

# Core Plus Strategy

2Q 2018

## Market Review

Global interest rates ended the quarter fairly close to where they began with a large change of direction in between. The US ten year yield climbed from 2.74% to 3.11% in mid-May before reversing course to close the quarter at 2.86%. European and Australian yields followed a similar pattern, rising until mid-May before falling. Australian 10YR yields ended the quarter at 2.63%, only 0.03% above where they began. Notably, German 10YR yields ended the quarter at 0.30%, finishing 0.20% below their level when the quarter began. Italy had the most volatile developed market rates due to its tenuous political situation. Two anti-establishment political parties, the League and the Five Star Movement, have formed a coalition government that raises questions about Italy's future in the European Union. Italian 10YR rates rose almost 1.00% in May while Italian 2YR rates traded in an astounding 2.95% range. The timing of global yield changes was consistent with the evolution of economic data. The quarter began with high hopes for an increased pace of globally synchronous growth but the data disappointed. Citigroup's surprise indices fell across the globe throughout the quarter. In Europe, the composite PMI average for the quarter stands at 54.7, implying a 2.3pt drop to a six-quarter low. This points to 0.5% QQ 2Q GDP growth which is less than economists anticipated and provides only a muted rebound from a disappointing first quarter. The US held up better than the rest of the world, with Q2 GDP estimates in the 3.8 – 4.0% range. The USD responded to relative US strength, pushing the US Trade Weighted Broad index up 5.5% during the quarter.

The combination of slower global growth and a stronger USD hit EM currencies hard. The JP Morgan EM Currency Index price fell 9% during the second quarter. The Turkish Lira had the first crisis, falling sharply in May before huge central bank rate hikes stabilized the currency. Most other EM currencies followed with the Brazilian Real, South African Rand, and Mexican Peso among the hardest hit.

Spread sectors struggled, with EM faring the worst. EM spreads widened 60 bps to +300. IG corporate spreads widened 14 bps to +123, continuing a trend that began in January. For the second consecutive quarter, HY outperformed IG, particularly on a beta adjusted basis. HY spreads only widened 9 bps to

+363. AAA CMBS spreads were dragged 9 bps wider due to their high correlation with IG corporate spreads. MBS spreads stayed stable in Q2, helped by interest rate volatility remaining low. EM spreads were hurt by the combination of USD strength, less synchronous global growth, and tensions resulting from the Trump administration's attempts to revamp US trade policy. In retrospect, the January 22 announcement of US tariffs on washing machines and solar panels looks like the start of a trade war that continues to impact risk markets. The widening of IG corporate spreads coincided with this trade action and the Shanghai stock index fell more than 17% between January 22 and June 30.

The June ECB meeting marked a significant development in central bank policy. The ECB will reduce its net asset purchases to €15 Bn per month after September and bring net asset purchases to a halt in December. The market initially anticipated this would be a hawkish development but the ECB put a dovish stamp on the report, saying that key interest rates will "remain at their present levels at least through the summer of 2019." An initial rate hike in September would be Mario Draghi's final act in office as his term expires in October 2019. The FOMC raised rates as expected in June with one or two more US rate hikes expected in 2018. The June FOMC statement dropped language contained in prior statements that current rates were well below rate levels that would prevail over the longer-term. In England, the MPC hinted at an August hike although data fluctuations and Brexit uncertainty muddle the picture.

## Portfolio Performance<sup>1</sup>

The Core Plus strategy returned -0.36% during the quarter, underperforming the Barclays Bloomberg Aggregate Index by 0.20%. The one year Core Plus return is -1.03%, underperforming the Index by 0.63%. All figures quoted are gross.

### Interest Rates and FX

Our macro positions underperformed during the quarter. We were generally positioned for rising rates which worked in April but hurt after yields began to fall in May. The primary sources of directional underperformance were short positions in Australian and EU rates. We broke even on a short US 2YR rate position. The choice to short the front end of the US curve was a good one

<sup>1</sup> Performance figures do not reflect the deduction of investment advisory fees. A client's 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%.

as the 2-10 curve flattened 15 bps to +34 but our timing cost us. Another source of underperformance was being long UK rates vs German rates. We like trading the UK vs Germany spread as Brexit developments, economic differences, and monetary policy differences create opportunities. Unfortunately we were caught off guard by the strong flight to quality bid for bunds in May and poor trading of gilts in June after surprisingly hawkish central bank comments. Our best macro position started poorly as we were long Italian rates vs German rates in April. Fortunately we went short Italian rates in time to benefit as the political situation deteriorated. Another outperforming position was being long US breakevens. US inflation has risen in 2018, buoyed by the strong economy, rising oil prices, and base effects as weak 2017 inflation numbers fall out of annual calculations. Our FX positions outperformed modestly.

### Securitized Sectors

Our securitized sector positions broke even. The securitized sector was quiet in the second quarter, with few opportunities to produce significant gains or losses. Our short position in agency MBS underperformed modestly as volatility remains contained and the market comfortably absorbed the spring supply pickup. We made money in ABS, primarily in government guaranteed student loans which have performed well overall. Additionally, student loans have frequently provided intra-sector trading opportunities. We had favorable timing enacting a long CMBS position in mid-April. Unfortunately we cut the position in half in May rather than exiting completely as corporate sector underperformance dragged CMBS spreads wider.

### Corporate Markets

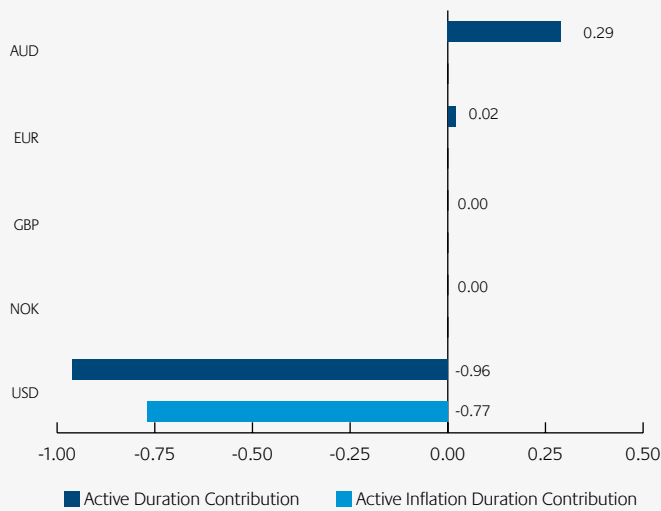
Our overall positioning in IG and HY remained neutral throughout the quarter. We took long positions in companies we thought would tighten relative to the overall market and used short CDX positions to hedge that exposure. IG corporates have been the laggard in US markets, producing their worst half of a year since 2013 and spreads are at their widest levels since 2016. While overall corporate profits have risen sharply, gross leverage has edged higher to 2.5 times, the second-highest level on record. Our cautious approach to selection in this environment helped our investment grade positions outperform the index during the quarter. We favor holding bonds at the long end of the credit curve due to strong demand from pension liability hedging. HY and especially the lowest rated sectors of the HY market continue to be the star credit performers of the year, benefiting from strong domestic fundamentals and demand/supply technical tailwinds. Our HY holdings detracted from performance as some of our holdings widened while the CDX hedge return was flat. EM spreads struggled in the quarter, and have now retraced half of their gains since 2016. We earned a small gain by using EM CDX to short EM spreads. The idea to short EM spreads was good but our timing limited our gain.

## Outlook

Although market moving news may slow down during July and August, the end of summer in the US and Europe should be accompanied by many market moving developments. Politics will be important, particularly with confrontation between Italy and the EU expected to resume in September when the 2019 budget is debated. Italian rate volatility spread around the globe in May and might do so again. The movement in Italian 2YR rates this year has been incompatible with an investment grade country. Brexit negotiations continue, with implications for the UK and the EU. Trade war concerns seem likely to continue, at least through the US midterm elections in November. Corporate earnings are outstanding but it may be getting late in the business cycle. The US 2-10 curve has flattened towards +30 basis points and may invert on further Fed hikes. Since at least the 1970s, every US curve inversion has been followed by a recession roughly 18 months later. Central banks are becoming less accommodative. US short rates are steadily increasing and the ECB is halting its asset purchases. With the ECB approaching their 33% limit on German bond purchases, the threshold for them to resume QE is very high. On a net global basis, central bank balance sheets may begin shrinking by late 2018. Regardless of whether or not IG corporate and EM widening in the first half indicates a broad based spread widening regime is upon us, it seems like most of the spread compression that has occurred since 2016 has run its course.

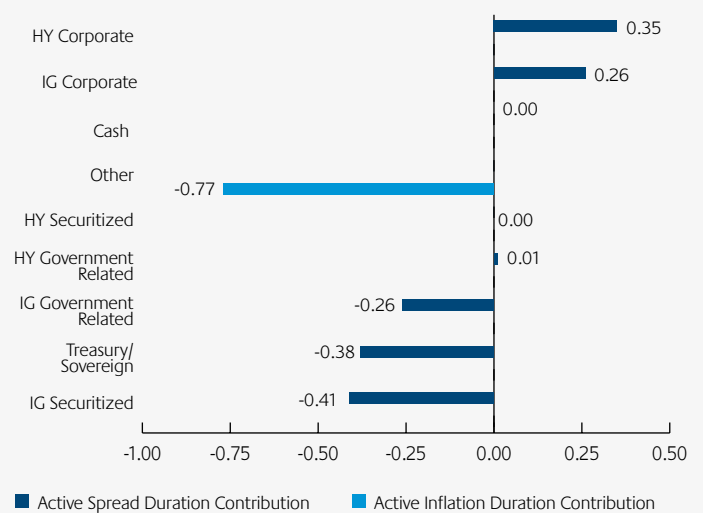
We enter the second quarter short US interest rates. YOY Core PCE finally reached the Fed's 2% target and the Fed is still hiking rates. US growth is supported by tax cuts, increased spending, and the strong labor market. These factors combined with increasing issuance lead us to believe US rates have room to rise. Similarly we are long US breakevens as inflation pressures slowly build. We are slightly long Australian rates vs US rates as the forces that pushed Australian rates below US rates remain in place. We are short the Euro vs the USD, GBP, and NOK as the ECB has committed to keep rates unchanged for at least a year and political turmoil should return to Europe before too long. As far as spread sectors, we are being fairly tactical. We are looking for directional trades in sectors or individual names that do not require holding large basis positions, especially on the long side.

Active DM Rates by FX



Source: Core Plus Strategy as at June 30 2018

Active Spread Duration Contribution



Source: Core Plus Strategy as at June 30 2018

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