INVESTMENT COMMENTARY

The Tax Cuts and Jobs Act was signed into law on December 22, 2017, initiating several tax cuts and much talked about tax reforms. The markets reacted with their normal enthusiasm as risk assets continued to rally. While the benefits and exact costs of the Act will continue to be debated, the markets focused on the perceived fiscal stimulus. Exogenous factors such as escalating geopolitical tensions and massive levels of developed market debt continued to take a back seat to fiscal and monetary policy.

Against this backdrop, the 2-year treasury yield climbed over 40 basis points in the fourth quarter, while the 10-year yield rose by a more modest 9 basis points. We continue to worry that projected future economic growth is based upon a foundation of perceived, but potentially unrealistic, benefits from fiscal and monetary policy. On December 14th, the Federal Reserve (Fed) continued with their modest plans of incremental Fed rate hikes, raising rates for the third time in 2017. This raised the Fed Fund Rate target to 1.25-1.50%. The Fed is also continuing their strategy to gradually reduce the size of their balance sheet by not reinvesting the paydowns of mortgage-backed securities. With the reported unemployment rate below the 5% Fed target and inflation under control, market expectations are for the Fed to either continue or even accelerate the pace of rate hikes. We believe that the fragility of the financial system and the massive amounts of debt caused by years of zero interest rate policy and multiple rounds of quantitative easing will dictate the monetary tightening pace. As a result, we expect a more measured pace of rate hikes for 2018 and beyond, coupled with a slow decrease in the size of the Fed balance sheet.

We believe the rate trajectory uncertainty, along with all the other factors that have created bond market volatility, should persist for some time. This volatility continues to create opportunities in several high quality corporate names. We are invested in credits that we believe are undervalued on a risk-adjusted basis and should continue to provide value-added as markets normalize and investors become more selective and risk-reward sensitive. We believe any future rate hikes by the Federal Reserve should cause spreads to tighten even further and provide investors with excess returns, although not without the occasional reversals.

We continue to seek to add value to our portfolios by investing in high quality corporate bonds, while maintaining the risk of our portfolios at acceptable levels. Because our process emphasizes risk-adjusted yields, our portfolios tend to have more yield than their respective benchmark, which should also benefit returns.

We maintain our neutral portfolio duration to our respective benchmark, while we also maintained our barbell yield curve positioning with greater emphasis on longer corporate bonds and shorter government securities. Over the next few quarters we anticipate a further flattening of the credit curve and expect our longer maturity corporate bonds will continue to outperform their shorter maturity counterparts.

We maintain our overweight in industrial bonds, which provide our portfolios with additional yield. We continue to selectively invest in Financials, as we believe the spreads offered by the overall sector still only fairly compensate for the sector volatility. We are modestly overweight agency mortgage-backed securities, as sector valuations remained at fair values on a risk-adjusted basis.

Evangelos Karagiannis
Managing Director,
Senior Portfolio Manager

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Mutual Fund investing involves risk. Principal loss is possible. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in Asset Backed and Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. The Fund may invest in derivatives, which may involve risks greater than the risks presented by more traditional investments. The risk of owning an ETF or mutual fund generally reflects the risks of owning the underlying securities that the ETF or mutual fund holds. It will also bear additional expenses, including operating expenses, brokerage costs and the potential duplication of management fees. These risks are fully disclosed in the Prospectus.

Fiscal Policy - The means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

Monetary policy - consists of the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Basis point (bp)- A unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument.

Zero Rate Policy - a method used, by the United States Federal Reserve, Japan and several EU memeber nations, for stimulating growth while keeping interest rates close to zero.

Duration - A commonly used measure of the potential volatility of the price of a debt security, or the aggregate market value of a portfolio of debt securities, prior to maturity. Securities with a longer duration generally have more volatile prices than securities of comparable quality with a shorter duration.

Barbell - An investment strategy primarily applicable to fixed-income investing, in which half the portfolio is made up of long-term bonds and the other half comprises very short-term bonds.

Yield - The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost.

Yield Curve - A line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt.

Spread - The difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

The BofA Merrill Lynch 1-Year US Treasury Note Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month that issue is sold and rolled into a newly selected issue. The issue selected at each month-end rebalancing is the outstanding Treasury note that matures closest to, but not beyond, one year from the rebalancing date. To qualify for selection, an issue must have settled on or before the month-end rebalancing date. You cannot invest directly in an index.

Past performance is not a guarantee of future results.

Opinions expressed are subject to change, are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

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