

Taxable Fixed Income Strategies

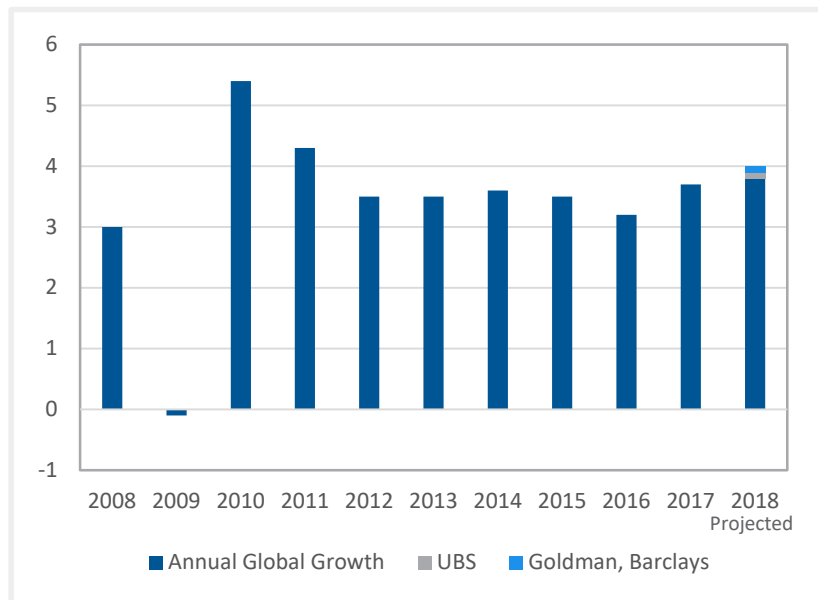
April 23, 2018



The first quarter was a bumpy ride for investors. After flying to all-time highs in January, stocks hit turbulence later in the period. Inflation risk and fears of Washington policy missteps changed the market's view on risk. Bonds became a safe haven in March, though higher rates resulted in negative quarterly returns.

The general economic picture is positive in the US and abroad. Real GDP growth (after inflation) in the US this year is projected between 2.5 to 3.0%, and global growth is about 4% (for the first time since 2010-11). Additionally, US unemployment is likely to fall below 4% this year, consumer and business confidence is strong, and financial conditions remain friendly to borrowers despite the rising Fed funds rate. Although the economic recovery has been long by historical standards, the economy does not show signs of overheating. Measures such as jobless claims, business surveys, and inflation readings indicate the recovery is not under stress.

GLOBAL ECONOMIC GROWTH (%)



Sources: IMF, UBS, Goldman Sachs, Barclays as of 3/31/18.

Jerome Powell assumed leadership of the Federal Reserve in February. His voting record as Governor and view as Chairperson indicate continuity in a "data dependent" approach to monetary policy. Chairman Powell has reiterated that the pace of normalization will be gradual and stated recently, "there's no sense in the data that we're on the cusp of an acceleration of inflation."¹ Continuity in policy means that as long as inflation is stable, there is no need to raise rates aggressively to slow the pace of economic growth.

Bond yields have risen this year. Stronger payrolls and wage data forced investors to take the Fed forecast of additional hikes seriously, and the 10-year Treasury yield has moved from 2.4% to a peak of 2.9% this quarter - a significant move for what has been a low-volatility environment. The bond market is fully priced for two more hikes in

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Market and Strategy Returns*

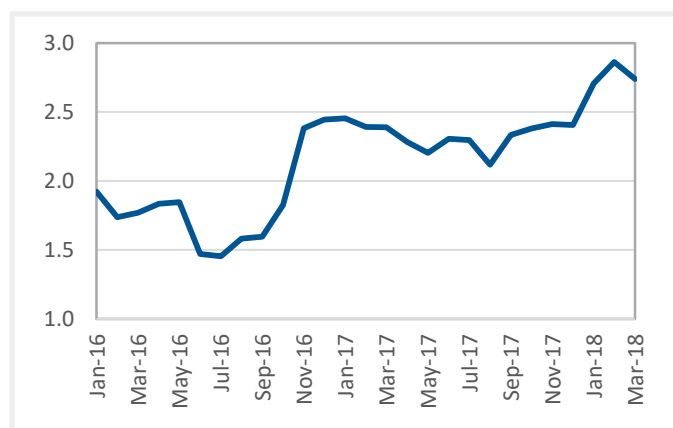
		1Q18
HGST	Gross	-0.09%
	Net	-0.13%
BBC US Gov/Cred 1-3Y		-0.20%
Ex BBB		-0.19%
HSCI	Gross	-0.89%
	Net	-0.97%
BBC Int. Agg		-1.05%
Ex. BBB/CMBS/ABS		-1.00%
Int Gov	Gross	-0.55%
	Net	-0.62%
BBC Int Gov		-0.73%
Corp 1-5	Gross	-0.91%
	Net	-0.97%
BBC 1-5 Corp		-0.80%
BBC Int. Treasury		-1.05%
BBC TIPS 1-10Y		-0.40%
BBC U.S. MBS		-1.19%
BBC Int. Corp		-1.50%
Industrials		-2.31%
Financials		-1.62%
BBC Muni 5 Year		-0.57%
ML High Yield		-0.94%
S&P 500		-0.76%

*Please see important disclosures at the end of this commentary for strategy and market definitions.
Sources: Bloomberg Barclays (BBC), Bloomberg as of March 31, 2018.

**Past performance is not a guarantee of future results.
Inherent in any investment is the potential for loss.**

2018, and provided the data stays strong, it sets up the Fed for continued hiking into 2019 and 2020. We believe this hiking will be gradual and in pace with current guidance.

RISING RATES: 10-YEAR TREASURY YIELD (%)



Source: Bloomberg.

Trade issues were a major force behind volatility in credit spreads and stocks during the quarter as the Trump administration established its protectionist agenda. So far this year, tariffs have been placed on washing machines, steel, and certain Chinese products. China has responded in kind. This appears to be a negotiating tactic as the US has granted a series of exemptions for some trading partners. Though tariffs announced so far are a small part of US GDP and unlikely to slow the economy, the impact could be felt more severely for certain companies and industries if negotiations fail and trade tensions escalate.

Portfolio Positioning

Treasury Inflation protected securities (TIPS) were among the best performing sectors this quarter. The macro economic picture supports this non-benchmark allocation, as the combination of strong labor markets, rising commodity prices, and fiscal stimulus are all inflationary. This isn't to say inflation is set to surge; rather TIPS valuations don't fully reflect this positive economic backdrop. We believe the main risk to TIPS is a deflationary scenario if the Fed funds rate becomes restrictive – an unlikely scenario given the Fed's current trajectory.

STRENGTHENING LABOR MARKET: WAGE GROWTH YEAR OVER YEAR (%)



Source: Bloomberg.

The same protectionist fears roiling the stock market affected corporates along with additional headwinds. Corporate underperformance in our view resulted from technical factors rather than fundamental. Due to tax law changes, US companies holding corporate bonds in overseas accounts sold their holdings to repatriate the cash at reduced tax rates. At the same time, currency and interest moves have made corporates slightly less attractive to foreign buyers. The recent spread widening prices-in the risk that these technical factors will persist.

Mortgage-backed securities (MBS) are a core holding in the strategy. We did not reinvest the pay downs on the assumption that corporates and TIPS would have superior excess returns, and have a modest underweight relative to the benchmark as a result. The large yield curve flattening seen this year makes MBS more attractive relative to corporates as there is less potential return from rolling down the yield curve. We prefer corporates at the moment, but MBS seem a likely destination once spreads narrow.

The higher volatility year to date provided opportunities to add value by rotating from overvalued to more attractive sectors. Our view that recession risks are low supports an overweight to corporate bonds, although we are likely to reduce the size of the position in coming quarters as each expected hike brings the end of the recovery closer. This is also a reason to trim back our TIPS allocation as higher short rates are likely to cause inflation expectations to fall. Our sectors of preference as the economic cycle turns are MBS, Treasuries, and tax-exempt municipals.

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Allocations presented herein are as of the date noted and subject to change. Returns reflect the reinvestment of income and other investment proceeds.

Composite Definitions:

- **High Grade Short Term (HGST)**
 - Definition: The High Grade Government/Credit Short Term Composite was created April 30, 2012. The Composite consists of all fully discretionary, fee paying separately managed accounts in the High Grade Government/Credit Short Term style. The strategy is a relative return focused mandate appropriate for investors with an 1-3 year investment horizon, seeking to maximize return with a lower degree of principal volatility than typical aggregate market strategies. The minimum account size for this composite is \$2.5 million.
 - Fees: Gross performance results do not reflect the deduction of management fees or other expenses. Net performance results, when shown, are calculated using the highest total fees and expenses currently charged to any US account, fund, or other investment vehicle using this strategy (collectively, the "accounts"), including management fees and all other expenses, but excluding custody fees. The actual management fee and expenses paid by an account may be higher or lower. The management fee schedule is as follows: 0.40% on the first \$10 million, 0.30% on the next \$10 million, and 0.25% thereafter. Additional information regarding the policies for calculating and reporting returns is available upon request.
- **Intermediate Government (Int Gov)**
 - Definition: The Intermediate Government (IG) Composite was created January 1, 2014. The Composite consists of all fully discretionary, fee paying separately managed accounts in the Intermediate Government style. The strategy is a relative return focused mandate appropriate for investors with an indefinite investment horizon desiring exposure to government supported credits. Benchmark: Barclays Intermediate Government Index. The minimum account size for this composite is \$500,000.00
 - Fees: Gross-of-fees returns are presented before model fees, but net of all actual fees which are trading expenses, custody fees, and withholding taxes. Net-of-fee returns, when shown, are net of model fees. Model fees are the highest advisory fee for an account in the composite. Model fees are deducted on a monthly basis. Actual fees incurred by clients may vary. The management fee schedule is as follows: 0.40% on the first \$10 million, 0.30% on the next \$10 million, and 0.25% thereafter. Additional information regarding the policies for calculating and reporting returns is available upon request.
- **High Grade Core Intermediate (HGCI)**
 - Definition: The High Grade Core Intermediate Composite was created September 30, 2005. The Composite consists of all fully discretionary, fee paying separately managed accounts in the High Grade Core Intermediate style. The High Grade Core Intermediate strategy is a relative return focused mandate appropriate for investors with an indefinite investment horizon, seeking to maximize return with a lower degree of principal volatility than typical aggregate market strategies. The minimum account size for this composite is \$2.5 million.
 - Fees: Gross performance results do not reflect the deduction of management fees or other expenses. Net performance results, when shown, are calculated using the highest total fees and expenses currently charged to any US account, fund, or other investment vehicle using this strategy (collectively, the "accounts"), including management fees and all other expenses, but excluding custody fees. The actual management fees and expenses paid by an account may be higher or lower. The management fee schedule is as follows: 0.40% on the first \$10 million, 0.30% on the next \$10 million, and 0.25% thereafter. Additional information regarding the policies for calculating and reporting returns is available upon request.
- **Corporate Index Replication (Corp 1-5)**
 - Definition: The High Grade Core Intermediate Composite was created September 30, 2005. The Composite consists of all fully discretionary, fee paying separately managed accounts in the High Grade Core Intermediate style. The High Grade Core Intermediate strategy is a relative return focused mandate appropriate for investors with an indefinite investment horizon, seeking to maximize return with a lower degree of principal volatility than typical aggregate market strategies. The minimum account size for this composite is \$2.5 million.
 - Fees: Gross performance results do not reflect the deduction of management fees or other expenses. Net performance results, when shown, are calculated using the highest total fees and expenses currently charged to any US account, fund, or other investment vehicle using this strategy (collectively, the "accounts"), including management fees and all other expenses, but excluding custody fees. The actual management fees and expenses paid by an account may be higher or lower. The management fee schedule is as follows: 0.40% on the first \$10 million, 0.30% on the next \$10 million, and 0.25% thereafter. Additional information regarding the policies for calculating and reporting returns is available upon request.

Sources:

¹<https://www.marketwatch.com/story/powell-expected-to-dismiss-hot-economy-talk-from-jamie-dimon-and-janet-yellen-2018-04-05>

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Index Definitions:

It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns and will bear the cost of fees and expenses that will reduce returns.

Bloomberg Barclays 1-3 Yr Gov/Credit is the 1-3 Yr component of the U.S. Government/Credit Index. The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. **Bloomberg Barclays 1-3 Yr Gov/Credit is the 1-3 Yr Ex BBB** is the 1-3 Yr component of the U.S. Government/Credit Index. The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. It excludes BBB securities. **Bloomberg Barclays Intermediate Aggregate Index** is the intermediate component of the US Aggregate Index. The Bloomberg Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. **The Bloomberg Barclays Intermediate Aggregate ex CMBS/ABS/BBB Index** is the intermediate component of the US Aggregate Index. The Bloomberg Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. The index excludes commercial mortgage backed securities (CMBS), asset backed securities (ABS), and BBB rated bonds. **Bloomberg Barclays U.S. Corporate Investment Grade Index** is a rules-based and market value weighted index of publicly issued U.S. corporate bonds. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds in the Index must have at least one year to final maturity regardless of call features and have at least \$250 million par amount outstanding. Bonds in the Index must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, must be dollar-denominated and non-convertible and must be publicly issued. **The Bloomberg Barclays 1-5 Corporate Index** is the 1-5 year component of the Corporate Index. **The Bloomberg Barclays Intermediate Corporate Index** is the Intermediate component of the Corporate Index.