Taxable Fixed Income Strategies

4Q 2016

FIERA CAPITAL

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Year in Review

This past year marked the return of volatility to markets as multiple political surprises intruded on an improving global economy. Interest rates started and finished the year essentially unchanged while stocks and other asset classes posted double digit returns. Returns in different sectors of the investment grade bond indices varied greatly, enabling nimble investors to respond to this challenging environment. With this landscape in mind, we believe our strategies performed well. Our performance was largely driven by our overweight to spread sectors. We remain positive on these sectors in 2017.

2016 stumbled out of the gate with Chinese stocks and oil prices in free fall. US stocks dropped nearly 10% between January and February but central banks rode to the rescue yet again. The Fed reversed course on plans to gradually hike rates, and central banks from China, Japan and Europe increased stimulus efforts. This brought calm that lasted until the surprise July decision by the British public to separate from the European Union (Brexit). The 10 year Treasury yield hit an all-time low of 1.4% in the immediate aftermath, but the panic proved short-lived. Global economic data improved, central banks maintained accommodative stances and markets avoided falling into a global recession. The last market moving event of 2016 was the election of Donald J. Trump as the 45th President of the United States. The immediate reaction has been increasing stock markets and Treasury yields as investors believe his policies are largely pro-growth and inflationary.

The US economic picture gained strength in the final months of 2016. Payroll gains continued for the 75th consecutive month, constituting the longest streak since the 1930s. Manufacturing activity and auto sales are also seeing increases. Corporate profits jumped, and inflation readings are continuing their steady progress as the labor market heals. Economists are forecasting 2017 GDP growth of 2.2% for 2017 versus 1.7% in 2016.

Market and Strategy Returns

		4Q16	2016
HGST	**Gross**	**-0.49%**	**1.26%**
	Net*	-0.58%	0.91%
BBC US Gov/Cred 1-3Y		-0.39%	1.28%
Ex BBB		-0.43%	1.05%
HGCI	**Gross**	**-2.34%**	**1.76%**
	Net*	-2.42%	1.40%
BBC Int. Agg		-2.05%	1.97%
Ex. BBB/CMBS/ABS		-2.06%	1.53%
Int Gov	**Gross**	**-2.27%**	**1.24%**
	Net*	-2.36%	0.89%
BBC Int Gov		-2.18%	1.05%
Corp 1-5	**Gross**	**3.55%**	**2.69%**
	Net*	2.91%	2.43%
BBC 1-5 Corp		3.31%	2.87%
BBC Int. Treasury		-2.25%	1.06%
BBC Int. TIPS		-1.47%	4.01%
BBC U.S. MBS		-1.97%	1.67%
BBC Int. Corp		-1.84%	4.04%
Industrials		-2.01%	4.64%
Financials		-1.52%	3.16%
BBC Muni 5 Year		-2.63%	-0.39%
ML High Yield		1.85%	17.34%
S&P 500		3.82%	11.96%

*Please see important disclosures at the end of this commentary.
Sources: Bloomberg Barclays (BBC), Bloomberg as of December 30, 2016.

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

Other large economies are seeing similar improvements. Better global data and rising commodity prices have greatly reduced the risk of deflation. The Federal Reserve finally raised its target rate in December, hiking only once in 2016.

Markets Now

Financial markets have traveled a great distance since the election. Stocks and the US dollar rose to recent highs. Interest rates rose across the US Treasury curve in a classic "bear steepener" – yields on all maturities moved higher with yields on longer maturities rising more than shorter ones. Inflation-indexed bonds outperformed traditional bonds while lower quality segments outperformed investment grade corporates. Markets have begun to look ahead of fundamentals, discounting accelerating growth and inflation.

President-elect Trump and the Republican Congress want to rewrite domestic and foreign policy. It is impossible to know the shape and size of these changes, but the general direction and overarching themes are already evident. Trump has proposed tax cuts, higher infrastructure spending and decreased regulation. The market moves we've seen since the election confirm investors believe these changes are likely to occur and are optimistic that policy changes could lead to higher growth.

What's Next

In order for interest rates to rise further, we believe more information is required about the details and timing of a possible fiscal stimulus. It is worth noting that although Republicans control Congress, they are not uniform in their views on how to pay for lower taxes/higher spending. It is possible that compromises will have to be made to reduce the size of tax cuts or spending to appease Republicans concerned about the size of the Federal debt. Infrastructure spending is necessary but likely to occur over a longer time-horizon (over the next several years) rather than to provide an immediate boost.

If we see a genuine shift from gridlock to unified government in Washington, it means investor views about Federal policy will play a much larger role over investment decisions in the years ahead. Corporate tax reform has bipartisan support and should make US companies more competitive. Changes around interest deductibility of debt will affect the entire sector and higher taxes on imported goods will impact industries differently. Protectionist trade policies in the form of tariffs and revoking agreements could prove inflationary. The new administration will have a number of appointments to the Federal Reserve Board which may alter the conduct of monetary policy. We are watching these shifts closely and will adjust portfolios accordingly.

Sector Positioning

After the post-election sell-off, the bond market is priced for the Fed to hike rates twice in 2017. We believe this is reasonable, if not slightly optimistic. Our view is that the steeper yield curve has discounted much of the reflationary effects of the new administration's policies. Just as was the case last year, it is difficult for the Fed to be too aggressive in hiking rates when its peers are still in easing mode. The interest rate differential between US and other countries means the US dollar will remain elevated, which is disinflationary and anti-growth. This argues for a slightly longer duration versus benchmarks.

This backdrop supports our preference for spread sectors. Our strategies have long been underweight government bonds in favor of sectors which have historically done well in periods of low growth. The overweight to corporate bonds has benefited as valuations are returning to pre-crisis levels. We have modestly reduced this overweight in favor of sectors we view as also undervalued.

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Yields on tax-exempt municipals rose higher during the quarter than Treasuries of similar maturity. The yield ratio of municipals to Treasuries rose substantially on the belief that a major tax overhaul would hurt the sector. We believe current valuations more than compensate investors for this risk. This was a drag on performance during the period and we were buyers as prices fell.

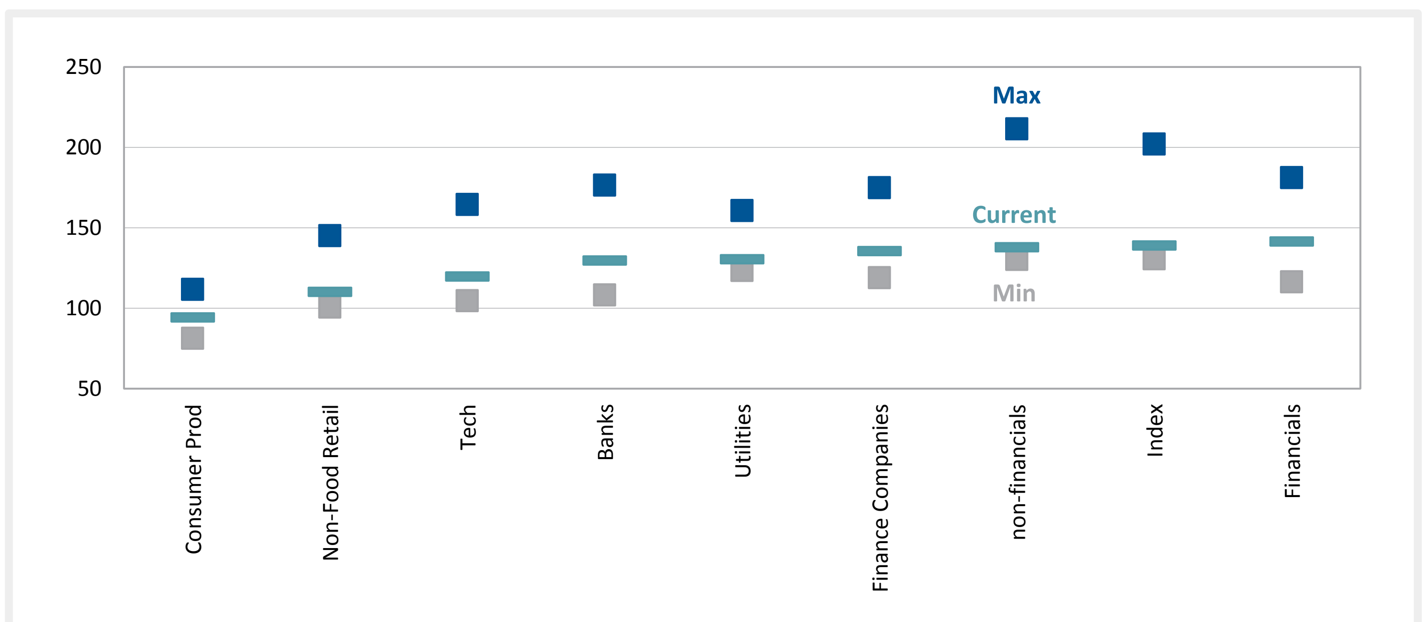
Another out-of-benchmark allocation is Treasury Inflation-Protected Securities (TIPS). We increased exposure modestly during the quarter. The market is now pricing 1.9% inflation annually over the next 10 years, compared to the Fed's 2% target. Our bias is to reduce TIPS in light of the surge in breakeven expectations since the election but policy pronouncements from Washington could change this view.

Our approach is tailored to clients seeking the diversification of the asset class while finding the attractive risk/return balance in high quality fixed income. Investors will likely be looking for confirmation that the bullish move in risk assets is warranted by actual policy. A failure to deliver either the size or timing of new stimulus will likely cause disappointment. Elections in Europe and details of Brexit also have the potential to curtail a sustained rally. In that light, bonds at current yields are an attractive entry point to counteract such risks.

Relative Value

2016 was a record year of new corporate supply. Despite this supply, corporate bonds generated significant excess returns, and spreads closed at year-to-date tight levels. Nonetheless, we see the 2017 macro environment supportive for corporate credit spreads. Fiscal policy should be positive for growth and inflation, which are drivers of corporate spread performance. Spreads widened early in 2016 due to the equity market sell-off, which was a panic and not fundamentally driven. We added to the sector during this sell-off and reduced exposure later in the year. Credit quality compression continued as higher beta names outperformed their higher quality peers. However, corporate spreads do still offer value at these levels. In fact, spreads are 20bps wider vs recent tights in mid-2014.

JP Morgan US Liquid Index (JULI) Benchmark Spread to Treasury, January 1 – December 31, 2016



Source: JP Morgan as of December 30, 2016.

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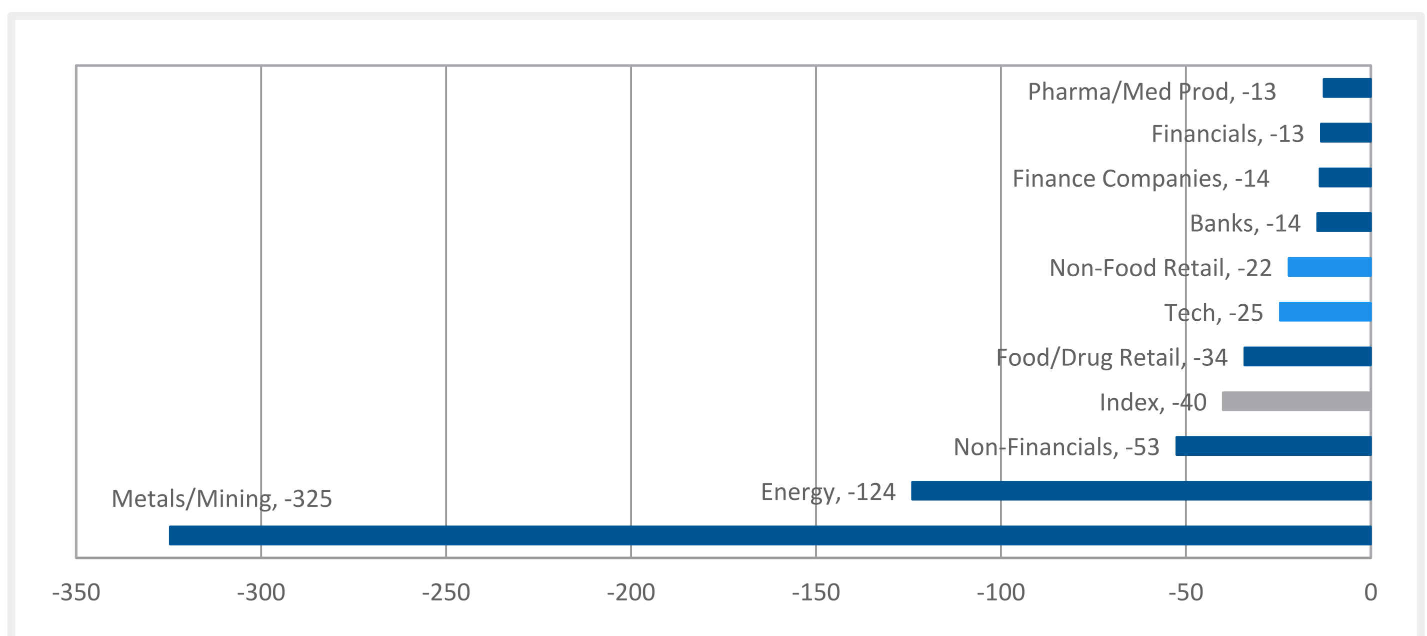
While we are positive on corporate spreads, we must acknowledge that an inflationary shock is a risk under the new administration, particularly as it relates to the border-adjustment tax. This would reverse our view of a slow grind tighter in spreads as corporates absorb anticipated rate increases. This could lead to a sell-off in spread product. We will watch policy developments closely.

These potential major policy changes will have dissimilar impacts on sectors. We have a positive stance on Financials, which we expect to benefit under the new policies. An improved regulatory environment that is less restrictive for banking business models should be positive for the sector and spreads. On the downside, near-term supply in financials, particularly as it relates to existing regulatory requirements, could weigh on spreads (though supply was well-received in 2016). Financials underperformed the broader investment grade index in 2016 as beta compression in commodity-related sectors lead the move tighter in spreads. We expect the financial-industrial basis may continue to compress in 2017. We are poised to take advantage of the current relative cheapness in the sector using those issuers with strong balance sheets and best-in-class business models.

We are less constructive on retail and technology sector spreads from both relative value and thematic perspectives. These sectors trade rich relative to the investment grade index. Market pricing may not offer enough compensation for the uncertainties the sectors face under the new administration. The early trading days of 2017 are already highlighting points of weakness in the retail sector, as reduced in-store consumer spending and potential tariffs are impacting corporate bond valuations. Although we do not tend to invest in the lower quality retailers that have made headlines, we are pulling back on the high quality retail names where the bottom line may be negatively impacted by the border-adjustment taxes. The dispersion between higher and lower rated investment grade retailers is notable, and potentially a sign of stress in the sector. The technology sector is similar in that increased costs related to imports may negatively impact profitability going forward, and that it trades rich relative to other sectors. We may begin to see the dispersion among quality buckets as we do in times of stress in other sectors.

JP Morgan US Liquid Index (JULI) Benchmark Spread Relative to Sector Indices, January 1 – December 31, 2016



Source: JP Morgan as of December 30, 2016.

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Corporate Credit Overview and Outlook

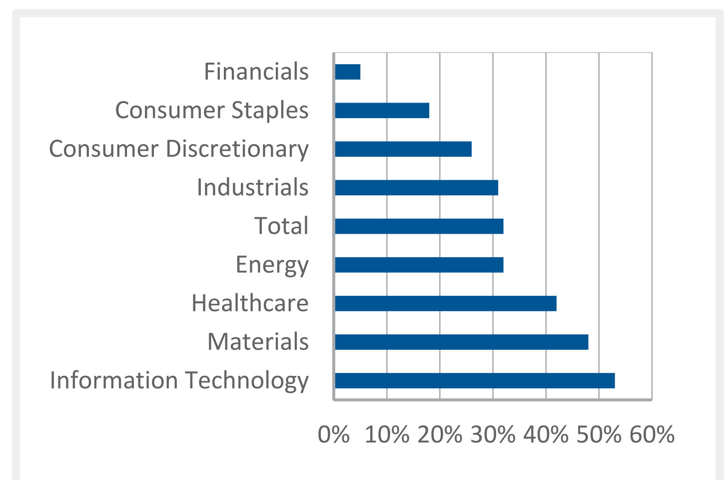
The new administration has ushered in great optimism for the economy and corporate credit, but also great risk that is largely immeasurable. The quarter was dominated by the Trump election news flow, with the immediate response to the election being one of optimism for corporate America. The prospect of corporate tax rate reduction, regulatory reform, increased fiscal spending, repatriation of foreign profits and the potential for immediate expensing of capital expenditures are being assessed against the potential for the loss of interest deductibility and the prospect of a border tax. The results of the proposals will create winners and losers across sectors, though it is still very early to tell what the ultimate package will look like. Additional risks to the credit markets in 2017 include political instability particularly with European elections, disruptive international trade measures, currency market volatility and rising funding costs. While the outlook for corporate credit is positive for 2017, the details and timing of policy implementation will likely drive performance.

Market appetite for risk played a key role in performance for 2016, with the widest trading sectors performing best. Cyclical sectors like energy and materials outperformed on the back of the higher beta rally and fundamental improvements. In the quarter, the Organization of the Petroleum Exporting Counties (OPEC) agreed to cut production by 1.2 million barrels per day to 32.7 million bpd effective January 1, 2017 through the end of the quarter, thus boosting energy prices. There were some non-OPEC members that also agreed to cut production, including Russia. This was the first cut by OPEC in over eight years and was at the higher end of the range. Iran was not included in the deal, nor were Libya and Nigeria, both of which have actually raised output since October and are allowed to keep increasing output.

We had a positive stance on US financials at the beginning of 2016. As the year played out, concerns about sustained low rates, European banks, energy market volatility and profitability weighed on the sector. Post the US election, sentiment shifted more favorably toward financials on regulatory reform, rising rates and a steepening yield curve. We entered 2017 with a positive stance on this front. On the regulatory front, while some regulatory relief will be welcomed, many bank management teams and investors agree that continued oversight of the sector is a positive as it creates a safer financial system. The long-anticipated final rules on bank regulatory debt requirements were announced, which was a positive development for sector spreads and issuance expectations as it grandfathers long term debt issued by banks on or before year end 2016.

Earnings momentum is expected to continue with the energy and financials sectors expected to be the main drivers of S&P growth in 2017. While many of the discussed policy measures could support earnings like corporate tax reform and infrastructure spending, measures such as the potential for a border import tax could be inflationary and bullish for the US dollar. The strengthening of the dollar may cause pressure for sectors with a large share of revenues abroad, such as the information technology sector and the healthcare sector.

Percent of S&P Revenues Earned Abroad



Source: Wells Fargo and Bloomberg as of the end of 3Q16.

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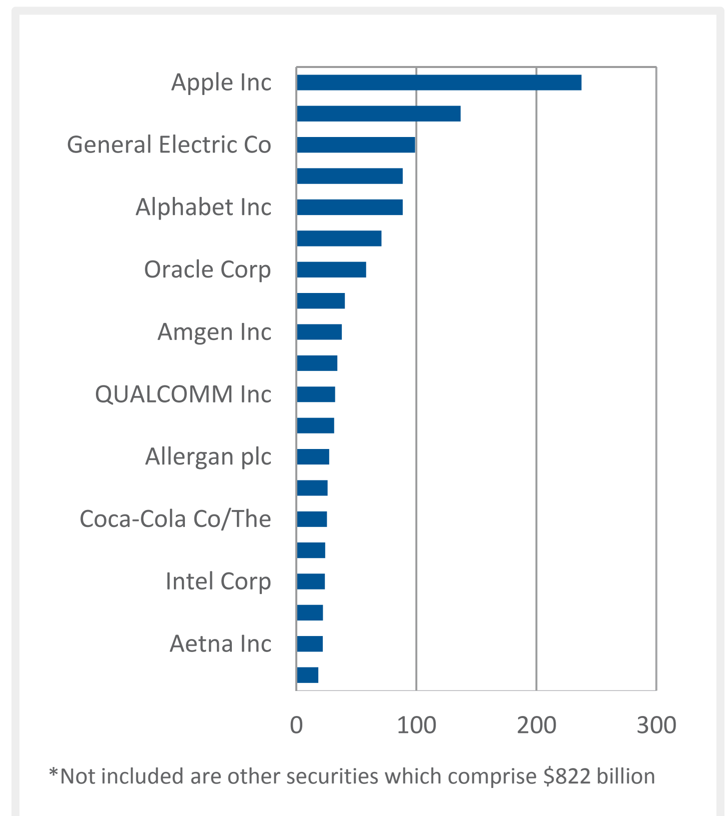
We see the following trends for the corporate credit market in 2017:

- Demand from foreign investors is expected to continue
- Corporate default rates are expected to decline
- Debt issuance in 2017 is expected to be slightly below 2016 levels largely due to higher yields, a smaller M&A pipeline and the potential for corporate tax repatriation

Issuance across the healthcare and consumer sectors is expected to be down versus the financial and telecom sectors which are expected to be up. S&P 500 companies excluding financials hold roughly $2 trillion in cash, with most of the holdings concentrated across the Information Technology and Healthcare sectors. The companies with the largest cash positions include: Apple, Microsoft, GE and Alphabet. These companies may be best positioned to benefit from cash repatriation. Though much of the cash is expected to go toward share buy-backs and M&A, some could be geared toward debt reduction, which would be positive for corporate credit.

S&P 500 Largest Cash Position (in billions)



Source: Bloomberg as of each company's most recent filing as of January 10, 2017.

Looking Ahead

We remain positive on credit and fixed income overall. At the same time, we note policy uncertainty is a dominant risk for markets in the immediate future. In that context, we will stay focused on the relative value disciplines that guide our strategies so we may deliver the diversification benefits of fixed income as an asset class in a risk-managed fashion.

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IMPORTANT DISCLOSURES

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Net returns are net of annual fees and expenses of 0.25% for Int Gov and Corp 1 – 5 and 0.35% for HGST and HGCI, relevant for accounts with $10 million in assets. Investors in certain classes may pay a higher fee, which would have the effect of reducing net returns.

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Certain information contained in this document may constitute "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," anticipate," "project," "estimate," "intend" "continue," or "believe" or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events or results or the actual performance of any strategy or market sector may differ materially from those reflected or contemplated in such forward- looking statements.

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Allocations presented herein are as of the date noted and subject to change.

Strategy Definitions:

- High Grade Short Term (HGST) – utilizes the same investment themes and sector rotation methodology as the Core Intermediate strategy but focuses on shorter maturities, limiting the interest rate risk.
- Intermediate Government (Int Gov) – emphasizes government quality bonds, but in a diversified approach that looks beyond Treasuries to include to pre-refunded municipals, Treasury Inflation-Protected Securities and U.S. dollar denominated sovereign-supported issuers.
- High Grade Core Intermediate (HGCI) – relative return focused versus the Barclays Capital Intermediate Aggregate Index, which offers diversification benefits comparable to the Aggregate Index, but with what we believe to be favorable risk/return metrics.
- Corporate Index Replication (Corp 1-5) – seeks to provide the return and risk profile of a selected benchmark with fewer securities through a separately managed account. This is designed for clients interested in a specific asset class, but wishing to avoid the premium/discount issues of exchanged traded funds.

Index Definitions:

- 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 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.
- 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 the 1-5 year component of the index.
- The Bloomberg Barclays Intermediate Corporate Index is the Intermediate component of the index.
- Bloomberg Barclays Intermediate Corporate Industrial Index is the Intermediate component of the Investment Grade Industrial Index. 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. Bonds in the Index must belong to the Industrial sector.
- Bloomberg Barclays Intermediate Corporate Financial Institutions Index is the Intermediate component of the Investment Grade Financial Institutions Index. 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. Bonds in the Index must belong to the Finance sector.
- Bloomberg Barclays 5 Year Municipal Index is the 5 Year component of the Municipal Bond Index. The Bloomberg Barclays Municipal Bond Index is a rules-based and market value weighted index engineered for the long-term tax-exempt bond market. 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. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of transaction of at least $75 million. The bonds must be fixed rate, have a double date after December 31, 1990, and must be at least one year from maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.
- Bloomberg Barclays US MBS is a component of the US Aggregate Index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates. In other words, each aggregate is a proxy for the outstanding pools for a given agency, program, issue year, and coupon. The index maturity and liquidity criteria are then applied to these aggregates to determine which qualify for inclusion in the index. About 600 of these generic aggregates meet the criteria. The aggregates included in the index are priced daily using a matrix pricing routine based on trader price quotations by agency, program, coupon, and degree of seasoning.
- The US Intermediate Treasury Index represent the intermediate securities of the U.S. Treasury Index, which represents public obligations of the U.S. Treasury with a remaining maturity of one year or more.
- The Bloomberg Barclays Intermediate TIPS Index consists of securities in the intermediate maturity range of the Inflation-Protection securities issued by the U.S. Treasury.
- The JPMorgan US Liquid Index, or JULI, provides performance comparisons and valuation metrics across a carefully defined universe of investment grade corporate bonds, tracking individual issuers, sectors and sub-sectors by their various ratings and maturities.
- Goldman Sachs Commodity Index (GSCI) is a composite index of commodity sector returns which represents a broadly diversified, unleveraged, long-only position in commodity futures.