DuPont Capital

Fixed Income Market Review and Outlook

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Mark Foust
Senior Portfolio Specialist

31 Years' Industry Experience
MBA - Pennsylvania State University
BS - Carnegie-Mellon University

Market Overview

"And now for something completely different" was a catchphrase used in the 1970's comedy TV series *Monty Python's Flying Circus* that was also the name of their first feature film. This segment of the show would feature a sensible-looking announcer, played by John Cleese, dressed in a black suit and sitting behind a wooden desk in some ridiculous location, such as behind the bars of a cage in a zoo. Sometimes, the phrase would also be used as a transition between unrelated comedy sketches to move the show forward in a humorous way. The statement, "And now for something completely different," perfectly sums up the U.S. Presidential election and the financial markets in the latter half of the 4th quarter, but without the humor. Donald Trump's election win shocked the world on the night of November 8th. After a brief period of a few hours that saw the equity futures market decline, U.S. equities rose significantly and bond prices declined under the belief that President-elect Trump, combined with a Republican Congress, would enact policies that would benefit economic growth and corporate earnings, including tax reform, a more business-friendly regulatory environment, and a large increase in government spending on infrastructure.

For the 4th quarter, the Barclay's Capital Aggregate returned -2.98%, with Treasuries, particularly longer maturities, getting pounded and with all investment grade fixed income sectors ending with negative returns. Mortgages held up better, mostly due to the shorter duration.

High yield performed well, buoyed by the rapidly rising U.S. equity markets. Emerging Markets Debt (EMD) had an extremely rough November caused by the combination of falling Treasury prices and the fear that Trump may try to implement onerous tariffs on imported goods. Local currency EMD was hit even harder as the US Dollar moved much higher compared to most currencies.

The following tables show the returns for the various fixed income sectors and rating categories for the 4th quarter and for all of 2016:

Sector	4th Quarter 2016 Return*	2016 Return*
U.S. Treasuries	-3.8%	1.0%
Agencies	-2.1%	2.3%
MBS	-2.0%	1.8%
Inv. Grade Corporates	-2.8%	6.1%
High Yield	1.8%	17.1%
Emerging Markets Debt	-4.0%	10.2%
EMD — Local	-6.1%	9.9%

Credit Rating	4th Quarter 2016 Return*	2016 Return*
AAA	-3.0%	1.4%
AA	-3.1%	3.1%
A	-3.2%	4.7%
BBB	-2.8%	7.9%
BB	0.4%	12.8%
B	2.0%	15.8%
CCC	4.7%	31.5%

* Returns are from Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures as of 12/31/2016.

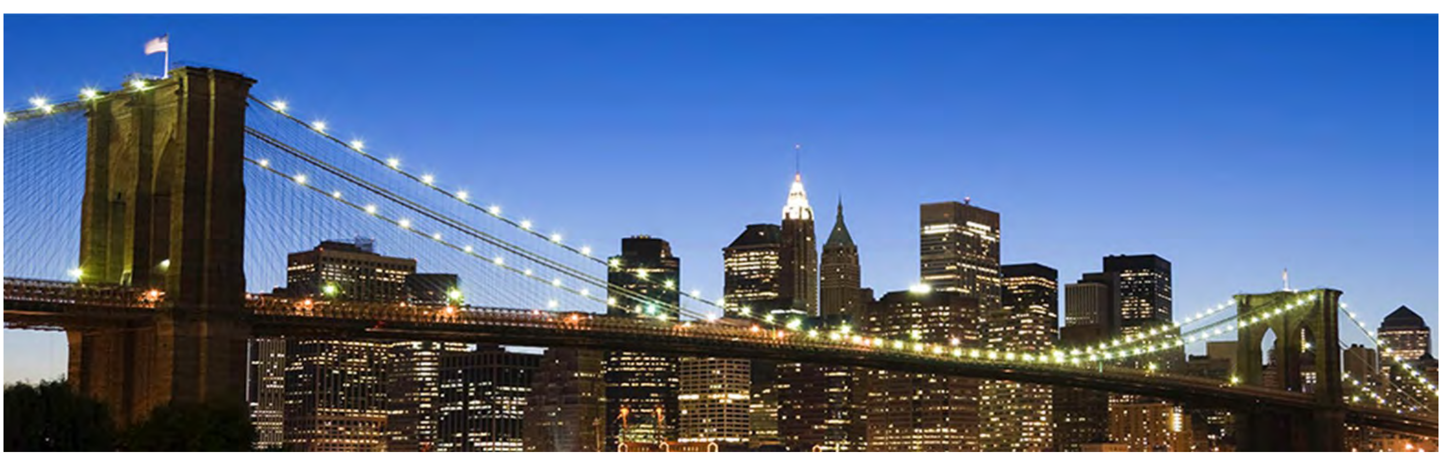
Market Overview (Continued)

U.S. Treasuries

Treasury prices declined significantly and yields rose for all maturities during the 4th quarter. The sell-off started before the election in a small way, but greatly accelerated after President-elect Trump was elected as investors jumped on the belief that his policies would increase both growth and inflation. The Federal Reserve finally made its first move of 2016 in December, raising the Federal Funds Rate by 0.25% to a range of 0.50% - 0.75%. After the election, investors shifted their views and are pricing in about three 25 basis point hikes in 2017.

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, and run from 1.9% in 2017 to 2% in 2018 and 2019. The Fed does not usually increase rates significantly when growth is 2% and inflation is at its target. The median forecast for the Fed is for two or three 25 basis point hikes in 2017, 2018 and 2019. In its forecasts, the Fed has consistently overestimated how soon and how many rate hikes it would announce. The Fed's credibility with investors is low and the market has typically been pricing in fewer hikes than the Fed was predicting. It will likely take a long period of increased accuracy in the Fed's forecasts to restore investors' confidence.

In the 4th quarter, yields increased for all maturities, with the two-year Treasury rising by 43 basis points, while the five, ten, and thirty-year Treasuries rose by 79, 85, and 74 basis points, respectively. The rise in the yield of the ten-year was the largest quarterly increase since 1994. The yield of the two-year note closed at 1.20% while the ten-year Treasury finished at 2.45%, with the latter up from 2.27% at the beginning of the year. The yield curve steepened from the 2-year to the 5-year during the quarter.



SPREAD PRODUCTS

Spreads tightened slightly in investment grade corporates while high yield tightened significantly during the quarter and both are trading much tighter than at the beginning of the year. Despite all of the concern about President-elect Trump's negative comments on Mexico and China, emerging markets debt spreads ended the quarter close to unchanged. Spreads in all sectors had widened significantly earlier in the 1st quarter with the widest point being on February 11 before the dramatic tightening that occurred throughout the balance of the year. 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 end of the 3rd quarter, the day of the Presidential election, and at year-end of 2016:

Sector	12/31/2015	2/11/2016	9/30/2016	11/08/2016	12/31/2016
Investment Grade Corporates	+172	+220	+135	+137	+127
High Yield	+707	+897	+509	+517	+442
Emerging Markets Debt	+415	+507	+336	+333	+342

*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 8 basis points during the 4th quarter to 127 basis points over Treasuries, and are trading slightly tighter than long-term averages. Financials held up better than utilities and Industrials, mostly because the financial sector has a shorter duration than the other sectors. The financial sector also benefits from higher rates and stronger economic growth, which is what investors are looking for post-election. In mortgages, CMBS spreads tightened with continued good fundamentals.

High Yield performed very well despite the huge decline in treasury prices. High yield typically does not have a high correlation to Treasuries and was bolstered by the significant rise in equity prices after the election. Spreads closed 67 basis points tighter at 442 over Treasuries while the average high yield price did not change much and ended the year at $99.8. The current spread for high yield is much tighter than long-term averages, and the yield-to-worst was close to unchanged at 6.12%. Default activity was lower during the quarter and declined each quarter as oil and metal/mining prices rose. The twelve-month default rate declined from 3.5% to 3.2% at the end of December. This is lower than the historical average of 3.7%. The default rate is only 0.7% over the last twelve months if the commodity-related sectors are excluded.

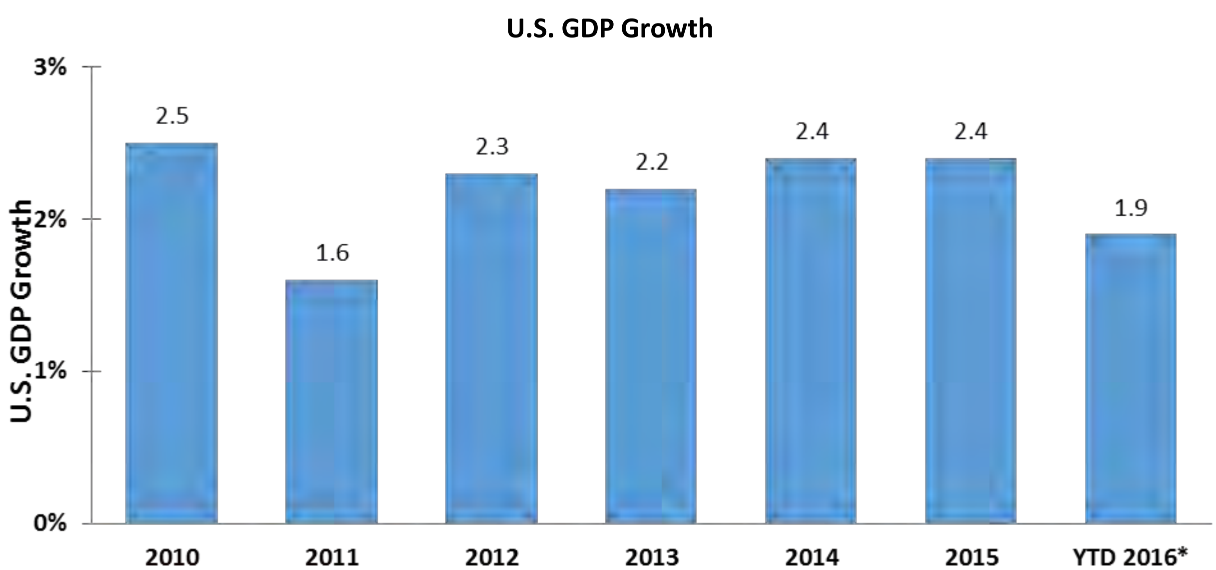
EMD spreads were close to unchanged both since the election and for the quarter, closing at +342 over Treasuries. Higher oil and other commodity prices helped offset the scare of higher U.S. interest rates. EMD yields rose by 81 basis points to 5.80% due to the rise in treasury yields. After the election, many lower credit quality countries performed better than higher credit quality countries, partly due to the lower correlation that lower quality countries typically have with Treasuries. In addition, rising commodity prices helped several oil producers. Local currency EMD performed very poorly due to the much stronger dollar, with Turkey and Mexico getting hit particularly hard.

The Economy

The first official estimate of GDP growth for the 4th quarter will be released on January 27. 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 the first week of January, this model forecasts growth of +2.9% in the 4th quarter. This could change significantly before the first official estimate is released at the end of January. Economic activity was strong in the 3rd quarter of 2016 with final estimated growth of +3.5%, but this was after a sluggish period of growth in the first half of 2016. Growth for all of 2016 will most likely be between 2% and 2.2%, similar or slower than the growth of the last four years.

The United States has now gone a record ten straight years without 3 percent growth in real Gross Domestic Product. During the last ten years, real annual growth in GDP peaked in 2006 at 2.7 percent. The recession ended in June 2009. In the six full calendar years since then (2010-2015), real annual GDP growth has never exceeded the 2.5 percent it hit in 2010, 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 very consistent between 2010 and 2016, with the exception of 2011. We believe growth for all of 2016 will be close to 2.2%.



Source: U.S. Department of Commerce, Data provided including revisions through 9/30/16.

The Economy (Continued)

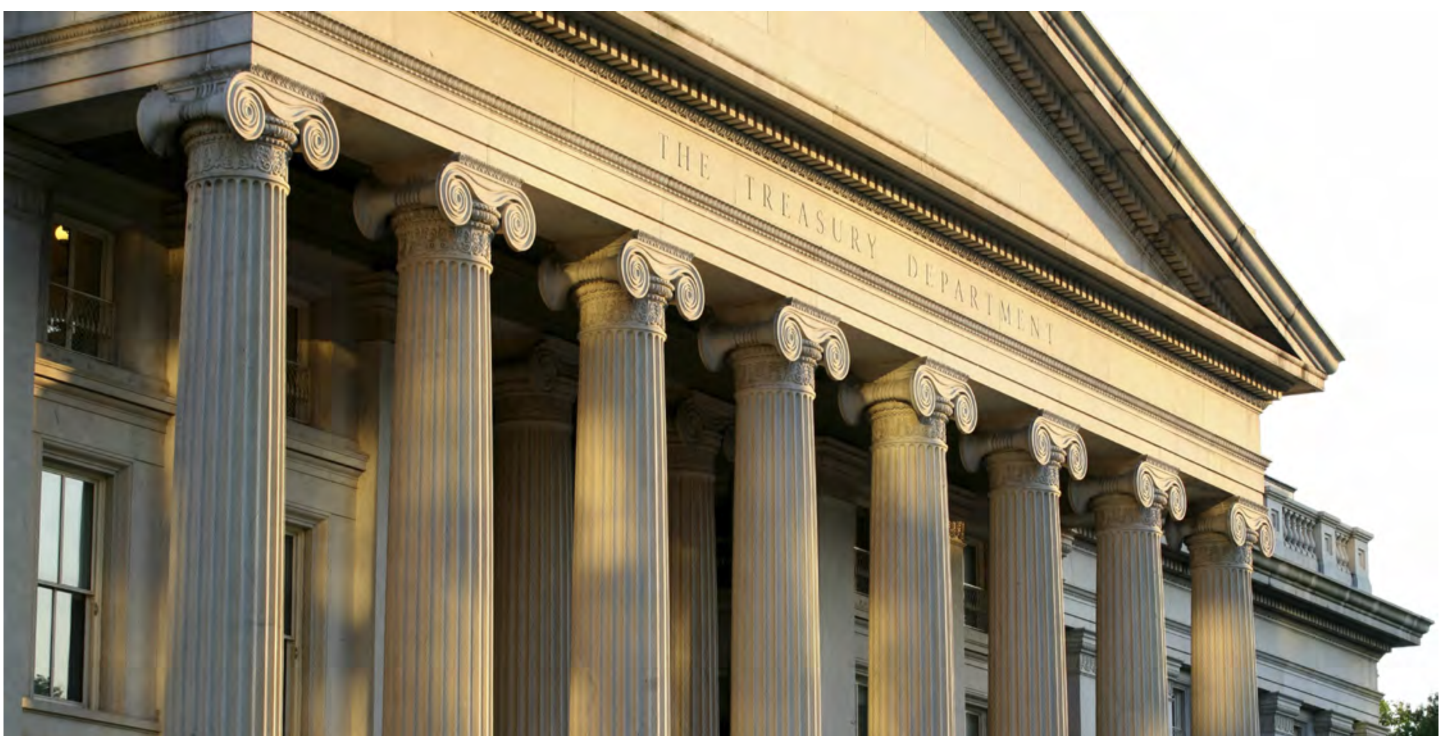
Retail sales and consumer spending data were moderate, but slower than in the 3rd quarter. Consumer confidence moved much higher after the election in November, reaching the highest level since 2001. Motor vehicle sales were fairly strong, with auto dealers increasing incentives in the hopes of keeping sales high for the year. Housing has been a slight positive source of growth, but it has not been particularly strong since before the recession. Housing prices are up +5.1% over the past year as measured by the S&P/Case-Shiller Home Price Index. Measures of manufacturing activity were mixed and lacked signs of strength.

The non-farm payroll gains have been solid, but not as strong as earlier in the year while the unemployment rate declined in November to the lowest level since August 2007. The average payroll gain between September and November has been 178,000 new jobs. The unemployment rate moved 0.3% lower and ended November at 4.6%. Unfortunately, a lower participation rate was part of the reason for the steep decline in November. The current unemployment rate of 4.6% compares to 5.6% at the end of 2014 and 6.7% at the end of 2013. Average hourly earnings declined slightly in November, and the year-over-year gain is now at +2.5%. 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 have moved slightly higher over the past quarter, with 263,000 as the 4-week moving average at the end of December. Claims remain at historically low levels.

Inflation

Commodity prices were mixed, but mostly higher for the quarter. The Bloomberg Commodity Index was up close to +3% for the quarter, with U.S. oil prices up over $5 a barrel to about $54 a barrel. For the year, the commodity index was up over 11%, with oil prices higher by about 45%. Metal prices were mixed over the quarter, with copper much higher, but with gold declining. Agricultural commodity prices varied significantly for the quarter, but with many experiencing declines for all of 2016.

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 Final Demand Index (PPI), remained low-to-moderate. The CPI was up +1.7% year-over-year, while Core CPI grew by +2.1% over the past year. The PPI has increased 1.3% over the past year, with Core PPI up +1.6% year-over-year. The Fed's preferred measure is the price index for Personal Consumption Expenditures (PCE). This measure has moved higher, but remains lower than the Fed's target, with an overall year-over-year increase of +1.4% and a Core PCE deflator increase of +1.6%. In summary, inflation is below 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 were fairly benign in 2016, with a gradual tightening versus the 5-year treasury. The 30-year fixed no-point mortgage rate now stands at 4.52%. This is up 76 basis points from the beginning of the quarter versus the 5-year treasury yield, which has risen 78 basis points over the same period. Uncertainty in government policies under the Trump administration have caused rate volatility to increase by 40% since the presidential election. We are taking a more defensive posture in managing the mortgage portfolio as the markets sort out the 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 and we are underweight Asset-Backed-Securities.

High Yield continued to do very well in the 4th quarter due to higher commodity prices, rising equity prices, investor inflows, and the belief that the new administration will be more business-friendly in regards to regulations. With the significant rally, spreads are much tighter and provide less of a cushion if markets turn negative. Any increase in concerns about the equity market, oil prices, or economic growth could lead to challenges for high yield. In our high yield portfolios, we want to maintain some liquidity due to the significant rise in prices this year, but we are selectively deploying cash as we find risk/reward situations that we expect to add value over the long-term. Recently, deployments have focused on secured debt and high quality situations in addition to some expected incremental investment in restructuring companies in which we are already involved.

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 5% to this sector. We believe that corporates should provide stronger returns than mortgages or Treasuries due to the yield advantage and supportive credit fundamentals for many industries. Spreads moved tighter this quarter, and 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 REIT sector. Regarding ratings, we are overweight to BBB rated corporates. Security selection will be important due to the uncertainty of rate hikes and the high potential for both new tax policies and fewer business regulations, all of which could have a significant effect on specific industries and companies.

While some uncertainty has developed for **Emerging Markets Debt** in the weeks following the U.S. Presidential election, we believe the increased uncertainty will create attractive investment opportunities in the near future. Once there is better clarity as to the new administration's policies, we anticipate that the outflows from EMD could lessen and performance could improve as confidence in the asset class is renewed. Overall, our models show that EMD valuations remain attractive. 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 the current global macro uncertainty. Currently, we see good opportunity in Ukraine, Brazil, Venezuela, Mexico, Indonesia, and Argentina.

The Look Forward

In my comments last quarter, I suggested that the 3rd quarter was "the calm before the storm." Well, that was some storm we just went through in November and December. Equity markets rose significantly while fixed income markets, outside of high yield, were routed by the rapid and substantial climb in Treasury yields. Investors seem to firmly believe that the new administration's proposed policies of tax reform for both corporations and individuals, fewer regulatory restrictions on businesses, significant infrastructure investment, and better trade policies will lead to stronger economic growth, higher corporate earnings and higher inflation. To quote the new President-elect, "It is going to be huge!"

Not so fast. Despite having a Republican-controlled Congress, it will not be entirely smooth sailing for the new administration. While there most likely will be tax reform, many Republican members (remember the Tea party?) have stated that they would like tax reform to be revenue neutral. This possibly will result in the tax changes for individuals to be more in the form of "reform" rather than "cuts," resulting in only a small bump to consumer spending. In regards to infrastructure spending, Trump and his team have not spelled out their plans yet and 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 add slightly to growth over the next two years.

We believe U.S. economic growth will be between 2% to 2.5% over the next year, similar to what has occurred since 2010. Consumer spending will probably continue to be the main growth engine for the U.S. economy. However, higher interest rates could dampen demand for housing while the stronger dollar will hurt manufacturing for the many U.S. companies that do business overseas. Global economic growth remains fragile and could worsen sometime later in 2017 or 2018. We believe a recession in 2018 is a possibility and should be factored in when making portfolio decisions.

The Federal Reserve will most likely make two or three rate hikes in 2017, but it would not surprise us if the Fed has to pause for an extended period at some point later in 2017 or in 2018. The Fed found many reasons to keep rates unchanged for the first eleven months of 2016 (one weak employment number, the Brexit vote, global stock market declines, 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 most 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 is an increased possibility of countries leaving the EU and economic and social issues continue to cause turmoil in Brazil, Turkey, and Venezuela. Immigration continues to be a hot issue globally and there are continued concerns of terrorism. With this underlying environment, we expect ten-year Treasury yields will most likely be volatile and possibly rise slightly from current levels early in 2017. 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, political uncertainty, and high volatility 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 nine months, 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 slightly above 6%. 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.

"And now for something completely different" does aptly describe the change that occurred in November. However, the "different" is just starting and the next few years will see many changes and possibly a very different investment environment from what we have seen over the last several years.

To summarize our outlook:

1. It is our belief that President-elect 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. The long and moderate economic expansion may run out of steam in 2018.
3. The Federal Reserve will most likely raise the Funds Rate two or three times in 2017, but 2018 may see very few if any hikes.
4. Overall inflation will most likely move higher over the next few months due to the increase in oil prices, but will remain near the Fed's target of 2% or below over the next twelve months.
5. We expect interest rates may move 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.
6. Growth in China will be lower, and there could be another growth scare sometime in 2017 similar to what happened early in 2016.
7. Growth in Europe should be 2% or lower, but will be helped by the weaker Euro; however, the long-term structural problems remain.
8. Numerous elections in Europe, including in France, Germany, the Netherlands, and probably Italy, could lead to more volatility and increase the possibility of a country leaving the EU in the long-term.
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

For additional information please contact:

Mr. Timothy Sweeney
Managing Director
Business Development and Client Service
(302) 477-6083
t.sweeney@dupont.com

DuPont Capital