2018 VOLATILITY REGIME CHANGE

SHORT VOL, LONG SPREAD "CARRY" THE YEAR 2017

SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

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The dominant themes in the second half of the year continued to be the lack of volatility (stock and bond volatility plumbed to record lows) and a loosening of financial conditions, which allowed the Federal Reserve (the Fed) to continue to raise the federal funds target. Exhibit 1 below is not remarkably different from our mid-year update on the capital markets as this low volatility, risk-market-friendly environment that drove returns over the first half of the year remained in force. The most notable difference was the lower total return numbers in the third and fourth quarters as the front end of the yield curve rose considerably, relative to the first half of the year. Despite these more muted total returns, excess returns were, for the most part, modestly better over the second half across the investment grade spread sectors as the narrative of a global synchronized growth acceleration began to gain broad acceptance. Corporate bonds, residential mortgage-backed securities (RMBS), and commercial mortgage-backed securities (CMBS) all saw their excess returns improve over Q3/Q4 relative to Q1/Q2; only asset-backed securities (ABS), the smallest of the investment grade spread sectors, saw a small downtick in excess return over the second half. Given that excess returns were positive across the board for the full year, performance in the investment grade space was driven by the degree to which portfolios were overweight the spread sectors. Exposure to the "plus" sectors, high yield (HY) bonds and emerging market (EM) debt, further enhanced relative performance, as these "plus" sectors enjoyed the best excess return over the full year.

EXHIBIT 1: RISK ASSETS RALLY AMIDST GLOBAL SYNCHRONIZED GROWTH NARRATIVE

	Q3 TOTAL RETURN	Q3 EXCESS RETURN	Q4 TOTAL RETURN	Q4 EXCESS RETURN	2017 TOTAL RETURN	2017 EXCESS RETURN
BB Aggregate	0.85	0.41	0.39	0.36	3.54	1.21
BB Treasury	0.38	n/a	0.05	n/a	2.31	n/a
BB Agency	0.82	0.45	0.06	0.21	2.98	1.48
BB RMBS	0.96	0.47	0.15	0.24	2.47	0.52
BB ABS	0.42	0.14	-0.01	0.24	1.55	0.92
BB CMBS	0.79	0.34	0.35	0.78	3.35	1.58
BB Corporate	1.34	0.87	1.17	0.99	6.42	3.46
BB High Yield Bonds	1.98	1.60	0.47	0.72	7.50	6.10
HY - Ba/B	1.89	1.50	0.38	0.62	6.92	5.45
HY - Ba	2.01	1.62	0.39	0.63	7.32	5.75
HY – B	1.75	1.38	0.36	0.61	6.49	5.14
HY – Caa	2.50	2.17	1.02	1.29	10.38	9.28
HY - Ca-D	1.24	1.96	0.80	1.14	13.76	12.95
BB Emerging Market	2.27	1.86	0.62	0.77	8.17	6.14
CS Instl Lev Loans	1.12	n/a	1.22	n/a	4.29	n/a
S&P 500®	4.48	n/a	6.64	n/a	21.82	n/a
Russell 2000®	5.67	n/a	3.33	n/a	14.63	n/a

Sources: Bloomberg, Bloomberg Barclays, Credit Suisse.

Past performance is not indicative of future results.

Central bank liquidity peaked in 2017 and the best performing strategies in 2017 revolved around carry, selling volatility, yield curve flattening, being short the dollar and long commodities as global synchronized growth gained traction. In the U.S., the economic data came in better than expected; however, the dichotomy between the soft data (implying a much higher growth rate) and the hard data (implying muddle along type growth) remained an issue. It will be interesting to see how the tax cuts passed at the end of December impact the economy through consumption and business capital investment.

While President Trump got off to a slow start legislatively in 2017, he finished the year on a bit of a roll as tax legislation passed after successfully rolling back significant amounts of regulation. He named Governor Jerome (Jay) Powell to succeed Janet Yellen; Randall Quarles was approved as Vice Chair of Supervision; and his nomination of Marvin Goodfriend (an advocate of employing negative interest rates during deep recessions) as a Fed governor is pending. President Trump will have the opportunity to appoint six of the seven members of the Board of Governors in his first two years in office.

Coming into 2018, the consensus was forming around “More of the Same” as the “Fear of Missing Out” coaxed more and more into the markets at valuation levels that are elevated in any historical context. From our vantage point, the most critical questions relate to central bank policy and the financial market’s response to any changes in global central bank policy. For the Fed, in addition to Jay Powell taking over for Janet Yellen as Fed Chair, we await who will replace Stanley Fischer as Vice Chairman, and who will be named to succeed Bill Dudley as President of the Federal Reserve Bank of New York. Will the European Central Bank (ECB) end its Quantitative Easing (QE) program in September? When will the Bank of Japan (BoJ) amend its Yield Curve Control strategy, and ultimately its bond buying and ETF purchase programs? Will China and the People’s Bank of China (PBoC) rein in their credit impulse and pursue actual deleveraging now that President Xi consolidated his power and had his legacy written into the Chinese constitution?

The biggest beneficiaries of this excess central bank liquidity have been the risk markets — equities, corporate and high yield bonds, EM debt, bank loans, and collateralized loan obligations (CLOs) — and as such, one must be cognizant of the second derivative effect as this liquidity is reduced and potentially withdrawn.

In addition to the aforementioned, how will the markets react to much less central bank liquidity — as the Fed reduces its balance sheet further until reaching a $50 billion a month “taper” pace in October, the ECB cut its bond buying in half starting in January with the potential end of QE in September, and the BoJ reduces its net purchases as long as the 10-year Japanese Government Bond (JGB) yield is around zero? The assumption is that as you remove indiscriminant central bank buyers, yields have nowhere to go but higher. This thesis is further supported in the U.S., in particular by the recently passed debt financed tax cuts, which will almost double the net supply of Treasuries to be issued in 2018. While this is true, the biggest beneficiaries of this excess central bank liquidity have been the risk markets — equities, corporate and high yield bonds, EM debt, bank loans, and collateralized loan obligations (CLOs) — and, as such, one must be cognizant of the second derivative effect as this liquidity is reduced and potentially withdrawn.

Other important questions relate to:

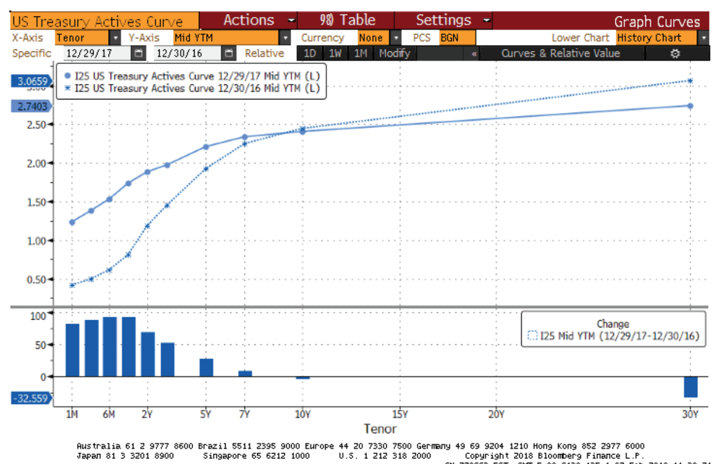
- Will the tax cuts impact corporate profits, share buybacks, capital spending and consumption?
- Will the incoming Fed Chairman be challenged early in his tenure like Bernanke, Greenspan, and Volcker?
- Will the U.S. economy expand at a 3% or higher growth rate, and if so, is that sustainable?
- Will an infrastructure plan be approved in the U.S. and, if so, how will it be financed?
- Will there be trade frictions with China and will NAFTA be renegotiated?
- Will the Democrats gain control of one or both chambers in the midterm elections in November?
- What happens to passive investments and ETFs when volatility reasserts itself and markets come under pressure?

In short, these represent just one subset of the many issues and questions investors need to focus on in 2018 and beyond.

YIELD CURVE GYRATIONS

Given the backdrop of a central bank tightening cycle, history informs us that a flatter yield curve is a fairly typical outcome. But there is no more perfect vision than hindsight and the movement of the yield curve turned out to be a bigger story than anticipated in 2017. Using the two-year and ten-year points as a curve proxy, this 2s/10s relationship flattened by 74 basis points (bps) over the full year; the first half saw about 34 bps of flattening while the second half experienced about 40 bps of flattening. Exhibit 2 below illustrates the change in the curve shape over the course of 2017. The initial impetus came from the Fed having delivered on its “dot plot” implied forecast of three rate hikes over the full calendar year in 2017 in addition to embarking on a balance sheet reduction plan as articulated over the summer. Throughout the balance of the post-financial crisis period, the Fed consistently failed to deliver on its implied forecasts for even modest (by historical standards) removal of excessive monetary policy accommodation. Both 2015 and 2016 saw the Fed imply the potential for three or even more rate hikes before delivering only one rate hike in each of those years. 2017 finally saw the Fed follow through to fulfill what was implied by the “dot plot” as announced in December 2016. This “dot plot” we keep referencing is a summary of likely rate hikes, as foreseen by each member of the Fed, and it informed the market that the “median” expectation for 2017 was three rate hikes.

EXHIBIT 2: TREASURY YIELD CURVE SHIFTS FLATTER IN 2017



Source: Bloomberg.

This was yet again an outlook that mirrored the prior two prior years, but given the Fed’s unwillingness to follow through historically, the market was unwilling to price in this anticipated tightening. Given that the Fed actually delivered these rate hikes, the yield curve needed to adjust for the higher target rate it refused to acknowledge at the start of the year.

What changed in 2017, unlike the prior years, was the ascendance of financial conditions; this was something we discussed in our prior Perspective published last summer. Bill Dudley, the President of the New York Regional Fed Bank, was an advocate of looking at broad financial conditions as an economist during his private sector tenure at Goldman Sachs. We surmise that it was Dudley's influence that steered the Fed to focus on this broader set of indicators that includes stock prices, Treasury yields, credit spreads, and a trade-weighted valuation of the dollar. By all measures, financial conditions had loosened considerably since the start of the tightening cycle at the end of 2015, thereby offering the Fed the opportunity to continue to hike rates throughout the calendar year. The Fed chose to pass on a September rate hike as it used that meeting to formally announce the commencement of the central bank's balance sheet reduction plan, a "tapering" of its reinvestment strategy that formally began in October. This "tapering" plan offered a slow, methodical, and gradual approach to reducing the size of the Fed's $4.5 trillion balance sheet.

By all measures, financial conditions had loosened considerably since the start of the tightening cycle at the end of 2015, thereby offering the Fed the opportunity to continue to hike rates throughout the calendar year.

An additional impetus for the curve flattening came from a shift in the Treasury's issuance plans, a funding shift that was announced in the fourth quarter and only added momentum to the yield curve flattening that was already underway as a result of the Fed's actions. Over the last decade, Treasury issuance has been done with the intent of lengthening the weighted average maturity (WAM) of the outstanding Treasury debt stock. By increasing the amount of longer maturity Treasuries since the financial crisis, the WAM of the debt stock has extended from 48 months at the end of 2008 to 70 months at the end of 2017. There was also considerable discussion, given this WAM extension backdrop, for the potential issuance of an ultra-long Treasury bond, where the current 30-year maximum maturity issuance could see a 40-year, 50-year, or even 100-year Treasury bond get added to the schedule of regularly issued maturities. This was seen as a win/win for the Treasury to lock in relatively low yields for an exceptionally long term as well as assist pension funds that require exceptionally long duration assets that match up with equally long liabilities. Much to our surprise, the November 1st refunding announcement reset the Treasury's issuance objective to WAM "stability" rather than WAM "extension." The bias towards longer Treasury issuance and WAM extension was formally suspended. The potential for an ultra-long Treasury bond was also disqualified for the time being, as the Treasury's borrowing advisory committee had expressed some reservations about the true natural demand for such long duration assets. This funding shift implicitly meant that, in proportional terms, issuance of short- to intermediate-term Treasuries would rise relative to longer term Treasury bonds, thereby imparting a flattening bias into the Treasury's issuance going forward.

In our mid-year Perspective, we also made note of the WAM extension, the potential for ultra-long Treasury bond issuance, as well as the Fed's balance sheet taper as factors likely to contribute to additional yield curve volatility. Much to our surprise, all outcomes were ultimately supportive of additional yield curve flattening. This was not a detractor from performance within our strategies as we were not positioned for a steeper yield curve. Instead it represented an opportunity cost whereby we failed to position accordingly to benefit from the reshaping of the curve in 2017. The second wave of this flattening trend in the fourth quarter was powerful and it progressed with very little reversal or pause. Said another way, it was essentially a one-way freight train. With the seasonal optimism that permeates every new calendar year, the bond market bear calls for higher rates will be front and center during the first quarter and potentially the first half of 2018. It's this higher rate backdrop that is likely to put pressure on the curve flattening further, as speculative positioning for higher rates typically focuses on ten-year or 30-year bonds. Our base case following the passage of the tax legislation, the promise of an infrastructure plan, and the resulting doubling of net Treasury issuance in 2018, calls for long rates to rise and retest critical technical levels and likely steepen the yield curve. Our secular view of "lower for longer" will be challenged in the short term but again our longer term view remains that the low in long-term rates is ahead of us (likely in the next recession) rather than behind us. We would view such a steepening move higher in rates as a potential opportunity to reconsider engaging in a curve flattening strategy, as we see significantly higher long-term rates as unsustainable, particularly in a global relative value framework that still sees the U.S. Treasury market as the high yielder amongst all other developed sovereign bond markets.

JAY POWELL — A KNOWN UNKNOWN

Jay Powell was sworn in as Fed chair at the beginning of February and the assumption is that he is a clone of Janet Yellen with a lighter regulatory touch. Powell has been a governor on the Federal Reserve Board since 2012 and has never dissented as a voter on the Federal Open Market Committee (FOMC), but it should be noted that it is rare for a Fed governor to dissent at all. Powell also lacks a Ph.D. (as a reminder, Alan Greenspan and Paul Volcker were not Ph.D.s) and is not an economist nor an academic. Powell is a Wall Street lawyer and, in addition to a career on Wall Street, served in the Treasury department in the early 1990s.

Considering the new Fed Chairman's Wall Street background leads us to posit that Chairman Powell is likely more market savvy/conscious than someone who came from academia or was a professional economic theoretician or prognosticator.

While it may be a safe assumption that Chairman Powell will continue the limited, gradual, and predictable rate hike policy of his predecessor, markets must consider the circumstances that he faces as he assumes the leadership of the Federal Reserve. Stock markets have soared since the election of Donald Trump, growth estimates are being raised following the passage of the tax legislation in December, the unemployment rate (4.1%) is indicating the economy is at or close to full employment, and the concern has shifted from deflation to inflation. Given that economic backdrop and considering the new Fed Chairman's Wall Street background leads us to posit that Chairman Powell is likely more market savvy/conscious than someone who came from academia or was a professional economic theoretician or prognosticator.

Our base case is that the strike price of the Powell put will be lower (Powell will allow the stock market to correct as long as it does not jeopardize financial stability, the financial system, and the global economy) than the Yellen, Bernanke, and Greenspan puts, given the elevated valuations and the parabolic nature of the rise in the stock market.

Why is this important? For starters, a market-savvy professional is very well aware that a market that goes up in a parabolic fashion can go down in that same parabolic way just as easily. To put the current stock market move in context, the S&P 500® is up 35.2% and the NASDAQ is up 44.7% since the election of President Trump through January 31, 2018. The pro-growth, pro-business agenda of President Trump has certainly energized animal spirits, along with business and consumer confidence, but the markets have gone so long without so much as a 5% peak-to-trough decline that there is increasing risk of a severe market correction. As such, Chairman Powell might want to see a market retracement to some degree with a stock market characterized by several measures (Cyclically Adjusted Price Earnings Multiple, Price-to-Sales, Price-to Book, Price-to-EBITDA, or Enterprise Value-to-EBITDA) being either in the top decile or very close to the top decile of market history. This may give rise to market concern about whether the "Fed put" can still be relied upon with each correction. Our base case is that the strike price of the Powell put will be lower (Powell will allow the stock market to correct as long as it does not jeopardize financial stability, the financial system, and the global economy) than the Yellen, Bernanke, and Greenspan puts, given the elevated valuations and the parabolic nature of the rise in the stock market.

It's too early to know how "Chairman" Powell may differ from "Governor" Powell, but he may have offered some insights into his views from previous statements. The full transcripts from the 2012 FOMC meetings were released recently following the usual five-year time lag and Governor Powell expressed serious reservations about Quantitative Easing (QE) and QE3, in particular. Per the transcripts, Powell offered this:

"I have concerns about more purchases. As others have pointed out, the dealer community is now assuming close to $4 trillion balance sheet and purchases through the first quarter of 2014. I admit that is a much stronger reaction than I anticipated and I am uncomfortable with it for a couple of reasons. First, the question is why stop at $4 trillion? The market in most cases will cheer us for doing more. It will never be enough for the market. Our models will always tell us that we are helping the economy, and I will probably always feel that those benefits are overestimated. And we will be able to tell ourselves that market function is impaired and that inflation expectations are under control. What is to stop us, other than much faster economic growth, which is probably not in our power to produce?"

He went on to say:

"I think that we are actually at a point of encouraging risk-taking and that should give us pause. Investors really do understand now that we will be there to prevent serious losses. It is not that it is easy for them to make money but they have every incentive to take more risk, and they are doing so."

Below are some other comments Powell made in 2012:

"I suspect that the channels that we are using now, which principally are asset prices, may not be working at all as well as our models say." (July 2012)

"On the list of potential costs, I would include inflation, the difficulty of exit, the risk of creating expectations we can't meet, the prospect of capital losses, market function, and the grab bag of stability issues." (July 2012)

"I'm concerned that the actions contemplated in this meeting are setting us on a path to a much larger balance sheet with likely benefits that are not commensurate to the risks that we're bearing… It will be difficult to get off that path unless we begin to prepare the markets starting with this meeting." (December 2012)

The financial markets will get their first glimpse into Chairmen Powell's views at the end of February when he offers his semi-annual Humphrey-Hawkins testimony before Congress and then his first press conference following the FOMC meeting on March 21st. While we expect Powell to play it right down the middle, we will be looking for any clues to the Chairman's views as it relates to financial conditions, financial stability, the reaction function of the Powell-led Federal Reserve, and the need for changing the Fed's policy framework.

A little over a year ago (January 2017), Powell offered a few interesting viewpoints on the Fed's job and the limitations of Fed power. Regarding the Fed's job, Powell reminded investors that, "If risk-taking does not threaten financial stability, it is not the Fed's job to stop people from losing (or making) money." Regarding the limitations of the Fed's power, he said "Ultimately, the only way to get sustainably higher interest rates is to improve the broader environment for growth by adopting policies designed to increase productivity and potential output over the long term, policies that are outside the scope of our work at the Federal Reserve." While it remains early to pass any conclusive judgment, our initial read is perhaps Chairman Powell will not be the Yellen clone everyone believes him to be and he may put the Fed on a path to taking monetary policy back from the financial markets and reversing a couple decades of overly accommodative policy that promotes boom/bust asset price cycles.

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FED MONETARY POLICY FRAMEWORK: A PREEMPTIVE CHALLENGE BY THE REGIONAL DOVES?

Regional Federal Reserve Bank presidents led by John Williams (San Francisco), Charles Evans (Chicago), and Eric Rosengren (Boston), along with former Fed Chairman Ben Bernanke and other former Fed officials, in an unprecedented move, may have launched what effectively amounts to a preemptive challenge to the incoming Federal Reserve Chairman before he was even sworn in by publicly advocating for a radical rethink of the Fed's policy framework. The options being advocated range from raising the inflation target (former Minneapolis Fed President Kocherlakota) to changing the inflation target to a range of 1-3% (Rosengren) to switching to a price level targeting (Williams, Evans, and Bernanke) or an even more aggressive nominal GDP targeting. While Chairman Powell has yet to weigh in on the matter, it seems presumptuous and potentially mutinous on the part of the regional Fed presidents and disrespectful and breaking with tradition on the part of the former Fed Chairman Bernanke.

Let's briefly review each of these options:

- **Raising the inflation target above 2%.** The Fed stated for the first time that it had a 2% inflation target in 2012 and since that time, the Core Personal Consumption Expenditure (the Fed's preferred inflation gauge) has been below the target for 68 of the 72 months with a 1.6% average over those six years. Common sense would dictate lowering rather than raising a target that has become so elusive in order to demonstrate that the Fed can actually hit its target. Moreover, raising the inflation target seems wholly inconsistent with other changes the Fed has made since formalizing the 2% target, such as lowering the potential growth rate of the economy, lowering Non-Accelerating Inflation Rate of Unemployment (NAIRU) as well as lowering the terminal federal funds rate estimate.
- **Switching to a range such as 1.5-3% from a fixed 2% inflation target.** This would give the Fed more flexibility, thereby justifying more accommodative policy when at the low end of the inflation range, while allowing the economy to run hot without having to remove accommodation when the inflation rate is above 2%.
- **Price level targeting** involves achieving the inflation target over a longer time frame. In other words, if the inflation rate ran at 1% for five years, the Fed would allow it to run at say 3% for five years, thereby averaging 2% over that time period.
- **Nominal GDP targeting** involves the Fed setting a goal for nominal GDP, which, unlike real GDP, is not adjusted for inflation. To calculate nominal GDP, one would add real GDP and inflation to arrive at nominal GDP. If real GDP was 2% and inflation was 4%, nominal GDP would equal 6%. However, switching to a nominal GDP target is problematic in that an economy with real GDP of 4% and inflation of 2% is very different from an economy with real GDP of 1% and inflation of 5%, yet both have a nominal GDP growth rate of 6%.

Powell has expressed concern that there are too many voices coming out of the Fed and he has also questioned the usefulness of the "dot plot" and its median forecast, in particular, as well as the accuracy of Fed models.

President Trump selected a sitting governor and colleague to succeed Janet Yellen who appears, by all accounts, to be respected by his FOMC members. So what could possibly be behind this initiative to preempt Chairman Powell and potentially radically alter the Fed's monetary policy framework? There are several plausible reasons starting with the fact that Powell is not a Ph.D. economist. Ph.D. economists dominate the Fed (9 of the 12 regional Fed presidents). In addition, as a Fed governor, Powell has expressed concern that there are too many voices coming out of the Fed and he has also questioned the usefulness of the "dot plot" and its median forecast, in particular, as well as the accuracy of Fed models. Although it is very difficult, if not impossible, to put that genie back in the bottle and have the Fed speak with a more unified voice, the regional presidents may be pushing back against Powell in case they are concerned that he may govern as a more dominant chairman in the mold of Alan Greenspan or Paul Volcker.

Another highly plausible reason may be that the model-driven, neoclassical monetary theoreticians dominating the Fed realize that as the economy approaches full employment, the Fed may have to normalize policy, and are attempting to move the goalposts by advocating for a radical policy framework change, thereby pushing out the inevitable bust that follows liquidity-driven booms. Financial markets once again have become overly dependent on higher and higher levels of debt and central bank-driven asset inflation that eventually results in asset bubbles, and the Fed, along with the rest of us, knows that asset prices and credit spreads are mean reverting and that the last two recessions were sparked by the asset price declines. By moving the goalposts again, the Fed is attempting to keep everyone dancing while the music is playing. In effect, the regional Fed presidents are trying to keep the music playing because—in this game of musical chairs—when the music stops there are no chairs left and the Fed-inspired boom-bust cycle is exposed once again.

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If this is a preemptive challenge, Chairman Powell will likely go along with having the Fed staff study these options as he establishes himself as Chairman, and by the time the studies are ready to be considered by the full FOMC, he will have established himself as Chairman, and the Board of Governors will likely have the imprimatur of Chairman Powell given the current slate of vacancies (it should be noted that San Francisco Fed President John Williams was interviewed for the Vice Chairman's vacancy, although he is not on the short list according to unnamed White House officials).

PORTFOLIO POSITIONING & OUTLOOK

Changes to institutional portfolio weightings over the second half of 2017 moved our strategic positioning in the primary spread sectors to a more defensive posture. Within the corporate credit sleeve, our positioning at the mid-year point was a slight overweight at 1.1x the benchmark weighting; this was essentially where our credit exposure began 2017. Over the second half of the year, we reduced this exposure to about 0.8x the benchmark weighting. In fact, portfolios reflected this underweight by the end of the third quarter and it was maintained through year end. Spreads within corporate credit stayed in relatively tight range all year, but the trend was consistently tighter. The Bloomberg Barclays Corporate Bond Index OAS (option-adjusted spread) began the year at +123 and never traded wider before ending the year at +93. Spreads were incrementally tighter each quarter of 2017. This spread is rich from a historical valuation standpoint over short- and intermediate-term intervals. The technical backdrop for investment grade credit remains relatively solid, although the consistent overnight bid from foreign investors has waned somewhat as currency hedging costs have risen. Fundamentally, the credit cycle peaked a few years ago, as issuers have only continued to leverage balance sheets to finance more shareholder-friendly initiatives such as buybacks and dividends. Overall, corporate leverage remains near its peak as the business cycle nears its latter stages. Typically, at this point of the cycle with profits near a peak, leverage is relatively far from its peak. For the coming year, should an environment of continued low volatility and further spread compression persist, we will likely lower spread risk within the corporate credit sleeve even further, preferring instead to position for an inevitable shift to more volatile markets that should improve the risk/reward profile. Having dry powder to be a liquidity provider in 2018 will likely offer more substantial alpha generating potential opportunities than just positioning for another year of carry and incrementally tighter spreads.

Overall, corporate leverage remains near its peak as the business cycle nears its latter stages.

Residential mortgage-backed securities (RMBS) exposure was essentially underweight the benchmark weighting for all of 2017. After starting the year at about 0.9x the benchmark weight, exposure was further reduced to a 0.6x weighting over the summer before rebounding slightly to end the year at 0.8x weighting. Valuations have been less than compelling for some time in RMBS, a consequence of the Fed's past QE initiatives and ongoing reinvestment, albeit at a slightly slower rate as a consequence of the balance sheet "taper" underway since October. Given the relatively rich valuations the sector still possesses, there should be more market anxiety as the Fed's "taper" intersects with greater supply this spring. The move to modestly higher rates at the onset of 2018, as well as a reduced pace of Fed buying, has proven to be modestly challenging to the RMBS market given the negative convexity of the sector, but again, the degree of widening thus far remains muted and not attractive enough to consider adding exposure. The advent of the 2018 housing market this spring will offer a more tangible opportunity to deploy capital when the cross currents of supply and the Fed's "taper" introduces volatility that has been sorely missed. When spreads adjust in the near/intermediate term, we are positioned to capitalize accordingly.

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Small overweights versus the benchmark persist within the smaller spread sectors, commercial mortgage-backed securities (CMBS), and asset-backed securities (ABS). CMBS exposure throughout most of 2017 stayed within a 4% to 5% range, in market value terms, while the ABS exposure was in a slightly wider 4% to 6% range. All this risk is high quality, essentially top-of-the-capital-structure-type risk that represents a "safe income at a reasonable price" strategy.

Our core plus mandates remain void of any strategic non-investment grade exposures. As illustrated in Exhibit 1, the high yield sector produced 610 bps of excess returns for the year, which thereby produced a formidable opportunity cost for our core plus mandates in 2017, particularly against peers positioned more aggressively (long HY) this year.

Similar to the investment grade credit sleeve, spreads remain rich and fundamentals have peaked. The driving force again remains a persistent technical bid in search of any incremental yield. The BB High Yield Index ended 2017 offering a 5.72% yield to worst and an OAS of +343, both levels that fail to offer ample reward for the risk being assumed.

The interest rate complex will get its usual increased scrutiny as the new calendar appears, because interest rates have nowhere to go but up, right? It's a tried and true ritual that appears annually and 2018 will be assisted by a doubling of net issuance as a result of the debt-financed tax cuts and the ongoing Fed balance sheet "taper," hence our expectation for a typically more challenging time in the rates market in the short term. As we emphasized over the summer, one never really knows whether the next 25 or even 50 bps is going to be higher or lower as short-term movements tend to be driven by positioning and psychology. Our base case is that the 10-year Treasury will remain range bound in a broader 2% to 3% band for the better part of 2018. As seen already over the past month, tax reform, a spending bill that lifts prior spending caps (sequestration), and talk about infrastructure investment has pressured rates higher to start the year, but our intermediate/ longer term view of "lower for longer" remains in place. These short-term rate spikes are a typical response to these fiscal stimulus measures, but the structural forces/headwinds we have written about over the years have not disappeared. Excessive debt and massive unfunded liabilities, long-term demographic trends, excess global capacity, and low productivity growth remain entrenched and serve as a governor to the economy's long term growth potential, and by extension a ceiling for long-term rates.

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INDEX DEFINITIONS

The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and nonagency).

The **Bloomberg Barclays U.S. CMBS Investment Grade Index** measures the market of US Agency and US Non-Agency conduit and fusion CMBS deals with a minimum current deal size of $300mn.

The **Bloomberg Barclays U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.

The **Bloomberg Barclays U.S. Corporate High Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt.

The **Bloomberg Barclays Emerging Markets USD Aggregate Index** is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers.

The **Bloomberg Barclays U.S. Government Bond Index** is comprised of the U.S. Treasury and U.S. Agency Indices. The index includes U.S. dollar-denominated, fixed-rate, nominal U.S. Treasuries and U.S. agency debentures (securities issued by U.S. government owned or government sponsored entities, and debt explicitly guaranteed by the U.S. government).

The **Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index** tracks agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The **Bloomberg Barclays U.S. Treasury Index** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting.

Credit Suisse Institutional Leveraged Loan Index is a subindex of the Credit Suisse Leveraged Loan Index which contains only institutional loan facilities priced above 90, excluding TL and TLa facilities and loans rated CC, C or in default. It is designed to more closely reflect the investment criteria of institutional investors.

The **Russell 2000® Index** is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies.

The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies.

The indexes are calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

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Basis point (bp): One basis point is equal to 1/100th of 1%, or 0.01%.

Option-adjusted spread (OAS): is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.

Yield to worst: The yield to worst on a bond represents the lowest potential yield that an investor would receive on a bond with embedded optionality if the issuer does not default. The yield to worst is calculated by making worst-case scenario assumptions on the issue by calculating the returns that would be received if provisions, including prepayment, call, or sinking fund, are used by the issuer.

All investments involve risk. Bonds offer a relatively stable level of income, although bond prices will fluctuate providing the potential for principal gain or loss. Intermediate term, higher-quality bonds generally offer less risk than longer-term bonds and a lower rate of return.

There is no guarantee a specific investing strategy will be successful. Individual investors are advised to consult with their investment professional about their specific financial needs and goals before making any investment decisions. Investment process, strategies and procedures detailed in this brochure are intended to be general guidelines, subject to market conditions and client-specific investment guidelines and restrictions, and are measured at the time of purchase. Seix Investment Advisors LLC may deviate from these guidelines if market conditions warrant, or if the investment professionals deem doing so would be in clients' best interests. Guidelines do not guarantee any reduction of risk or loss.