

Core Bond Wrap

TAXABLE FIXED INCOME STRATEGY

SEIX ◆
INVESTMENT
ADVISORS LLC®

Liquidity Rocks as the Fed Crosses the Rubicon

The second quarter of 2020 got off to a rocky start as pandemic mitigation swept the country, but unprecedented fiscal and monetary responses from both a size and speed perspective provided some welcome relief in the deepest contraction since the Great Depression.

Talk about strong cross-currents: The Dow Jones Industrial Index had its best quarter since 1Q87. The S&P 500® had its best quarter since 1998. The Nasdaq saw its best quarter since 2001. The Russell 1000® Growth Index had its best quarter ever. Oil saw its best quarter since 3Q90 as West Texas Intermediate prices rallied by almost 92% after a brief stay in negative territory. Gold had its best quarter since 1Q16 and year-to-date has gained 17.4%. As haven asset performance goes, only long Treasuries outperformed gold. Silver also had its best quarter since 4Q10. Yet, the confluence of very good performance by risk assets, thanks to the Federal Reserve (Fed), and haven assets signaled ongoing deep-seated problems with the economy.

The recession, it turns out, actually started in February 2020, according to the National Bureau of Economic Research (NBER), which may be the fastest the NBER has ever declared a recession relative to its start. No surprise, given the millions of workers who joined the unemployment rolls each week.

Then, on April 9, a date financial historians will long remember, the Fed wheeled out what amounted to a money cannon (forget bazookas) by announcing that it would purchase fallen angel corporate bonds and ETFs, including high yield ETFs. Fast forward three months, the Fed is already one of the largest holders of several large ETFs in the corporate space.

It bears repeating why such intervention was so important. Remember that before the pandemic, there was about \$2.1 trillion in non-financial, BBB-rated corporate debt. And according to the rating agencies, about \$700 billion of that amount were credits with leverage statistics more akin to non-investment grade. So, what the rating agencies were doing was providing ratings forbearance that would continue until there was an economic slowdown/recession that would inevitably force their hand and the downgrades would surely follow.

The Fed knew it had to step in. Some 37% of that \$2.1 trillion in BBB, non-financial corporate debt was either under review for downgrade, or had a negative ratings outlook, raising dire implications for the high yield market, which at approximately \$1.3 trillion in market value, was now facing the potential for several hundred billion dollars in fallen angel supply. This pending flood of additional downgrades would have occurred at the same time that high yield mutual funds and ETFs were likely experiencing significant outflows, thereby further pressuring the high yield market and by extension the stock market.

Holdings are subject to change. The top holdings are as of the period indicated. There is no assurance that any of the securities noted will remain in a portfolio at the time you receive this commentary. Actual holdings and percentage allocation in individual client portfolios may vary and are subject to change. It should not be assumed that any of the holdings were, or will prove to be, profitable, or that the investment recommendations or decisions we make in the future will be profitable. A list of all securities held in this strategy in the prior year is available upon request.

To obtain the top/bottom holdings calculation methodology, call 800-243-4361.

TOP 10 HOLDINGS

	% of Portfolio
Huntington Bancshares	1.92
Boeing Co.	1.24
Citigroup Inc.	1.20
Bank of America Corp.	1.15
U.S. Treasury N/B	1.13
Schlumberger Investment	1.06
NetApp Inc.	0.91
Southern Co.	0.89
Abbvie Inc.	0.86
EOG Resources Inc.	0.84

PORTFOLIO MANAGERS



Jim Keegan
CIO & Chairman
Industry
experience
since 1982
Joined Seix in
2008



Perry Troisi
Senior Portfolio
Manager
Industry experience
since 1986
Joined Seix in 1999



Michael Rieger
Senior Portfolio
Manager
Industry
experience
since 1986
Joined Seix in 2007



Carlos Catoya
Portfolio Manager
Head of IG
Credit Research
Industry
experience
since 1987
Joined Seix in
2001



Jon Yozzo
Portfolio Manager
Head of IG Corp
Bond Trading
Industry experience
since 1991
Joined Seix in
2000

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That was really a critical data point for both the credit markets and the equity markets. As massive fiscal stimulus and liquidity injections took effect, there was a lot of excitement building over the second half of the quarter about the re-opening of the economy, prompting significant gains in risk assets. Now, however, 60% of the states are either reconsidering relaxed restrictions or locking down parts of their economies again. We'll be paying close attention to the implications of that about-face.

The Hole Truth

For all the positive economic surprises, particularly on employment and retail sales, it is more important to assess the data in the context of the **level** of the change, relative to the pre-pandemic lockdown, as opposed to the **rate** of change given the depth of the hole that was dug in the economy. Sure, there has been improvement, but we still have double-digit unemployment (with some federal benefits slated to run out soon, if not extended), many consumers are in limbo, a number of sectors remain distressed, and corporate defaults and bankruptcies are on the rise.

Against that backdrop, we would caution that the Fed can solve liquidity problems, but it's not in a position to address solvency problems, which we think remain a significant risk within the credit markets and particularly within the non-investment grade sectors of the corporate bond market. All Fed liquidity does is buy time; it doesn't create revenues or cash flow, and we have to pay close attention as that story plays out. The reckoning we anticipate may not occur in the third quarter, or even the fourth quarter for that matter, but underestimating the challenges ahead would be a mistake for all investors. That said, the Fed will be there should the economy or the financial markets require more support.

While the economy should snap back in the third quarter, we believe the shape of any recovery is likely to resemble a reverse square root symbol (see Exhibit 1), as opposed to the V- or U-shaped recoveries seen by optimistic prognosticators. Our second recovery scenario would look more like a W, or maybe a series of Ws.

EXHIBIT 1. INITIAL SHOCK TO THE ECONOMY MAY BE BEHIND US, BUT RECOVERY PATH REMAINS VERY UNCERTAIN 7/31/14 - 5/31/20



Source: The Conference Board Leading Economic Index®, Bloomberg

Performance

Despite the ongoing uncertainty in the second quarter, the portfolio posted a positive return of 2.81% versus the Bloomberg Barclays Government/Credit Index (Index) return of 3.71%. Due to overall asset allocation positioning, as well as solid security selection, the portfolio outperformed the Index by 2.21% year to date, generating a positive return of 9.42%.

In the second quarter, there wasn't much change in rates or the yield curve. Treasury rates really didn't move. Two-year and five-year Treasuries declined by about 10 basis points (bps). The 10-year was pretty much unchanged on the quarter. And the 30-year was up about nine bps. Ranges over the second quarter for Treasuries were very muted relative to the first quarter, especially compared to what we experienced in March, when flows were overpowering in both directions. Q2 was more about risk asset performance and, in particular, corporate credit, both investment grade and high yield.

On the investment grade side, the corporate bond sector delivered 847 bps of excess return, accounting for most of the sector's 8.98% total return. Investment grade corporate credit was led by the lower quality sector, the BBBs, which outperformed the As by 429 bps. For the plus sector, high yield corporate credit generated 966 bps of excess; similarly, this was the bulk of the 10.18% total return. In high yield, however, higher quality BBs outperformed Bs by 286 bps and CCCs by 236 bps. Those excess returns explained most of the total return on the quarter due to the aforementioned muted move in Treasury rates after the Fed's actions of late March and early April.

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Energy was the best performing sector in both the investment grade corporate market and the high yield market. The investment grade energy sector was up a little over 19%, and high yield energy was up 40%. With crude oil having advanced 92% over the quarter, this outcome was not particularly surprising.

Moving away from credit, the securitized asset classes were pretty subdued. With the Fed still actively buying residential mortgage-backed securities (RMBS), this largest sector of the securitized market produced only 38 bps of excess return.

Commercial mortgage-backed securities and asset-backed securities generated 323 and 326 bps of excess return, respectively, which was good, but certainly not what we saw in credit. That's largely because the commercial mortgage market faces a long-term re-evaluation given how much the pandemic has disrupted behavior at both the corporate and individual level. Employers will begin to analyze their office space needs going forward while at the same time employees will question the need to live in urban centers. Should the work-from-home model become a more permanent part of many industries, the implications for urban center office space and multi-family housing will take time to sort out.

Economic Outlook

On its present course, the Fed is going to take its balance sheet from around \$7 trillion now to \$10 trillion by the end of the year— just under 50% of GDP—and it's very clear that it will do more if it needs to, but what some investors may not realize is that there's an inverse relationship between the Fed's balance sheet and economic growth. The more aggressive the Fed is with its balance sheet, the more we're convinced that the economy will weaken, not strengthen, while the risk of deflation rises, not shrinks. In other words, the Fed's zero interest rate policy and balance sheet expansion are not stimulative to the economy, but they sure do drive risk assets.

On the fiscal side, following the Senate's swift rejection of the House's \$3.5 trillion stimulus plan, Senate Majority Leader Mitch McConnell said that he would like to see an alternative by the end of July. The Trump administration said it wants something by the first week of August, albeit on the order of \$1 trillion or less. In the face of such political headwinds, we believe the larger infrastructure stimulus is more likely in 2021 than in 2020.

Small business may be left in the lurch. Consider the pessimism gleaned by a recent Census Bureau survey that asked small businesses through the end of June when they expect things to return to normal: 41% said "longer than six months," but 9.3% said "never." Adding that up reveals 50% of the small businesses surveyed think we're at least six months away from returning to "normal," whatever that may be.

Also worth noting: a COVID household survey done by the University of Chicago in which 25% of those surveyed remain concerned about having enough food, and 65% said they had no plans to use a credit card. That's a dramatic change from what we've seen up to this point. As for the elusive concept of returning to normal, 75% of those surveyed said they are avoiding large crowds and public places, 72% are avoiding restaurants, and 38% feel "hopeless about the future."

China Tensions

Clearly, there is a new cold war between the United States and China. So, the question is, how does that manifest itself? While the State Department under Secretary Mike Pompeo is becoming very hawkish on China, we doubt the Trump administration is going to do anything to upset the financial markets between now and the election. If Trump is reelected, the cold war will likely accelerate. If former Vice President Joe Biden is elected, policy may turn dovish, although members of the current House of Representatives are closer to Trump than they are to Biden as it relates to China.

The implications for emerging markets really relate to global trade, which continues to be very weak. The best proxy for global trade, in our view, is South Korean export data, which remains down around 11% y-o-y even after a bounce back in June. Since the end of 2018, y-o-y export data from South Korea has only seen one month of positive growth.

The other issue for emerging markets is the U.S. dollar, which weakened in the second quarter, but is still well within a trading range. So, we would watch the dollar very closely. If the dollar breaks lower, that's going to be good for emerging markets, and if the dollar strengthens, that's bearish for emerging markets. When you combine weak global trade and a weak recovery that favors a stronger dollar, it suggests emerging markets will remain under pressure.

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The combination of a weakening global economy, weak global trade, a shortage of dollars, and a formidable amount of dollar denominated debt, particularly within the emerging market corporate sector, bodes well for the dollar. That's an out-of-consensus view right now, but it's a relative world. While the Fed was first to ramp up aggressive monetary policies, the European Central Bank was right behind it, along with the Bank of Japan and the Bank of England. Given that sequencing, all we saw was a minor dollar correction as the Fed was out of the gate the fastest.

As always, please let us know if you have any questions about the market or your portfolio. We thank you for your support of Seix Investment Advisors LLC.

ANNUALIZED PERFORMANCE (%) AS OF 6/30/2020



Net returns are calculated by subtracting the highest applicable wrap fee (2.50% on an annual basis, or 0.21% monthly) on a monthly basis from the gross composite monthly return.

Past performance is not indicative of future results. The information shown above is supplemental information only and complements the fully compliant presentations. Periods greater than one year are annualized.

Benchmark: Bloomberg Barclays US Government/Credit Bond Index includes treasuries and agencies that represent the government portion of the index, and includes publically issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

For information, contact:

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Core Bond Wrap Composite Data

Year End	Total Firm	Composite Assets		Annual Performance and Standard Deviation					
	Assets (\$ mil)	US\$ (\$ mil)	# of Wrap Sponsors	Net Composite Return	Pure Gross Composite Return	Composite 3-Year Std. Dev.	Bloomberg Barclays US Govt/Credit Bond Index	Index 3-Year Std. Dev.	Composite Dispersion
2019	18,071	191	5 or fewer	5.67%	8.33%	3.40%	9.71%	3.26%	N/A
2018	21,160	185	5 or fewer	-2.81%	-0.34%	3.19%	-0.42%	3.16%	N/A
2017	24,843	224	5 or fewer	1.11%	3.67%	3.26%	4.00%	3.28%	N/A
2016	27,631	208	5 or fewer	1.05%	3.61%	3.44%	3.05%	3.46%	N/A
2015	25,698	205	5 or fewer	-2.91%	-0.45%	3.16%	0.15%	3.25%	N/A
2014	30,989	186	5 or fewer	3.09%	5.69%	2.92%	6.01%	2.95%	N/A
2013	26,600	200	5 or fewer	-5.50%	-3.10%	3.38%	-2.35%	3.17%	N/A
2012	26,141	247	5 or fewer	0.78%	3.33%	3.30%	4.82%	2.96%	N/A
2011	26,147	218	6	6.79%	9.48%	3.52%	8.74%	3.42%	0.2%
2010	25,855	229	7	3.84%	6.46%	-	6.59%	-	N/A

N/A - Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year.

Seix Investment Advisors LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Seix Investment Advisors LLC has been independently verified for the periods January 1, 1993 through December 31, 2018. The verification reports are available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Seix Investment Advisors LLC is an SEC-registered investment adviser and wholly owned subsidiary of Virtus Investment Partners. The firm maintains a complete list and description of composites, which is available upon request.

The Seix Core Bond Wrap Composite consists of all Core Bond Wrap Fee accounts managed by Seix in all participating Wrap Fee Sponsors' Programs. The minimum account size for inclusion in the composite is \$500,000. For comparison purposes, the composite is measured against the Bloomberg Barclays US Government/Credit Bond Index. The Bloomberg Barclays US Government/Credit Bond Index is an unmanaged index consisting of Treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year), 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), and publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. Securities must be rated investment-grade (Baa3/BBB- or higher). Index returns do not reflect the deduction of any fees.

The Seix Core Bond Wrap Composite was created October 1, 1998, and has a performance inception date of July 1, 1993. Prior to September 30, 2017, the Seix Core Bond Wrap Composite was named the Seix Core Bond SMA Composite.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. The U.S. dollar is the currency used to express performance. Returns include the reinvestment of all income. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the wrap sponsors in the composite the entire year.

Pure Gross returns are presented as supplemental information, do not reflect the deduction of any trading costs, fees or expenses and are presented for comparison purposes only. Net returns are calculated by subtracting on a monthly basis the highest assumed wrap fee (2.50% annually or 0.21% per month) from the gross composite monthly return. The assumed wrap fee includes all charges for portfolio management, trading costs, custody and other administrative fees.

Actual wrap fees vary by Program Sponsor. Please refer to the Program Sponsor's ADV 2A for a full disclosure of the fee schedule for wrap fees. Returns realized by clients will be reduced by the actual wrap fee rates and rates incurred by clients will vary.

Performance presented for the period prior to March 31, 2008 occurred while the Portfolio Management Team was a part of Seix Advisors, the Fixed Income division of Trusco Capital Management, Inc. ("Trusco") and the predecessor of Seix Investment Advisors LLC. Effective as of March 31, 2008, Seix Advisors began operating as a separate legal entity, named Seix Investment Advisors LLC ("Seix"), and Trusco was renamed as RidgeWorth Capital Management, Inc. Effective as of May 23, 2014, RidgeWorth Capital Management, Inc. became RidgeWorth Capital Management LLC, and Seix merged with StableRiver Capital Management LLC, a wholly owned subsidiary of RidgeWorth Capital Management LLC. Effective June 1, 2017, RidgeWorth Capital Management LLC was acquired by Virtus Investment Partners, Inc. ("Virtus"). Seix is an SEC-registered investment adviser and is a wholly owned subsidiary of Virtus Partners, Inc., a wholly owned subsidiary of Virtus.

Seix has retained the identical investment style since the inception of the composite. Seix also maintains the records necessary to support the performance of all composites and will provide these records upon request. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. **Past performance is not indicative of future results.**

IMPORTANT RISK CONSIDERATIONS

Credit & Interest: Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **ABS/MBS:** Changes in interest rates can cause both extension and prepayment risks for asset- and mortgage-backed securities. These securities are also subject to risks associated with the repayment of underlying collateral. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **Market Volatility:** Local, regional or global events such as war, acts of terrorism, the spread of infectious illness or other public health issue, recessions, or other events could have a significant impact on the fund and its investments, including hampering the ability of the fund's portfolio manager(s) to invest the fund's assets as intended.

DEFINITIONS & DISCLOSURES

Bonds offer a relatively stable level of income, although bond prices will fluctuate providing the potential for principal gain or loss. Intermediate-term, higher quality bonds generally offer less risk than longer-term bonds and a lower rate of return. Generally, a Portfolio's fixed income securities will decrease in value if interest rates rise and vice versa. Although a Portfolio's yield may be higher than that of fixed income strategies that purchase higher rated securities, the potentially higher yield is a function of the greater risk of that strategy's underlying securities.

This information and general market-related projections are based on information available at the time, are subject to change without notice, are for informational purposes only, are not intended as individual or specific advice, may not represent the opinions of the entire firm, and may not be relied upon for individual investing purposes. Information provided is general and educational in nature, provided as general guidance on the subject covered, and is not intended to be authoritative. All information contained herein is believed to be correct, but accuracy cannot be guaranteed. This information may coincide or conflict with activities of the portfolio managers. It is not intended to be, and should not be construed as investment, legal, estate planning, or tax advice. Seix Investment Advisors does not provide legal, estate planning or tax advice. Investors are advised to consult with their investment professional about their specific financial needs and goals before making any investment decisions.

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