate of GDP growth for the 1st quarter will be released on April 28. The Federal Reserve Bank of Atlanta has a model, GDPNow, that forecasts growth during the quarter and is revised every few days as economic data are released. As of March 31, this model forecasts growth of only +0.9% in the 1st quarter. This could change significantly before the first official estimate is released at the end of April. Economic activity "feels" stronger than the official data, particularly with the low unemployment rate and the extremely high consumer confidence. Some of the "soft" data points toward higher growth; however, it is also possible that the surveys will decline to more moderate levels over the next few months. We believe growth for all of 2017 will most likely be between 2% and 2.5%, similar to the growth of the last five years.

As mentioned last quarter, the United States has now gone eleven straight years without 3 percent growth in real Gross Domestic Product, a record. The recession ended in June 2009. In the seven calendar years since then, real annual GDP growth has never exceeded the 2.6 percent it hit in 2015, as shown in the chart below. Before this period, the longest stretch of years when real GDP did not grow by at least 3.0 percent was the four-year stretch from 1930 to 1933 -during the Great Depression.

Despite the volatility of quarterly data, annual GDP growth has been fairly consistent between 2010 and 2016.



Source: Yardeni Research. Data provided including revisions through 3/31/17.

Retail sales and consumer spending data were moderate, but disappointing given the strong employment and consumer confidence data. Consumer confidence moved much higher and has reached the highest level since 2000. Housing has been a slight positive source of growth, but it has not been particularly strong since before the recession. Housing prices are up +5.7% over the past year as measured by the S&P/Case-Shiller Home Price Index, the highest year-over-year gain in 2 ½ years. Measures of manufacturing activity were mixed, with strength in aircraft manufacturing, but no significant signs of overall strength.

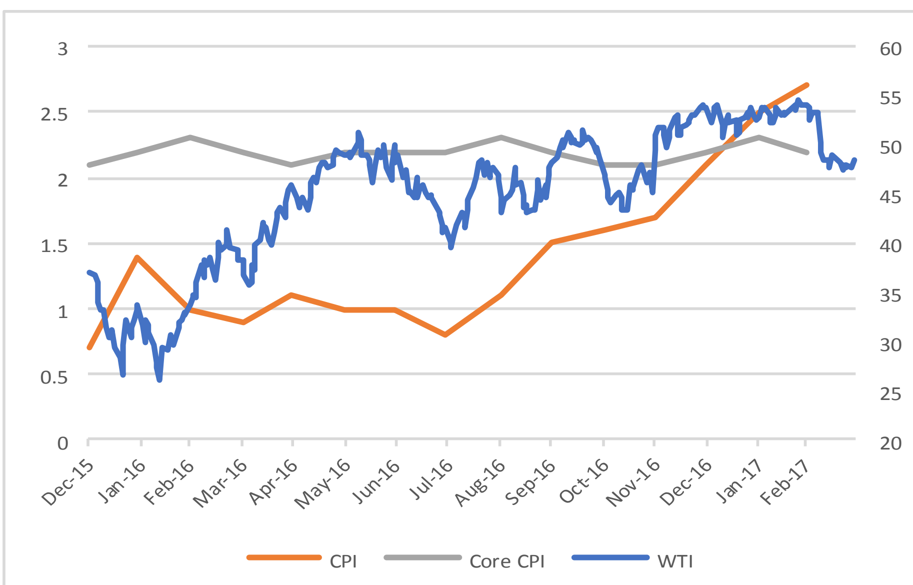
The Economy (Continued)

The non-farm payroll gains have been strong over the first two months of 2017 while the unemployment rate held fairly steady at 4.7%. The average payroll gain in January and February has been 236,000 new jobs, higher than the average gains at the end of 2016. The current unemployment rate of 4.7% compares to 5.6% at the end of 2014 and 6.7% at the end of 2013. Average hourly earnings rose only +0.2% in February, but the year-over-year gain has risen to +2.8%. The Fed would like to see wages rise at least +3% as an additional sign that employment is on a sustainable path. Initial jobless claims moved higher over the past quarter, with 254,250 as the 4-week moving average at the end of March. Claims remain at historically low levels.

Inflation

Commodity prices were mixed for the quarter, but mostly higher if oil is excluded. The Bloomberg Commodity Index was down about -2%, with U.S. oil prices down over $5 a barrel to $50 a barrel. Metal prices were mostly higher over the quarter, including for copper, silver and gold. Agricultural commodity prices varied, with corn, wheat and cotton higher and soybeans and coffee lower.

The Fed targets an overall annual inflation rate of 2%, a pace it views as appropriate for economic growth and price stability. Current inflation, as measured by the year-over-year Consumer Price Index (CPI) and Producer Price Index (PPI), moved higher during the quarter. The CPI was up +2.7% year-over-year, while Core CPI grew by +2.2% over the past year. The PPI has increased 2.2% over the past year, with Core PPI up +1.5% year-over-year. The overall CPI and PPI numbers were driven higher due mostly to the increase in oil prices since oil bottomed in February of 2016. Core CPI only rose slightly over the past year. Below is a chart that shows how steady Core CPI has been while overall CPI has risen with the increase in oil prices.



The Fed's preferred measure is the price index for Personal Consumption Expenditures (PCE). This measure has moved higher and is close to the Fed's target, with an overall year-over-year increase of 2.1% and a Core PCE deflator increase of +1.8%. In summary, inflation has risen, mostly due to the rise in energy prices over the past year and is close to the Federal Reserve's target for most measures.

PORTFOLIO POSITIONING

In the **Government** sector, our Core and Core Plus portfolios have durations that are shorter than the benchmark by about -0.3 to -0.5 years. We continue to have a large underweight to Treasuries as we find better value in the Corporate and Agency sectors. We also hold a very small position in inflation-indexed U.S. Treasuries (TIPS).

Spreads in the **Mortgage** sector in the quarter were fairly quiet with the current coupon spread to the 10-yr Treasury yield widening by 4 bps. The current coupon 30-year mortgage now sits at 3.14%, only 4 bps lower than where it started 2017. Likewise, the 30-year effective mortgage rate observed by borrowers did not change much and stands at 4.45%. One of the more noticeable first quarter dynamics in the mortgage sector was the increased number of borrowers applying for adjustable rate versus fixed rate mortgages. Refi applications also decreased versus purchase applications, indicating that the sustained period of low rates had already led most borrowers to refinance.

Uncertainty in policies under the Trump administration continue to be a concern. We continue to take a more defensive posture in managing the mortgage portfolio as

the markets sort out their future direction. Higher future rates are possible, but many questions remain as to the timing and magnitude. The negative convexity in mortgages makes duration extension in a rising rate environment a key concern. We have been slowly moving higher in coupon and using more seasoned collateral to mitigate this potential issue. Our CMBS exposure, which we may increase, is slightly overweight versus the benchmark. We are underweight Asset-Backed-Securities.

Our **Investment Grade Corporate** strategy focuses on issues with the potential to outperform the benchmark on a risk-controlled basis. We continue to believe that investment grade corporate bonds represent the best opportunity in the investment grade fixed income markets and hold an overweight of over 3% to this sector. Our overweight has been reduced slightly over the last few months. We believe that corporates should provide stronger returns than mortgages or Treasuries due to the yield advantage and supportive credit fundamentals. Spreads are slightly tighter than long-term averages. We are currently overweight basic industry and insurance companies where we find some good value. We also have an overweight to the capital goods sector. Regarding ratings, we are overweight BBB rated corporates. Security selection will be important due to the uncertainty of rate hikes and the potential for both new tax policies and fewer business regulations, all of which could have an effect on specific industries and compa-

Emerging Markets Debt rebounded very well in the first quarter. Overall, our models show that EMD valuations remain slightly attractive although they are close to fair value. The fundamentals for several countries have improved over the past year, and we expect the asset class will continue to mature and develop over the next several years. Our research and investment continues to be focused on identifying key positive drivers for EM countries that are more resilient to any future global macro uncertainty. Currently, we see good opportunity in Brazil, Mexico, Ukraine, Venezuela, and Argentina.

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The Look Forward

Global financial markets performed well despite a significant amount of political noise and some softer than expected economic data in the U.S. Better global economic growth outside of the U.S. and the continued belief by investors that the new administration's proposed policies of tax reform, fewer regulatory restrictions on businesses, and significant infrastructure investment will lead to stronger economic growth and higher corporate earnings.

It is early in the game and the transition thus far has not been particularly smooth. Things may get better, but there are reasons to think the road could continue to be bumpy. While there most likely will be tax reform, many Republican members have stated that they would like tax reform to be revenue neutral. This could possibly mean that tax changes for individuals may be more in the form of "reforms" rather than "large cuts," resulting in only a small bump to consumer spending. Regarding infrastructure spending, Trump and his team have not spelled out their plans to date and there is some speculation that they may be more focused on tax credits to bring in private money rather than directly increasing government spending. In addition, infrastructure projects take time to plan and get started and would more likely impact growth in 2018 or 2019 rather than this year. Time will tell, but we believe that the new administration's policies will only not impact growth much in 2017.

We believe U.S. economic growth will be between 2% to 2.5% over the next year, similar to what has occurred over most of the last seven years. Consumer spending will continue to be the growth engine for the U.S. economy. However, slightly higher interest rates could dampen demand for housing while the stronger dollar will hurt manufacturing for many U.S. companies. Global economic growth has improved, but remains fragile and could worsen sometime later in 2017 or 2018. We believe a recession next year is a possibility and should be factored in when making portfolio decisions.

The Federal Reserve will most likely make two or three more rate hikes in 2017, but it would not surprise us if the Fed has to pause at some point late in 2017 or in 2018. As I said last quarter, the Fed found many reasons to keep rates unchanged for the first eleven months of 2016 (one weak employment number, the Brexit vote, concerns about China's growth, etc.) and some disappointments are bound to arise over the next year. If economic growth shows any hints of weakness or if global financial markets become turbulent again, the Federal Reserve would likely pause in making additional moves. Growth in China could slow; Japan and Europe, despite significant quantitative easing, will probably have growth averaging around 2% or less for the foreseeable future due to their structural problems. Greece continues to struggle and Italy has seen increased discontent with a stagnant economy.

Political and geopolitical issues are pervasive around the globe, as evidenced by Brexit, the U.S. Presidential election, and the referendum in Italy. In the longer-term, there continues to be the possibility of countries leaving the EU and economic and social issues have caused turmoil in Venezuela and Turkey. Immigration will continue to be a hot issue globally and terrorism, unfortunately, will likely continue to occur as evidenced in London recently. With this underlying environment, we expect ten-year Treasury yields will most likely rise slightly from current levels. However, the significant uncertainties lead us to maintain our current allocation to fixed income and to keep our interest rate durations only slightly shorter than the benchmark in our Core and Core Plus portfolios. Treasury yields could end 2017 lower than they are now. The combination of a still-fragile global economic environment, extremely low policy rates in most countries, and political uncertainty will present a challenging environment for global central banks and for investors.

The Look Forward (Continued)

We believe returns will be in the low-single digits for investment grade fixed income over the coming twelve months, with the potential for higher volatility. Even with the very strong move over the past year, most of the non-Treasury U.S. fixed income markets are still slightly attractive. Yields in investment grade corporates, high yield, and emerging markets debt are attractive compared to developed sovereign yields. High yield spreads are on the expensive side, but yields are still close to 6%. The concern on our part is that spreads do not provide as much cushion if sentiment turns negative or if rates rise more or faster than expected. Returns in emerging markets debt and high yield could be in the mid-single digits over the next twelve months. Overall in fixed income, we are cautious, but see value in some sectors, countries, and specific securities.

I am hopeful that our elected and appointed leaders will start putting America first. I am also hopeful that I will not have to discuss politics nearly as much over the balance of 2017. However, if the last few months are any indication, that is not the most likely scenario. The calm markets of this past quarter could become more turbulent later this year. Investing will become more challenging, but new opportunities may arise.

To summarize our outlook:

1. It is our belief that President Trump's new policies will not add as much to economic growth as the market is expecting. We expect U.S. growth of between 2% and 2.5% in 2017 – no change from the last 5 years.
2. Credit products, including investment grade corporates, high yield, and emerging markets debt, should continue to provide better returns than Treasuries due to higher income and positive fundamentals. However, any decline in oil prices will result in spread widening, particularly in high yield.
3. The long and moderate economic expansion could run out of steam in 2018 or 2019.
4. The Federal Reserve will most likely raise the Funds Rate two or three times in 2017, but 2018 may see very few hikes if economic growth falters.
5. Inflation has moved higher over the last few months, but will most likely stabilize close to 2% as the rise in oil prices from 2/2015 to 2/1016 rolls off the year-over-year calculations.
6. We expect interest rates may move slightly higher over the next few months, but the ten-year Treasury will likely end 2017 not too far from where it is now. Short rates should move higher as the Federal Reserve moves the Funds Rate higher.
7. Growth in China could slow later in 2017, and there could be another growth scare over the next 12 to 18 months similar to what happened early in 2016.
8. Growth in Europe should be 2% or lower, but will be helped by the weaker Euro; however, the long-term structural problems remain.
9. Caution is warranted, but opportunities exist.

About our Firm

DuPont Capital has a long history of institutional asset management. Our parent company, DuPont, established a retirement pension plan for employees in 1942, and in 1975 created a separate pension management division.

In 1993, DuPont Capital was established and became an SEC registered investment advisor. We share our parent company's history of innovation and, over the years, have been on the forefront of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income, and alternative investments.

Fixed Income Team Summary

- 7 Portfolio Managers
- 5 Research Analysts/Traders
- 1 Portfolio Specialist

Fixed Income Capabilities

- Core Fixed Income
- Core Plus Fixed Income
- Emerging Markets Debt
- High Yield
- Stable Value

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