Interest Rate Strategy

Morley
Capital Management

Highlights

Treasury rates were on a steady though gradual upward trend during October; however, market sentiment shifted following the surprising results of the US Presidential election. By year end, the yield curve had steepened with the 2 yr and 10 yr Treasury rates rising by 43 bps and 85 bps, respectively. Interestingly, the rise in rates and the steepening of the curve resulted in both measures finishing the year very close to where they began.

Early sentiment was focused on steady but weak economic growth, job gains and core inflation below the Federal Reserve's (Fed) 2% target. Following the election, the level of rates shifted abruptly in response to policy risk concerns. Focus shifted to the prospect of stronger economic growth stemming from anticipated fiscal stimulus, a ramping up of inflation expectations, and fear of a larger supply of US government securities. Stock prices rose as a result of the shift which led to selling pressure for investors shifting from bonds to equities.

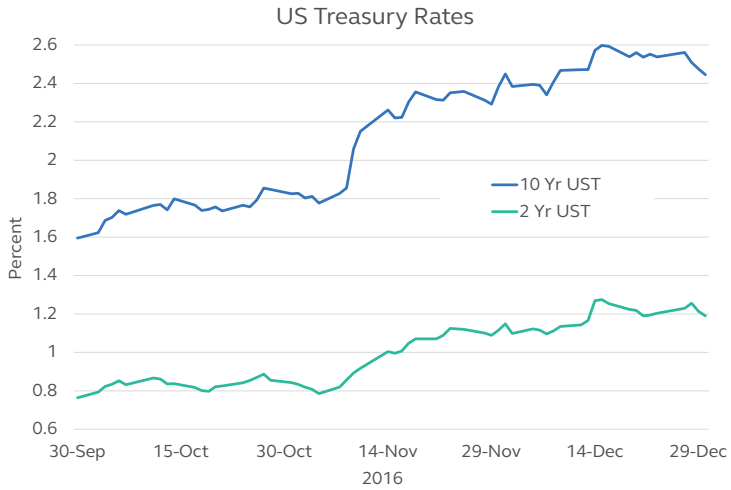
By the time the Federal Open Market Committee (FOMC) meeting on December 17 occurred, the long-awaited and telegraphed increase in the fed funds rate was a foregone conclusion.

Outlook

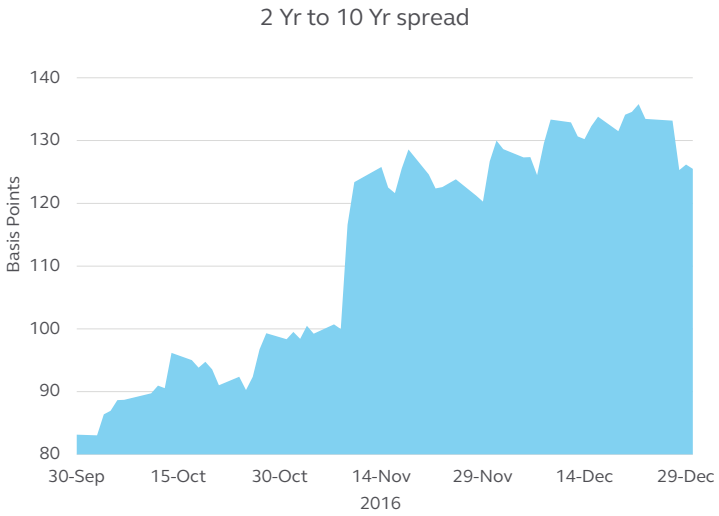
Bond market participants will likely be focusing on the promised fiscal stimulus; how much will be delivered and the market's perception of its effectiveness and impact. It is reasonable to expect higher market volatility in the coming months.

We believe rates will continue to increase modestly as US Gross Domestic Product (GDP) continues its steady growth and inflation continues to trend higher. US Treasury rates are the highest among the major industrial countries; this relative attractiveness may temper further rate increases.

In spite of the expected shift in policy to a more relaxed regulatory environment and potential fiscal stimulus, the FOMC stated "the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. We expect at least two increases in the fed funds rate during 2017.



Source: Bloomberg



Source: Bloomberg

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Corporates

Morley
CAPITAL MANAGEMENT

Highlights

The Bloomberg Barclays Investment Grade Corporate Index posted a total return of -2.83% due to the significant rise in interest rates during the quarter; however, the excess return compared to US Treasuries was1.85%. For the full year, the Index produced 6.11% and 4.93% total and excess returns, respectively, the strongest excess return performance since 2012.

The 4th quarter continued the year's string of surprises with a Trump presidential victory and Republican sweep of Congress. Risk assets performed well as optimism for fiscal stimulus, tax cuts and reform, as well as regulatory roll-back, offset increased uncertainty regarding new policies and trade relationships. Aiding risk sentiment was OPEC's agreement for its first production cuts in eight years.

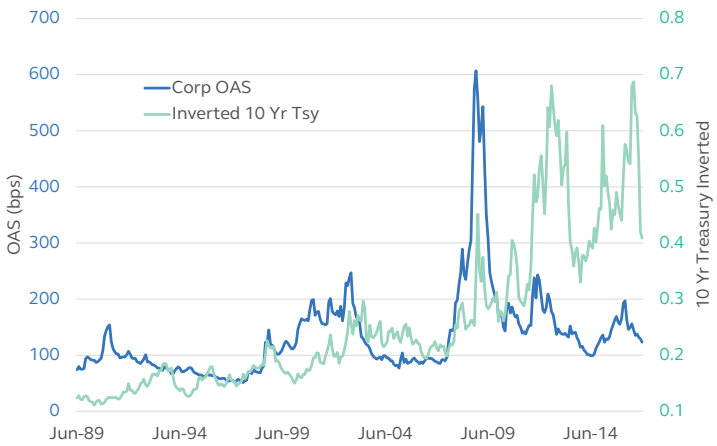
During the quarter, cyclical credits and those with higher volatility outperformed. Notable sector performers include energy and banking; the former benefiting from rising oil prices while the latter was helped by higher rates and prospects for lower regulatory burdens. Besides high quality credits, healthcare/pharma credits were pressured during the quarter due to intense scrutiny of drug prices and disappointing earnings.

Corporate bond performance was strong yet volatile during 2016. The year started off with a perfect storm of China devaluation fears, plunging oil prices, and increased recession worries. Spreads began to tighten as oil prices recovered and global central banks expanded their monetary policies. Following the surprising BREXIT vote, the Bank of England joined other central banks in quantitative easing (QE). As a result of the collective central bank action, negative yielding foreign bonds drove demand for US dollar assets.

Outlook

As rates rise, spreads tend to narrow and vice versa; generally, higher rates are associated with positive economic activity and lower credit risk. Over the last eight years, the Fed's anchor on rates and quantitative easing have driven demand for US dollar assets, including corporate bonds, which have not fared well when trying to wean from the Fed. For the coming year we believe credit spreads will be supported and excess returns will be solid. An improved macro picture with associated earnings improvement, less M&A activity and lower expected supply should benefit spreads. Recent history of volatility should continue for the foreseeable future. Numerous policy unknowns from President-elect Trump and the Republican Congress could significantly alter our fundamental views.

Option Adjusted Spread (OAS) vs. Inverted 10-Yr Treasury



Source: Bloomberg

OAS versus Federal Reserve QE

Source: Bloomberg

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Mortgage-Backed Securities (MBS)

Morley
Capital Management

Highlights

The Bloomberg Barclays US Agency Mortgage-Backed Securities Index posted total and excess returns of -1.97% and -0.39%, respectively, during the fourth quarter and 1.67% and -0.11% for the year. 15-year bonds outperformed 30-year bonds by 30-35 bps on a total and excess return basis as Treasury yields surged by 85 bps and the curve bear steepened; that is, longer-term rates increased at a faster rate than short-term rates.

MBS performance met challenges following the surprise Trump victory and Republican sweep of Congress. Fiscal policy initiatives under the new administration are likely to spur growth and inflation, raising uncertainty around monetary policy and heightening rates volatility. The FOMC proceeded with their December rate hike and projected three additional hikes in 2017, potentially accelerating the timeline for when the Fed commences tapering reinvestments on its MBS book.

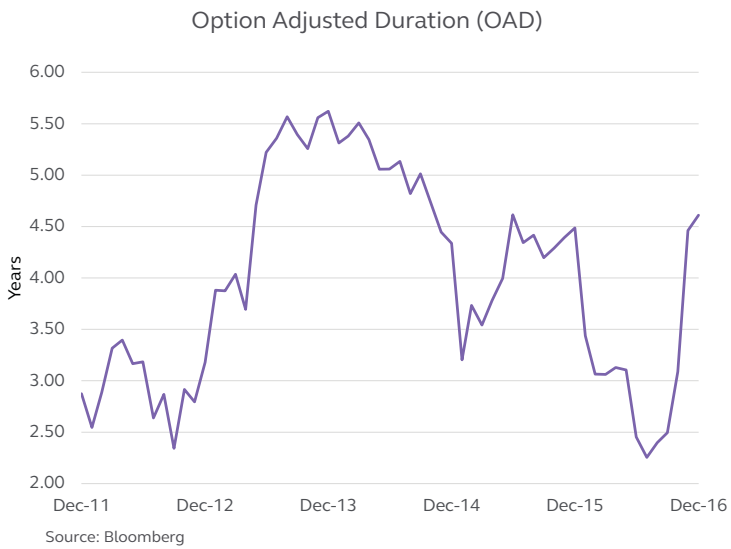
The option-adjusted duration of the US MBS Index lengthened from 2.5 years to 4.6 years during the 4th quarter as mortgage rates surged by over 80 bps, taking the average borrower's refinancing incentive from a peak of 95 bps in the 3rd quarter to just 15 bps by year-end. While dramatic, the duration extension effectively returned the Index to the level it started the year, though rates were relatively unchanged. Notably, MBS nominal and option-adjusted spreads to Treasuries tightened by 5-10 bps during the year, reflecting strong bank and foreign demand.

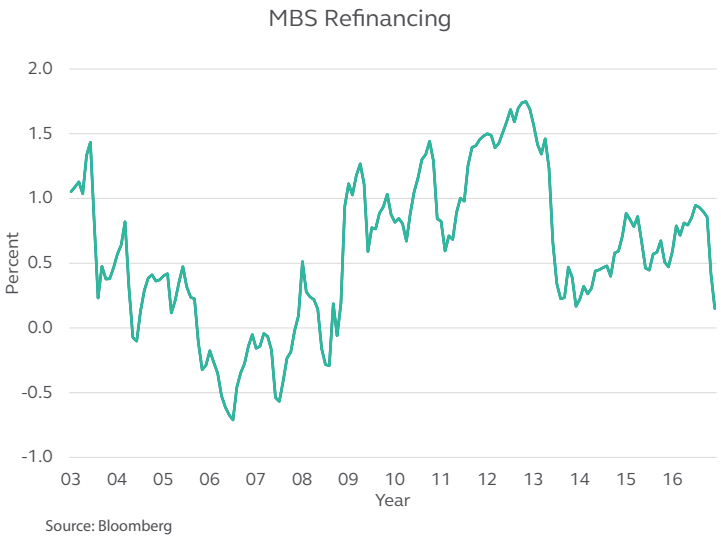
Outlook

We expect the fed funds rate to increase to 1.0-1.5% in 2017, the level at which the Fed may begin tapering paydown reinvestments, if the new administration is able to quickly implement effective stimulus measures. MBS spreads could widen by 10-20 bps in anticipation as private investors must absorb roughly $200B in excess supply in the Fed's absence.

Higher mortgage rates should cause gross/net MBS issuance to decline to under $1.0T/$200B in 2017 compared to $1.4T/$230B in 2016, drawing continued support for MBS from yield-based buyers. The rapid duration extension in the MBS sector improves expected returns going forward.

We expect relative value opportunities in the Agency MBS sector to improve as it begins the transition from a government-supported, technically-driven market back to a fundamentals-driven market led by private investors. We will look for investment opportunities resulting from market dislocations during this transition, focusing on stable structures with lower option costs and less susceptibility to policy risks such as Agency CMOs.





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Asset-Backed Securities (ABS)

Morley
Capital Management

Highlights

The Bloomberg Barclays AAA Asset Backed Securities Index posted total and excess returns of -0.76% and -0.02%, respectively, for the fourth quarter and 1.85% total and 0.76% excess returns for the full year. New issuance volume of $195B for the year was essentially flat compared to 2015. Spreads did widen 2-10 bps through the 4th quarter as there was a relatively robust new issue supply ahead of the risk retention rules that went into effect on December 24, 2016.

Auto ABS issuance decreased 4.4% year-over-year with a 19% decline in auto lease paper. The largest issuer in 2016 was Ford Motor Co. with $11B of new issuance, a significant share of the $99B in total auto issuance for the year. Concern regarding underwriting as well as deteriorating used vehicle prices led to higher quality new issue paper than was expected at the beginning of the year; consequently, spreads tightened throughout 2016 with prime auto paper widening only 2 bps in the 4th quarter.

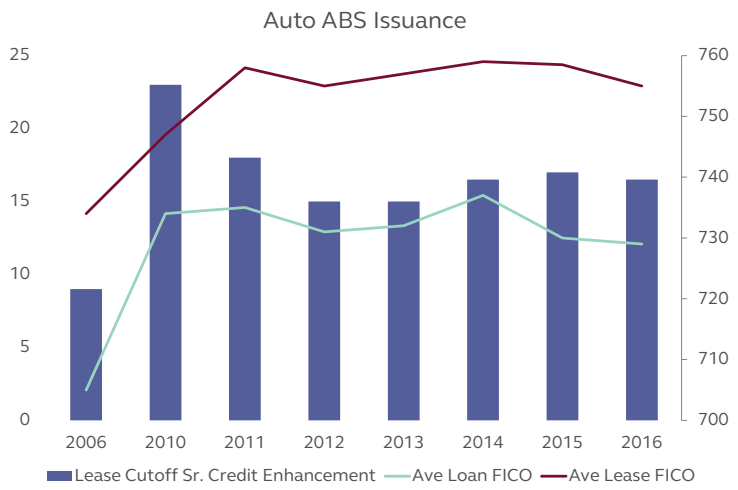
Credit card ABS issuance increased 2% year-over-year, mostly due to a $4.1B increase in non-US collateral. Underlying consumer debt increased 6% year-over-year to $981B but master trust volumes continue to be around one-third of issuers' book of business. The receivables remain well-seasoned and credit metrics continue to be excellent despite some recent weakening. Charge-offs are still well below historic norms, averaging around 2%, and delinquencies are around 1.50% as of November 2016.

Outlook

Consumer debt-to-income continues to trend at low levels and an expected tax cut should increase disposable income. ABS fundamentals across sub-sectors have been remarkably strong and, even with some weakening expected as rates increase, short duration bonds should remain resilient.

Liquid on-the-run sectors, such as credit cards, are relatively attractive due to less risk-based pricing resulting from the market strength in the 4th quarter. New issuers and sub-sectors that are not being priced with a risk premium pose the risk of spread widening.

Swap rates on the 2-Yr Treasury ended the year at 25 bps over Treasuries with absolute yields reaching new highs. The 1-month LIBOR increased over 35 bps through 2016, making floating-rate paper competitive with fixed rate paper. Short duration and amortizing bonds are attractive in this environment where we believe the absolute yield will more than compensate for the upcoming rate hikes.



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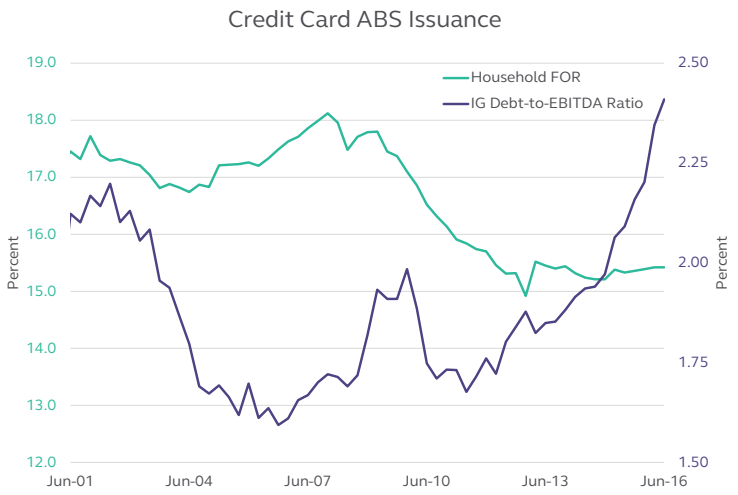

Source: Federal Reserve Bank and Citi Research

Rupa Raman, CFA
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Commercial Mortgage-Backed Securities (CMBS)

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Highlights

The Bloomberg Barclays AAA Commercial Mortgage Backed Securities Index posted total and excess returns of -2.99% and 0.41%, respectively, for the 4th quarter and 3.37% total and 2.10% excess returns for the full year. Total year-to-date private label issuance reached $69.6B, 27% less than last year with most, $42B, in the last half of the year.

New issue spreads tightened close to 50 bps over the year, despite significant widening at the beginning of 2016. CMBS continues to benefit from a net negative supply and small deal sizes, especially the front-pay AAA-rated tranches. Underwriting has improved through the course of the year including higher debt yields and higher net operating incomes (NOIs).

Moody's/RCA Commercial Property Price Indices in October were up 8.6% year-over-year and 22% above the pre-crisis peak. Commercial real estate (CRE) prices are up despite CRE sales volumes of $32B in October 2016, 43% less than October 2015.

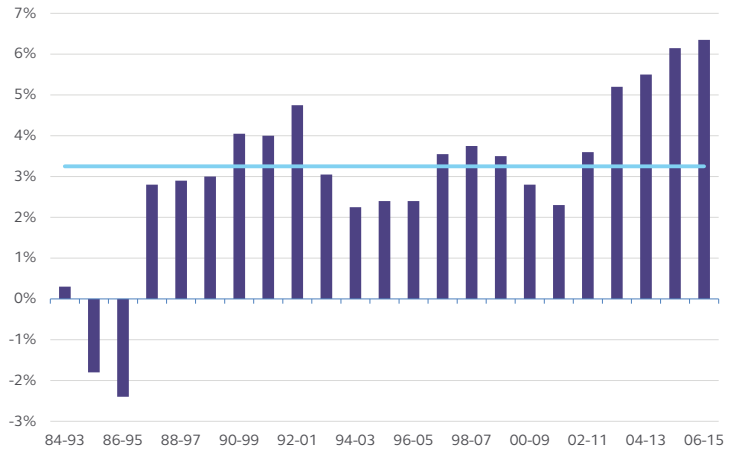
Outlook

Continued price appreciation will depend on whether NOIs can keep pace with higher capitalization rates as overall interest rates have risen. Weakness has already started to emerge in the luxury apartment segment, where rents are starting to decline with an oversupply of new construction.

Despite $87B of paper maturing in 2017, supply is still expected to be only negative $30B, which should bode well for the sector. The outstanding universe is expected to decline below $500B, with pre-2010 deals becoming a much smaller share of the market. The dominance of post-crisis new issue deals creates a more homogenous AAA-rated sector, less prone to unanticipated prepayment risks.

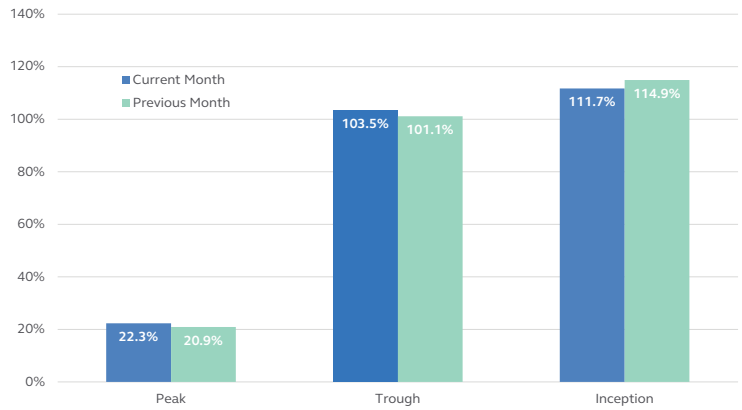
Risk retention rules went into effect December 24, 2016, and new deals in 2017 are expected to have a variety of risk retention compliant structures; consequently, there could be a divergence in spreads based on investor preferences and perceived risks. Given conservative credit enhancement levels for non-risk retention deals, the spread pickup for pre-2017 deals could be attractive.

Historical Net Operating Income (NOI)



Source: MCREIF, Morgan Stanley Research

National All-Property Index Change



Source: Moody's/RCA, Morgan Stanley Research

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The Barclays US Corporate Investment Grade Index is a component of the 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 Barclays U.S. Aggregate Index.

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

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

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

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