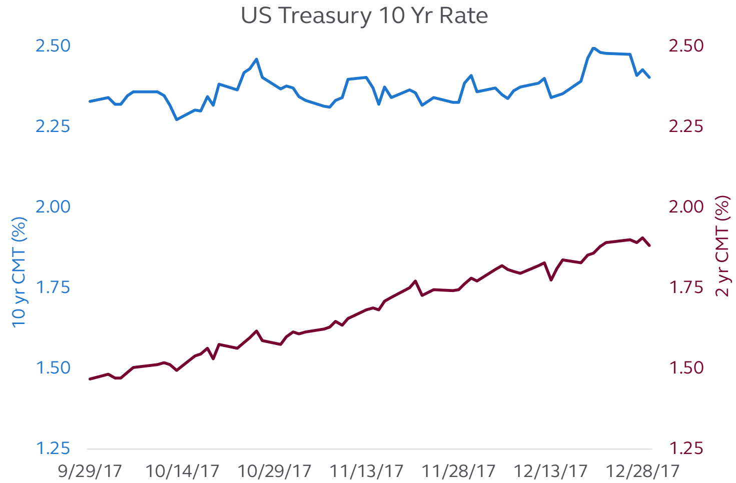
Highlights

The shape of the yield curve flattened as rates moved higher over the quarter. The 2-yr U.S. Treasury marched steadily higher to 1.88% at the quarter's end, its highest yield since October 2008 and an increase of 40 bps over the previous quarter end. The rise of longer rates was muted with the 10-yr U.S. Treasury increasing by 7 bps during the quarter to finish at 2.41%. Flattening of the curve was a trend during 2017; the spread between 2-yr and 10-yr U.S. Treasuries was 52 bps at the close of the year compared to 125 bps at start of the year.

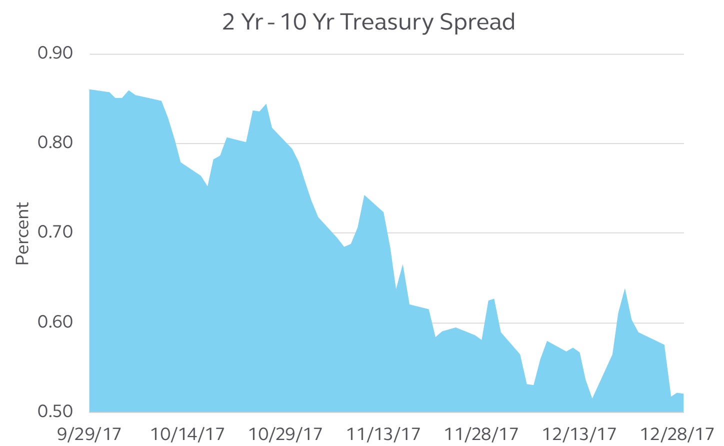
The increase in short rates reflects market expectations that the Fed will continue to normalize monetary policy. The Federal Open Market Committee (FOMC) has shown the desire to put space between current policy rates and 0%, regardless of whether core personal consumption expendicures index (PCE), its favored inflation measure, is running below the 2% target. The FOMC believes that below-target inflation is transitory; this coupled with continued solid economic performance, an optimistic employment picture and asset price inflation should offer the Fed more confidence in continuing to raise rates.

Outlook

We expect the FOMC to increase rates at least twice in 2018. Supply dynamics argue for upward pressure on rates, particularly on the short end, as a result of the Fed's balance sheet reduction and higher budget deficits. We expect a greater issuance of shorter maturities, particularly Treasury Bills, placing much of the supply pressure on the short end. Inflation readings will likely rebound, with the extent of the increase the key to long rates and potential curve steepening or continuation of the flattening trend.



Source: Bloomberg



Source: Bloomberg

Mark Kummerer, CFA
Sr. Portfolio Manager

Highlights

The Bloomberg Barclays Corporate Investment Grade Credit Index posted total returns of 1.17% for the 4th quarter and 6.42% for the year; excess returns relative to Treasuries were 0.99% and 3.46%, respectively, for the quarter and year. Spreads tightened 8 bps to end the year with an option-adjusted spread of 93 bps. The start of the 4th quarter continued the strong tightening trend exhibited in September supported by better than expected macro data, a positive earnings season, and strong flows into investment grade funds. During November, spreads widened as weakness in the high-yield market and renewed concerns about China hurt market sentiment. Exacerbating the spread widening was the heavy new issuance calendar during late October/early November. As has been the case all year, the widening was temporary and spreads rallied into year end.

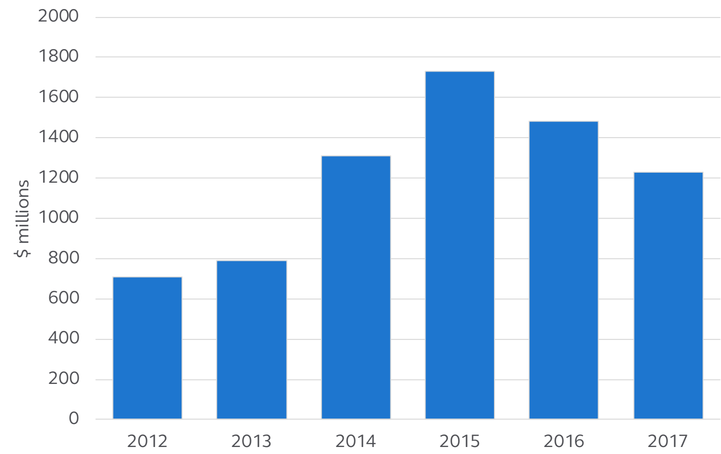
During the quarter, the Tax Cuts and Jobs Act was introduced, passed and finally signed. With the main impacts similar to the initial bills, we view the final tax law as a net positive to the investment grade corporate market. The expected incremental positive macro growth, higher equity market cushion, and potentially higher after-tax free cash flow expected from the law should all be positive; however, in most cases we do not expect a major change in the credit profiles based on the tax bill alone. Rather, fundamental changes to corporate behavior is the key to meaningful changes for any credit. Corporate balance sheets may be impacted in three ways based on the new tax law changes: 1) according to the latest Bank of America Merrill Lynch Risk Management Survey, company management teams maintain that debt paydown would be a key priority with the proceeds of any repatriated cash, therefore, the assumption that all cash would go to share repurchases is not necessarily true; 2) the limit on interest deductibility for highly leveraged companies may create a higher quality bias for corporate balance sheets; 3) lower corporate tax rates reduce the benefits of interest rate deductions. Areas that are potential "losers" in the bill include hospitals (repeal of Affordable Care Act mandate) and housing (lower value of the mortgage interest deduction), although the impact appears to be limited.

Outlook

With the passing of the tax reform bill, we are more confident in the extension of the credit cycle and hence continue to be constructive on credit risk. We believe that the largest risk to an otherwise positive risk environment is meaningful change to foreign investor demand. Consistent with this late stage in the cycle and with high valuations resulting in spreads at historical tights, we expect credit/sector selection to be a larger source of excess return in 2018.

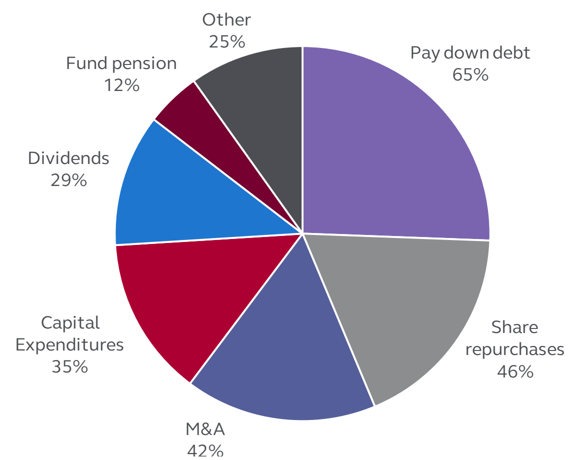
For 2018, we expect a resurgence of merger and acquisition (M&A) activity as greater confidence in the economy and the uncertainty of policy lifting provides a conducive transactional environment. After peaking in 2015, large M&A (transaction value greater than $2B) have declined. The credit impact is both fundamental and technical, meaning credit metrics may weaken and more debt needs to be issued. The ability to navigate event risk will be an important source of excess return generation for 2018.

North America and Western Europe M&A Deal Volumes (>$2B in value)



Source: Bloomberg

How would the proceeds of repatriated earnings be used?



Source: BofA Merrill Lynch Corporate Risk Management Survey, July 2017

Dan Kang, CFA
Head of Credit

Mortgage-Backed Securities (MBS)

Highlights

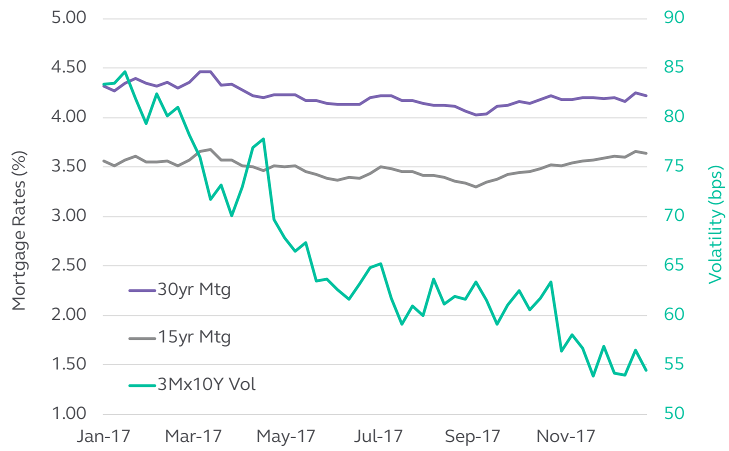
The Bloomberg Barclays U.S. Agency MBS Index posted total returns of 0.15% for the 4th quarter and 2.47% for the year. Excess returns were modest at 0.24% and 0.52%, respectively, for the quarter and year as the yield advantage offset a modest widening in spreads. Mortgage rates remained rangebound and volatility declined to historical lows, providing a benign prepayment and carry environment.

Gross Agency MBS issuance totaled $337B during the 4th quarter, bringing the 2017 total to $1.3T. 30 yr paper accounted for all net issuance ($81B/$314B for the quarter/year), as the outstanding balance of shorter MBS (10/15/20yr/ARMs) contracted by $31B over the year.

Despite tight nominal spreads, Agency MBS drew strong demand from banks and overseas investors as the global search for yield continued. Coupled with strong buying from REITs and domestic money managers, aggregate demand for MBS exceeded $300B, easily absorbing net supply for the year. The Federal Reserve (Fed) still owns around 30% of all MBS outstanding.

The appointment of Jay Powell as Fed Chair over of one of the more hawkish candidates (Warsh/Taylor) reassured markets that the Fed's policy course would not deviate significantly from that outlined by Chairwoman Yellen. The FOMC began executing its well telegraphed balance sheet reduction program in October, allowing $4B/month in MBS paydowns to run off its books. The FOMC December rate hike had little impact on the MBS market.

Volatility



Source: Bloomberg

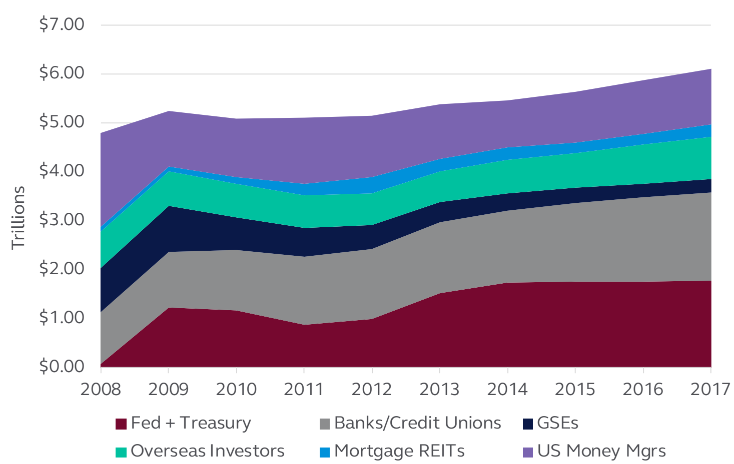
Outlook

The supportive supply technicals that have kept MBS spreads anchored at historically tight levels are expected to weaken in the 2nd and 3rd quarters of 2018 as mortgage purchase origination rebounds into the spring and summer months while Fed runoff ramps up. Supply from the Fed is expected to generate $150-$160B in incremental net supply to private investors in 2018 in addition to the $300B of originator supply. The tax law changes limiting property tax and mortgage interest deductions on new mortgages may reduce housing demand and supply in higher tier/jumbo markets while lower tier markets could strengthen as the doubling of the standard deduction leaves more cash in hand. Home price appreciation and housing turnover could consequently decline in high-end markets while increasing in the lower end.

While supply technicals could worsen into mid-2018, we expect many of the positive demand technicals from 2017 to continue in the coming year. Index fund buyers, an expanding overseas buyer base and continued bank demand for MBS could limit the extent of any spread widening assuming an orderly execution of previously outlined central bank policy measures.

With MBS zero-volatility spread and option-adjusted spread near all-time lows, the sector has little cushion against a potential rebound in volatility driven by factors such as stronger growth/inflation or geopolitical risks arising from North Korea and the U.S. midterm elections. We believe it is prudent to reduce spread duration in the MBS sector and focus on 15yr/20yr/CMO issues that are less susceptible to basis widening given limited Fed balance sheet exposure and better convexity characteristics.

Ownership of US Agy MBS Market



Source: Nomura Securities Internationl

Perpetua Phillips
Sr. Portfolio Manager

Please see Disclosures for important information.

Morley Capital Management

Highlights

The Bloomberg Barclays AAA Asset Backed Securities (ABS) Index posted total returns of -0.05% for the 4th quarter and 1.39% for the year; excess returns were 0.18% and 0.77%, respectively, for the quarter and year. The Bloomberg Barclays AAA Commercial Mortgage Backed Securities (CMBS) Index posted total returns of -0.02% for the 4th quarter and 2.05% for the year; excess returns were 0.41% and 1.01%, respectively, for the quarter and year.

In ABS, auto credit metrics have weakened with lower new auto sales, increased lease penetration, and residual value declines. New auto sales peaked in 2016 at 17.5MM vehicles. Lease penetration increased from 10% in 2009 to 29% in the 3rd quarter of 2017. Post-recession recovery rates for prime auto loans peaked in 2012 at 71.4% versus 54.3% at end of 2017; as a result, the 2015 and 2016 vintage cumulative net losses are tracking levels similar to the 2004 vintage, post-recession highs but not as high as the 2007 vintage.

In CMBS, retail dominated the headlines with the excess of retail space continuing to pressure valuations. Throughout 2017, weaker malls were liquidated at very high loss severities, greater than 50%. Some malls, however, have been successful in shifting the mix of stores to complement online sales as well as promoting more activity-based spaces. The universe is becoming bifurcated into "good" and "bad" malls though that may not meaningfully affect CMBS with limited maturities in 2018.

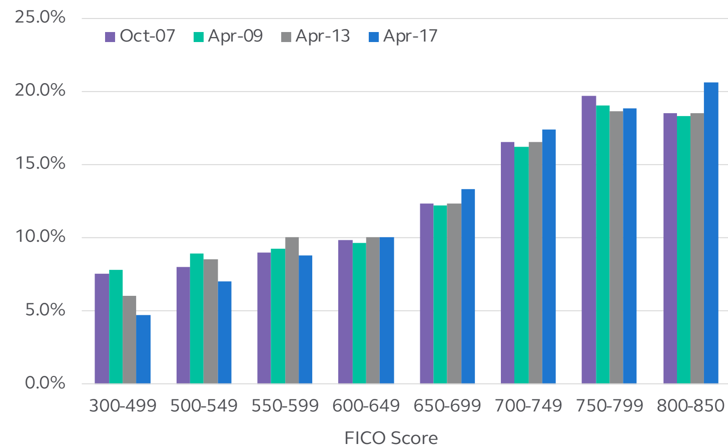
Outlook

The risk-on sentiment was evident throughout 2017, as the off-the-run ABS sectors and credit-sensitive CMBS bonds provided outsized returns. New ABS sub-sectors as well as single asset CMBS deals continue to be the growth parts of the structured credit market. Focusing on newer issuers and/or sub-sectors with strong structures and collateral metrics will be more beneficial than stretching for yield in more credit-sensitive bonds.

Weakness could emerge in the office sub-sector as new construction has increased in recent years as well as workers using less space. New office inventory has increased 1% per year for the last three years while vacancies are still around 13%. Office properties have been a greater percentage of new conduit deals and have cleared at aggressive cap rates. Any small economic downturn in cities such as New York or Washington D.C. could quickly pressure office valuations. The recent growth of shared work spaces is an incremental supply pressure.

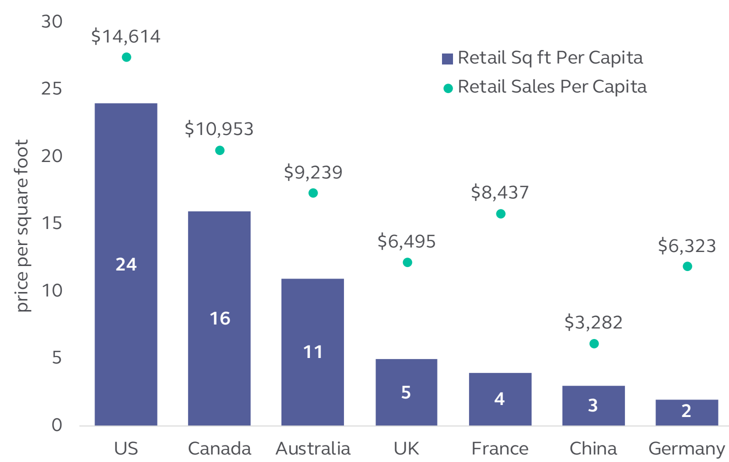
The swap spread in the 2-yr and 3-yr parts of the curve continue to be attractive, around 18 bps, providing an overall yield comparable, if not better, to corporates. Post-crisis deals in structured credit are still very clean with many CMBS deals having limited or no delinquencies and ABS on-the-run sectors experiencing very low losses. Going into 2018, the shape of the curve will matter for longer portfolios, given how tight credit spreads are and how flat the yield curve is. From an overall risk/return basis, we believe short structured credit is attractive relative to longer structured credit and/or shorter corporate credit.

US FICO Score Distribution



Source: FICO Blog, Morgan Stanley Research

Retail Real Estate Space and Sales Per Capita



Source: General Growth Properties, International Council of Shopping Centers, Planet Retail and Knight Frank Research

Rupa Raman, CFA
Head of Structured Credit

Disclosures

Morley
Capital Management

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The Bloomberg Barclays US Corporate Investment Grade Index is a component of the Bloomberg Barclays US Credit Index which includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements within the Bloomberg Barclays U.S. Aggregate Index.

The Bloomberg Barclays US Agency Mortgage-Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg Barclays AAA ABS Index represents the asset-backed securities within the Bloomberg Barclays US Aggregate Index.

The Bloomberg Barclays AAA CMBS Index represents the commercial mortgage-backed securities within the Bloomberg Barclays US Aggregate Index.

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