# Fixed Income Market Review and Outlook

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## Market Overview

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"Calm with low volatility" accurately describes the financial markets during the second quarter. Stock market volatility was near a multi-decade low, equity markets rose, and fixed income prices generally moved higher. Everything seemed nice and serene and most investors were content. Maybe too content.

When I was much younger, I used to love a good horror movie. They were all basically the same, with some scary looking guy with a name like "Freddy" or "Jason" wearing a mask and chasing young, unsuspecting teens. There would always be a scene in which everything was very peaceful and quiet. Everything seemed just perfect. In the audience, you knew that at some point soon, the scary guy would jump out and create chaos for the group of teens. You would want to yell at the movie screen and say, "Don't go in that room!" Ah, but they would never listen and the next thing you knew, people were covering their eyes as havoc erupted in the movie and another teen met an untimely death. I am starting to feel like the current calm state of the financial markets is similar to the scene a little before "Freddy" jumps out and creates mayhem. Unlike the movie though, the start of any disruption in the financial markets is much, much harder to predict. But, at least for now, we can sit back, relax, and enjoy the results of the last three months.

For the 2nd quarter, the Barclay's Capital Aggregate returned +1.45%, 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 rising U.S. equity markets. Emerging Markets Debt (EMD) continued to rebound after a tough 4th quarter as fears of protectionist policies subsided, and investors clamored for international assets. Local currency EMD performed even stronger 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 2nd quarter of 2017:

| Sector | 2nd Quarter 2017 Return* | YTD 2017 Return* |
|---|---|---|
| U.S. Treasuries | 1.2% | 1.9% |
| Agencies | 0.9% | 2.1% |
| MBS | 0.9% | 1.4% |
| Inv. Grade Corporates | 2.5% | 3.8% |
| High Yield | 2.2% | 4.9% |
| Emerging Markets Debt | 2.2% | 6.2% |
| EMD — Local | 3.6% | 10.4% |

| Credit Rating | 2nd Quarter 2017 Return* | YTD 2017 Return* |
|---|---|---|
| AAA | 1.1% | 1.7% |
| AA | 1.6% | 2.6% |
| A | 2.4% | 3.5% |
| BBB | 2.7% | 4.4% |
| BB | 2.7% | 4.8% |
| B | 1.7% | 4.3% |
| CCC | 1.9% | 6.6% |

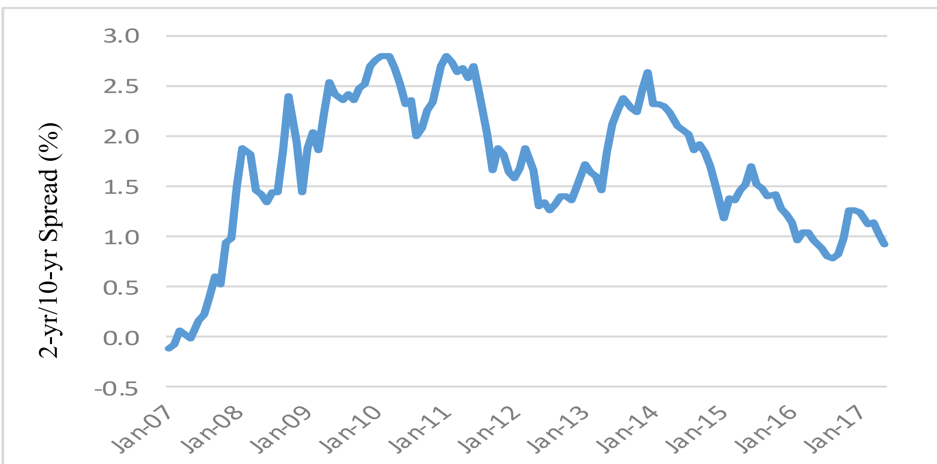
* Returns are from Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures as of 6/30/2017.

### U.S. TREASURIES

Treasury prices rose for intermediate and longer maturities during the quarter despite stronger economic data and the 25 bps increase in the Fed Funds Rate in June. The Funds Rate is now at 1.00% to 1.25%. The yield curve flattened significantly, with shorter maturities rising in yield due to the hike while long rates were held down by lower inflation expectations. The Fed's comments after the rate hike in June were not materially different than those from the previous meeting, and it continues to forecast one more 25 bps hike in 2017. Investors are not fully pricing in another hike this year.

Below is a chart of the 10-year Treasury minus the 2-Year Treasury to show how the yield curve has flattened over the last few years. The curve is not very far from the flattest it has been in almost a decade. Historically, an inverted yield curve has been a good predictor of a coming recession, but the curve is not close to being inverted as of quarter-end. This bears watching as it could flatten further if inflation remains below target and the Fed tightens in September.

**Spread of 10-Year Treasury over 2-Year Treasury**




Source: Bloomberg

In the 2nd quarter, yields increased for short maturities, with the two-year Treasury rising by 11 bps, while the five-year, ten-year and thirty-year Treasuries fell by 4, 9, and 18 bps, respectively. The yield of the two-year note closed at 1.38% while the ten-year Treasury finished at 2.31%.

## Spread Products

Spread products performed well with some spread tightening in high yield and investment grade corporates, and with spreads close to unchanged in emerging markets debt. 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 1st and 2nd quarters of 2017:

| Sector | 12/31/2015 | 2/11/2016 | 12/31/2016 | 3/31/2017 | 6/30/2017 |
|---|---|---|---|---|---|
| Investment Grade Corporates | +172 | +220 | +127 | +121 | +111 |
| High Yield | +707 | +897 | +442 | +412 | +390 |
| Emerging Markets Debt | +415 | +507 | +342 | +310 | +310 |

*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 10 basis points during the 2nd quarter to 111 basis points over Treasuries, and are trading tighter than long-term averages. Utilities and industrials performed slightly better than financials while longer duration corporates had higher returns than shorter duration corporates. In mortgages, CMBS outperformed mortgage pass-throughs and ABS.

High Yield performed well although the decline in oil prices in the later part of the quarter slightly dampened the enthusiasm for the asset class. 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. Even with the decline in oil, high yield spreads closed 22 basis points tighter at 390 bps over Treasuries while the average high yield price rose slightly and ended the quarter at $101.5. The current spread for high yield is much tighter than long-term averages, and the yield-to-worst decreased by 22 bps to 5.62%. Default activity remained at a low level over the past year. The twelve-month default rate declined over the quarter from 1.9% to 1.5% at the end of June. This is much lower than the historical average of 3.7%.

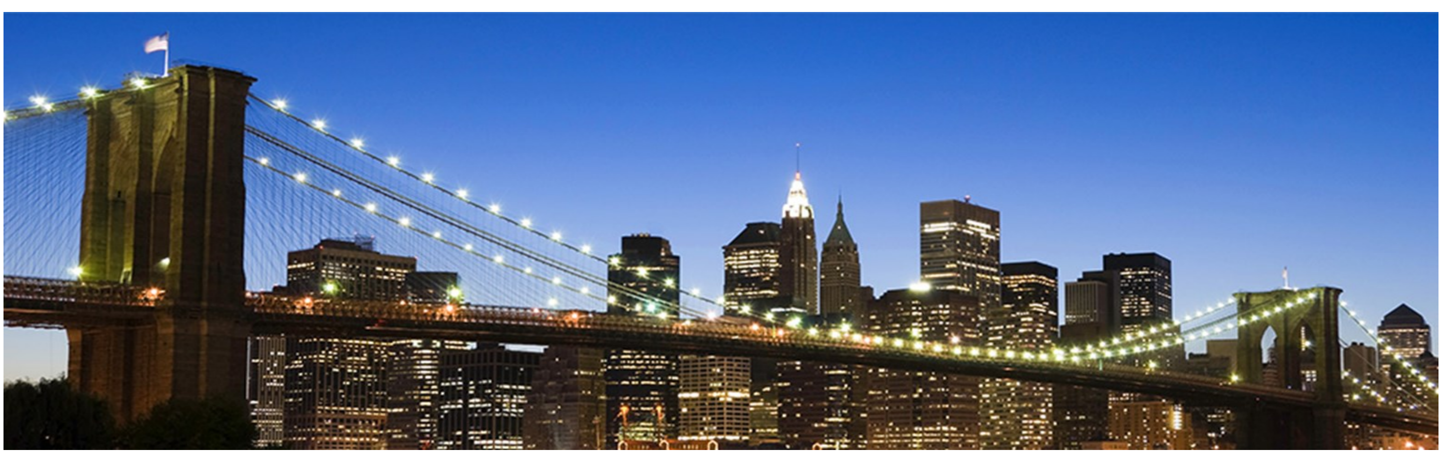
EMD performed very well, with spreads close to unchanged and yields falling due to the decline in treasury yields. An improved economic outlook for EM countries, fairly stable commodity prices outside of oil, lower volatility in interest rates, and reduced fear about changes in trade policies combined to drive EMD prices higher, both for US Dollar and local currency bonds. EMD yields declined by 10 basis points to 5.37%. In US Dollar sovereigns, some of the best performing countries included Mozambique, Ghana and Ukraine. Local currency EMD was the stand-out performer in fixed income globally. Eastern European countries led the way with Czech Republic, Poland and Hungary all posting impressive returns in the second quarter on their local currency bonds.

## The Economy

Economic growth in the U.S. improved in the 2nd quarter after lackluster activity earlier in the year. The first official estimate of GDP growth for the 2nd quarter will be released on July 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 June 30, this model forecasts growth of +2.7% in the 2nd quarter. This could change significantly before the first official estimate is released at the end of July. Most estimates are in the range of 2.5% to 3.0%. Growth in the first quarter was revised higher for the second time and was finalized at +1.4%, up from +1.2%. Economic activity continues to feel stronger than the official data, particularly with the low unemployment rate and the extremely high consumer confidence. Some of the "soft" data point toward higher growth; however, it is possible that the surveys will decline to more moderate levels over the balance of the year. 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 moderate, but disappointing given the strong employment and consumer confidence data. Consumer confidence remained high mostly due to the strong labor market. Housing started the quarter weaker than expected, but picked up later in May. Housing prices are up +5.7% over the past year as measured by the S&P/Case-Shiller Home Price Index, down from 5.9% in March. Measures of manufacturing activity were mixed, with weakness in autos and aircraft manufacturing and only mediocre growth in other areas.

The non-farm payroll gains have been weaker over the last three months while the unemployment rate declined further to 4.3%. The average payroll gains in March, April and May were only 121,000 new jobs, much lower than the average gains in 2016. The current unemployment rate of 4.3% compares to 5.6% at the end of 2014 and 6.7% at the end of 2013. This is the lowest unemployment rate since February of 2001. Average hourly earnings rose only +0.2% in May, and the year-over-year gain has fallen to +2.5%. The Fed would like to see wages rise at least +3% as an additional sign that inflation would move toward its 2% target. Initial jobless claims moved lower over the past quarter, with the 4-week moving average declining to 242,250 as of the end of June. This is down by over 10,000 claims from last quarter. Claims remain at historically low levels.

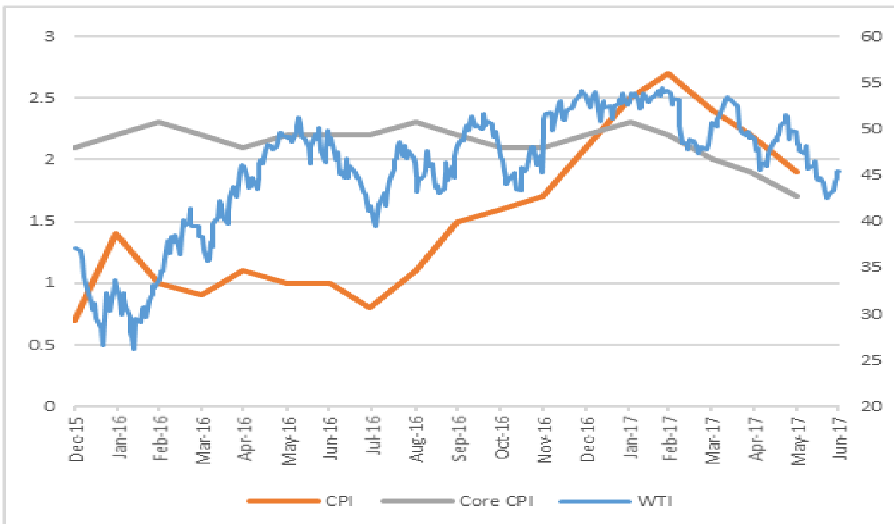


## Inflation

Commodity prices were mixed for the quarter, with oil continuing to decline. The Bloomberg Commodity Index was down over -3%, with U.S. oil prices down $4 a barrel to $46 a barrel. Most metal prices did not change materially, with copper up slightly and silver 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), were mixed with CPI lower and PPI higher during the quarter. The CPI was up only +1.9% year-over-year, while Core CPI grew by +1.7% over the past year. These are down from 2.7% and 2.2% respectively. The PPI has increased 2.4% over the past year, with Core PPI up +2.1% year-over-year. The CPI numbers were driven lower partly due to falling telecom prices and some declines in medical care. 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 recent decline in inflation including the impact that oil prices have had on overall CPI.

**Inflation and Oil Prices**




The Fed's preferred measure is the price index for Personal Consumption Expenditures (PCE). This measure has moved lower and is now well below the Fed's target, with an overall year-over-year increase of 1.4% and a Core PCE deflator increase of also +1.4%. The Core PCE deflator is the lowest it has been in a year-and-a-half. In summary, inflation has recently declined, and it is important to monitor to see if the data moves higher and closer to target.



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## 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 -0.3 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 remained quiet, ranging from 70-75 bps with the current coupon spread to the 10-yr Treasury yield at 73 bps. The current coupon 30-year mortgage now sits at 3.03%, only 10 bps lower than where it started 2017. The borrower 30-year effective mortgage rate stands at 4.23%, 29 bps lower than at the start of 2017, even though the Fed has raised short term rates twice this year.

The continued U.S. political gridlock between Democrats and Republicans has generated uncertainty as to the economy's future path. However, the market is becoming more accustomed to expectations of a low growth/low inflation environment as realized volatility in the treasury market has gradually fallen in 2017. Due to narrow spreads and the policy uncertainties, 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. However, as corporates continued to perform well and spreads inched tighter, we continued to reduce our overweight. We believe that corporates should provide slightly higher returns than mortgages or 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. 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 companies.

**High Yield** continued to do well in the 2nd quarter due to rising equity prices, moderate economic growth, and the belief that the new administration will be more business-friendly regarding taxes and regulations. However, the decline in oil prices took the steam out of high yield in June. With the significant rally over the past sixteen months, 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 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. We have increased our exposure to local currency EMD as valuations look more attractive as compared to some of the US dollar sovereign valuations.



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## The Look Forward

Financial markets have produced strong returns in the first half of 2017 across most asset classes as investors have absorbed many events, including a turbulent start to President Trump's new administration, the aftermath of Brexit, continued terrorism throughout the globe, lower and volatile oil prices, stubbornly low inflation, and the stronger possibility of tightening global financial conditions. Investors appear to be complacent due to the steady economic growth and ample liquidity. 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.

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 will probably pick up over the rest of the year. However, higher home prices could dampen demand for housing while the fairly strong dollar will hurt manufacturing for many U.S. companies. Global economic growth has improved, but remains fragile and could worsen sometime in 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 one or two more rate hikes in 2017, but it would not surprise us if the Fed has to pause at some point later in 2017 or 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; 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. Political and geopolitical issues are pervasive around the globe, as evidenced by Brexit, the U.S. Presidential election, and the referendum in Italy. Add to this the major social unrest and economic situation in Venezuela, another political scandal in Brazil, and potentially serious issues with North Korea. 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 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 ballast 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.

Over the course of 2017, we have gradually reduced risk in our fixed income portfolios. We believe returns will be in the low-single digits for investment grade fixed income over the coming twelve months, with the strong potential for higher volatility. There is not any sector that looks 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 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.

Markets may remain calm for a while longer, but I keep getting that feeling that "Freddy" is going to jump out later in 2017 or early in 2018. It might just be a short-term disruption similar to early 2016, but it could last longer.

## SUMMARY

**To summarize our outlook:**

1. Markets are too calm and 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 and so far this thesis has been correct. We continue to expect U.S. growth of between 2% and 2.5% in 2017 – 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. However, any further decline in oil prices will result in spread widening, particularly in high yield.
4. The long and moderate economic expansion could run out of steam in 2018.
5. The Federal Reserve will most likely raise the Funds Rate one or two more times in 2017, but 2018 may see very few hikes if economic growth falters.
6. Inflation has stabilized close to 2% as continued strong global competition has kept a lid on price increases and as the rise in oil prices from 2/2015 to 2/1016 rolled off the year-over-year calculations.
7. 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.
8. 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.
9. Growth in Europe should be around 2% or lower; however, the long-term structural problems remain.

## 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

- 8 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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