INVESTMENT COMMENTARY

Following the passing of the Tax Cuts and Jobs Act in late December, investors focused on the anticipated stimulus and economic benefits from the comprehensive tax reduction plan and positive economic data including the lowest level of jobless claims since 1973, signs of modest growth in wages (+2.9% for 12 months ending in January) and GDP (+2.88% in 4Q17), and the highest level of consumer sentiment measured since 2004. We believe the monetary benefit from the Tax Cuts and Jobs Act could add approximately 75 basis points to U.S. GDP over the next few years and caused the considerable spike in interest rates in the first half of the quarter with the 10-Year Treasury yield peaking near 3%. Late in the quarter, the market shifted its attention to threats of trade tariffs and concerns of a global trade war, which we estimate could negatively impact U.S. GDP by as much as 50 basis points. Nonetheless, the Federal Reserve continued their measured pace of incremental rate hikes raising the Fed Funds Rate by a quarter point to a target of 1.5 to 1.75%.

Against this backdrop, the 2-year Treasury yield climbed 39 basis points during the quarter to 2.27% and the yield curve continued to flatten, although not as dramatically as in the previous quarter. The 10-year Treasury yield increased by 33 basis points to 2.74%, producing a negative return for the quarter (-2.39%). In fact, there was no place to hide in the investment grade bond market as all sectors posted negative returns for the quarter. Corporate bonds also generated a negative first quarter return (-2.32%) as spreads widened by 18 bps to 113 bps. Mortgage-backed securities returned -1.19%, but underperformed Treasuries on a duration-adjusted basis due to their extension risk caused by higher interest rates. U.S. Agencies outperformed Treasuries slightly on a duration adjusted basis but still produced a negative return of -0.72%.

Looking forward, PIA remains fairly cautious when reviewing the macro underpinnings of the bond market. We are increasingly concerned about the elevated long-term risks to our socio-economic structure. The recent tax cuts and an aging demographic will shrink the tax base and likely add to the more than $1 trillion U.S. deficit at a time when the Federal Reserve is raising rates and increasing the cost to service our national debt. Additionally, if the increased antagonism between the US and China results in a trade war, this will likely be inflationary and detrimental to the U.S. economy. Lastly, we continue to monitor potential geo-political risks that include, but are not limited to, the Mueller investigation, fiscal attacks on some bellwether companies like Facebook and Amazon, a potential correlation between the dot.com-like meltdown of Bitcoin and investor appetite for risk assets, news out of the Korean peninsula and a potential shift in investor sentiment related to mid-term elections.

Currently, the market projections for short-term interest rates are based on a consensus of three additional Fed Fund rate hikes in 2018. Despite continual improvement in the labor market and recent signs of wage growth, we presently do not anticipate a meaningful pick up in inflation or GDP and continue to believe that exceptionally low global yields will continue to translate into a supply-demand imbalance and a ceiling on U.S. intermediate and long-term treasury yields in the near future. Therefore, we believe the Fed may be more cautious than anticipated and more than two rate hikes could advance the risks of an economic contraction. Historically, the yield curve has inverted in nearly 80% of past occurrences in which the yield differential between the 2- and 10-year Treasuries was less than 50 basis points. The spread between 2- and 10-year yields at the end of the first quarter was 47 basis points. This is meaningful because all of the past six recessions were preceded by an inverted yield curve. We believe there is causality for this correlation between inverted yield curves and recessions, as access to capital is the lifeblood of the U.S. economy. When the yield curve inverts and short-term rates are higher than long-term rates, it creates a significant disincentive for banks to lend money. Lending institutions pay short term rates for deposits and earn long term rates on their loans, and constricted capital to businesses and households typically pushes the economy closer to recession. Since we don't expect the Fed to induce an economic slowdown, we anticipate the yield curve to remain modestly flat with the spread between 2- and 10-year yields staying near or above 50 bps and interest rates remaining in a trading range for the foreseeable future. Given our outlook, we maintain our neutral to slightly short portfolio duration relative to our respective benchmarks. We also maintain a modest maturity barbell, as we expect the credit curve to flatten from current levels with longer maturity corporate bonds outperforming their shorter maturity counterparts.

We expect market volatility and uncertainty to continue, which may create interim opportunities in high quality corporate names, despite the relatively tight spread environment, as corporate issuance remains strong and increased M&A activity could add a layer of unpredictability. We believe the rise in overall corporate leverage is manageable for high quality investment grade borrowers with strong revenue/EBITDA growth, debt service improvement from low rate issuance and lowered corporate tax rates and, thus, maintain a corporate overweight. We continue to invest in credits that we believe are undervalued on a risk-adjusted basis and that should continue to provide value-added as investors become more selective and risk-reward sensitive but are consistently monitoring any changes in near-term economic outlook. We maintain an overweight in Industrial bonds providing our portfolios with additional risk-adjusted yield and continue to selectively invest in primarily high-quality Senior Unsecured Financial credits, as we believe the spreads offered by the overall sector still only fairly compensate for the sector volatility. Lastly, we remain modestly overweight agency mortgage-backed securities, as sector valuations remain at fair value on a risk-adjusted basis.

PIA Macro Strategy Group

KEY **RATES**

	3/31/18	12/31/17	3/31/17
Fed Funds Target Rate	1.5 - 1.75%	1.0 - 1.25%	0.75-1.0%
3 Month LIBOR	2.31	1.69	1.15
On-the-run Treasuries:			
3 Months	1.70	1.38	0.75
6 Months	1.91	1.53	0.90
2 Years	2.27	1.88	1.25
5 Years	2.56	2.21	1.92
10 Years	2.74	2.41	2.39
30 Years	2.97	2.74	3.01

Source: Bloomberg

KEY **ECONOMIC INDICATORS**

as of	3/31/18	3/31/17
U.S. $ (DXY)	89.97	100.35
Oil	64.94	50.60
Gold	1,325.00	1,249.35
CRB	195.36	185.88
GDP	2.9	2.1
CPI	2.2	2.7
Core (Ex - Food & Energy)	1.6	1.8
Unemployment Rate	4.1	4.7
Consumer Confidence	127.70	125.60
S&P/Case-Shiller – Comp-20	6.40	5.73

Source: Bloomberg

INDEX **RETURNS**

	1Q'18	YTD	1-Year
Bloomberg Barclays –			
Universal	-1.41%	-1.41%	1.52%
Aggregate	-1.46	-1.46	1.20
Aggregate ex-credit	-1.17	-1.17	0.60
Gov-Credit	-1.58	-1.58	1.39
Int. Gov-Credit	-0.98	-0.98	0.35
Corporate	-2.32	-2.32	2.70
Treasury only	-1.18	-1.18	0.43
1-3 year Gov	-0.15	-0.15	0.02
BofA Merrill – 1-yr T-Note	0.25	0.25	0.66
High Yield	-0.86	-0.86	3.78
International Debt	3.62	3.62	11.75
Emerging Markets Debt	-1.48	-1.48	3.18
S&P 500	-0.76	-0.76	13.98
DJIA	-1.96	-1.96	19.39
NASDAQ 100	3.15	3.15	22.39
MSCI EAFE	-1.41	-1.41	15.35

Source: Bloomberg Barclays

SECTOR **RETURNS**

1Q'18	Total Return	Excess Return
U.S. Treasuries	-1.18%	0.00%
Government-related U.S. Agency	-1.03	0.02
Government-related Credit	-1.19	-0.01
Corporate	-2.32	-0.79
Corporate Financials	-2.21	-0.99
Corporate Industrials	-2.31	-0.67
Corporate Utilities	-2.87	-0.87
Corporate AAA-rated	-3.11	-0.92
Corporate AA-rated	-1.83	-0.60
Corporate A-rated	-2.57	-1.04
Corporate BBB-rated	-2.15	-0.59
Corporate High-Yield	-0.86	-0.17
Securitized	-1.19	-0.36
Mortgage-backed Securities-FR	-1.19	-0.39
CMBS	-1.32	-0.06
ABS	-0.39	-0.19

Source: Bloomberg Barclays

Pacific Income Advisers, Inc. (PIA) is an autonomous investment management firm registered under the Investment Advisers Act of 1940. PIA manages a variety of fixed income, equity, and balanced assets for primarily United States clients.

BENCHMARK DESCRIPTION

Bloomberg Barclays U.S. Universal Index represents the union of the U.S. Aggregate Index, U.S. Corporate High-Yield Index, Investment-Grade 144A Index, Eurodollar Index, U.S. Emerging Markets Index, and the non-ERISA eligible portion of the CMBS Index. The index covers USD-denominated, taxable bonds that are rated either investment-grade or below investment-grade. Some U.S. Universal Index constituents may be eligible for one or more of its contributing subcomponents that are not mutually exclusive. These securities are not double-counted in the index. You can not invest directly in an index.

Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index that covers the investment grade fixed rate bond market with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. The issues must be rated investment grade, be publicly traded, and meet certain maturity and issue size requirements. You can not invest directly in an index.

Bloomberg Barclays U.S. Aggregate Ex-Credit Index (LB Agg (Ex-Credit)) The index covers the U.S. investment grade fixed rate bond market, with index components for government, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. You can not invest directly in an index.

Bloomberg Barclays U.S. Government/Credit Bond Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. You can not invest directly in an index.

Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index is the Intermediate component of the U.S. Government/Credit index. The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. You can not invest directly in an index.

Bloomberg Barclays U.S. 1-3 Year Government Bond Index consist of securities in the U.S. Government Index with a maturity from 1 up to (but not including) 3 years. Securities issued by the U.S. Government (i.e., securities in the Treasury and Agency Indices). Inclusions: Public obligations of the U.S. Treasury with a remaining maturity of one year or more. Publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government. You can not invest directly in an index.

Bloomberg Barclays U.S. Treasury Index includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double-counting. Securities in the Index roll up to the U.S. Aggregate, U.S. Universal, and Global Aggregate Indices. You can not invest directly in an index.

Bloomberg Barclays U.S. Corporate Bond Index covers USD-denominated, investment-grade, fixed-rate, taxable securities sold by industrial, utility, and financial issuers. It includes publicly issued U.S. corporate debentures and secured notes that meet specific maturity, liquidity, and quality requirements. Securities in the index roll up to the U.S. Credit and U.S. Aggregate indices. The U.S. Corporate Index was launched on January 1, 1973. You can not invest directly in an index.

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 can not invest directly in an index.

Bloomberg Barclays Corporate U.S. High Yield Index - covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which include both U.S. and non-U.S. corporations. The Yankee sector has been discontinued as of 7/1/00. The bonds in the former Yankee sector have not been removed from the index, but have been reclassified into other sectors. You cannot invest directly in an index.

Bloomberg Barclays Global Aggregate Index provides a broad-based measure of the global investment-grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the U.S. Aggregate Index (USD 300 million), the Pan-European Aggregate Index (EUR 300 million), and the Asian-Pacific Aggregate Index (JPY 35 billion). In addition to securities from these three benchmarks (94.4% of the overall Global Aggregate market value), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300 million), Euro-Yen (JPY 35 billion), Canadian (CAD 300 million), and Investment-Grade 144A (USD 300 million) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized subindices by liquidity constraint, sector, quality, and maturity. The Global Aggregate Index is a component of the Multiverse Index. You can not invest directly in an index.

Bloomberg Barclays Global Emerging Markets Index consists of the fixed and floating-rate USD-denominated U.S. Emerging Markets Index and the primarily EUR and GBP-denominated fixed-rate Pan-European Emerging Markets Index and includes emerging markets debt from the following regions: Americas, Europe, Asia, Middle East, and Africa. For the index, an emerging market is defined as any country that has a long term foreign currency debt sovereign rating of Baa1/BBB+/BBB+ or below using the middle rating of Moody's, S&P, and Fitch. The index does not overlap with the U.S. Corporate High-Yield Index or the Pan Euro Corporate High-Yield Index, but may overlap with other investment-grade Aggregate Indices if the securities meet their index eligibility rules. You can not invest directly in an index.

S&P 500 Index – The S&P 500 index includes 500 leading companies in leading industries of the U.S. economy. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. You can not invest directly in an index.

The NASDAQ-100 Index is a modified capitalization-weighted index of the 100 largest and most active non-financial domestic and international issues listed on the NASDAQ. No security can have more than a 24% weighting. The index was developed with a base value of 125 as of February1, 1985. Prior to December 21, 1998 the Nasdaq 100 was a cap-weighted index. You can not invest directly in an index.

The Dow Jones Industrial Average (DJIA) is an index used to measure the performance of the U.S. financial markets. Introduced on May 26, 1896 by Charles H. Dow, it is the oldest stock price measure in continuous use. Over the past century "the Dow" has become the most widely recognized stock market indication in the U.S. and probably in the entire world. Most of the stocks included in the index are listed on the New York Stock Exchange, and are all large blue-chip companies that reflect the health of the U.S. economy. All but a handful of these have major business operations throughout the world, thus providing some insight into the economic well-being of the global economy. You can not invest directly in an index.

MSCI EAFE Index is a capitalization weighted index that monitors the performance of stocks from Europe, Australiasia, and the Far East. You can not invest directly in an index.

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