DuPont Capital

Fixed Income Market Review and Outlook

December 31, 2017

Market Overview

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"Here Comes the Sun" was a very popular song from the Beatles' 1969 Abbey Road album. A section of the lyrics state:

Little darling, the smiles returning to the faces
Little darling, it seems like years since it's been here
Here comes the sun
Here comes the sun, and I say
It's all right

Since the 2008 recession, a constant refrain from some politicians, economists and investors has been that the U.S. economy has not grown at its full potential since before the financial crisis. In essence, the "sun has not been here" since 2005, when the U.S. economy last grew above 3% on a calendar year basis. This period of lower growth since the end of the recession may change for the better in 2018 and the "sun" may finally shine again. Certainly, the last nine months of 2017 have exhibited growth of approximately 3%. This higher growth has led to strong financial market returns for all of 2017, particularly in the equity markets and in the riskier segments of fixed income. For the 4th quarter, equities continued to soar while many sectors of fixed income took a breather as the stronger growth led investors to position for slightly higher interest rates in the coming year.

For the 4th quarter, the Bloomberg/Barclay's Capital Aggregate managed to end with a positive result with a return of +0.39%. Investment grade corporates provided the highest returns while Treasuries lagged the Index and ended with a return close to 0%. In the other fixed income sectors, Emerging Markets Debt (EMD) led the way, as investors continued to exhibit strong demand for international assets and the higher coupon yields. In High Yield, prices declined overall, but coupon income kept returns in positive territory.

The following tables show the returns for the various fixed income sectors and rating categories for the 4th quarter and all of 2017:

Sector	4th Quarter 2017 Return*	YTD 2017 Return*
U.S. Treasuries	0.1%	2.3%
Agencies	0.0%	2.1%
MBS	0.2%	2.5%
Inv. Grade Corporates	1.2%	6.4%
High Yield	0.5%	7.5%
Emerging Markets Debt	1.2%	10.3%
EMD — Local	0.8%	15.2%

Credit Rating	4th Quarter 2017 Return*	YTD 2017 Return*
AAA	0.1%	2.4%
AA	0.6%	4.2%
A	1.1%	6.0%
BBB	1.2%	7.5%
BB	0.4%	7.3%
B	0.4%	6.5%
CCC	1.0%	10.4%

* Returns are from Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures as of 12/31/2017.

Market Overview (Continued)

U.S. Treasuries

Treasury prices declined for short and intermediate maturities during the quarter while 30-year Treasury prices rose slightly. The Federal Reserve hiked the Funds Rate 25 bps in December, bringing the rate up to 1.25% - 1.50%, the third hike of 2017. The yield curve flattened, with shorter maturities rising more in yield due to the belief in an increased probability of additional hikes in 2018, while long rates did not rise because of continued low-to-moderate inflation data. The Fed began the slow process of unwinding its balance sheet during the fall and is forecasting three 25 bps hikes in 2018. Based on Treasury yields, investors are currently pricing in two hikes for next year.

In the 4th quarter, yields increased significantly for short maturities, while intermediate maturities rose more modestly. The two-year Treasury rose by 42 bps while the five-year and ten-year Treasuries rose by only 28 and 7 bps, respectively. The thirty-year yield bucked the trend and declined by 12 bps. The yield of the two-year note closed at 1.89% while the ten-year Treasury finished at 2.40%. During all of 2017, the ten-year moved as low as 2.05% in September and as high as 2.62% in March, but closed the year only 5 bps lower than it started.

SPREAD PRODUCTS

Spread products outperformed Treasuries, with some slight spread tightening in high yield, emerging markets debt, and investment grade corporates. Good synchronized global economic growth, rising equity prices, and the continued search for yield led many 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 year-end 2015, February 11, 2016 (the widest point), year-end 2016, the end of the 3rd quarter of 2017, and year-end 2017:

Sector	12/31/2015	2/11/2016	12/31/2016	9/30/2017	12/31/2017
Investment Grade Corporates	+172	+220	+127	+103	+96
High Yield	+707	+897	+442	+370	+364
Emerging Markets Debt	+415	+507	+342	+287	+285

*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 7 basis points during the 4th quarter to 96 basis points over Treasuries. This is the tightest level since before the financial crisis in 2008. Utilities performed better than industrials and financials while longer duration corporates had higher returns than shorter duration corporates. In mortgages, no sector materially outperformed as most had returns hovering around 0% for the quarter

High Yield experienced a small decline in prices during the quarter, but provided a positive return due to coupon income. Rising equity markets and higher oil and metal prices supported the asset class. High yield spreads closed 6 basis points tighter at 364 bps over Treasuries while the average high yield price declined 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 rose by 27 bps to 5.72% due to higher Treasury yields. Default activity was very low during the quarter and for all of 2017, with the lowest volume of defaults since 2013. The twelve-month default rate was 1.3% at the end of December. This is much lower than the historical average of 3.7%.

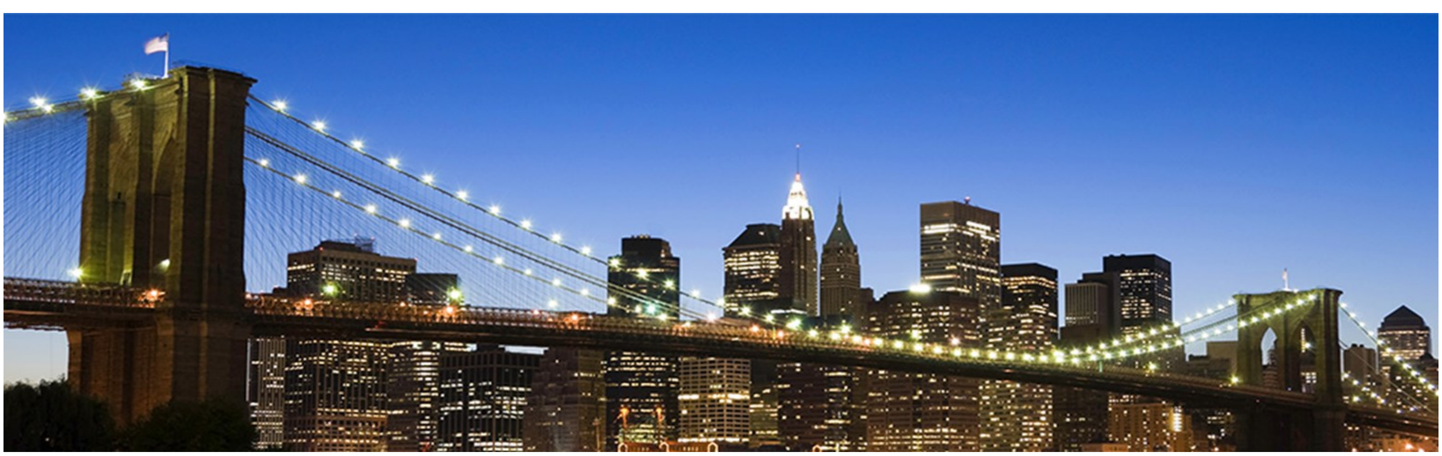
U.S. Dollar Emerging Markets Debt spreads and yields ended the quarter close to unchanged, despite declining Treasury prices. An improved economic outlook for some EM countries, continued investor demand for non-U.S. assets, rising commodity prices, and continued low volatility combined to provide support for EMD. Yields for the asset class rose by 7 basis points to 5.27%. Local currency EMD rebounded in December after declining earlier in the quarter. Local currency was still the stand-out performer for the year in fixed income globally.

The Economy

Fourth 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 4th quarter will be released on January 26th. 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 December 22nd, this model forecasted growth of +2.8% in the 4th quarter. This could change significantly before the first official estimate is released near the end of January. Most estimates are in the range of 2.5% to 3.0%. Growth in the third quarter was 3.2%, the second consecutive quarter with growth above 3%.

Retail sales and consumer spending data were stronger near the end of the year, which was encouraging after disappointing data in the 3rd quarter. Consumer confidence moved lower late in the year, but remains at healthy levels mostly due to the strong labor market. Housing data were slightly stronger with new home sales and housing starts rising in November and housing prices also moving higher. Housing prices were up +6.4% year-over-year as measured by the S&P/Case-Shiller Home Price Index, up from +5.8% in August. Measures of manufacturing activity were mixed, but better overall than earlier in the year.

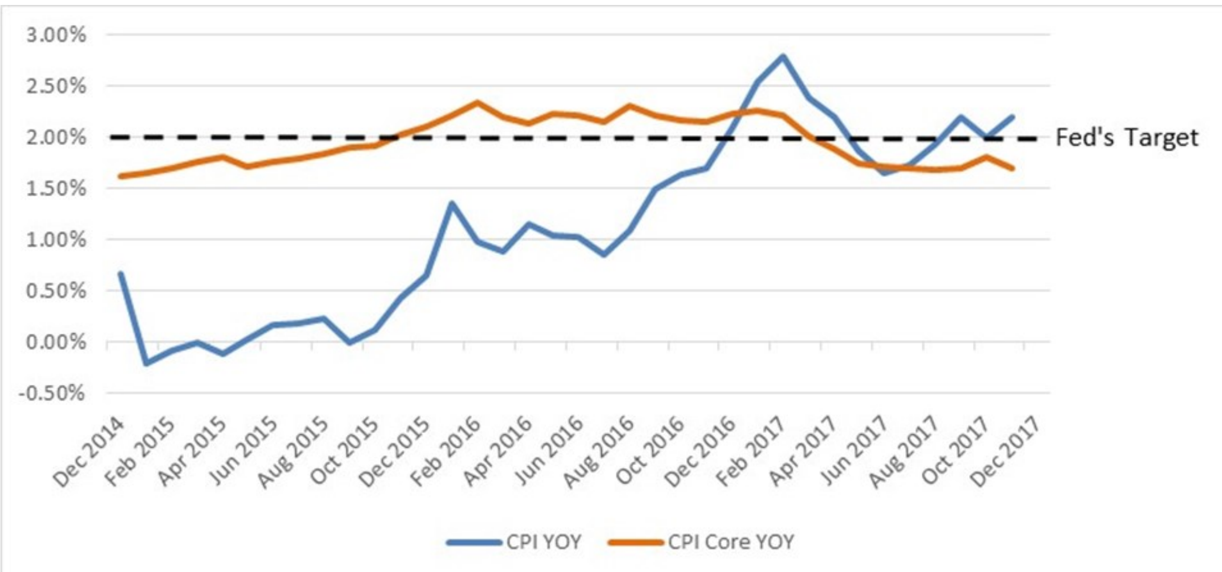
The non-farm payroll gains have been stronger over the last two months after slowing due to the hurricanes in September. The payroll gains in October and November were 244,000 and 228,000, respectively, after adding only 38,000 jobs in September. The unemployment rate declined further to 4.1% after fluctuating between 4.3% and 4.5% from March through August. The current rate of 4.1% compares favorably to 4.7% at the end of 2016. Average hourly earnings rose only +0.2% in November, 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 came back down from September's hurricane-induced rise. The 4-week moving average declined from 278,000 to 245,000 in late December. This is only slightly above the historically low levels seen in August before the hurricanes.



Inflation

Commodity prices were mixed for the quarter, with oil moving much higher. The Bloomberg Commodity Index was up close to +5%, with U.S. oil prices up over $8 a barrel to $60.40. Copper and cotton prices were up strongly while gold and silver were up slightly.

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 mostly higher over the last three months. The CPI was up +2.2% year-over-year, while Core CPI grew by +1.7% over the past year. The PPI has increased +3.1% over the past year, with Core PPI up +2.4% year-over-year. 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 moved higher, but is still below the Fed's target, with an overall year-over-year increase of 1.8% and a Core PCE deflator increase of +1.5%. In summary, inflation has moved higher this quarter, but is mostly below the Fed's target. The Federal Reserve is forecasting that inflation will move higher in 2018.

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 -0.7 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 +62 to +66 bps range for most of the fourth quarter until mid-December when spreads tightened 6 bps finishing 2017 at 59 bps. This move coincided with the Fed's announcement of their rate hike in December. Though interest rates are fairly low on a historical basis, mortgage loan refinancings have slowed to levels that have not been seen since the year 2000. The flatter U.S. Treasury curve may cause reduced demand from banks for longer duration assets such as lower coupon 30-year mortgage loans. The housing supply/demand mismatch continues 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.

The lack of market volatility is perplexing. The global QE impact seems to have lured markets into a low volatility/low yield equilibrium with investors reaching for higher yields while discounting the risks associated with such a move. Many investors envision the QE backstop as an insurance policy against higher rates and wider spreads reducing the possibility of long tail events that could send the market reeling.

We continue our defensive posture 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 value in the investment grade fixed income markets and hold an overweight of about 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. The portfolios are underweight technology and consumer non-cyclicals. 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 effect of the new tax policies, both of which could have an impact on specific industries and companies.

High Yield exhibited a small positive return during the quarter, supported by 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 was one of the best performing fixed income sectors in the 4th quarter and also performed very well for the year. We are slightly positive for EMD as the fundamentals for several countries have improved over the past year and global growth has strengthened. Our research continues to be focused on identifying key positive drivers for EM countries that could lead to future credit improvement. 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

The sun has certainly been shining over the past nine months for the global economy. The combination of stronger synchronized global growth, the new U.S. tax cuts, record high household wealth, and improved business regulatory environment has led us to revise our economic outlook, at least for the short-term. We are more positive on U.S. economic growth for the next nine-to-twelve months and believe U.S. economic growth will be closer to 3% over the next year, higher than the 2% to 2.5% that has been experienced from 2010 until early in 2017. We expect that consumer spending will benefit from the new tax cuts and should be one of the drivers of growth next year, particularly if wage growth accelerates. We expect business investment spending to increase in 2018 due to improved global growth and the large cuts in corporate tax rates. Global economic growth is more synchronized than it has been in many years, with Europe and Japan finally showing the improvement that has eluded these countries for several years. In addition, we expect China to have growth in the mid-single digits.

The Federal Reserve will most likely make three or four rate hikes in 2018. Our belief is in-line with the Fed's forecast for the number of hikes, but exceeds the two hikes that are currently priced into the market. The hikes will be the result of good growth, continued low unemployment, and inflation near the Fed's 2% target. With this underlying environment, we expect ten-year Treasury yields will most likely rise at least 30 to 50 bps from current levels. In our fixed income portfolios for Core, Core Plus, Emerging Markets Debt, and High Yield, we are positioning our interest rate duration to be shorter than their respective benchmarks.

We have gradually reduced risk in our fixed income portfolios over the past year. We believe returns will be in the low single digits for investment grade fixed income over the next year, with the potential for higher volatility. No sector 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 5.7%. The concern on our part is that spreads may not provide much cushion if sentiment turns negative or if rates rise 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.

For years, many people have been wanting changes to be made to generate higher growth rates. Well, you need to be careful what you wish for. This stronger growth will most likely lead to higher interest rates. In addition, the benefit of the personal tax cuts will fade over time as the current savings rate in the U.S. is at the lowest level since 2007. High government debt in the U.S. and in most developed countries and aging populations will constrain growth over the longer-term. The sun will most likely only shine in 2018 before moving behind some clouds in 2019. Enjoy the sun while you can, but invest cautiously.

SUMMARY

To summarize our outlook:

1. We are more positive on short-term U.S. economic growth than we have been in many years. We expect U.S. growth to be closer to 3.0% in 2018 – slightly better than the previous 7 years. The growth will come from capital investment and consumer spending, driven by the new tax cuts and better regulatory environment.
2. Credit spreads are narrow, but 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.
3. Although credit products could outperform Treasuries in 2018, we have reduced risk in our fixed income portfolios due to stretched valuations. Caution is still warranted over the longer-run.
4. The Federal Reserve will most likely raise the Funds Rate three or four times in 2018, which is more than what is currently priced into the market.
5. Inflation will rise in 2018 driven by stronger wage gains. Strong global competition, technology advances and demographics will keep prices from rising too much.
6. We expect interest rates to move higher in 2018 due to strong growth, higher inflation and increased debt issuance by the U.S. government.
7. Global growth is more synchronized than it has been in many years. Growth in Europe, China, and Japan should continue to be moderate in 2018.
8. Although growth should be moderate in 2018, higher interest rates and inflation may cause the long economic expansion to run out of steam in 2019.

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

For additional information please contact:

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