## Highlights

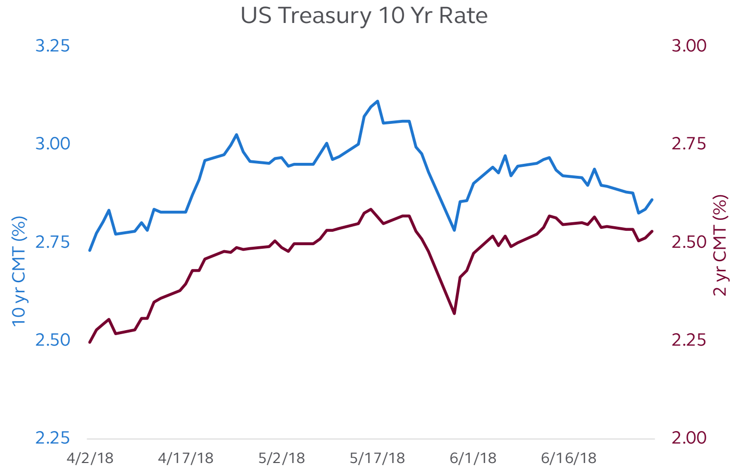
Rates rose during the second quarter of 2018 while the yield curve continued to flatten. The 2 yr U.S. Treasury yield rose 26 bps to 2.53% at the end of the quarter. The 10 yr Bellwether Treasury yield finished the quarter at 2.86%, an increase of just 12 bps. The 33 bp spread between the 2 yr and 10 yr Treasury represents the tightest spread since August 2007.

The Federal Open Market Committee (FOMC) relied on strong economic performance citing job gains, declining unemployment, household spending, and a core PCE inflation measure to close at 2% as justification for increasing the federal funds rate to 1.75%-2.0%.

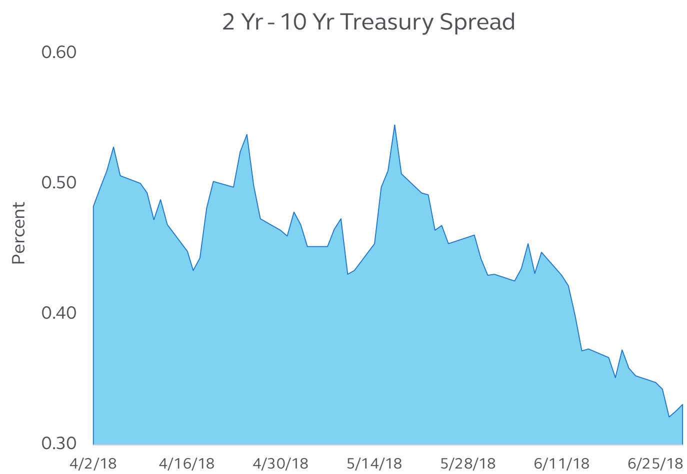
## Outlook

The healthy U.S. economy should result in modestly rising rates accompanied by more yield curve flattening. This comes with the risk of an inversion of the U.S. Treasury yield curve which, if history is an indicator, could be followed by an economic slowdown or recession. Market participants may debate that this time is different due to the low level of interest rates.

The flattening of the yield curve is likely not entirely due to monetary policy; it may, in part, be due to the stronger bid for government debt resulting from policy risks, most notably, current trade tensions with the potential to escalate. It is also possible that the modest growth and subdued inflation we are experiencing along with current rates represent a need for a more neutral policy stance. Larger budget deficits are likely to increase U.S. Treasury issuance; net new issuance is expected to shift out the coupon curve and increase the size of Treasury auctions by nearly $600B over the remainder of this year. All else being equal, we believe that should apply significant technical pressure on bond yields. These possible forces are all valid and unless one of them emerges as a primary driver, the countervailing nature of the combination supports our expectation for modest rate increases.




Source: Bloomberg




Source: Bloomberg

**Mark Kummerer, CFA**
Head of Treasury/Agency

Morley Capital Management

## Highlights

The Corporate Investment Grade Credit Index posted total and excess returns of -0.98% and -1.00%, respectively for the quarter. Credit markets continue to be impacted by the rollercoaster of trade war fears and headlines. Spreads rallied at the start of the quarter as conciliatory comments from both the U.S. and China culminated in Treasury Secretary Mnuchin stating at the end of May that the trade war is on hold. Credit risk, however, reacted poorly as the Mnuchin's statement was quickly retracted and tariffs on China and around the globe were imposed.

After underperforming in the beginning of the year, the front end of credit curve outpaced the rest of the curve during the second quarter. Many of the negative factors, such as corporate cash and foreign investor selling pressure, dissipated as the year progressed. We also saw inflows in the front end of the curve from total return investors as yields looked attractive versus the longer end of the curve.

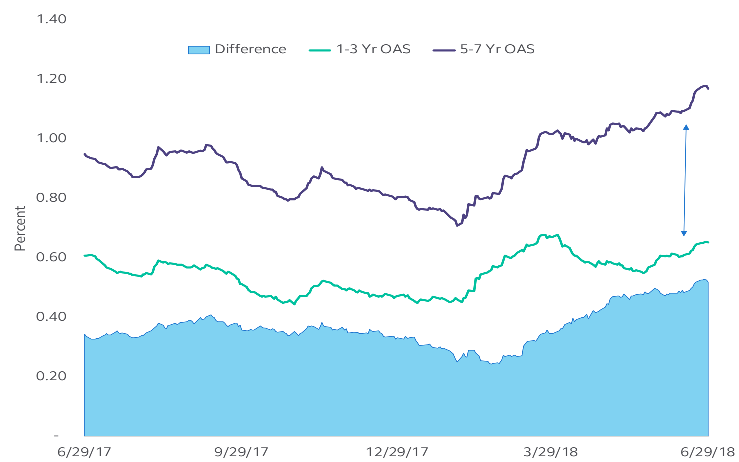
As expected, the underlying fundamentals remain solid. The overall economy is rebounding strongly from the soft patch in the first quarter and corporate earnings have been better than expected. Additionally, company reports from the large cash holders showed limited selling in their securities portfolios versus what had been feared during first quarter.

## Outlook

Presently, fundamentals have taken a back seat to a more challenging risk environment due to an overhang of trade wars and a more fluid supply/demand dynamic. We believe a negotiated trade settlement will be made between the U.S. and the rest of the world; however, more pain will likely be required to move both sides closer to an agreement. Poor technicals was a major driver of underperformance in credit. The insatiable demand for yield from investors, especially foreign-based investors, has become more modest. As hedging costs and relative value continue to be more attractive we would expect foreign investors to continue purchasing U.S. dollar assets.

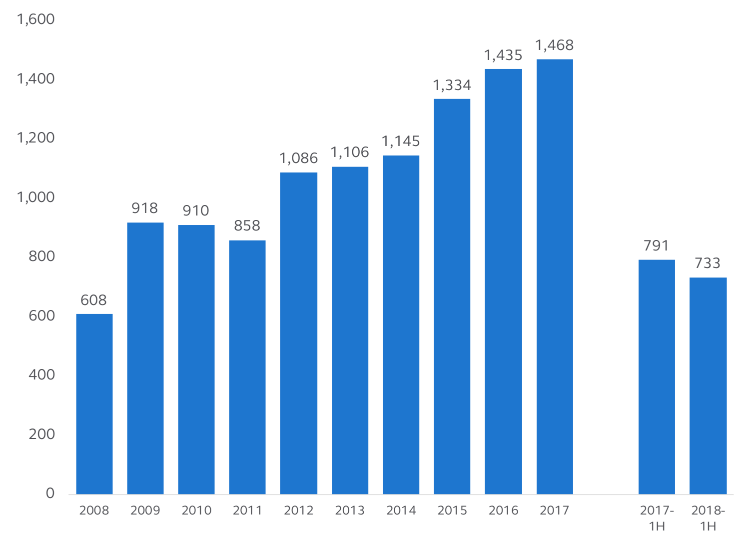
At the peak of central bank accommodative policies, there was approximately $14T of negative yielding bonds compared to $8T at the end of the second quarter. Although, a combination of lower primary supply and more stable demand from foreign investors should provide a more favorable supply/demand dynamic for the second half of the year. For the first time since 2011, credit markets are on track to end their streak of breaking new records in primary new issuance.

Corporate option adjusted spreads




Source: Bloomberg

Primary new issuance




Source: Bloomberg

**Dan Kang, CFA**
Head of Credit

# *Mortgage-Backed Securities (MBS)*

## Highlights

The U.S. Agency MBS Index posted total and excess returns of 0.26% and 0.20%, respectively for the quarter. 30 yr MBS outperformed 15 yr given the reduced duration exposures to short-intermediate yields as the yield curve continued to flatten.

The 60 bp rise in mortgage rates this year dampened both purchase and refinance originations. Resulting gross supply totaled $292B in the second quarter and $569B YTD, well below last year's pace. Consequently, the Fed's MBS portfolio runoff was easily absorbed by investors, defying predictions of a summer supply glut. Fed monthly runoff caps ramped up to $12B during the quarter and are slated to rise to $16B in Q3 and $20B in Q4.

The prepay curve flattened markedly as mortgage rates approached 5% and speeds converged around 10-12% CPR. Anti-churning measures enacted by the U.S. Department of Veterans Affairs and Ginnie Mae have proven effective in slowing Ginnie multi-issuer pool speeds. Turnover and cashout refinancing activity drove strong baseline speeds, alleviating extension concerns and prompting solid demand from money managers and banks during the quarter.

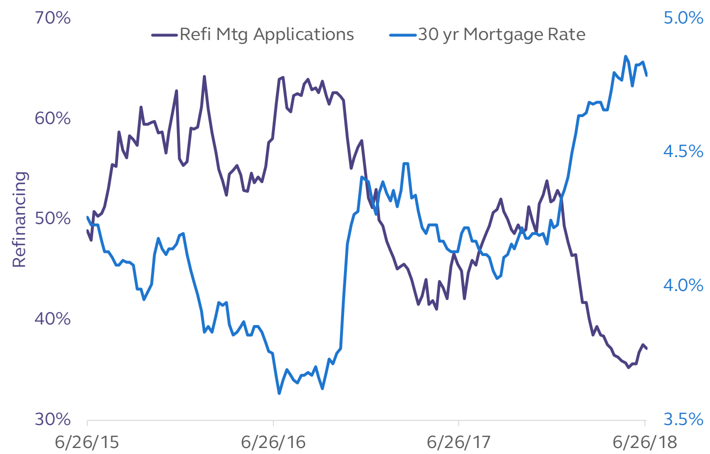
## Outlook

Elevated macro-market uncertainty arising from escalating trade wars, unwinding of central bank quantitative easing and the upcoming U.S. midterm elections pose challenges for all spread sectors, including MBS. While the sector could benefit from flight-to-quality demand in a credit downturn, it remains vulnerable to upticks in volatility. Nevertheless, mortgage market convexity has improved dramatically as the rise in interest rates this year has rendered most of the market out of the money for refis, while expectations for slower speeds have been largely priced in.

Net MBS issuance should continue to decline over the next two quarters given slower seasonal housing activity and the dampening effects of higher mortgage rates. Net issuance is currently on track to total just $250B this year compared to $315B last year, with risks to the downside. This should temper the performance impact of increased Fed runoff supply in the second half of 2018.

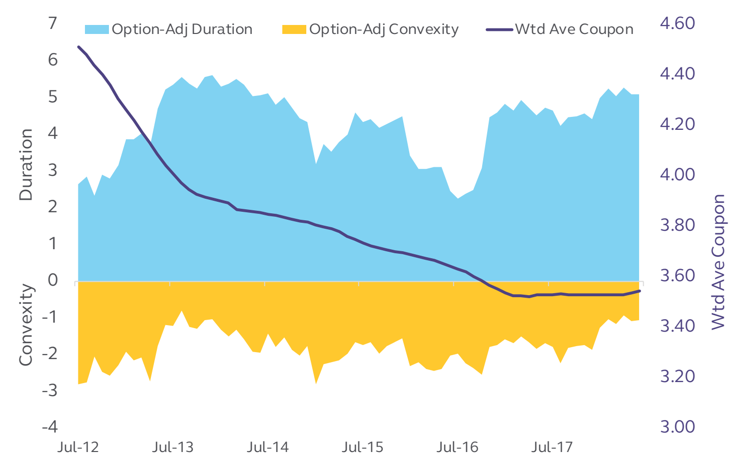
A flatter Treasury curve, persistently low volatility and wider option-adjusted spreads have improved MBS valuations and carry relative to U.S. Treasuries and investment grade credit. The sector also offers defensive positioning against a weakening global economy as well as strong market liquidity, although the transition to Fannie/Freddie Uniform MBS next year could impact liquidity in the medium term. Overall, we are constructive on the sector as a high quality source of carry within our portfolios.

Mortgage rates and refinancings




Source: Mortgage Banker's Association

US MBS Index Characteristics




Source: Bloomberg

**Perpetua Phillips**
Head of Mortgages

## Highlights

The AAA ABS Index posted total and excess returns of 0.40% and 0.15%, respectively, for the quarter. The CMBS Index posted total and excess returns of 0.17% and 0.11%, respectively, for the quarter.

Total ABS issuance in the second quarter was down 5.5% YOY at $64.5B, resulting in net negative supply. All sub-sectors had YOY increases in new issuance, except credit cards; equipment was up 69.6% YOY. The sub-sector Other ABS has been a significant driver of growth, with smaller issuers and more esoteric collateral coming to market. Performance for the first half of the year has been best for off-the-benchmark names while the on-the-run AAA credit card and auto ABS sectors have underperformed. Demand has been less robust for short duration high quality assets with the Fed raising rates and investors seeking higher yields. 2018 has been defined by a flattening yield curve as well as a flattening credit curve in the ABS sector.

Total private label CMBS issuance in the second quarter was $24.5B and Agency CMBS was $33B, bringing YTD issuance to $57B. Limited maturities as well as higher issuance is resulting in positive net supply. Compared to the summer of 2017, where monthly maturities were over $3B, the first five months of 2018 have seen less than $300M in underlying loan maturities. Most of the growth in the CMBS market has been in the single asset, single borrower space as well as in the commercial real estate collateralized loan obligation sectors, both of which benefit from floating rate securities. Although commercial real estate prices continue to hold, there is softness emerging in prime office properties. Capitalization rates are trending below the historical average spread to the 10 yr U.S. Treasury, implying valuations are getting rich.

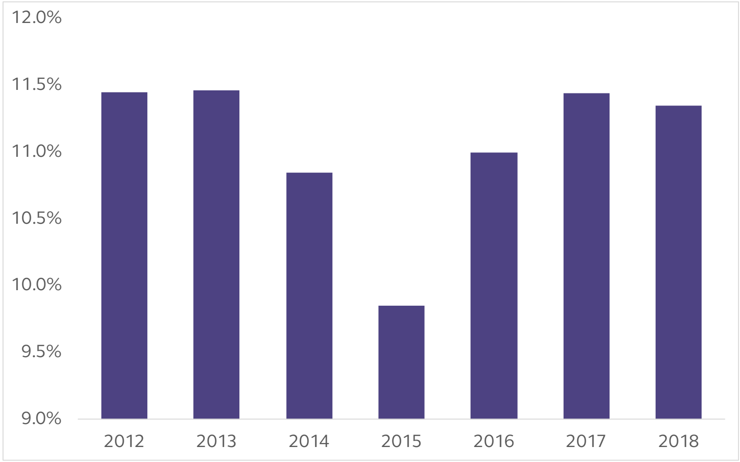
## Outlook

Limited upside in going down in credit or extending duration make short structured product assets attractive. Although there is a rising rate headwind, the opportunity to reinvest seems more compelling as the credit cycle eventually turns.

Legacy rolled down CMBS paper provides a good spread pickup over new issue securities. The underlying fundamentals are stronger, given the equity build-up of properties post-crisis and the limited exposure to current looser credit underwriting. Generally, the technical landscape continues to be favorable as there are limited maturities this year and a continued bid from banks and insurance companies.

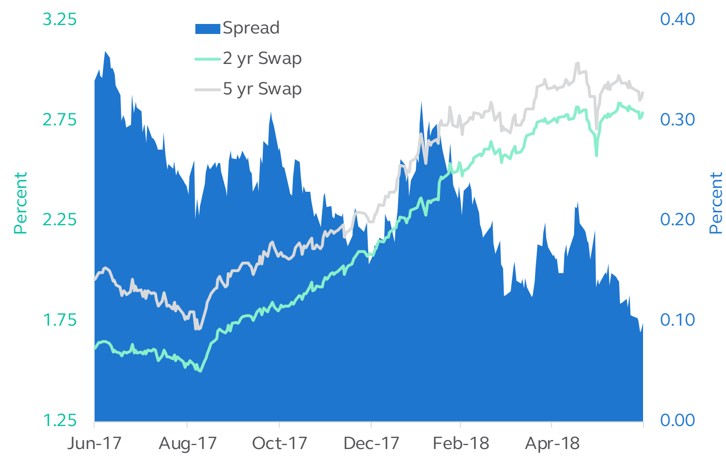
Treasuries, swap spreads, and Libor continue to be the biggest drivers of performance in fixed income during the second quarter. The U.S. Treasury curve has compressed to around 20 bps between 2 yr and 5 yr and the swap curve is around 12 bps. This magnitude of yield curve flattening has not been seen since 2005. Given the timing uncertainty of a downturn, staying short and safe is a compelling theme. Relative to the less risky part of the investment grade corporate market, short ABS and CMBS provide a better investment opportunity.

Net operating income debt yield by vintage for 2.0 conduit loans




Source: CMBS Weekly - BOA (6JULY2018)

Swap spreads




Source: Bloomberg

**Rupa Raman, CFA**
Head of Structured Credit

# *Disclosures*

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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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