Interest Rate Strategy

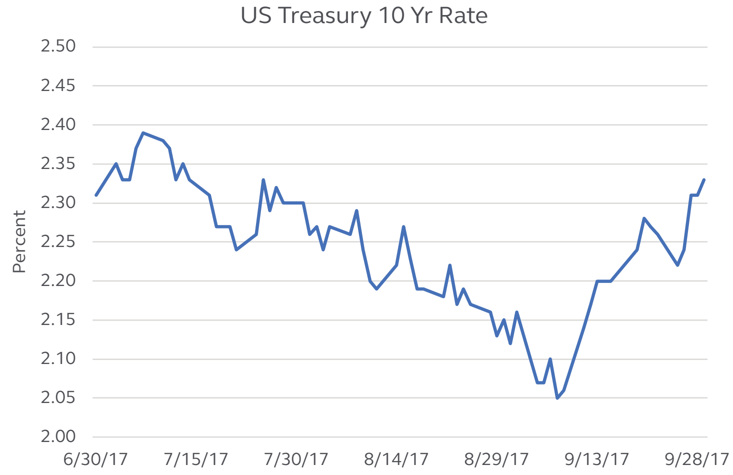
Highlights

Rates exhibited little direction and volatility trended lower during the quarter as the US Treasury 10-yr maturity cohort continued in a narrow trading range 2.05%-2.33%, similar to the range of 2.12%-2.41% seen in the previous quarter. Shorter maturities exhibited a greater tendency to seek higher levels in response to the expectation of increases in Fed policy rates as the 2-yr Bellwether finished at 1.48%, its highest yield in over 9 years. The result was a continuation of the gradual flattening of the spread between 2-yr and 10-yr Treasuries that has been the trend since the end of 2013.

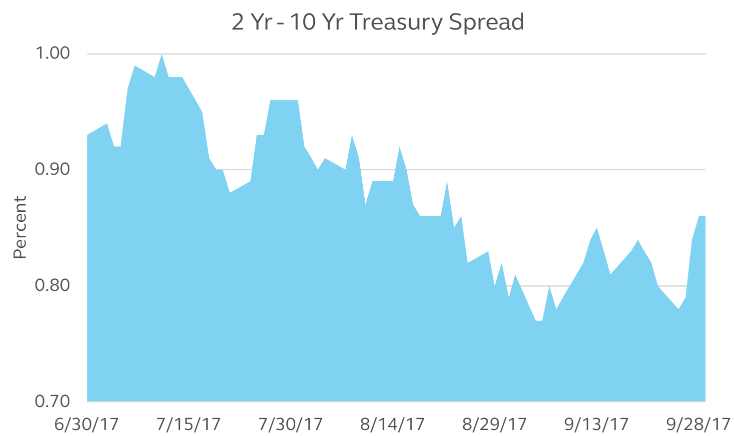
US Gross Domestic Product (GDP) growth for the second quarter was reported at 3.1% annualized QOQ. If that stands through subsequent revisions, it will be the highest growth in two years. The employment picture remains solid with the unemployment rate having fallen to 4.2% even though the labor force participation rate has increased only slightly. Average hourly earnings have been trending higher since the late spring and are currently increasing at 2.9% YOY. Yet inflation, as measured by the Consumer Price Index (CPI), remains at 1.9% and the core personal consumption expenditures index (PCE) is even lower at 1.3%. We, along with others, expect only slight increases.

Outlook

The Fed has met its goals of its monetary policy: promote maximum employment, enable stable prices and moderate long-term interest rates. We expect that there will continue to be modest increases in inflation hovering around a 2% rate which will continue to stabilize the long end of the curve. Meanwhile, the shorter end of the curve will continue to respond to the Fed's carefully telegraphed changes in policy rates. These factors combined should provide some upward pressure on rates and result in a flattening bias to the term structure of Treasury yields going forward.



Source: Bloomberg



Source: Bloomberg

Mark Kummerer, CFA
Sr. Portfolio Manager

Morley Capital Management

Highlights

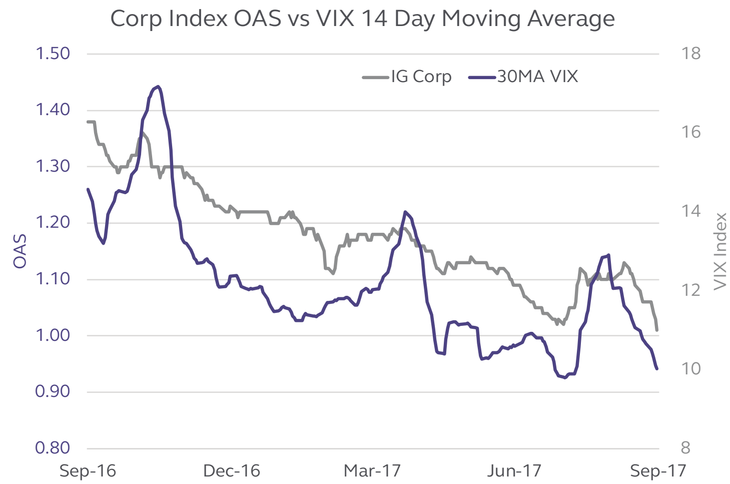
The Bloomberg Barclays Corporate Investment Grade Credit Index posted total and excess returns of 1.34% and 0.87%, respectively, compared to US Treasuries. The third quarter started off with a strong move tighter driven by higher yields, rising energy prices and positive performing equities. The result of both equity volatility and rate volatility at multi-year lows was strong risk asset performance.

In August, the slow summer lull was interrupted as North Korean geopolitical tension spiked. In addition to the escalating rhetoric, several jumbo debt M&A financing deals (ATT's $22.5B funding of Time Warner, Amazon's $16B funding of Whole Foods, BAT's $17.25B funding of Reynolds American) created a new issue supply technical overhang. As geopolitical tension eased, new issuance slowed down, and the prospect for tax reform brightened, corporate spreads re-traced to multi-year tights.

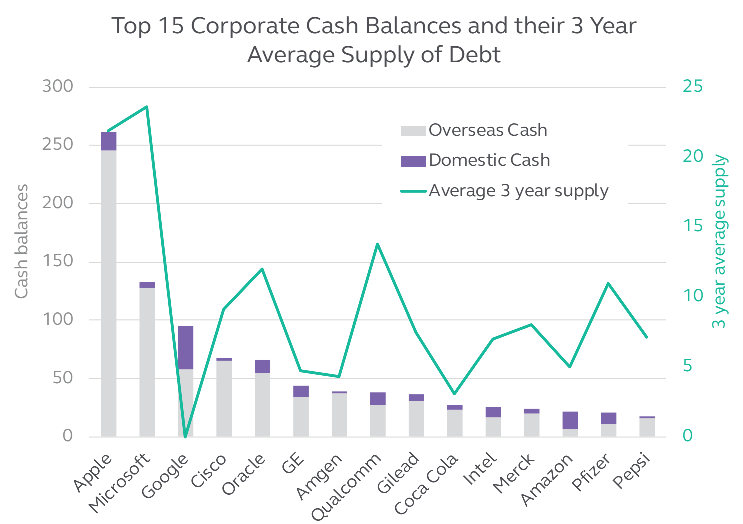
With the recent introduction of the GOP's blueprint for tax reform, we are focused on two elements of the announced tax proposals. First, a tax repatriation plan at a low rate, approximately 10%, combined with a territorial tax system would unlock significant cash overseas. The top 15 corporate cash holders had most of their cash overseas and have been significant issuers in the investment grade market. The technology and healthcare sectors appear to be the biggest beneficiaries of that factor. Second, a limitation on interest rate deductibility would alter the preference for debt in a company's balance sheet. We believe there would be a strong incentive to deleverage industrial balance sheets when the subsidy is reduced. While lower marginal tax rates should benefit corporate net incomes, especially domestically focused corporations, any benefit from a lower marginal tax rate could be offset by other provisions. The devil is in the details of any new tax reform legislation and lobbyists will likely be active, making the benefits of any tax reform package and probability of completion both uncertain.

Outlook

As we look towards the remaining part of this year, we believe that excess returns will be generated primarily through carry. Valuations have been challenging; however, spreads should be supported by a solid macro outlook, higher rates, positive earnings and a strong technical backdrop.



Source: Bloomberg



Source: Bloomberg

Dan Kang, CFA
Head of Credit

Morley Capital Management

Highlights

The Bloomberg Barclays US Agency MBS Index posted total and excess returns of 0.96% during the third quarter. MBS outperformed comparable duration Treasuries by 0.47% during the period as nominal spreads tightened by around 7 bps; while option-adjusted spreads tightened by up to 10 bps as volatility continued to decline to historical lows.

Gross and net agency MBS issuance totaled $343B and $53B, respectively, during the quarter, bringing the YTD totals to $966B and $203B. The 30-yr sector accounted for nearly 80% of gross issuance and all net issuance while the outstanding balance of shorter maturity MBS such as 15-yr continued to shrink (-$13B YTD).

Despite imminent balance sheet reduction by the Federal Reserve, MBS enjoyed strong demand from a variety of investors. Fixed income fund inflows of nearly $300B YTD have prompted buying from passive/indexed funds while rising price/book ratios have spurred resurgent demand from REITs. Additionally, banks have been reallocating high-quality liquid assets from Treasuries into Agency MBS to boost net interest margins.

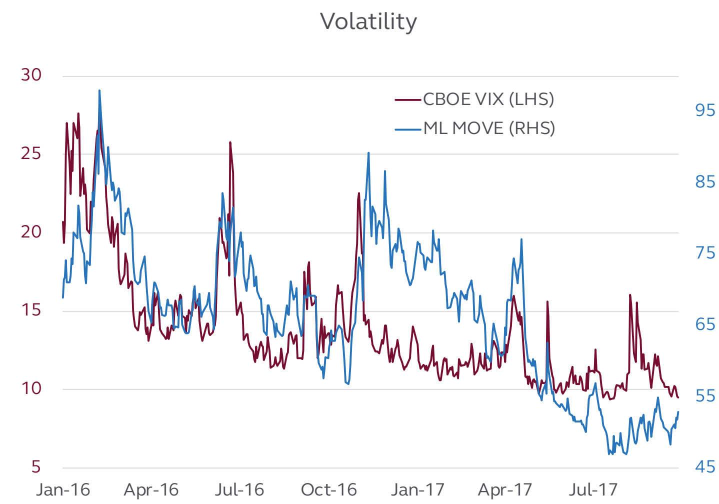
As was widely expected, the FOMC announced that it would begin allowing up to $4B/month to run off its MBS holdings beginning in October. Runoff caps are slated to rise by $4B/month each quarter until reaching $20B/month. The committee maintained its outlook for a December rate hike plus three additional hikes next year, a somewhat more hawkish outcome than markets had priced in.

Outlook

MBS have benefited from an environment of low volatility, limited supply and strong, broad-based investor demand in the face of tight spreads across other fixed income sectors. MBS supply is expected to decline over the next two quarters on slower seasonal purchase origination, while runoff from the Fed's portfolio should be modest at $10-12B through year-end. Barring any geopolitical or policy surprises, the sector should continue to modestly outperform Treasuries over the remainder of the year.

With option-adjusted spreads (OAS) having compressed to 6-year lows, the MBS sector has little cushion against downside risks. We believe the most significant risks would arise from a hawkish appointee to the Fed chairmanship, which could accelerate the pace and magnitude of rate hikes and balance sheet reduction relative to the market's dovish expectations. This could prompt fixed income fund outflows, higher volatility and a sharp repricing of risk across fixed income spread sectors, including MBS.

We believe there are pockets of value within the MBS sector that can better weather the downside risks facing investors as the Fed and other central banks remove monetary accommodation and rates/volatility recalibrate higher accordingly. With persistently low volatility having driven down investors' compensation for taking negative convexity risk, we find value in stable structures with lower option costs, including loan balance and seasoned passthroughs, as well as stripped coupon CMOs off HARP collateral. These securities have lower exposure to Fed policy risks and provide better convexity and OAS for the lowest incremental cost in years.



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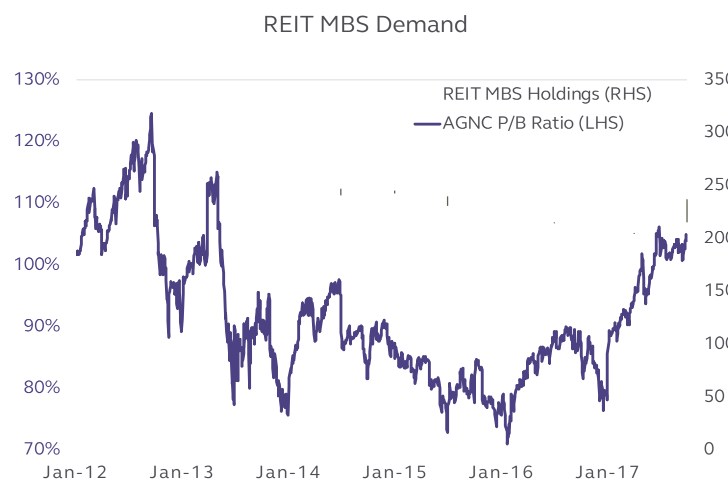

Source: Bloomberg and Nomura Securities

Perpetua Phillips
Sr. Portfolio Manager

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Asset-Backed Securities (ABS)

Morley Capital Management

Rupa Raman, CFA
Head of Structured Credit

Highlights

The Bloomberg Barclays AAA Asset Backed Securities (ABS) Index posted total and excess returns of 0.39% and 0.10%, respectively, for the third quarter. New issuance volume in the third quarter was $49.7B, down 28% from the second quarter. Issuance of $177B YTD is 14% higher than at the end of the third quarter in 2016..

New auto sales have been declining as used car prices have been falling. August light vehicle sales were down 5.7% while dollars spent were up 0.2% YOY. This has not yet had a material impact on auto loan originations, with over $148B in loans made during the second quarter. Auto ABS continues to dominate the ABS market with over 46% of new issuance, in line with 50% seen in 2016.

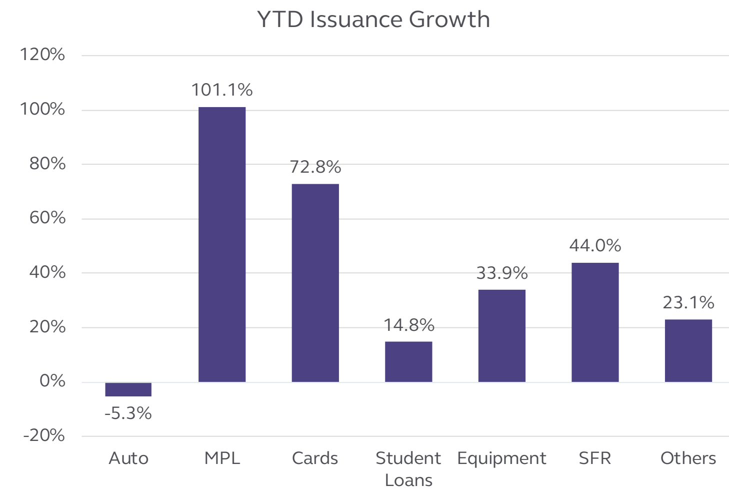
Credit Card and Other ABS subsectors have had the biggest growth in new issuance, with an increase of 29% for both subsectors. The Credit Card ABS space continues to benefit from well-seasoned receivables, insulating it from the broader market deterioration in credit fundamentals. Spreads are at the tighter end for benchmark names, trading around, or less than, 10 bps to swap spreads.

Outlook

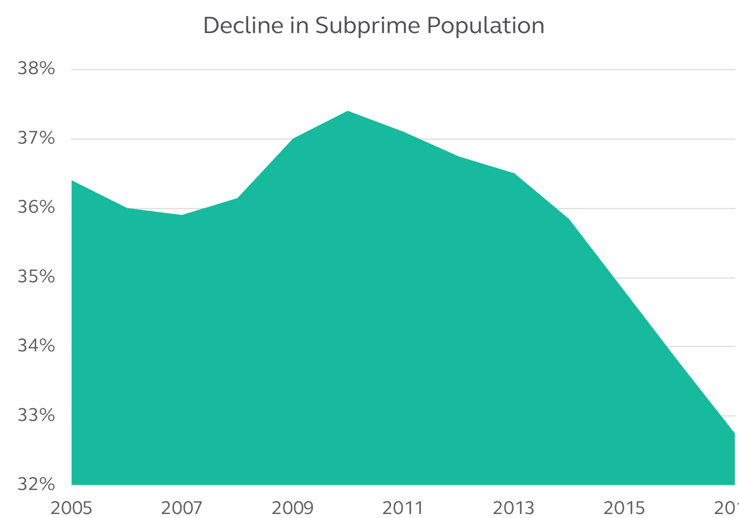
Spreads moved tighter in the third quarter, with most of the tightening in the off-the-run subsectors and subordinate tranches. Most new issue deals have been well over-subscribed, reflecting the technical imbalance from investor demand. Due to the roll-off of existing paper, strong markets, and limited dealer inventory, this positive technical is expected to last through the year and keep spreads contained.

Recent auto lease deals offer value as spreads have widened with investor concerns surrounding residual values. Used car prices have continued to decline with prime recovery rates trending around 54%. In 2012, prime recovery rates were at post-recession highs of 71%. The lower recovery rates have been modeled into newer deals and current credit enhancement levels should be able to withstand impending losses. However, the overhang of close to 4M vehicles coming off-lease in the next year could put even more pressure on prices.

2-yr and 3-yr swap spreads continue to hover above 20 bps, providing a pick-up to corporate credit in the short duration space. Most of the tightening in the third quarter was for non-benchmark names; however, given the technical supply-demand imbalance as well as positive credit fundamentals, these off-the-run subsectors still provide value relative to on-the-run names. Additionally, even for some of the tighter ABS bonds, the swap spread allows for a relatively attractive overall yield.



Source: Morgan Stanley Research



Source: Morgan Stanley Research - US Housing, Resi Credit and Consumer ABS Strategy

Highlights

The Bloomberg Barclays AAA Commercial Mortgage Backed Securities (CMBS) Index posted total and excess returns of 0.77% and 0.33%, respectively, for the third quarter. Issuance exceeded $99B YTD for the Agency CMBS space and $62B for the non-Agency CMBS space. Most of the growth in the non-Agency CMBS space was related to single-asset deals, which have exceeded $25B in issuance YTD, compared to $11B this time last year.

Commercial real estate investment activity is cooling off as foreign investors are pulling back. Transaction volumes are down 6% YOY. Foreign investments, as a percentage of transaction volumes, has declined from 16% in 2016 to 13% as of the first half of 2017. Middle East investment activity declined 73% while Canadian investment grew 40% YOY for the first half of 2017.

Moody's/RCA Commercial Property Price Index is up 7.9% YOY as of July and 27% above the pre-crisis peak, representing a recovery of 167.6% from peak-to-trough losses. Price appreciation has been much faster and stronger than residential real estate, although residential price increases have been catching up. The Case-Schiller 20-City composite was up 6.9% YOY.

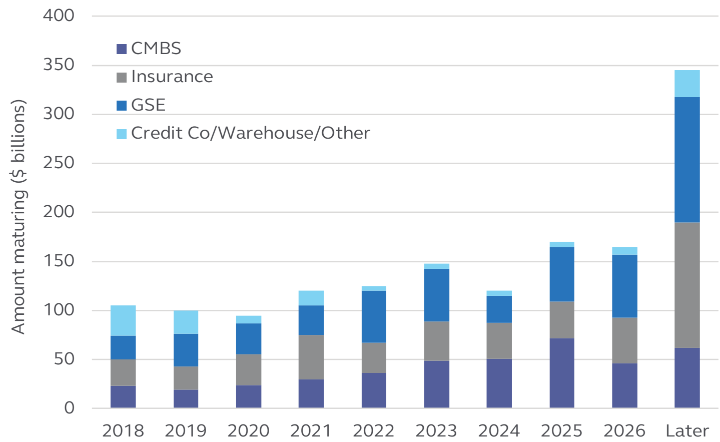
Outlook

Net operating income (NOI) growth rates have been slowing, pressuring future valuations and the ability for properties to refinance. Four-quarter NOI growth rates were 5.23% in the second quarter versus 5.74% in the first quarter. Multi-family rents continued to grow 3.1% YOY though has been slowing for the past six quarters. Affordability has been pressuring rents in major cities and slowly reversing the trend away from homeownership.

The supply/demand imbalance continues to keep spreads in a tight trading range with net negative supply for non-agency CMBS at -$34B YTD. The total conduit universe stands at $331B, with only $42B in legacy deals. Agency CMBS continues to dominate new issuance and is a bigger component of investor portfolios. Given the longer duration and tighter spreads of most types of Agency CMBS, there is still added value to overweight the front-end AAA private CMBS paper.

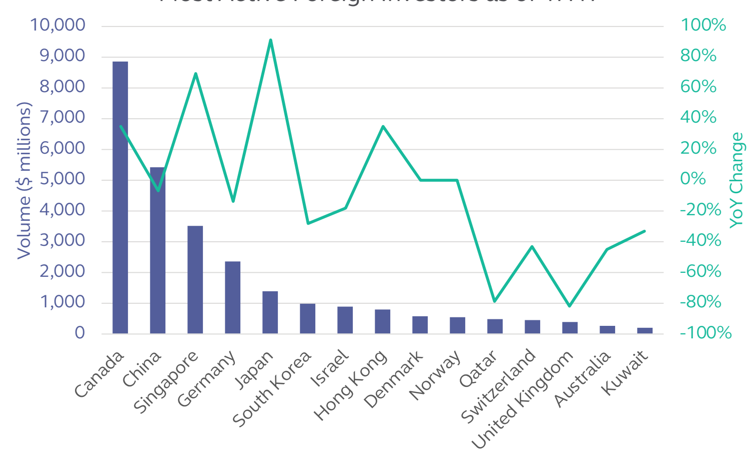
Although retail weakness continues to pressure exposed CMBS deals, there is limited credit exposure to the front-end paper. As large loans get liquidated, prepayment risk becomes more of a concern, especially for premium priced bonds. The pressure point for loan maturities, especially large malls, is limited until 2020.

Non-Bank Commercial Real Estate Refinance Schedule



Source: Bank of America Merrill Lynch CMBS Weekly

Most Active Foreign Investors as of 1H17



Source: Morgan Stanley CRE Tracker

Rupa Raman, CFA
Head of Structured Credit

Please see Disclosures for important information.

Disclosures

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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.

The Moody's/RCA Commercial Property Price Index (CPPI) measures United States commericial real estate prices.

The CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

The Merrill Lynch Option Volatility Estimate (MOVE) Index is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options which are weighted on the 2, 5, 10 and 30 year contracts.

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