Fixed Income

Quarterly Market Commentary

First Quarter 2019

Quarterly Market Summary

- The Federal Open Market Committee (FOMC) pivoted to a more dovish stance in the first quarter, with Chairman Powell emphasizing a patient approach and signaling monetary policy is near neutral.
- At the March 20 meeting, the FOMC announced a reduction in the pace of quantitative tightening: balance sheet run-off will slow beginning in May and stop in September.
- Risk assets responded to the shift in policy stance, as investment grade credit spreads tightened each month of the first quarter. January produced the third-best month of excess returns for investment grade credit since 2010.
- Global economic growth continues to be an area of concern, as the International Monetary Fund cut its growth forecast three times in the last six months; the economic backdrop in the U.S. remains relatively healthy.
- Volatility subsided in the first quarter from the elevated levels in late 2018; trade policy, Eurozone economic growth, and a resolution to Brexit remain sources of potential volatility.

Duration Positioning	Neutral to slightly short	Maintaining a benchmark-like duration stance across strategies, with a modest underweight to the front-end maturities that are directly influenced by Fed policy.
Credit Sector	Modest Overweight	Overweights Financials and select BBB Industrials focused in maturities less than 5 years. Remaining underweight non-corporate credit.
Structured Product	Remain overweight, particularly in short-duration portfolios.	Asset-Backed Securities and Agency Mortgage-Backed Securities provide compelling longer-term risk/return characteristics.

First Quarter Sector Review

An increasingly dovish message from the Fed stoked risk appetites in the first quarter and helped reverse weak performance in the final months of 2018. U.S. Treasury yields have moved sharply lower over the last six months, as markets adjusted to a rapidly changing narrative from the Federal Reserve that suggested a likely end to the tightening cycle. Markets are becoming increasingly comfortable with moderate growth in the domestic economy, while the Fed attempts to avoid a late-cycle policy mistake that could negatively impact sentiment and growth.

Bloomberg Barclays Aggregate Bond Index Sector	Option-Adjusted Spread (OAS) (bps)	Excess Returns 3 Months	 YTD
U.S. Agency	13.00	0.20	0.20
U.S. Credit	113.00	2.52	2.52
Industrial	125.00	2.95	2.95
Utility	116.00	1.56	1.56
Financial Institutions	109.00	2.57	2.57
Non-Corporate Investment Grade	76.00	1.45	1.45
U.S. Mortgage Backed Securities	35.00	0.28	0.28
Asset-Backed Securities	39.00	0.40	0.40
CMBS: Erisa Eligible	69.00	1.18	1.18
U.S. Corporate High Yield	391.00	5.73	5.73

Source: Bloomberg Index Services Limited
See Important Disclosures at the end of this document for additional information.

The Bloomberg Barclays Aggregate Index produced a total return of 294 basis points (bps) during the quarter with spread sectors accounting for 84 bps of excess return, as all sector risk premiums compressed. U.S. Credit produced 252 bps of excess return during the period, as the option-adjusted spread (OAS) of the Bloomberg Barclays U.S. Aggregate Credit Index tightened by 30 bps. This snap back in investment grade spreads almost completely reversed the 280 bps of negative excess returns in 2018, which was the worst year for investment grade credit since 2011. It was a similar story in High Yield, which outperformed investment grade considerably, as the OAS of the Bloomberg Barclays U.S Corporate High Yield index declined by 135 bps, leading to an impressive 573 bps of positive excess return in the quarter. While trailing the robust returns of credit, Agency Mortgage-Backed (MBS) and Asset-Backed Securities (ABS) produced positive excess returns of 28 bps and 40 bps, respectively.

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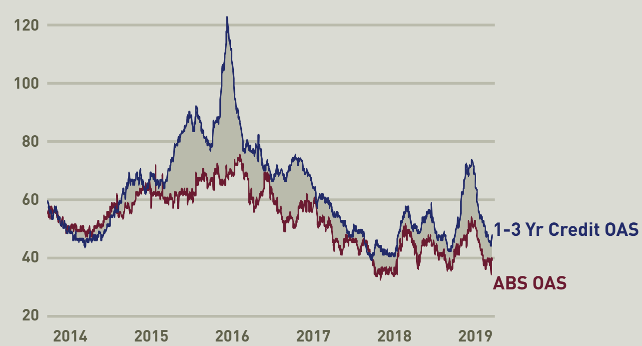
The tenuous tone in credit markets during the fourth quarter deteriorated further following the December 19 FOMC meeting, which brought the fifth consecutive quarterly hike in the policy rate. Following the decision, accommodative financial conditions tightened, as investors fretted that the the Fed was increasingly at risk of committing a policy error by becoming too restrictive. Just 16 days after the December meeting, Chairman Powell pivoted towards a much more patient stance on future policy decisions, which set the stage for a rally in risk assets.

While we believe the Fed's dovish pivot was the primary driver of the improved technical backdrop for credit, the fundamental story was a little more varied. Some modestly disappointing economic data in the U.S began to raise concerns about decelerating domestic growth, while concerns over global growth caused even more angst. Additionally, the relentless flattening of the U.S. Treasury curve, which culminated with a temporary inversion of the 3-month bill/10-year note spread at the end of quarter, raised anxiety levels further given the predictive nature of this recessionary indicator. Alternatively, in response to the growing apprehension of the credit quality of corporate debt, there was a renewed commitment from a handful of large BBB issuers to stabilize their credit profiles. Asset sales, dividend cuts, and debt repurchases were a common theme during the first quarter, as these companies looked to assuage investor (and rating agency) concerns that they were not moving aggressively enough to meet targeted leverage metrics.

Bloomberg Barclays 1-3 Year Credit Index OAS vs. Bloomberg Barclays U.S. Aggregate ABS OAS
(in bps)



Source: Bloomberg Index Services Limited
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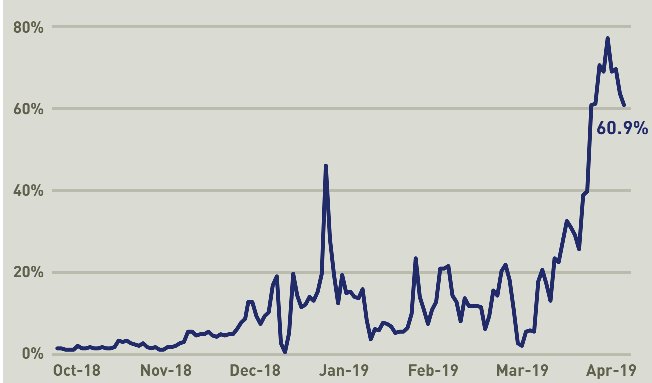
High-quality securitized assets (Agency MBS, ABS) provided positive excess returns, but they trailed Credit, largely as a result of the sectors' relative stability during the volatile fourth quarter. We believe the stability of these asset classes at this stage of the economic/credit cycle is particularly attractive in protecting portfolios from bouts of episodic volatility, such as what we've witnessed over the last several quarters. Consumer ABS fundamentals remain stable and continue to be aided by a strong labor market and steady economic growth. Valuations are undoubtedly rich based on historical measures, but with the relative spread pickup in credit contracting once again to recent lows, our preference is for AAA-rated structured products. In its March statement, the FOMC outlined plans to taper its balance sheet runoff beginning in May and conclude it in September. Subsequent paydowns on MBS holdings will be reinvested solely in U.S. Treasuries. The MBS market has remained resilient since the Fed began winding down its balance sheet in the fourth quarter of 2017. While prepayment risk could increase due to the level of interest rates, we believe the sector maintains attractive risk/return characteristics and we continue to increase portfolio allocations accordingly.

Focus on Monetary Policy: One Less Cook in the Kitchen?

The Fed's desire to remove itself from the lengthy list of potential sources of market volatility was clear throughout the first quarter. At both the January and March FOMC meetings, Powell reinforced a dovish message that emphasized patience and completely reversed the tightening bias that had been in place over the last couple of years. The market response was evident, not just in the robust performance of risk assets, but also in the rapid flattening of the yield curve, which resulted in inversions along short and intermediate maturities. Fed funds futures shifted to price in a greater than 50% probability of a rate cut by the end of 2019.

Probability of a Fed Rate Cut in 2019



Source: PNC Capital Advisors analysis, Bloomberg

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A primary concern for the Fed is a recent softening in inflationary pressures, with core personal consumption expenditure trending back below 2%. While average hourly earnings remain in a notable uptrend, broad inflation measures remain relatively subdued, despite the Fed's stated willingness to support "symmetry" around a 2% target. Oil prices firmed, but remain below fourth quarter 2018 peaks, and the break-even spread on 10-year Treasury Inflation-Protected Securities remains below 200 bps. Without a significant change in the economic backdrop, we expect the Fed will opt for a "time-out" and remain safely on the sidelines for the remainder of this year.

Outlook – Reset Button

By early April, risk markets generally recovered to levels consistent with the end of third quarter 2018, while oil prices and inflation-related measures remain lower. Yields across core European sovereigns and the U.S. are approximately 0.5% below levels six months ago due to the shift in policy guidance from the Fed and the European Central Bank. Many catalysts for potential volatility, such as trade, tariffs, and BREXIT, remain unresolved. Markets are becoming more sensitive to expectations for global economic growth, and flare-ups in geopolitical risks will likely be more impactful. As credit spreads again approach 100 bps, and given the low level of absolute yields, we are cautious about forward return expectations and seek to position client portfolios defensively. The commentary from our third quarter 2018 outlook bears repeating:

> *"Fundamentals are generally supportive of these lofty valuations, and there is little on the horizon to suggest the credit cycle will turn for the worse in the near term. Our concerns lie more as to whether we are being adequately compensated, should volatility return or investor demand for credit once again not meet supply. Therefore, we have taken advantage of the recent rally to lighten up on those credits that we feel do not compensate us for these risks."*

Within the structured product space, we maintain an overweight allocation to MBS and ABS in shorter styles and have reduced our underweight to MBS in core styles. We are finding increasingly attractive relative value opportunities in these sectors. Additionally, their defensive qualities are especially appealing given comparative spreads in other risk sectors, their suppressed volatility, and their superior risk/return characteristics.

Key Definitions

Basis point (bps):1 bps (basis point) is equal to 0.01%.

Indexes

The **Bloomberg Barclays U.S. Credit Index** measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market.

The **Bloomberg Barclays U.S. High Yield Index** covers the universe of fixed rate, non-investment grade debt. Canadian and SEC-registered global bonds of issuers in non-emerging countries are included. The index includes both corporate and non-corporate sectors.

The **Bloomberg Barclays U.S. Credit 1-3 Year Index Option Adjusted Spread (OAS)** calculates spreads between the computed OAS of the Bloomberg Barclays U.S. Credit 1-3 Year index and a spot Treasury curve. An OAS index is constructed using each constituent bond's OAS, weighted by market capitalization.

The **Bloomberg Barclays U.S. Aggregate Asset Backed Securities (ABS) Option Adjusted Spread (OAS)** calculates spreads between the computed OAS of the Bloomberg Barclays U.S. Aggregate ABS index and a spot Treasury curve. An OAS index is constructed using each constituent bond's OAS, weighted by market capitalization.

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