

Core Plus Strategy

Q3 2018

Highlights

- The Core Plus strategy returned 0.30% during the quarter, outperforming the Barclays US aggregate which returned 0.02%¹.
- Short positioning in the US 2YR benefitted the fund as the market priced in an additional 20 bps of FOMC rate hikes during the quarter pushing rates higher.
- Long positioning in IG corporates improved returns in July as spreads tighten 20 basis points. IG selection added value throughout the quarter, primarily in TMT and other industrials.
- Tactical positioning of Italian rates versus German rates added value. The fund was short Italy during the August widening and long Italy during its recovery in the first half of September.
- All our ABS holdings added to returns, benefitting from the strong economic backdrop and a steady bid for floating rate securities as short rates moved higher.
- Short positioning in EM was a net positive, with August gains larger than losses in July and September.

Market Review

Global interest rates rose during the quarter, led by the US. The US ten year yield climbed from 2.86% to 3.06%. Ten year rates ended the quarter at the top of the recent range, a range that has persisted for most of the year. Fairly robust economic data contributed to higher rates with 3rd quarter GDP expected in the 3.5 – 4.0% range. Unemployment claims are the lowest since the 1960s. Wage data finally showed signs of improvement while recent inflation measures softened. Consistent with the data, higher rates were driven by real yields with US breakeven inflation rates only moving 0.01% higher. Most indicators of market positioning continue to point toward a fairly extreme level of market shorts, implying that many participants expect rates to rise. This extensive short position may partly explain the market's struggle to move significantly higher in rates. The 2-10 curve flattened 0.09% as the market priced in an additional 20 bps of FOMC rate hikes during the quarter. The market perceives the Fed shift in a hawkish direction, while also increasing its dependence on data rather than models.

German 10YR rates rose from 0.30% to 0.47%. As expected, ECB President Draghi confirmed that the QE purchase pace would be halved in October to €15bn/month, with the likelihood the program will end in December. The ECB downgraded its growth assessment somewhat, but expressed stronger confidence that inflation will continue to converge towards its aim. Likewise, the timing of the first 15bp hike by the ECB has been brought forward to December 2019. European PMIs have stabilized around levels consistent with 0.4-0.5% quarter over quarter growth. UK rates climbed 0.16% as Brexit continues to dominate the political backdrop. Japanese rates joined the global move higher, primarily at the long end, as JGB 30 YRs climbed from 0.70% to 0.90%. Australian 10YR bonds rose only 0.03% to 2.67% as Australian bonds continue to outperform global markets. The Italian political backdrop and particularly the 2019 budget deficit proposal dominated sovereign spread price action. Spreads widened in August as speculation grew that the budget deficit would be >2.5%. However the Finance Minister's insistence that it would be restricted to 1.6% led to a narrowing of spreads in September. The actual 2.4% deficit plan of 2.4% for 2019-21, was a negative surprise to investors and will almost certainly put Italy in direct conflict with the EU fiscal rules. The three year plan makes it hard for the EU to avoid triggering an excessive deficit procedure against Italy.

EM currencies continued to struggle although the -3.7% change in the JP EM Currency index was a big improvement over the calamitous second quarter. Oil prices rose sharply in September as the market became concerned about a supply shock caused by sanctions on Iran. The Argentine Peso and the Turkish Lira were the worst performers for country specific reasons. Other underperformers were countries that are simultaneously exposed to a stronger dollar and must import their oil.

Spread sectors had a strong quarter overall. Spreads tightening in July reversed in August due to EM and Italy related stress. To stem the tide, the IMF doubled down on Argentina, increasing its bailout package to \$57 Billion and front loading more payments. Meanwhile, Italian budget rhetoric improved in September and the overall spread rally reemerged. IG corporate spreads tightened 17 bps to +106, reversing the widening trend from the first half of the year. CMBS spreads tracked IG, tightening 12 bps to +78. HY continued its solid 2018 performance, tightening

¹ Past Performance is not an indication of future performance

47 bps to +316. MBS spreads stayed stable, helped by interest rate volatility remaining low. EM spreads went on a wild ride, tightening 15 bps overall on the quarter, despite a 52 bp widening from late July to early August.

Portfolio Performance

The Strategic Core Plus strategy returned 0.30% during the quarter, outperforming the Barclays Aggregate by 28 basis points. The one year return is -1.81%, underperforming the index by 59 basis points (gross of fees²)³.

Interest Rates and FX

Our macro positions outperformed, driven by a short position in the US 2YR. 2YR yields rose due to solid economic growth and diminishing slack in the economy. The 3.9% headline unemployment rate has not been meaningfully lower since the 1960s. The market perceives the Fed to be shifting in a hawkish direction, while also increasing its dependence on data rather than models. For Fed watchers, some of the most notable changes are the transition of Lael Brainard and Charles Evans from dovish stalwarts to solid centrists. As a result, the market priced in an additional 20 bps of FOMC rate hikes during the quarter.

Tactical positioning of Italian rates versus German rates also added value during the quarter. We remain inherently skeptical of the outlook for Italy, particularly as the ECB prepares to reduce support for the market. Our preference is to invest Italy on the short side but we recognize that many of the problems are priced in and the political situation fluctuates. We were short Italy during the August widening and long Italy during its recovery in the first half of September. Those positions were closed out and we ended September flat Italy, ready to respond as the situation evolves.

Our other positions did not add or subtract meaningfully during the quarter. These included a long position in UK rates versus German rates and a short outright position in German rates.

Securitized Sectors

Our securitized sector positions added value across a variety of ABS sub-sectors. The favorable outlook for ABS is supported by strong fundamentals, robust demand, and the perception of limited downside exposure if the market were to turn. We had profitable positions in Canadian credit cards, government guaranteed student loans, time share ABS, and data center ABS. We have been avoiding benchmark sectors like US credit cards and prime autos that have limited ability for further tightening. Within the ABS subsector, towards the end of the quarter, we added structured settlement and whole business securitization deals. We made a small gain being modestly long CMBS before moving neutral in August, reflecting our general preference for shorter spread duration and less downside exposure to higher rates or some other catalyst causes spreads to widen in the 4th quarter. We incurred a small loss being short agency MBS. We believe MBS has more downside than upside should volatility eventually climb from historically low levels.

Corporate Markets

We began the quarter long IG, increased our position in late July, and then reduced our position to neutral in early September. Our overweight positioning was beneficial, particularly in July when corporate spreads were steadily tightening. Our move to neutral at the beginning of September came early as spreads continued to tighten through the month. We moved neutral due to concerns that technical support was deteriorating, which would ultimately pressure IG spreads wider. IG security selection added value throughout the quarter, primarily in the TMT sector and other industrials. We remained modestly long HY throughout the quarter. Our HY gains were modest due to our relatively small overweight and focus on BB and B names while the lowest rated sectors of the HY market experienced the most tightening. We used EM CDX to short EM spreads during the quarter. Short positioning was successful overall with large Argentina driven spread widening in August partially offset by positive EM performance in July and September. Our gains from a long position in Asian iTraxx were offset by losses on a short position in Australia iTraxx.

Outlook

We entered the 4th quarter short US interest rates at the 2YR and 10YR points on the curve. Strong growth, an active Fed, global central banks moving in the direction of less accommodation, and lots of debt issuance that need to find buyers all contribute to the potential for higher rates. 30 YR rates entered the 4th quarter at 3.21%, not far from an important support level at 3.25%. A move above that support may signal the end of the bull market to many investors. The 5 year trend towards a flatter 2-10 curve has stalled and may not continue. Curve flattening ended in 2004 – 2006 while the fed hike cycle continued, a pattern that may repeat itself again.

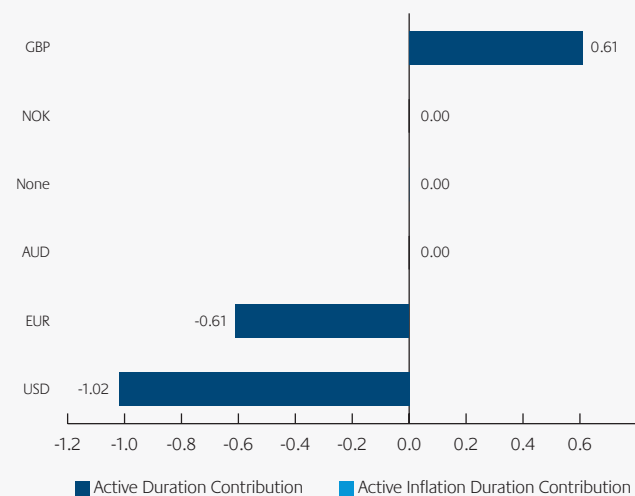
We are cautious on risk markets as tight spreads and low volatility leave limited upside. While, politics could provide a source of volatility in late 2018, the U.S. midterm elections in November are not expected to be major market movers but they will be hotly contested. Brexit and Italian fiscal concerns dominate the European landscape. There have been positive developments on trade with US agreements with South Korea and a revised version of NAFTA. On the other hand, US confrontation with China regarding trade and Iran regarding oil and nuclear sanctions may not be resolved so easily.

The era of central bank QE supported risk markets is gradually ending, as proved by the US Fed reinvestment of MBS that will stop completely in the 4th quarter. The ECB is extremely likely to stop growing its balance sheet in December. The UK raised rates 0.25% to 0.75% in August and indicated that limited, gradual hikes may occur in the future. Even the BOJ has allowed long end JGB yields to rise. We remain cautious and will carefully evaluate spread markets for long and short position opportunities as the reversal of QE policies picks up steam.

² 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%.

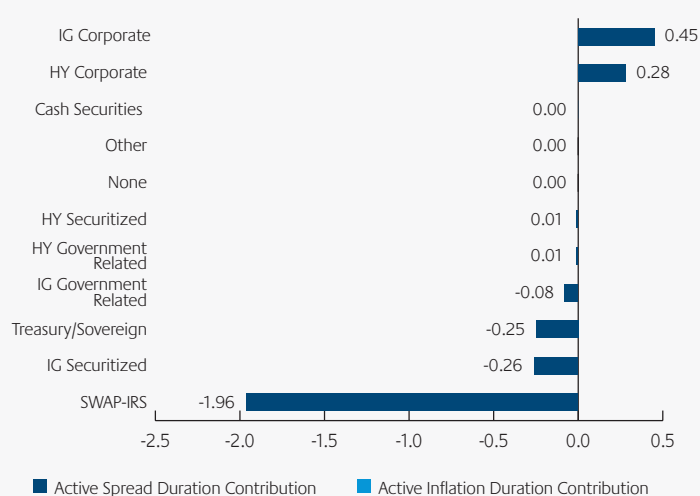
³ Past Performance is not an indication of future performance

Active Duration Contribution by Currency



Source: First State Investments; As of September 30, 2018

Active Spread Duration Contribution



Source: First State Investments; As of September 30, 2018

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