DuPont Capital

Fixed Income Market Review and Outlook

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Market Overview

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Last quarter I wrote about horror movies. This quarter, I will shift to mysteries. I love a good mystery, whether it is a movie, a book or a television show. Some favorite titles include "Murder on the Orient Express," "Chinatown," "The DaVinci Code," "Memento," and many Alfred Hitchcock movies. I enjoy the suspense and trying to unravel the mystery. Although they are great entertainment, mysteries are not so great for investing. I would prefer if everything were more clear, as it would be easier to make investment decisions.

For one thing, inflation is a mystery. Those are not my words, but a direct quote from Fed Chairman Janet Yellen. Recently she said, "This year, the shortfall of inflation from 2%, where none of those factors (slack in labor market, large reduction in energy prices, large appreciation of the dollar) are operative is more of a mystery. I will not say that the committee clearly understands what the causes are of that." To me, while I greatly appreciate her honesty, it is disconcerting that the Fed has no idea why inflation cannot stay close to 2%.

Another mystery, and one with more dire potential consequences, is how we will handle the rising problem of North Korea. This problem is almost impossible to factor into investment decisions unless one wants to allocate mostly to cash. Finally, and much less frightful, we have the prospect of significant changes to our tax code.

Despite these assorted conundrums, except for a few bumps along the way, financial markets were "steady as she goes" for most of the quarter. Equity markets rose, fixed income prices were generally slightly higher, and volatility was low. The horrific hurricanes that created havoc for people in Texas, Florida, and Puerto Rico did not have a meaningful effect on financial markets. The hurricanes have led to a small short-term hit on economic activity, including consumer spending, manufacturing, and employment, but data should bounce back as reconstruction commences.

For the 3rd quarter, the Barclay's Capital Aggregate returned +0.85%, with corporates providing the highest returns and Treasuries lagging the Index. All investment grade fixed income sectors ended with positive returns. High yield performed well, buoyed by rising U.S. equity markets. Emerging Markets Debt (EMD) led the way in fixed income, as investors continued to have strong demand for international assets. Local currency EMD performed 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 3rd quarter of 2017:

Sector	3rd Quarter 2017 Return*	YTD 2017 Return*
U.S. Treasuries	0.4%	2.3%
Agencies	0.8%	2.9%
MBS	0.9%	2.3%
Inv. Grade Corporates	1.3%	5.2%
High Yield	2.0%	7.0%
Emerging Markets Debt	2.6%	9.0%
EMD — Local	3.6%	14.3%

Credit Rating	3rd Quarter 2017 Return*	YTD 2017 Return*
AAA	0.6%	2.3%
AA	1.0%	3.6%
A	1.3%	4.8%
BBB	1.6%	6.1%
BB	2.0%	6.9%
B	1.8%	6.1%
CCC	2.5%	9.3%

* Returns are from Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures as of 9/30/2017.

U.S. Treasuries

Treasury prices barely changed for intermediate and longer maturities during the quarter while shorter maturities declined slightly. Although the changes over the quarter were minimal, the ten-year closed as low as 2.05% on September 7th when inflation declined and investors temporarily felt that the Fed would not make another move until late in 2018. Interest rates rose during the final weeks of September as data improved and the Fed said it was still on track for one more hike in 2017. In the 3rd quarter, the Federal Reserve did not change the Funds Rate and it remains at 1.00% to 1.25%. The yield curve flattened slightly, with shorter maturities rising more in yield due to the increased possibility of another hike in December while long rates were held in by lower inflation data. The Fed will begin the slow process of unwinding their balance sheet and it continues to forecast one more 25 bps hike in 2017. Investors are only partially pricing in another hike this year.

In the 3rd quarter, yields increased for short maturities, with the two-year Treasury rising by 9 bps while the five-year, ten-year and thirty-year Treasuries rose by only 3, 2, and 2 bps, respectively. The yield of the two-year note closed at 1.47% while the ten-year Treasury finished at 2.33%. As mentioned, the ten-year did close as low as 2.05% in early September before inflation moved slightly higher late in the quarter.

SPREAD PRODUCTS

Spread products performed well, with some spread tightening in high yield, emerging markets debt and investment grade corporates. Better global economic growth, rising equity prices and the continued search for yield all led investors to buy higher yielding fixed income. 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), year-end 2016, and the end of the 2nd and 3rd quarters of 2017:

Sector	12/31/2015	2/11/2016	12/31/2016	6/30/2017	9/30/2017
Investment Grade Corporates	+172	+220	+127	+111	+103
High Yield	+707	+897	+442	+390	+370
Emerging Markets Debt	+415	+507	+342	+310	+287

*Spread data are from the Barclays U.S. Corporate Index for IG Corporates, Barclays U.S. High Yield Index for high yield and from the JP Morgan EMBI Global Diversified Index for Emerging Markets Debt.

Investment grade corporates tightened by 8 basis points during the 3rd quarter to 103 basis points over Treasuries. This is very close to the tightest level since before the financial crisis in 2008. Utilities performed slightly better than industrials and financials while longer duration corporates had higher returns than shorter duration corporates. In mortgages, pass-throughs outperformed CMBS and ABS.

High Yield performed very well, aided by higher oil and metal prices and rising equity markets. High yield spreads closed 20 basis points tighter at 370 bps over Treasuries while the average high yield price rose slightly and ended the quarter at $101.9. The current spread for high yield is much tighter than long-term averages, and the yield-to-worst decreased by 17 bps to 5.45%. Default activity was very low during the quarter with the lowest volume of defaults since 2013. The twelve-month default rate declined over the quarter from 1.5% to 1.1% at the end of September. This is much lower than the historical average of 3.7%.

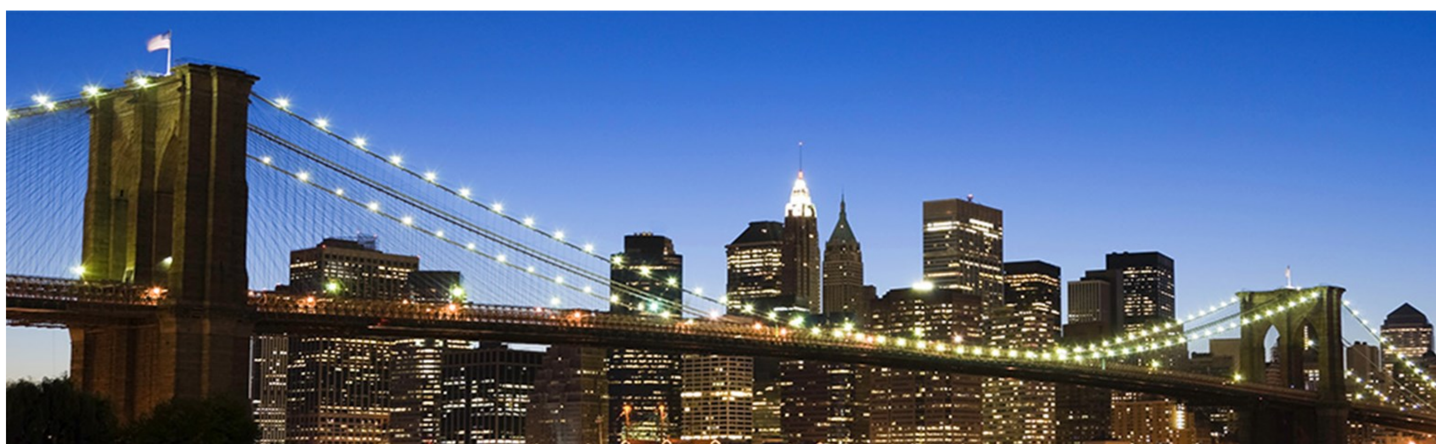
EMD performed very well, with spreads tightening by 23 basis points. An improved economic outlook for many EM countries, strong demand for non-U.S. assets from investors, rising commodity prices, and continued low volatility in interest rates combined to drive EMD prices higher, both for US Dollar and local currency bonds. EMD yields declined by 17 basis points to 5.20%. In US Dollar sovereigns, some of the best performing countries included El Salvador, Mozambique, Iraq, and Ukraine. Local currency EMD was again the stand-out performer in fixed income globally. Brazil led the way with returns over +10% for the quarter in their local currency bonds while Russia and Hungary also posted strong returns.

The Economy

Third quarter U.S. economic growth continued on the stronger path that began in April after lackluster activity in the first quarter. The first official estimate of GDP growth for the 3rd quarter will be released on October 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 October 2nd, this model forecasted growth of +2.7% in the 3rd quarter. This could change significantly before the first official estimate is released near the end of October. Most estimates are in the range of 2.5% to 3.0%. Growth in the second quarter was revised from +3.0% to +3.1%. 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.

Retail sales and consumer spending data were weaker near the end of the quarter, which was disappointing given the strong employment and consumer confidence data. Consumer confidence remained high mostly due to the strong labor market. Housing data were slightly weaker than expected and did not contribute much to growth in the quarter just ended. Housing prices were up +5.8% over the past year as measured by the S&P/Case-Shiller Home Price Index, up from 5.7% in June. Measures of manufacturing activity were mixed, but better overall than earlier in the year.

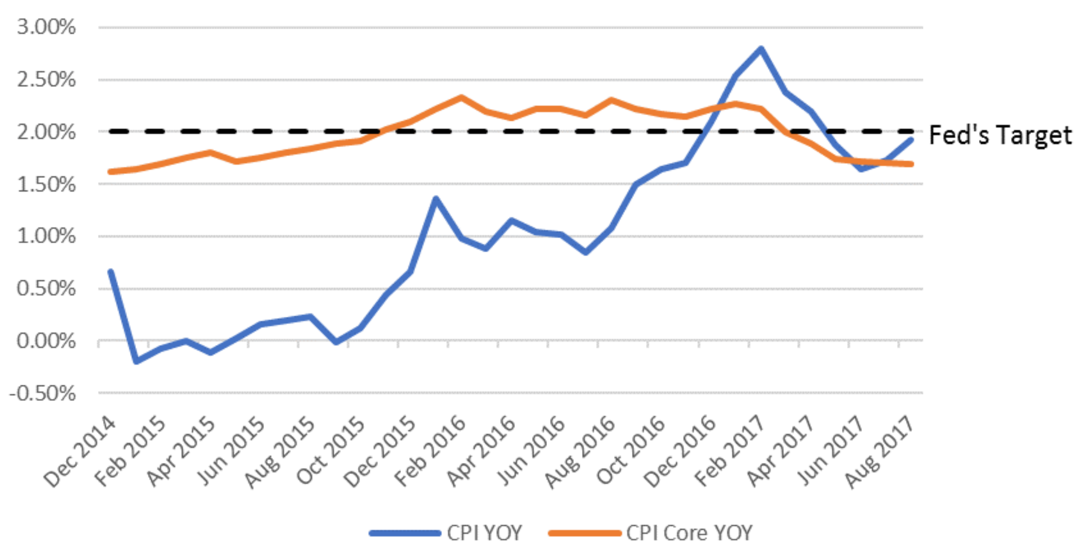
The non-farm payroll gains have been stronger over the last three months while the unemployment rate rose slightly to 4.4%. The average payroll gain in June, July, and August was 185,000 jobs, higher than the March through May gains of only 121,000 new jobs. The current unemployment rate has been fluctuating between 4.3% and 4.4% for five months and the current rate of 4.4% compares favorably to 4.7% at the end of 2016. Average hourly earnings rose only +0.1% in August, and the year-over-year gain has remained constant at +2.5%. The Fed would like to see wages rise at least +3% as an additional signal that inflation could move toward its 2% target. Initial jobless claims moved lower during the first two months of the quarter before the effects of the hurricanes pushed claims higher in September. The 4-week moving average declined from 242,250 to 236,750 before ending the quarter higher at 278,000. Claims were at historically low levels in August.



Inflation

Commodity prices were mixed for the quarter, with oil moving higher. The Bloomberg Commodity Index was up almost +3%, with U.S. oil prices up over $5 a barrel to $51.70. Most metal prices were up, with copper up over 9% and gold and silver up slightly. Wheat and corn prices were down.

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), was close to unchanged over the last three months. The CPI was up only +1.9% year-over-year, while Core CPI grew by +1.7% over the past year. These are unchanged from May, but down from earlier in the year. The PPI has increased +2.4% over the past year, with Core PPI up +2.0% year-over-year. For overall CPI, oil prices bottomed in February of 2016, so the jump in overall CPI due to energy faded in February of 2017 and has since declined. Below is a chart that shows the CPI since the end of 2014.



Source: Bloomberg

The Fed's preferred measure of inflation is the price index for Personal Consumption Expenditures (PCE). This measure has stayed very low and is well below the Fed's target, with an overall year-over-year increase of 1.4% and a Core PCE deflator increase of +1.3%. The Core PCE deflator is the lowest it has been in over a year-and-a-half. In summary, inflation has remained below the Fed's target, and it is important to monitor to see if the data move higher, towards the Fed's 2% target.

Portfolio Positioning

In the **Government** sector, our Core and Core Plus portfolios have durations that are shorter than the benchmark by about -0.2 to -0.4 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).

Mortgage spreads hovered in the +67 to +72 bps range for most of the third quarter until September when ten year Treasury rates moved sharply higher by 30 bps while the current coupon mortgage rate only moved higher by 20 bps. This 10 bps mortgage spread tightening occurred in the face of the Fed communicating plans to reduce its balance sheet exposure for both Treasuries and MBS. This illustrates the lack of yield opportunities available for investment managers throughout the fixed income space.

There have been several shifting trends within the Mortgage origination market. Ten-year Treasury rates in 2017 have been range bound between 2.0% and 2.6%. This is similar to 2015, but substantially higher than in 2016 when rates spent most of the year below 2.0%. As a result, mortgage refinancings have been subdued in 2017 without the benefit of lower rates. There also has been a housing supply mismatch, with demand for affordable (lower priced) housing stock outpacing supply. Conversely, there is a greater supply of units for sale at the upper end of the price range where the demand has been weaker.

We continue our defensive posturing with a benchmark neutral mortgage coupon distribution and with selective exposure to higher yielding, off-benchmark mortgage securities. Our overweight CMBS exposure is slowly declining through gradual pay downs as we have abstained from adding additional CMBS at the current tight market spread levels. 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 less than 3% to this sector in our Core portfolio. This overweight was reduced earlier in the year as corporates performed well and spreads tightened. We believe that corporates should provide slightly higher returns than mortgages and Treasuries due to the yield advantage and supportive credit fundamentals. We are currently overweight basic industry and insurance companies where we find some good value. Regarding ratings, we are overweight BBB rated corporates. We are also overweight intermediate maturities and underweight longer corporates. Security selection will be important due to the uncertainty of rate hikes and the potential for new tax policies, both of which could have an effect on specific industries and companies.

High Yield continued to do well in the 3rd quarter due to rising equity prices, moderate economic growth, and higher oil prices. With the significant rally over the past 1 ½ years, 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 are maintaining some liquidity due to the significant rise in prices over the past year, but we are selectively deploying cash as we find opportunities to add value in the long-term.

Emerging Markets Debt performed very well in this quarter and for the year. Overall, our models show that EMD valuations are priced close to fair value. We are slightly positive for EMD as the fundamentals for several countries have improved over the past year and global growth has improved. Our research 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, and Argentina. We have increased our exposure to local currency EMD as valuations look more attractive when compared to some of the US dollar sovereign valuations.

The Look Forward

Like an old, but well-maintained tug boat, financial markets continued to chug along steadily in the 3rd quarter. Financial markets have produced strong returns over the first nine months of 2017 across most asset classes. Investors have witnessed and mostly ignored numerous events, including the problems with North Korea, a turbulent start to President Trump's administration, stubbornly low inflation, continued terrorism throughout the globe, volatile oil prices, and the stronger possibility of tightening global financial conditions. Investors appear to be complacent due to the steady economic growth, ample liquidity, and lack of attractive investment alternatives. We feel that caution is warranted in this environment and overall risk should be reduced so that investors can take advantage of any opportunities that arise if markets suddenly change.

Our outlook is mostly unchanged. 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 has been slightly disappointing this year, but may pick up over the rest of the year. However, auto sales are down and higher home prices could dampen demand for housing. Auto sales could bounce back due to possible future demand in Texas and Florida. Global economic growth has improved, but remains fragile and could worsen later in 2018. We believe a recession late next year or in 2019 is a possibility and should be factored in when making portfolio decisions.

The Federal Reserve will most likely make one more rate hike in 2017, but it would not surprise us if the Fed pauses for an extended period later in 2018. 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 in 2018; Japan and Europe, despite significant quantitative easing and better recent growth, will probably have growth close to 2% or less for the foreseeable future due to high debt levels and aging populations. Geopolitical issues are pervasive around the globe, with North Korea adding to the uncertainties. Immigration will remain a hot issue globally and terrorism, unfortunately, will likely continue to occur. With this underlying environment, we expect ten-year Treasury yields will most likely only rise slightly from current levels by the end of 2017. In our Core and Core Plus portfolios, we are keeping our interest rate duration slightly shorter than the benchmark. The significant uncertainties lead us to believe that high quality fixed income allocations should not be reduced and will provide the anchor if markets become turbulent again. 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.

We have gradually reduced risk in our fixed income portfolios over the last year. We believe returns will be in the low-single digits for investment grade fixed income over the next year, with the strong potential for higher volatility. No sectors look very attractive, but some of the non-Treasury sectors could continue to outperform Treasuries. Yields in emerging markets debt, high yield, and, to a lesser extent, investment grade corporates are slightly attractive compared to developed sovereign yields. High yield spreads are on the expensive side, but yields are still above 5.5%. The concern on our part is that spreads may not provide 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.

Hopefully, some of the mysteries will be solved with a happy ending. However, this may be wishful thinking. Markets may remain calm through year-end and early next year, but we are getting prepared for a disruption to occur in financial markets sometime in 2018. It may just be a short-term dislocation similar to early 2016, but it could last longer.

SUMMARY

To summarize our outlook:

1. Markets remain calm despite uncertainties over taxes and increased geopolitical concerns. We are slowly reducing the overall risk in our portfolios. Caution is warranted.
2. We have been skeptical about investors' belief that the new administration's policies would be able to push economic growth higher. So far, this thesis has been correct. We continue to expect U.S. growth of between 2% and 2.5% in 2017 and 2018 – no change from the last 7 years.
3. 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.
4. The long and moderate economic expansion could run out of steam in late 2018 or early 2019.
5. The Federal Reserve will most likely raise the Funds Rate one more time in 2017, but 2018 may see very few hikes if economic growth falters.
6. Inflation has been below the 2% target as continued strong global competition has kept a lid on price increases in many segments of the economy. Inflation may rise from current levels, but should remain close to 2% over the next few years.
7. The beginning of the unwinding of the Fed's balance sheet will not have a meaningful impact on the markets. The process is very measured and controlled.
8. 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.
9. Growth in Europe, China and Japan has been better than expected, but high debt levels and poor demographics will weigh on growth in the longer-term.

ABOUT OUR FIRM

DuPont Capital has a long history of institutional asset management. Our parent company, DuPont (a wholly owned subsidiary of Dow-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

- 8 Portfolio Managers
- 6 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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