Interest Rate Strategy

Morley
Capital Management

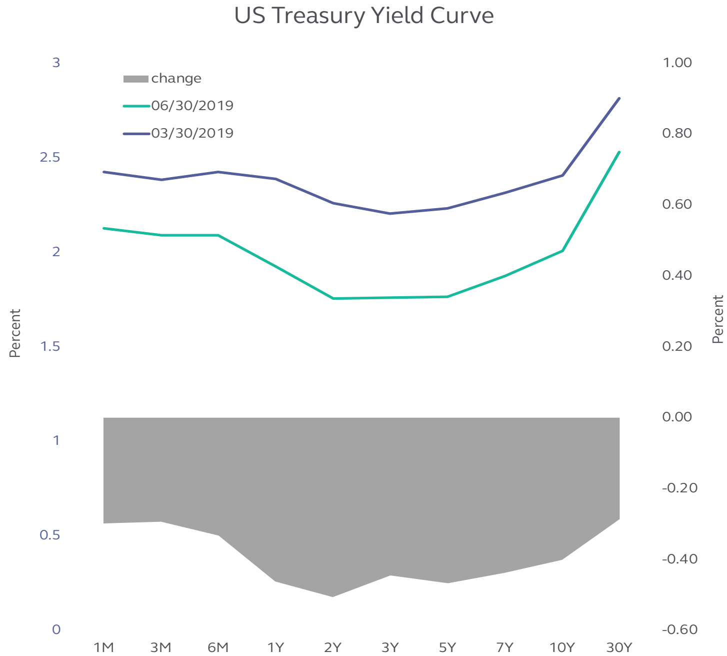
Highlights

Signs of moderation in global and US economic growth, escalating trade tensions, and a shift in the Federal Reserve's (Fed) monetary policy combined to push interest rates lower during the second quarter. Rates fell across the curve; the strongest move, down 50 bps, occurred in 2yr to 3yr maturities slightly deepening the inversion in the short end and steepening the curve from 2yrs out. The bond market's view of a need for monetary accommodation was supported by slower housing and manufacturing activity along with a low job growth report in May. Core inflation at 1.6% year-over-year, well below the Fed's 2% target, is paving the way for the Fed to pivot with central banks around the world to provide synchronized quantitative easing.

The market is anticipating as many as three rate cuts this year as it waits for a statement from the Federal Open Market Committee (FOMC), led by Chairman Jerome Powell, who could be embarking on his first policy rate cut. Presumably, the statement will be dovish. It does not appear that businesses are able to pass the cost effects of tariffs to consumers yet and tight labor markets have not resulted in significant wage pressures. Assuming a flat Phillips curve, the inverse relationship between the level of unemployment and the rate of inflation, perhaps there is little inflation risk if the Fed eases, continuing to effectively support prices of risk assets. Rates in the US remain attractive around the globe, particularly relative to the $12.5 trillion of worldwide debt that is sporting a negative yield.

Outlook

We believe market and economic dynamics will lead to the continuation of a low rate environment for the foreseeable future and provide positive support for spreads.



Source: Bloomberg

Mark Kummerer, CFA
Portfolio Manager

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Please see Disclosures for important information.

Morley Capital Management

Highlights

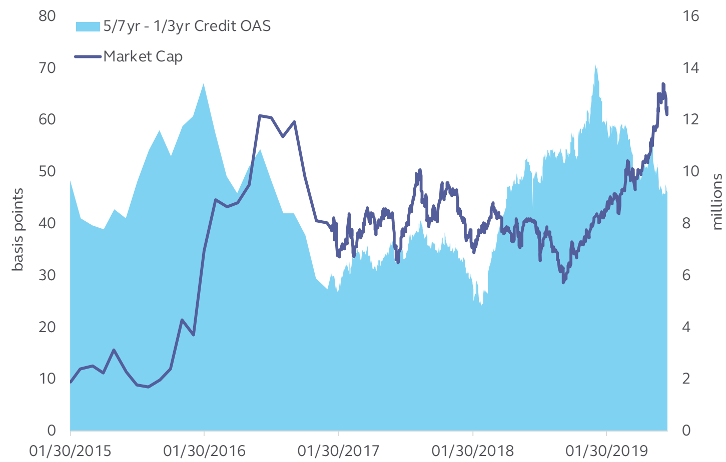
The Bloomberg Barclays US Intermediate Corporate Index posted total and excess returns over like-duration Treasuries of 3.14% and 0.62%, respectively for the quarter. The 2nd quarter was a positive period for total and excess returns as dovish central banks drove both rates and spreads tighter. In April, risk continued its positive tone, but volatility/spreads spiked in May as trade talks abruptly broke down between China and the US. Reversing the previously favorable headlines, trade rhetoric escalated during the quarter with higher tariffs expected on an expanded number of Chinese imports. Also, in early June, Trump surprisingly threatened tariffs with Mexico as a tool to stem immigration flow from Central America. Trade tensions subsided as Trump announced a deal with Mexico, and China and the US agreed to resume talks at the G20 summit.

While trade concerns simmer beneath the surface, central banks have completed the pivot from tightening to expected easing. Both the Fed and the European Central Bank have communicated an easing bias in their benchmark rates and the potential for quantitative easing which was necessitated by downward shifts in economic activity and inflation expectations. Global manufacturing purchasing manager's indices have been trending below 50 (indicating contraction) as the uncertainty surrounding trade talks have taken their toll on business confidence.

Outlook

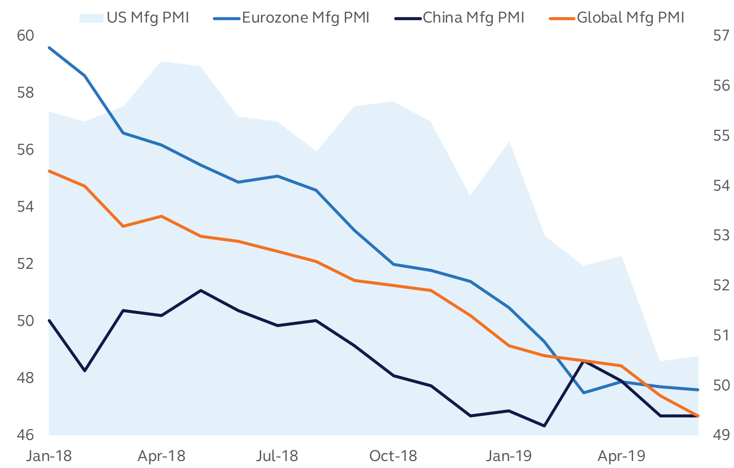
We continue to have a constructive view of credit risk in the near term. We believe global central banks have provided a backstop and expect spreads to grind in. The extent of any spread tightening will be a function of the rebound in economic activity and the aggressiveness of the dovish central banks. With the significant rate rally we would expect yield-oriented buyers to be challenged and the front end to underperform versus the intermediate part of the curve. When we last saw a similar amount of negative yielding debt, 2nd quarter 2016, spreads flattened as investors reached for yield. Likewise, we would expect lower quality to outperform in a negative yielding environment. In terms of quality, we maintain our more conservative bias. Lingering concerns of the end of current cycle or possible recession and the potential resumption of merger and acquisition activity could limit tightening potential for lower quality corporates.

Negative yielding debt vs corporate curve



Source: Bloomberg

Global purchasing managers' indices (PMI)



Source: Bloomberg

Dan Kang, CFA
Portfolio Manager

Mortgage-Backed Securities (MBS)

Highlights

The Bloomberg Barclays US Agency MBS Index posted total and excess returns of 1.96% and -0.39%, respectively, for the quarter. Total returns were led by the longer duration 30yr sector while 15yr outperformed on an excess returns basis as front-end Treasury yields declined by 50 bps and long rates fell by 30-40 bps.

Central banks turned increasingly dovish to shore up global growth amidst ongoing trade uncertainties. Somewhat discordantly, risk appetite surged as markets priced in multiple Fed rate cuts, causing MBS performance to lag credit sectors. Treasuries rallied alongside equity markets, intensifying prepayment concerns and leading to a 20% surge in rates volatility over the quarter.

Mortgage durations shortened markedly during the period with the option-adjusted spread of the Index contracting from 4.03 to 3.15 years, led by a 1.1 year decline in 30yr GNMA. The 15yr sector was more stable, shortening by just 0.4 years. While the sharp drop in rates has worsened the convexity profile of the sector, risks are concentrated in recent vintages with high weighted average coupons and large loan sizes as well as non-bank serviced pools.

In addition to lower rates, MBS faced headwinds from a 40% increase in gross issuance that drove second quarter and YTD totals to $323B and $554B, respectively. Supply of 15yr MBS was muted, totaling just $19B for the quarter and $31B YTD.

Outlook

With global central banks committed to buffering the economy and markets from geopolitical and trade risks, we expect volatility to settle back within a modest range. The 75 bps YTD plunge in mortgage rates has had a relatively muted impact on refinancing activity relative to comparable past rate environments, illustrating the effects of burnout and diminishing marginal returns from low policy rates on the housing sector.

Gross originator supply coupled with Fed balance sheet runoff are likely to remain headwinds for the sector over the next several months. Fed paydowns should exceed the $20B/mo runoff cap into the 4th quarter while lower mortgage rates and seasonal factors are sustaining organic supply. Net MBS issuance of $70B YTD was driven by positive net supply in 30yr bonds while 15yr continue to have negative net supply averaging $15B per quarter. We expect continued demand from banks, overseas investors and money managers to temper basis volatility arising from short term supply dislocations.

Overall, we expect MBS performance to remain correlated with rates, underperforming in rallies and outperforming in selloffs. The rally-driven widening in the basis over the second quarter has resulted in attractive valuations within the sector and relative to investment grade credit and ABS. We see opportunities within call-protected segments that have widened alongside TBAs and view the sector's lower market beta, reliable liquidity and expected carry advantage over Treasuries as key elements in maintaining MBS as a core holding within our stable value portfolios.

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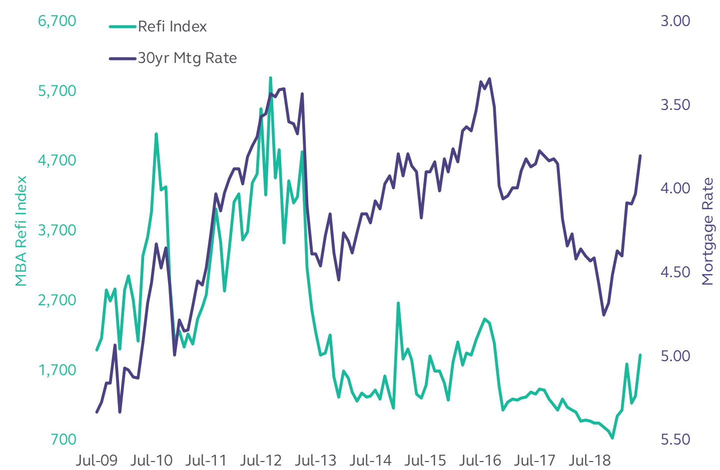
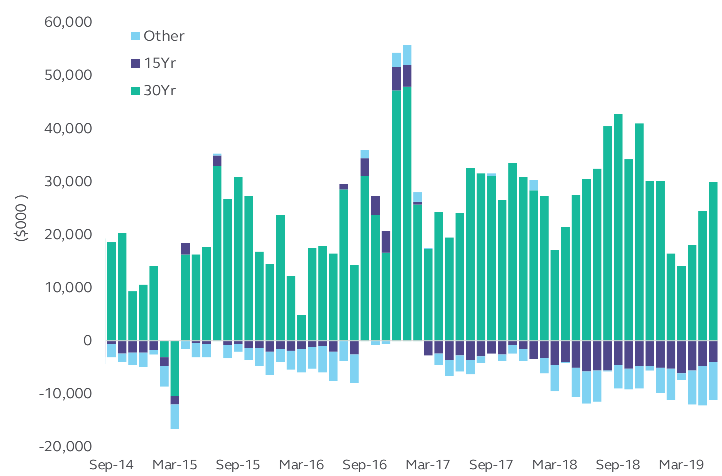
Mortgage rates and refis



Source: JP Morgan

Net issuance



Source: JP Morgan

Perpetua Phillips
Portfolio Manager

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Morley
CAPITAL MANAGEMENT

Highlights

The Bloomberg Barclays AAA Asset Backed Securities Index posted total and excess returns of 1.66% and 0.10%, respectively, for the quarter.

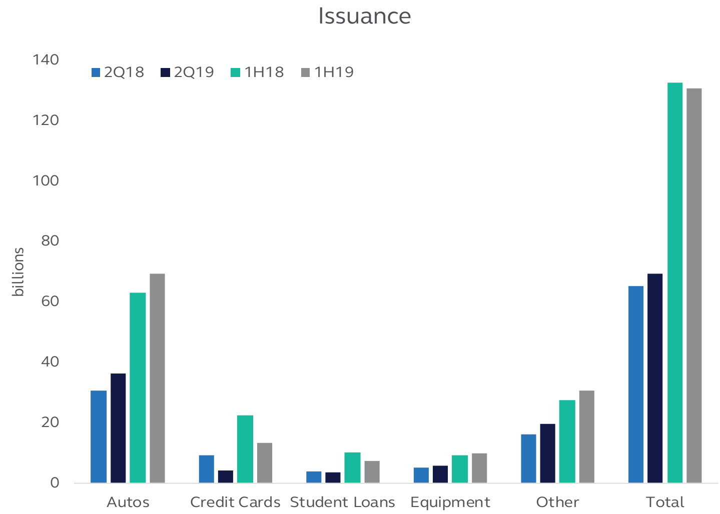
Changing Fed expectations set the tone for markets during the second quarter, leading to lower rates and strong performance in risk assets. Early in the quarter, weak inflation data reinforced the expectation that the cycle of Fed rate hikes was over, leading to strong performance in risk assets. Risk assets briefly sold off mid-quarter as trade negotiations between the U.S. and China broke down and the U.S. government threatened tariffs on Mexico. However, markets quickly returned to a risk-on mode as expectations built for a series of rate-cuts in the second half of the year.

ABS spreads gradually widened throughout the quarter to compensate for the significant 2yr-3yr Treasury rate rally. Swap spreads at that point of the curve also compressed over the same period, further eroding the yield advantage of ABS. The combination of these factors, along with increased primary and secondary supply, led to most ABS sectors trading at their widest spreads in two years.

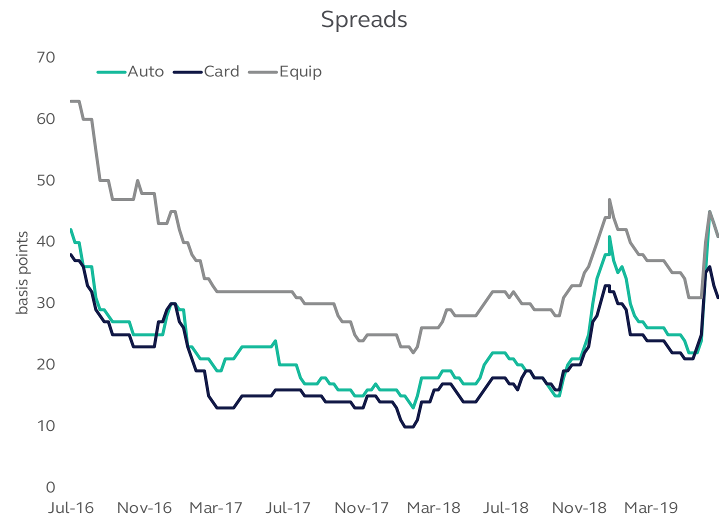
Outlook

The US consumer remains healthy and the unemployment rate continues to decline below 4%. This environment is supportive of the ABS sector. ABS supply is $120B YTD. This is similar to the $125B issued in the first half of 2018. Total supply expected for 2019 is $230B, which is the same amount that was issued in 2018. Prime auto loan ABS is the largest asset class in annual issuance. This sector has a short weighted-average life and requires continued investment to maintain investment exposure. Auto performance has gradually weakened both seasonally and cyclically, though not to levels that would threaten ABS with potential downgrades or losses.

Collateral performance in post crisis ABS issuance has been strong as underwriting standards and access to credit remain generally conservative. We expect stable 2019 performance as consumers benefit from a stable economy, wage growth and continued improvement in employment.



Source: BofA Merrill Lynch



Source: BofA Merrill Lynch

Perpetua Phillips
Portfolio Manager

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Commercial Mortgage-Backed Securities (CMBS)

Morley
Capital Management

Highlights

The AAA CMBS Index posted total and excess returns of 3.22% and 0.28%. respectively, for the quarter. The technical factors of lower conduit CMBS supply and low market volatility helped to support the relative performance of CMBS during the quarter. The recovery in spreads from the late 2018 volatility took a bit of a pause in higher rated assets after a strong 1st quarter, however, the credit curve did flatten as A- and BBB- spreads outperformed AAA spreads. For the first half of 2019, AAA-rated spreads tightened 28bps, AA- spreads tightened 35bps, A- spreads tightened 92bps and BBB- spreads tightened 135bps with limited spread tightening occurring in the 2nd quarter. The CMBS spread tightening lagged corporate bond spreads, leaving room for further tightening during the second half of 2019.

Total private label CMBS issuance in the 2nd quarter was $26.6B and Agency CMBS was $21.6B. For the first half of 2019, conduit issuance was down 8% year-over-year ($18.0B), single-asset/single borrower issuance was down 6% ($19.1B) and CRE CLO issuance was up 27% ($9.0B).

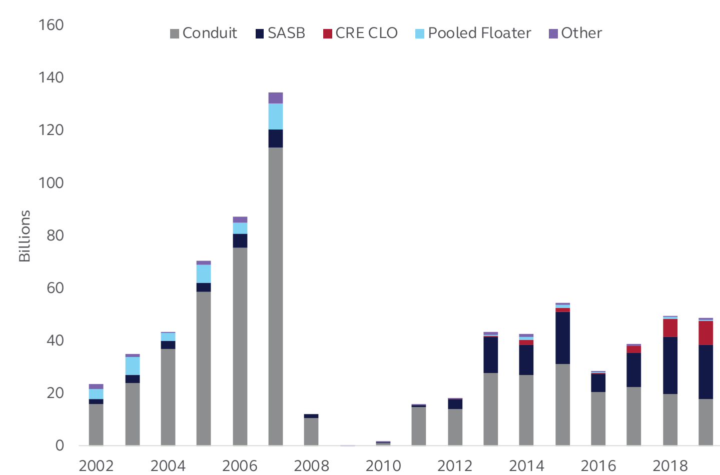
Fun¬damentals and commercial real estate pricing continued to remain firm during the quarter as the rally in 10yr Treasuries helped support capitalization rates expectations for income growth. The delinquency rate on loans originated after the great financial crisis remains historically low and well within expectations for seasoned loans. The real estate recovery that started in 2012, which featured low interest rates and conservative underwriting standards, has helped support strong loan performance.

Outlook

The late cycle performance of CMBS should continue to be exposed to idiosyncratic risk in real estate markets, such as exposure to energy, student housing or overbuilt hotel markets. 10yr conduit loans are currently at a cyclical low for loan maturities considering that there were no conduit loans originated in 2009 and only $10B originated in 2010. This reduces the systematic risk of loan maturities during a potential downturn in the market over the next 12-24 months.

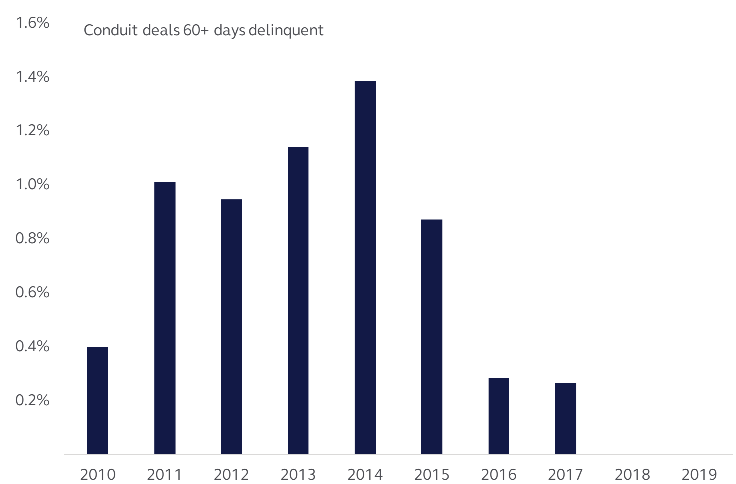
We see relative value in short duration CMBS as default driven cash flow volatility should be low and spreads are attractive relative to alternatives in the market.

Issuance (YTD)



Source: JP Morgan

60+ day deliquencies



Source: JP Morgan

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Portfolio Manager

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Index descriptions:

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 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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