Taxable Fixed Income Strategies

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FIERA CAPITAL

Jonathan E. Lewis
Chief Investment Officer

Brian Meaney, CFA
Vice President, Portfolio Manager, Fixed Income Investments

Miriam Legrand
Vice President, Corporate Credit, Fixed Income Investments

Lacey Greenwalt, CFA
Assistant Vice President, Portfolio Manager, Fixed Income Investments

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To start the year, stocks and bonds moved higher in price as investors found something to like in each asset class. Stock investors believing pro-growth policies are on the way bid up domestic and foreign indices. Bond yields stabilized as central banks reiterated their cautious approach to tightening rates as the political process to enact tax reform and infrastructure programs will be more drawn out than expected.

As fundamental investors, we look beyond Washington promises about new policy to the real economy. The data paints a positive picture and pre-dates the election. Housing statistics, industrial production and employment are reaching new highs. What is noteworthy is the global synchronization of positive data, with Europe, Japan and China demonstrating their own recovery. So-called "softer data" measuring consumer and business sentiment point to confidence that the economy should be able to move above 2% growth.

The Federal Reserve has taken note as well, raising the target interest rate to 0.75 to 1% at its March meeting. Fed members believe the economy is moving closer to its employment and inflation target and the gradual tightening of policy is warranted. Their forecast is for two more hikes this year, but that is contingent on the underlying data. Our theme that the Fed is raising rates from a very low base and at a measured pace is supportive of corporates and other sectors at the expense of government bonds remains intact.

Pro-growth policies are being prepared in Washington but a degree of caution is in order. Fiscal stimulus will be legislated by a fractious Congress rather than monetary stimulus coming from the central bank. There is the risk that changes could underwhelm expectations and the process could be messy and time consuming. Nevertheless Republicans are largely united in lowering tax rates and it stands to reason they will want to pass some form of legislation to provide President Trump the chance to fulfill a campaign promise before the mid-term elections. The great unknown is whether or not the Freedom Caucus will support the President's proposals. The Republicans may have a majority, but they are not united.

Market and Strategy Returns*

		1Q17
HGST	**Gross**	**0.46%**
	Net	0.37%
BBC US Gov/Cred 1-3Y		0.41%
Ex BBB		0.35%
HGCI	**Gross**	**0.84%**
	Net	0.75%
BBC Int. Agg		0.68%
Ex. BBB/CMBS/ABS		0.58%
Int Gov	**Gross**	**0.80%**
	Net	0.71%
BBC Int Gov		0.54%
Corp 1-5	**Gross**	**0.77%**
	Net	0.71%
BBC 1-5 Corp		0.94%
BBC Int. Treasury		0.54%
BBC Int. TIPS		-1.47%
BBC U.S. MBS		0.47%
BBC Int. Corp		1.16%
Industrials		1.17%
Financials		1.20%
BBC Muni 5 Year		1.90%
ML High Yield		2.71%
S&P 500		6.07%

*Please see important disclosures at the end of this commentary for strategy and market definitions. Sources: Bloomberg Barclays (BBC), Bloomberg as of March 31, 2017.

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

We are hopeful the recovery gains strength but we are not complacent. There is a meaningful probability that the new Administration will remain frustrated in its ability to implement its proposals. Another factor is that while falling unemployment should be cheered, other measures like under-unemployment, capacity utilization and productivity point to slack remaining. This means inflation may cause a modest rise in bond yields, but a bear market is unlikely. At this time, we are content to maintain slightly higher duration than benchmarks.

This macroeconomic backdrop supports overweight to corporate bonds. Our long-held view that corporations were improving their balance sheets and benefiting from easy financial conditions appears to be correct. Although valuations have richened, spreads to Treasuries remain above pre-crisis levels. We remain acutely aware that corporate bond spreads are at the tighter end of the trading range, so we will be particularly sensitive to changes in data, or policy that would impact spreads. Tax reform would be a positive for US companies who compete against foreign firms with much lower tax rates. Even without lower tax rates, we believe corporates are well-positioned to outperform other fixed asset classes. Earnings growth is the highest year over year on record since 2013. There could be winners and losers depending on specific policy ideas on overseas repatriation or import taxes, but it is too soon in the process to impact positioning.

Municipal securities were the best performing high quality sector during the quarter. Investors had become too negative post-election, as higher Treasury yields and tax reform considerations caused a wave of mutual fund redemptions and lower prices as a result. We maintained our non-benchmark allocation and exited when prices normalized. This is an example of finding under-valued sectors that index-focused managers overlook.

Another out of benchmark allocation is Treasury Inflation Protected Securities. We maintained modest exposure during the quarter. Inflation data has been rising slightly and firmer commodity prices should reduce deflationary risks. The market is pricing 1.9% inflation annually over the next 10 years, still below the Fed's 2% target. We noted that in previous Fed tightening cycles inflation-linked bonds outperformed nominal bonds. This has been the case since December 2015 and with the Fed moving gradually, TIPS should continue to perform well.

Agency mortgage-backed-securities are a core holding but we are likely to begin moving to slightly underweight relative to the index. Although the US housing market is improving, the Fed minutes indicate a desire to reduce their balance sheet perhaps by the end of the year. During the crisis, the Fed bought MBS to keep rates low and financial conditions accommodative. Now that the economy is improving, such emergency measures are no longer required. The Fed has not outlined its plans but care will be taken to minimize market impact. It is unlikely the Fed will outright sell its holdings, but rather allow them to mature or taper reinvestments.

Corporate Relative Value Discussion

Given our overweight to corporates, it is particularly important we review our case for credit:

The corporate bond market appears to remain healthy and has successfully managed to distribute a wave of issuance while maintaining tighter spread valuations – this is a technical positive for the market. The first quarter of 2017 was a period of record supply in the investment grade corporate bond market. Issuance reached nearly $400bn, surpassing the previous record in the first quarter of 2016. The front-loaded issuance was driven by the anticipation of tax reform and potential loss of interest deductibility, and the expected higher path of interest rates. The domestic banking, telecommunications and technology sectors were the largest issuers. The heightened supply was generally well-received by the market. Trading volumes were approximately $22bn per day or 14% higher in the first quarter of 2017

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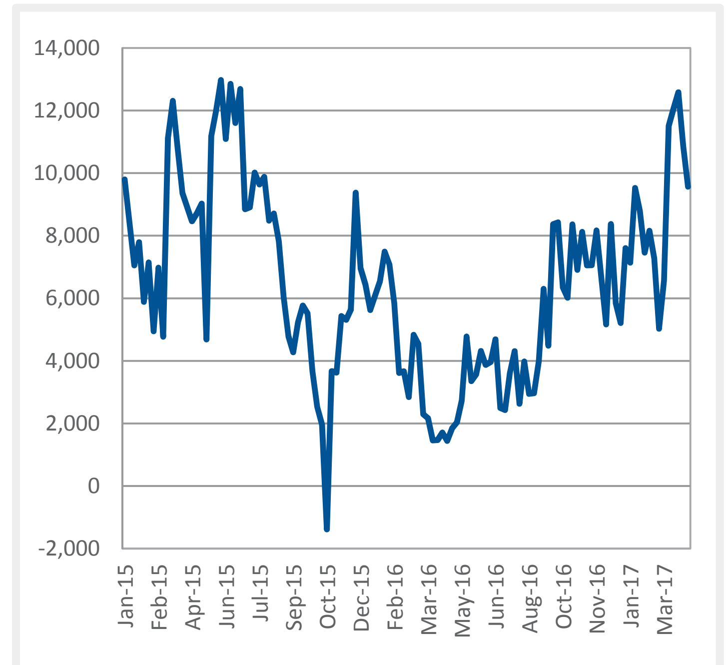
compared to the first quarter in 2016, which was an especially volatile period in the market. Dealer balance sheets grew throughout the first quarter, and reached levels not seen since 2015, led by shorter maturity bonds. Increased trading volume and larger dealer balance sheets are signs of good liquidity.

Macroeconomic and liquidity conditions remain supportive of current valuations: A sustained period of easy monetary policy has led to spread compression across sectors and across the quality spectrum. Spread compression over the past year created a primarily beta driven market. *However, drivers of spread performance in the current market environment are beginning to show signs of change. As we move toward a market driven by fiscal policy rather than monetary policy, we expect there will be clear beneficiaries (and victims) of new policies. We would anticipate outperformance to be driven by alpha, and are shifting away from those sectors and issuers that may be negatively impacted by changes to trade and tax policies.*

Dealer Balance Sheet: Inventories of Investment Grade Corporate Bonds with >13 months to Maturity



Source: Federal Reserve Bank of New York as of March 31, 2017.

Sector relative performance: There were notable sector trends in the first quarter. The retail sector, particularly the non-food retailers, underperformed meaningfully in the first quarter. Lower quality retailers fared the worst as disappointing sales, store closures and negative outlooks weighed on the sectors. REITS with elevated exposure to retailers also came under pressure. Certain high quality retailers remain relatively rich despite sector headwinds. The telecommunications sector underperformed during the quarter on corporate action related news. The other major sector underperformer was the automotive sector, as unexpectedly weak sales reports added to existing pressure on the sector from the anticipated negative consequences of tax reform. We remain cautious on the retail, telecommunication and automotive sectors despite the recent cheapening relative to the broader market.

Outside of retail, the spread and quality compression in the first two months of the quarter resulted in material outperformance of the higher beta commodities sectors. The metals and mining and oil-related sectors underperformed as oil price volatility rose in March. The higher beta commodity related sectors remained the largest source of alpha in the first quarter. We see value in the energy and commodity sectors, particularly in the higher quality names and in those issuers who are committed to deleveraging. The divergent performance periods in the quarter illustrate how quickly volatility can emerge in the contemporary market environment and we are cautious on sectors that may be susceptible to increased spread volatility as news on fiscal policy emerges and geopolitical events unfold abroad.

Forward Looking: Corporate spreads may trend tighter if the growth outlook continues to improve. Tax reform should be simulative for corporate issuers with high current tax rates, and encourage deleveraging. However, corporate leverage is high, and a disruption in growth or increased interest rate volatility may pressure the market and drive spreads wider.

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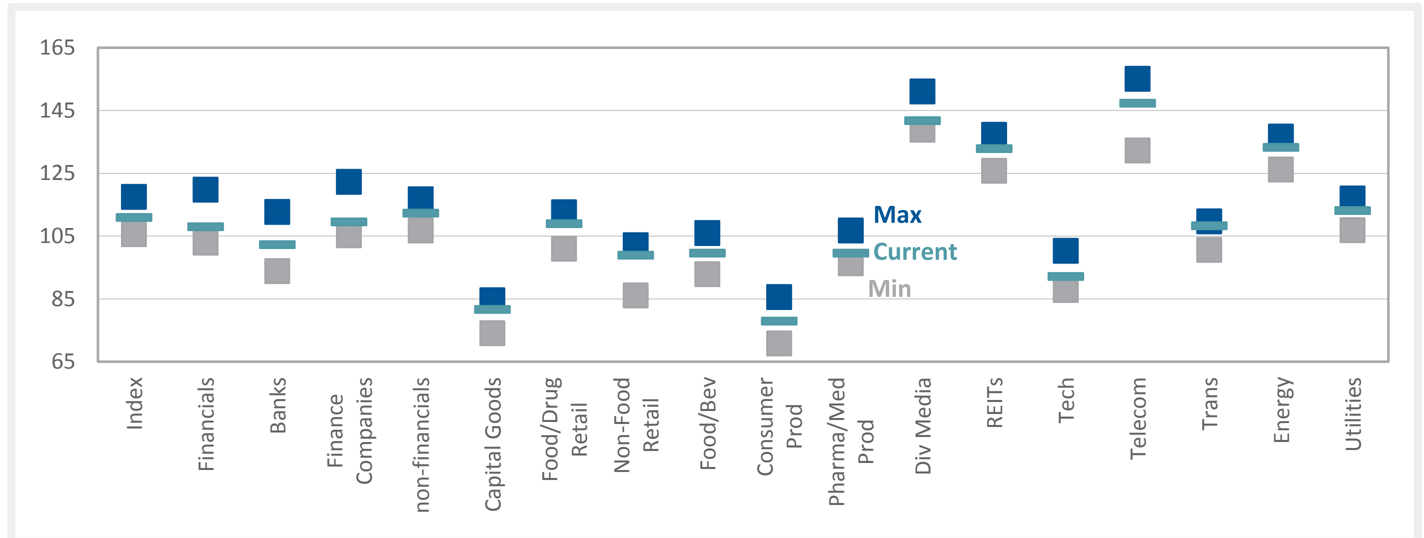
JP Morgan US Liquid Index (JULI) Benchmark Spread to Treasury, January 1 – March 31, 2017



Source: JP Morgan as of March 31, 2017.

Credit Close-up:

As the quarter began, the markets seemed to have high hopes for the Trump Administration, but as time progressed, the markets reduced the probability of successful new policy implementation. Hope was spurred by the potential for fiscal stimulus, infrastructure spending, and corporate tax reform providing a boost to the economy. But the initial healthcare reform proposal was unsuccessful and the focus on getting comprehensive tax reform completed in 2017 seems to be pushed further down the timeline. While there are concerns about the impact of healthcare reform on the market, investment grade credit issuers are less sensitive to many of these factors.

We have taken a negative view toward the telecom and retail sectors in 2017. The telecom sector has two of the largest non-financial issuers in the corporate markets. We see the risk of convergence between cable and wireless potentially leading to credit quality deterioration for these large issuers who hold massive balance sheets and may require large deal funding that could put pressure on the names. The convergence is being driven by secular changes in the industry where consumers are using most of their internet service outside of the traditional homes. Providers are faced with increase network upgrade costs with the need to build infrastructure to meet the demand for streaming services.

Additionally, the competitive environment in the wireless sector has resulted in the two largest players in the industry losing market share to the smaller players. This has resulted in the players announcing unlimited data plans, which could cause further earnings pressure. We expect to see consolidation play out in the sector in 2017.

In retail, although consumer macro indicators appears solid, secular pressure continues to be a major headwind. This is particularly evident in the department stores and apparels sub-sector. It is being driven by shifting consumer preferences, on-line competition and fast fashion trends. A concern during the first quarter was the prospect of

10 Largest Non-Financial Issuers

	Market Value [%]
AT&T INC	2.73
VERIZON COMMUNICATIONS INC	2.47
MICROSOFT CORP	2.41
APPLE INC	2.11
ANHEUSER-BUSCH INBEV FINANCE I	1.74
ORACLE CORP	1.60
COMCAST CORP	1.28
SHELL INTERNATIONAL FINANCE BV	1.28
GENERAL ELECTRIC CO	1.27
WAL-MART STORES INC	1.07

Source: Barclays as of March 31, 2017.

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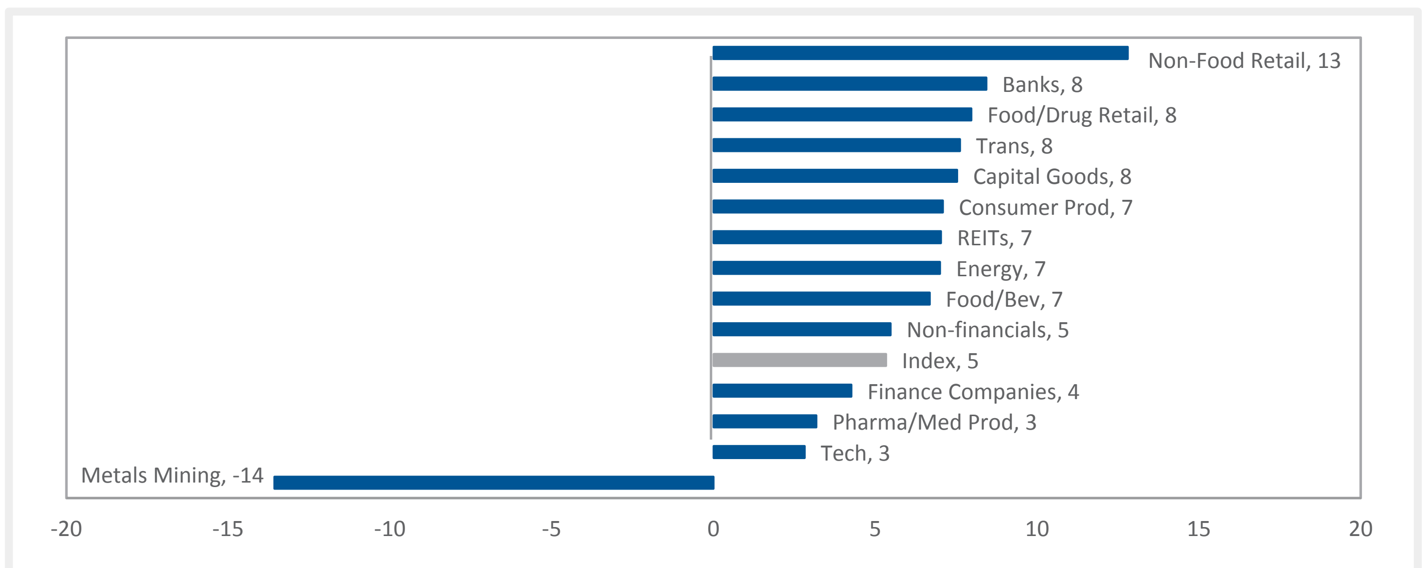
a border adjustment tax which could also weigh heavily on the sector. We see the ratings migration trending negatively for many of the retail issuers. We are more favorable on defensively positioned and highly rated retailers which includes the home improvement sub-sector where housing demand remains strong and discounters as consumers are more focused on value post the financial crisis.

Bank lending standards began to tighten as banks became more uncertain about the global macro environment and business investment spending began to slowdown. The weakness was mostly noted in the auto and consumer lending side. The auto sector has seen some pressure in the quarter driven by lower new car sales which seemingly peaked in 2016, loan and lease credit quality concerns and declining lease residual values. In general, the banks appear to be more cautious here. While we remain vigilant in assessing credit fundamentals across all sectors, the global political landscape continues to take center stage in driving market performance in 2017.

JP Morgan US Liquid Index (JULI) Benchmark Spread Relative to Sector Indices, January 1 – March 31, 2017



Source: JP Morgan as of March 31, 2017.

Outlook

Markets will look for more details on timing and scope of tax cuts, spending and deregulation in coming months. In this "wait and see" environment, we believe investors are best served by high quality bond portfolios that provide diversification benefits in case the economy or fiscal policy disappoints. We are particularly mindful that clients may look to our strategies as good diversifiers against riskier exposures as geopolitical tensions rise and the probability of domestic and foreign policy shocks grow. We will keep this role in the forefront of our thoughts as we strategize in the coming months.

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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:

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 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 is the 1-5 year component of the Corporate Index.
- The Bloomberg Barclays Intermediate Corporate Index is the Intermediate component of the Corporate 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.