Fixed Income Market Review and Outlook

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Market Overview

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In July of last year, I discussed how calm the markets were and that it felt like an old horror movie where everything in a small-town neighborhood was calm right before a scary guy with a name like "Freddy" or "Jason" jumped out and wreaked havoc on unsuspecting teens. I mentioned at that time my thought that late in 2017 or early in 2018, there was a good chance that something was going to "jump out" and disrupt the financial markets. Well, after a great start for the equity markets in January, something did jump out and scare the financial markets in February. It started early in the month when the initial January Employment report showed higher wages than expected. This triggered a sell-off in intermediate and longer Treasuries. The higher rates put the equity markets on edge. Then, the markets became really spooked by the announcement of tariffs on specific items by President Trump, first on steel and aluminum, and additional items later. Equity markets sold off significantly and fixed income markets were unsure how to react; prices declined in February before rebounding in March. The calmness and low volatility of 2017 quickly disappeared, just as when "Freddy" jumped out and disrupted the lives of teens in the small town.

For the 1st quarter, the Bloomberg/Barclay's Capital Aggregate Index returned -1.46%. The Index was down approximately 2% before a flight to quality occurred in March due to concerns about the equity market. All investment grade sectors had negative returns, with investment grade corporates providing the worst return (-2.3%) while Treasuries and mortgages both posted returns of -1.2%. In other fixed income sectors, local currency Emerging Markets Debt (EMD) led the way. It was the only sector with a positive return, as the weakness of the US Dollar propelled the valuation of the asset class higher. In High Yield, prices declined, but held in better than expected given the weakness in the equity market over the last two months of the quarter.

The following tables show the returns for the various fixed income sectors and rating categories for the 1st quarter of 2018:

Sector	1st Quarter 2018 Return*
U.S. Treasuries	-1.2%
Agencies	-0.7%
MBS	-1.2%
Inv. Grade Corporates	-2.3%
High Yield	-0.9%
Emerging Markets Debt	-1.7%
EMD — Local	4.4%

Credit Rating	1st Quarter 2018 Return*
AAA	-1.2%
AA	-1.4%
A	-2.5%
BBB	-2.2%
BB	-1.6%
B	-0.6%
CCC	0.3%

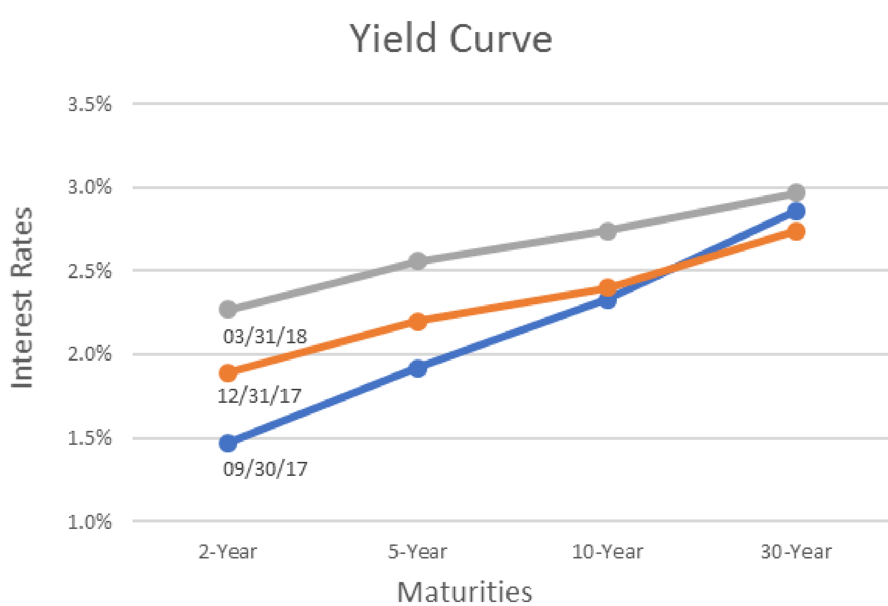
* Returns are from Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 3/31/2018.

Market Overview (Continued)

U.S. Treasuries

Treasury yields rose for all maturities during the quarter although the 30-year Treasury did not rise as much as other maturities. The Federal Reserve hiked the Funds Rate 25 bps in March, as expected, bringing the rate up to 1.50% - 1.75%; this was the first hike of 2018. Short rates rose in expectation of further hikes in 2018 while longer rates rose due to the outlook for higher inflation. Based on Treasury yields, the market is pricing in two more hikes in 2018. The Fed also continued its very measured process of unwinding its balance sheet.

In the 1st quarter, yields increased close to the same amount for 2-year, 5-year, and 10-year Treasuries, while longer maturities held in slightly better. The 2-year Treasury rose by 38 bps while the 5-year and 10-year Treasuries rose by 36 and 34 bps, respectively. In comparison, the 30-year yield rose by only 23 bps. The yield of the 2-year note closed at 2.27% while the 10-year Treasury finished at 2.74%. The 10-year yield closed at 2.94% on February 21, before yields came down later in the quarter due to weaker economic growth. This was the highest closing yield on the 10-year in over four years. Yields have risen significantly over the past six months, particularly in the front-end of the curve. Below is a chart that shows the yield curve as of the end of the last three quarters.



Spread Products

All spread products ended the quarter with negative returns, with some spread widening in high yield, emerging markets debt, and investment grade corporates. Higher volatility, lower equity prices, slightly weaker economic growth in some countries, and fear of a trade war led many investors to raise cash and take some risk off the table. Below is a table that shows spreads for investment grade corporates, high yield, and emerging markets debt as of year-end 2015, 2016, 2017, and the end of the first quarter of 2018:

Sector	12/31/2015	12/31/2016	12/31/2017	3/31/2018
Investment Grade Corporates	+172	+127	+96	+113
High Yield	+707	+442	+364	+370
Emerging Markets Debt	+415	+342	+285	+304

*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.

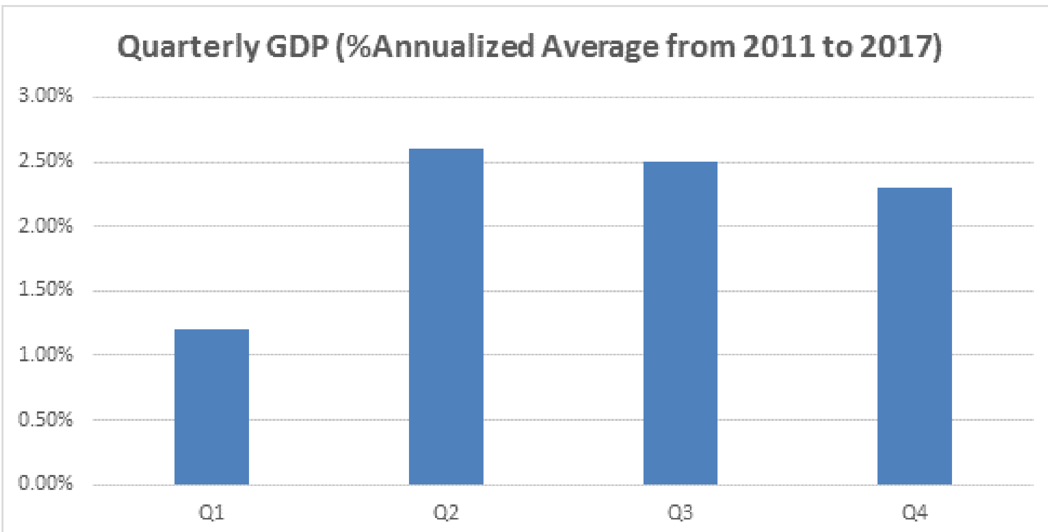
Investment grade corporates widened by 17 basis points during the 1st quarter to 113 basis points over Treasuries. Financials and Industrials performed slightly better than utilities while longer duration corporates had much weaker returns than shorter duration corporates. In mortgages, most sectors had similar performance of close to -1.2%, except that ABS declined less due to having shorter duration.

High Yield experienced a decline in prices during the quarter, but held in better than expected given the decline in equity prices and higher volatility over the last two months of the quarter. High yield spreads closed 6 basis points wider at 370 bps over Treasuries while the average high yield price declined by over 2 points and ended the quarter at $98.7. The current spread for high yield is much tighter than long-term averages, and the yield-to-worst rose by 47 bps to 6.19%, mostly due to higher Treasury yields. Default activity increased during the quarter, but remains at a low level. The twelve-month default rate was 2.2% at the end of March, up from 1.3% at the end of the year. This is much lower than the historical average of 3.7%, but it bears watching to see if the recent uptick continues.

U.S. Dollar Emerging Markets Debt spreads and yields rose during the quarter. Concerns over a possible trade war and higher U.S. interest rates combined to make investors more cautious on EMD denominated in U.S. dollars. Moderate economic growth for most EM countries, continued investor demand for non-U.S. assets, rising commodity prices, and the need for yield combined to provide some support for EMD. Yields for the asset class rose by 51 basis points to 5.78%. Local currency EMD was the stand-out performer in fixed income due to the weakness of the U.S. dollar. Local currency continues to be favored by investors, which is somewhat reminiscent of 2011 and 2012.

THE ECONOMY

First quarter U.S. economic growth appears to have slowed from a 2.9% growth rate in the fourth quarter. This was partly due to a “payback” for the strength in motor vehicle and building material sales later in 2017 for the replacement and reconstruction required due to the severe hurricanes. The first official estimate of GDP growth for the 1st quarter will be released on April 27th. 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 April 2nd, this model estimated growth of +2.8% in the 1st quarter. This could change significantly before the first official estimate is released near the end of April. Most estimates are in the range of 2.0% to 2.5%. It will be interesting to see if growth ends above 2% since growth has only averaged +1.2% in the 1st quarter over the past seven years, well below growth in each of the other three quarters. Below is a chart of average quarterly GDP growth over the past seven years.



Source: Thompson Reuters

Retail sales and consumer spending data were weaker to begin the year, which was surprising given the new tax cuts, high consumer confidence numbers, and strong labor market. As mentioned before, some of this weakness was due to a pullback in auto sales. Housing data were mixed, with weak housing starts and mediocre new homes sales. Housing prices were up +6.4% year-over-year as measured by the S&P/Case-Shiller Home Price Index. The combination of high home prices and higher mortgage rates could dampen housing activity in the near-term. Measures of manufacturing activity were mixed, but better overall than early in 2017.

The non-farm payroll gains have been stronger over the last several months after slowing due to the hurricanes in September. The payroll gains in January and February were 239,000 and 313,000, respectively. The unemployment rate remained steady at 4.1% and compares favorably to 4.7% at the end of 2016. Average hourly earnings rose only +0.1% in February, and the year-over-year gain inched higher to +2.6%. The Fed would like to see wages rise around +3% as an additional signal that inflation could move toward its 2% target. Initial jobless claims moved to the lowest level since 1973 and the lowest on record, if you adjust the data for population growth. The 4-week jobless claims moving average declined from 245,000 to 224,500 in late March.

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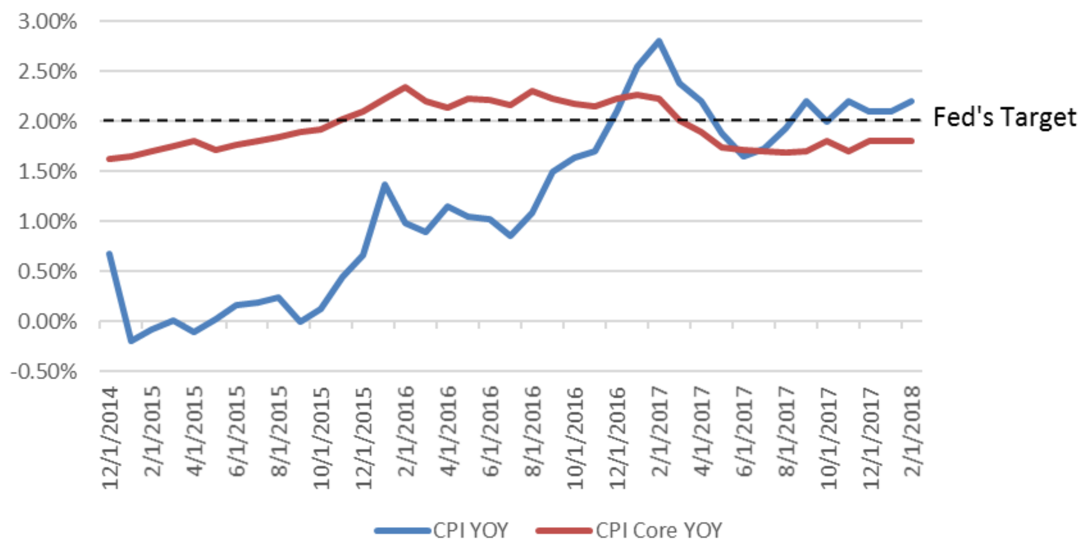
Inflation

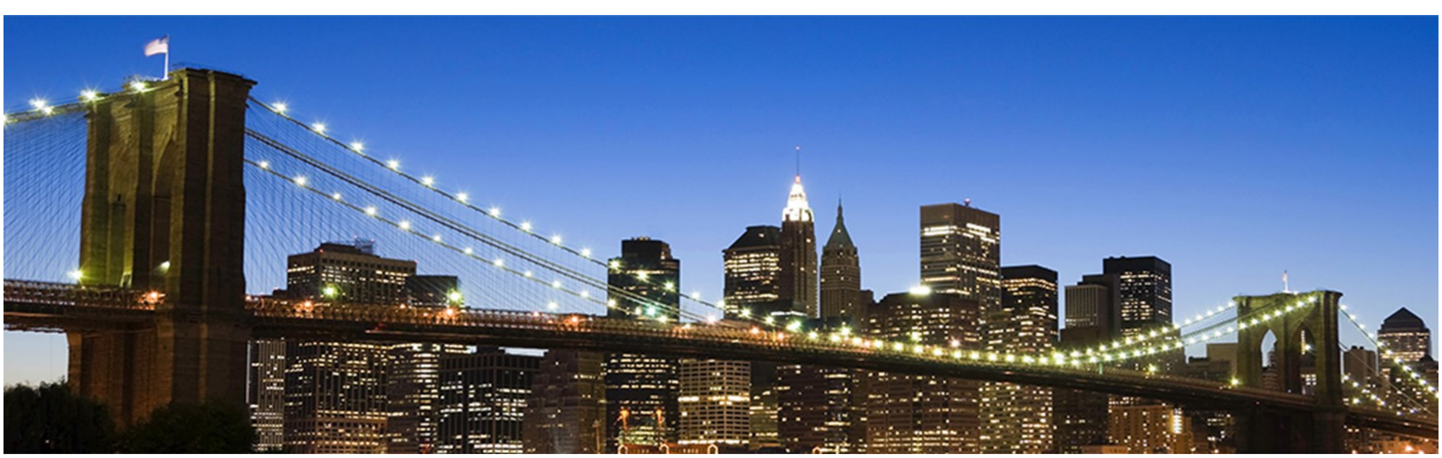
Commodity prices were mixed for the quarter, with oil moving higher. The Bloomberg Commodity Index was close to unchanged with U.S. oil prices up over $4 a barrel to $64.9. Copper and silver prices were down while corn and wheat were up.

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 slightly higher for several measures over the last three months. The CPI was up +2.2% year-over-year, while Core CPI grew by +1.8% over the past year. The PPI has increased +2.8% over the past year, with Core PPI up +2.5% year-over-year. Below is a chart that shows the CPI since the end of 2014. Of note, the Y-O-Y Core CPI has been very stable at either 1.7% or 1.8% for the last ten months.



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 +1.6%. 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 widened by 13 bps during the quarter as the result of the increased market volatility caused by inflation scares, tax cuts, rate hikes, and trade wars. Higher volatility is typically not beneficial to the mortgage market. The mortgage benchmark had lost 2% by mid-February, but recovered to a loss of only 1.2% by quarter-end. Refinancings remain muted and home prices are strong. 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.

We continue our defensive posture, with a benchmark-neutral mortgage coupon distribution and selective exposure to higher yielding, out-of-benchmark mortgage securities. Our overweight CMBS exposure is slowly declining through gradual paydowns 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. Although not cheap, 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 in 2017 as corporates performed well and spreads tightened significantly. 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, banking and consumer non-cyclicals. Regarding ratings, we are overweight BBB and AA-rated corporates and underweight AAA. 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 held in better than most fixed income sectors during the quarter, particularly given the declining equity prices over the last two months and the higher treasury yields. The small decline did not do much to make high yield attractive as spreads remain tight and yields do not provide much of a cushion if markets turn more negative. If equities decline further or if economic growth unexpectedly falters, high yield could decline more significantly. In our high yield portfolios, we are maintaining some liquidity, but we are selectively deploying cash as we find opportunities to add value in the long-term.

Emerging Markets Debt had divergent performance, with US Dollar EMD declining while local currency posted strong returns due to the weakness in the U.S. Dollar. For EMD, we are cautious in the near-term, but positive for the long-term as the fundamentals for several countries have improved over the past year and global growth has strengthened. Our research continues to focus 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 U.S. dollar sovereign valuations. In local currency, our main exposures are in Brazil, Mexico, Poland, Russia, and South Africa.

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The Look Forward

At first blush, it seems that a lot has changed from the end of 2017. But, when you look at the details, not much really has. Global economic growth is still fine, although slightly below expectations. Despite the scare on wages in early February, inflation both in the U.S. and abroad is still contained below most targets. Corporate earnings should be positive when they begin to be announced over the coming weeks and consumer confidence remains high. We believe the combination of synchronized global growth, the new U.S. tax cuts, strong U.S. household wealth, and improved business regulatory environment will continue to lead to economic growth between 2.5% and 3% over the next six-to-nine months. We expect that consumer spending will benefit from the new tax cuts and should rise moderately, particularly if wage growth accelerates. We also expect business investment spending to increase this year due to improved global growth and the large cuts in corporate tax rates.

Our best guess is that the Federal Reserve will most likely make three more rate hikes in 2018, taking the Funds Rate up to 2.25% to 2.50%. Our forecast of three more rate hikes exceeds the two rate hikes that are currently priced into the market. Any additional hikes will be the result of good growth, continued low unemployment, and inflation at or above the Fed's 2% target. With this underlying environment, we expect ten-year Treasury yields will rise modestly 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 did not make many significant changes to the portfolios in the first quarter, although we have reduced risk in our fixed income portfolios over the past year. We believe returns will be in the very low single digits for investment grade fixed income over the next year, with the potential for continued higher volatility. No sector looks particularly attractive, but some of the non-Treasury sectors could outperform Treasuries. Yields in emerging markets debt, high yield, and, to a lesser extent, investment grade corporates, are somewhat attractive compared to developed sovereign yields. High yield spreads are on the expensive side, but yields have moved above 6%. The concern on our part is that spreads do not provide much cushion if sentiment turns more 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.

We believe the current havoc in financial markets will subside somewhat over the next few months. However, we believe there is a chance that "Freddy" will come back for another sequel in 2019 and cause more disruption to financial markets. The additional rate hikes from the Federal Reserve and heavier Treasury supply will likely lead to higher rates, which would take a bite out of housing and auto sales. In addition, high government debt in the U.S. and in most developed countries, along with aging populations, will constrain growth over the medium and longer-term. Enjoy the calmer markets when they come back while you can, but invest cautiously.

SUMMARY

<u>To summarize our outlook:</u>

1. We believe growth will be between 2.5% and 3% over the last nine months of 2018. The growth will come from capital investment and consumer spending, partly driven by the new tax cuts and better regulatory environment.
2. Our base case is that the trade war will be settled with prolonged negotiations between the U.S. and various countries without meaningfully impacting global economic growth. However, there will be significant posturing on all sides for political purposes and a full-out trade war cannot be ruled out.
3. Despite widening in the 1st quarter, credit spreads are still narrow on a historical basis. However, we believe credit products, including investment grade corporates, high yield, and emerging markets debt, should provide better returns than Treasuries due to higher income and positive fundamentals.
4. 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.
5. The Federal Reserve will most likely raise the Funds Rate three more times in 2018. Three more moves would be more than what is currently priced into the market.
6. Inflation will rise further in 2018 driven by stronger wage gains and the weaker dollar. Strong global competition, technology advances and demographics will keep prices from rising much more than 2%.
7. We expect interest rates to move higher over the rest of 2018 due to higher inflation and increased debt issuance by the U.S. government.
8. 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.
9. Although growth should be moderate in 2018, the long economic expansion may run out of steam in 2019 partly due to higher rates.

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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