For qualifed investors only

First State Investments

Quarterly Update

Unconstrained Fixed Income

Absolute Return Strategy

Q3 2017

Market Review

Bond markets experienced several trend reversals during the third quarter with rates and credit markets moving independently. The Bloomberg Barclays US Aggregate index returned 0.85%. During July, spread sectors continued their extended rally that began in February 2016. By late July, IG corporate spreads were within 5 bps of their post-crisis tights set in 2014. Volatility was muted throughout the market with the VIX equity volatility index and MOVE interest rate volatility index both setting multi-decade lows. Tight spreads and low volatility felt justified as liquidity risk fell and the US economy began exceeding expectations. August marked a turnaround, as spread markets did not have a cushion to buffer duel threats from US politics and North Korea. The investigation into the Trump campaign's dealings with Russia reached a fever pitch in early August as special counsel Robert Mueller impaneled a grand jury. In a rare act of bipartisanship, Congress passed sanctions on Russia with veto-proof majorities and took preemptive action to limit Trump's ability to fire Mueller. Meanwhile, North Korea accelerated its nuclear missile testing as the UN increased sanctions. Negative headlines receded into the background in September, allowing the spread rally to resume. High yield spreads tightened during the quarter by 17 bps to +347 over Treasuries while IG corporate bond spreads tightened 8 bps to +101. EM spreads had a strong quarter, tightening 22 bps to +246. Mortgage spreads also outperformed, spurred on by record low interest rate volatility. US and most European interest rates fell in July and August before rising in September. The USD continued its extended decline in July and August before turning up in September.

Politics continue to be an important driver of markets. Healthcare legislation failed to move forward in the US. President Trump and the Republican Congress abandoned healthcare, turning to tax reform in September. Optimism about lower taxes propelled markets higher in September. It is worth noting that tax legislation faces similar challenges to prior Republican legislative efforts. Strains continue to grow in Europe. Angela Merkel won a fourth term as German chancellor but centrist parties had their worst result since the late 1940s. Although Merkel remains in power, she has lost room to maneuver domestically at the same time strains increase throughout the EU

GDP is expected to be in the 2.5% range in the second quarter. The Citi Economic Surprise index soared during the quarter. ISM surveys accelerated sharply in September as the economy carries momentum into the 4th quarter. CPI exceeded expectations in August, reversing 5 consecutive monthly disappointments. Core inflation was boosted by rent increases while total inflation benefited from gains in oil.

The FOMC announced it will began shrinking its balance sheet in October. Market expectations for a December rate hike jumped from 30% to 70% after Chair Yellen indicated she would like to raise rates in what is likely to be her final action as FOMC chair. Other than the December meeting decision, market focus is on who President Trump will nominate to head the FOMC in 2018.

Portfolio Performance

The Absolute Return strategy returned 0.74% during the quarter. Cumulative one year return is 2.53%

Interest rates and FX

Our interest rate positions were net positive during the quarter. Our rate positions were small during July and August. Our gains came in September when we bet on higher global rates. Higher rate calls included outright short duration positions in the US and Australia and a curve steepener in Europe. In September, we also benefited from selling UK rates vs European rates. The UK rates market faces ongoing Brexit related stress, fears of an inflation overshoot, and potential rate hikes by the BOE. We actively traded Italian rates vs German rates during the quarter, breaking even overall. In July we thought investors were overcompensated to own Italian bonds. We turned negative on Italian rates in August as the ECB prepares to reduce its support for bond markets while problems in the European periphery continue. Our long/short FX basket had positive performance during the quarter. Most of our FX gains came in September as the USD strengthened and EM currencies declined.

Inflation markets

We benefitted from long positions in UK and European inflation breakevens. European economic strength has exceeded expectations, providing a boost to European inflation pricing. Additional support for global breakevens came from oil prices which rallied throughout the quarter. The spread between Brent and West Texas crude jumped from $2.5 to $6.0 per barrel as European and Middle East tensions boosted Brent prices. Turkey threatened to cut off the pipeline to Northern Iraq when the Kurds began discussing an independence vote. We went long US inflation breakevens after the August CPI numbers came in higher than expected. Hurricanes in the US provided a short-term inflationary impulse that will be felt primarily in the fourth quarter.

Past performance is not indicative of future performance. Returns do not reflect the deduction of investment advisory fees. A client'sactual return will be reduced by the investment fees. If a client placed $100,000 under management and a hypothetical gross return of 10% were achieved, the investment assets before fees would have grown to $259,374 in 10 years. However, if an advisory fee of 1% were charged, investment assets would have grown to $234,573, or an annual compounded rate of 8.9%.

Securitized sectors

Our securitized sector positions outperformed overall. Gains in non-agency sector holdings more than offset losses we incurred being short agency MBS. Our short position in agency MBS is predicated on tight spreads, low volatility, and the FOMC beginning to reduce its reinvestment of MBS prepayments. Unfortunately, volatility fell to multi-decade lows and spreads kept tightening. Strong demand from banks, money managers, and REITs is enough to offset initial FOMC pay downs. We expect the cumulative effects of FOMC paydowns to eventually lead agency MBS wider but this does not seem imminent. Our best performing holdings were government guaranteed student loans. Non-agency CMBS, CMO whole loans, and timeshare ABS also provided positive contributions.

Corporate markets

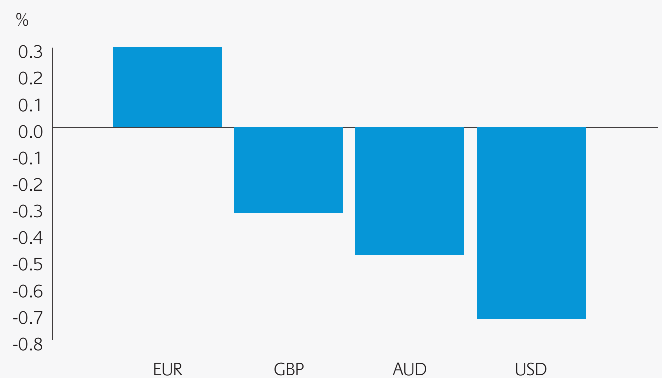
High Grade and High Yield corporate spreads fluctuated broadly in the 3Q amid geopolitical tensions, policy expectations and global Central Banks appearing to move toward less accommodation. Credit spreads broadly tightened into quarter-end retracing all of the widening that was seen in August and ending at the tightest levels in over three years. Higher beta sectors outperformed against the backdrop of strong technical, new record highs in U.S. equities and records low volatility. Spread tightening was broadly distributed across sectors, with REITs leading financials and commodity-linked issuers ahead in the industrials space as oil moved above $50. Issuers flocked to the new issue market to get ahead of an FOMC that's looking increasingly likely to raise interest rates again before the end of the year. Credit curves broadly outperformed with longer bonds producing higher excess returns than shorter dated bonds.

For the Absolute Return Strategy the Investment Grade and High Yield credit positions produced strong positive performance during the quarter. In investment grade, the portfolio benefitted from overweights in financials and banks while the hedge basis detracted slightly over the course of the quarter. Our bottom up corporate security selection was again positive as the Funds' positions tightened on balance more than the broader market. Our positions in the HY Energy and Chemical sectors produced the strongest performance while our bias toward higher quality HY names detracted from performance. The portfolio was actively positioned long credit spread duration across markets for much of the quarter before reducing positioning late in the quarter primarily on expectations for rising volatility as geopolitical risks and the potential for policy missteps rose. We continue to be selective in credit positioning as idiosyncratic risks mount and credit valuations offer razor-thin risk premia and appear particularly vulnerable to fundamental shocks.

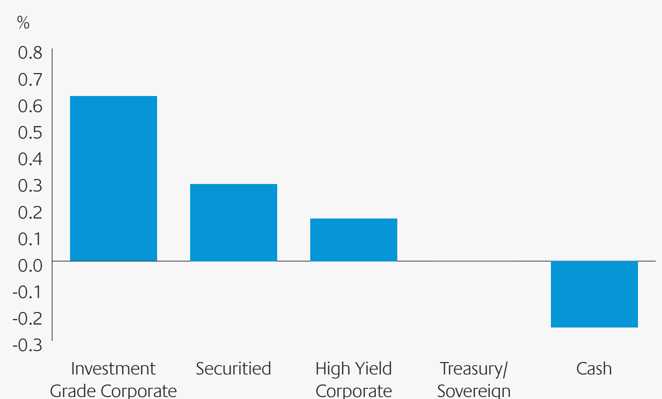
Outlook

Synchronized global growth, inflation below central bank targets, and stimulative monetary policies seem to portend higher yields and tighter spreads as we move into the fourth quarter. The possibility of tax cuts in the US also supports these trends. We will be watchful for signs of reversal which could come from a number of fronts. On the monetary policy side, the FOMC announced balance sheet paydowns in September but does not actually begin paydowns until October. In late October, the ECB may announce it will reduce the amount of bonds it purchases in 2018. Meanwhile, the political discord in the US seems minor relative to the turmoil in Europe. Threats of secession from Spain by Catalonia are the latest in a seemingly endless series of threats to European harmony. China has been a source of global strength in 2017, leading up to its 19th Party Congress that begins October, 18th. It should be noted that China accentuates good news before each new political cycle begins which may result in temporarily suppressed bad news coming to the surface in 2018. Meanwhile, further market moving problems with North Korea or Iran are certainly possible. Volatility is exceptionally low throughout the market and we alert for a reversal. Our initial positioning at the start of Q4 is summarized in the graphs below.

Active Duration Positioning vs Benchmark



Active Spread Duration Contribution



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