SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Investment Grade: Taxable and Tax-Exempt Fixed Income

> A flattening yield curve has dominated markets in the fourth quarter and year. In the **investment grade-taxable market**, longer-duration assets outperformed shorter-duration assets, and investment grade credit outperformed high yield and bank loans. Changes at the Federal Reserve are prominent on the watch list for 2018.

> The **tax-exempt municipal bond market** saw record issuance in the fourth quarter as issuers rushed to market on fears they would lose access to the tax-exempt market once final tax reform legislation was passed.

INVESTMENT GRADE – TAXABLE

Fourth Quarter and Full-Year Performance

The dominant theme of the fourth quarter, as well as the year, was the flattening of the yield curve. The Federal Reserve (Fed) raised its target rate 25 basis points (bps) in December for the third time in 2017 and for the fifth time since the Fed embarked (December 2015) on what we refer to as the "unloosening" cycle. During the quarter, the spread between the two-year and 10-year Treasury flattened by 33 bps (+85 bps to +52 bps). For the full year, the curve flattened by 74 bps (+126 bps to +52 bps).

As a result of the flatter curve in the fourth quarter, longer-duration assets outperformed shorter-duration assets and investment grade credit outperformed high yield and bank loans. 30-year Treasuries were the only segment of the yield curve that was lower in yield over the quarter compared with all of the other primary points of the curve. The U.S. dollar continued to sell off, though not as much as earlier in the year. Volatility for both stocks and bonds plumbed record lows. October, which historically is the most volatile month of the calendar year in the stock market, was the least volatile month in the stock market's history, only to be eclipsed by November. Economic data came in better than expected during the quarter, as measured by the economic surprise indices. Finally, commodities performed well with oil prices up over 16% and copper up over 11%.

Given that the yield curve flattening was in force throughout the year, longer-duration assets also outperformed for all of 2017. Long Treasuries were up slightly more than 8.5%, while intermediate Treasuries were up just over 1%. Long corporates returned over 12%, outperforming intermediate corporates by more than 800 bps. The dollar fell 9.9% for the full year and copper was up almost 31%.

Total returns across most asset classes were more muted relative to the prior three quarters of 2017 given that rates rose primarily in the front and intermediate parts of the curve. With respect to spread sectors in the fourth quarter, the corporate sector delivered 1.17%, the best absolute total return in the investment grade space given its longer duration and fair amount of exposure on the long end of the curve. The overall shorter-duration residential mortgage-backed securities (RMBS) sector, on the other hand, only generated a total return of 0.15%. On an excess return basis, corporates again excelled, producing 99 bps of excess over the quarter compared to 24 bps for RMBS. Across spread sectors, the flatter curve drove returns based on the overall duration of the specific sector.

For the full year, high quality corporates once again had the best performance among investment grade spread sectors with an index total return of 6.42% and an excess return of 3.46%. On an industry sector level, there was a remarkable convergence in excess return as evidenced by the industrials, utilities, and financials producing excess returns of 349 bps, 341 bps, and 343 bps, respectively. The carry trade has clearly been at play and indiscriminate among sectors. RMBS, the other major spread sector in the investment grade arena, generated a total return of 2.47% for the year and 52 basis points of excess return. The Fed has had an impact on valuations in the Agency RMBS sector, which for the most part explains why spreads in the sector have been exceptionally low and why excess returns have been low relative to corporate bonds.

The strength of the corporate investment grade sector in 2017 has largely been a result of the insatiable overseas demand for high quality spread product. Spreads between U.S. Treasuries and German bunds, for example, are near record levels. In the 10-year part of the yield curve, the spread is upwards of 200 bps; in the two-year maturity range, the differential is 250+ bps. To the extent that the Fed is tightening while other central banks remain actively engaged in expanding their balance sheets, foreign investors continue to look to the U.S. markets for yield in high quality spread assets.

To sum up performance, investors that underweighted Treasuries and overweighted spread sectors were rewarded in 2017, the degree to which depended on their sector allocations.

Changes at the Fed

The Fed will undergo one of the most widely anticipated shifts in 2018 that has ever occurred. The Senate Banking Committee approved President Trump's nomination of Fed governor Jerome Powell to succeed Janet Yellen as Fed chair. In addition, the widely recognized "big three" members of the Federal Open Market Committee (FOMC) (Yellen, Stanley Fischer, and Bill Dudley) are either going or gone. Given that there were already two vacancies at the Fed before these members stepped down, President Trump will thus have the opportunity to appoint the entire Board of Governors with the exception of one. From what we already know about the annual voting rotation of Regional Fed Presidents on the FOMC, the shift in the composition of the voters on the FOMC appears overall to lean more hawkish versus 2017.

As a major revamp in Fed leadership is about to take place, we face a number of known unknowns including Powell's view on financial conditions, his reaction function to a stock market selloff or general risk-off environment, and his view on financial stability risk. Powell will make his speaking debut at the semi-annual Humphrey Hawkins testimony before Congress in February followed by his first press conference subsequent to the March 21st FOMC meeting, both instances where he will likely restrain his remarks. Unlike his predecessor, Powell may very well be tested by the market early on in his tenure, given current valuations, the late stage of the economic cycle, and the nearing end of quantitative easing by other global central banks.

The End of Quantitative Easing?

Starting in January 2018, the European Central Bank (ECB) will reduce its bond purchases from €60 billion to €30 billion a month. At this point, the market anticipates that the ECB will likely taper to zero in the fourth quarter of this year. The Bank of Japan (BOJ) is rumored to be reconsidering its "yield curve control" target. In conjunction with the Fed beginning to unwind its balance sheet, the aggregate global central bank balance sheet is projected to inflect sometime in the fourth quarter based on currently available information. While the situation may change, the likelihood is that the aggregate central bank balance sheet may actually start to shrink rather than increase, which would be the first time that has occurred since 2008.

Lower for Longer

We believe that the "lower for longer" thesis remains intact for interest rates, driven by the fact that structural forces continue to overwhelm cyclical responses. President Trump has rolled back a significant amount of regulations, which accounts for high business confidence. The recently passed tax legislation, in our view, is less tax reform than a tax cut that benefits the corporate sector. Add to this Trump's promise to roll out an infrastructure plan in the early months of 2018 and the risk of a reflation psychology trade rises as it did immediately after the 2016 election. Even though the potential exists for long rates to rise as a result, we do not believe that higher long-term rates are sustainable given the amount of debt, both in the U.S. and globally. When we look at the potential for sustainably higher long-term rates, we focus on the structural forces of excessive debt/unfunded liabilities, aging demographics, excess global capacity, and low productivity growth – all of which cannot be alleviated by any tax legislation or infrastructure plan in the near term. We believe, in fact, that high rates could cause a significant selloff in risk assets, which would drive the already-high demand for high quality income-producing assets even higher. The secular low in interest rates may not be set until at least the next recession. In the short term, there is a risk for potentially higher long rates, which we would view as a buying opportunity because of their unsustainability.

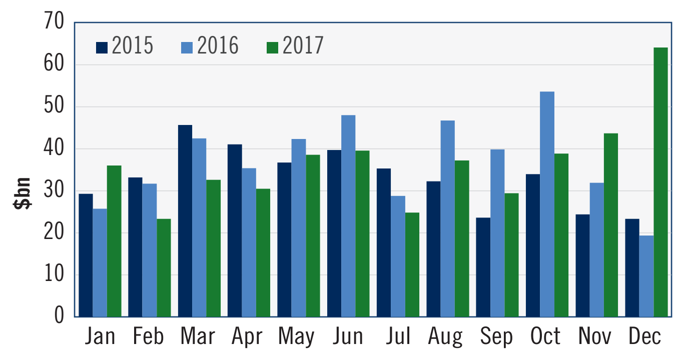
Our View

We enter 2018 with many of the same risks as 2017. Foremost among them is the threat the complacency bubble pops after another year of record-low volatility as the flow of global central bank liquidity abates. While risk continues to be well bid, volatility may pick up as we go through the course of the year and markets remain vulnerable to a sustained risk-off period. We will be watching the Fed closely as the new leadership navigates whatever challenges the markets may deliver.

INVESTMENT GRADE – TAX-EXEMPT

The tax-exempt municipal bond market experienced volatility in the fourth quarter driven by record issuance, consistent demand, and the underlying uncertainty over the potential impact of tax reform.

MUNICIPAL/ISSUANCE, BY MONTH ($BN)



Source: SIFMA, Barclays Research
Past performance is no guarantee of future results.

Supply was exceptionally strong for the quarter at more than $130 billion, with a record $62 billion in December alone. The year ended at roughly $410 billion, which exceeded most predictions. Supply began to surge in November when the Senate and House announced their respective tax reform proposals. There were key provisions in each proposal that could have restricted, and ultimately did restrict, some specific municipal issuance. As a result, many issuers entered the market early for fear of not being able to have access to the tax-exempt market once the final legislation passed.

November's heavy issuance and heightened legislative uncertainty led to weakness and underperformance in the municipal bond market. December brought more clarity to the market as the Tax Cuts and Jobs Act moved through Congress to the President's desk to become law. Municipal bond yields subsequently moved lower in the month and the market recovered.

On the demand side, mutual fund flows continued to demonstrate sufficient ability to handle all of the supply. While there was a mix of inflows and outflows during the quarter, a rotation did occur from shorter-maturity funds into intermediate and longer funds. For the year, the mutual fund complexes added $18.1 billion in municipal bond assets.

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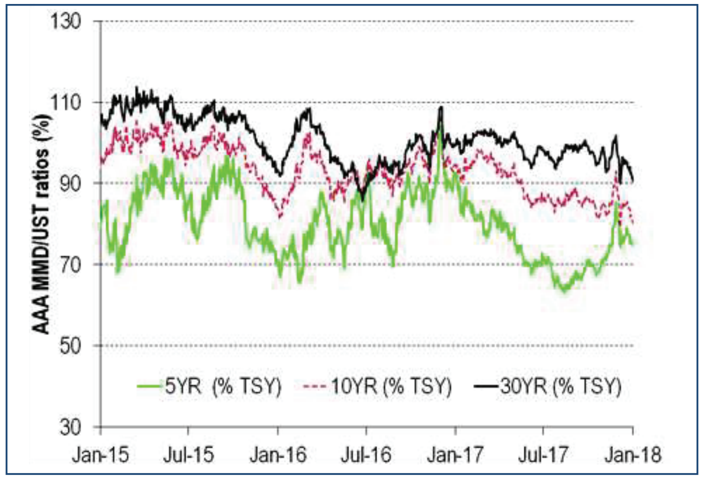
The rush to market was particularly evident among higher education and hospital bond issuers, which were most vulnerable to the limitations on issuance under the different variations of tax reform. Setting another record for December, there was $9 billion in issuance of hospital bonds in just that month. With the potential shortage of this type of yield product, higher education and hospital bonds provided the best returns for the quarter. At the other end of the spectrum, state and local GOs provided the lowest returns given their lesser risk to any sort of limitations.

Credit spreads continued to remain narrow. November's backup in yields provided a reasonable entry point to add some lower-rated paper, but BBB and A-rated paper continued to provide the strongest returns for the quarter as well as the year.

In terms of the yield curve, the fourth quarter saw a significant flattening. The spread between the 2-year and 30-year bond went from 184 basis points (bps) at the end of the third quarter to 98 bps at year-end. This was driven largely by rates in the front end adjusting higher and rates ten years and longer moving lower. The 2-year yield increased by 56 bps, the 10-year moved lower by 2 bps, and the 30-year fell by 30 bps.

How then did municipal bonds perform versus other asset classes? Given their upward move in yields at the front end, municipal bonds underperformed U.S. Treasuries in that part of the curve. The Municipal/Treasury ratio for the two-year thus moved higher, from 67% at the end of the third quarter to 82.7% at year-end. Conversely, with yields moving lower at the longer end, municipals outperformed Treasuries in the ten years and longer space. The ratio on the ten-year went from 86% at the end of the third quarter to 82% at year-end; the 30-year ratio fell from 99.5% to 92.6%.

AAA MMD TREASURY YIELD RATIOS



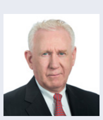
Source: Citi Research and Thomson Reuters
Past performance is no guarantee of future results.

Credit issues surrounding state and local governments are still a concern, particularly in the area of pension funding. It remains to be seen how changes in the tax code will affect revenue collections, and the extent to which states will feel the pressure to cut their tax rates given that residents no longer can deduct state and local taxes on their federal tax returns. 2018 will not provide the answers to these questions but they are longer-term issues that state and local governments will grapple with.

As we look to the year ahead, tax reform will continue to influence the municipal bond market. In summary, we believe that a net decrease in supply, a decrease in corporate demand, outperformance of lower-coupon bonds, and strong performance by debt from high tax states is likely to materialize over the next year. For more detail, please refer to *The Potential Impact of The Tax Cuts and Jobs Act on the Municipal Market 2018.*

Authored by:

Investment Grade – Taxable



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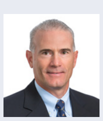

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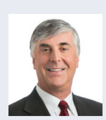
Investment Grade – Tax-Exempt



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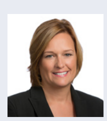

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Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up focused, top-down aware process. Seix employs multi-dimensional approaches based on strict portfolio construction methodology, sell disciplines, and trading strategies with prudent risk management as a cornerstone.