Midyear Market Update

June 30, 2019

We started the year asking "What Could Go Right?" and it's time to get the market's pulse as we begin the second half of the year.

We identified 7 key themes we felt could impact investors at the beginning of 2019:

1) Interest Rates
2) The Fed
3) Credit
4) Curves
5) CEO/CFO Behavior
6) Washington
7) Active Fixed Income

The core of our thesis around the 7 themes was a significant increase in volatility in 2019. This view rests on the basic tenet that we are coming off a period of money being priced too cheap, meaning we were in an artificial rate environment that created capital market distortions and, in many places, poor allocation of capital.

We believe the mispricing of money has also created unhealthy imbalances in the markets and that the market will continue to contend with these imbalances and the re-pricing of risk throughout 2019. With these ongoing changes, we anticipate new valuations and opportunities.

Below we outline our views and expectations of the impact of the 7 themes, both so far this year and more importantly for the rest of 2019.

Theme 1: Interest Rates

As of mid-March, U.S. Treasury rates held within a very tight range. The front-end was pegged to the Fed Funds Rate while the long-end reflected global growth concerns. **We expected rate volatility in 2019 and this theme has not disappointed. In the second quarter, Treasuries returned to low yields last registered in the 2016/2017 time period**.

The bond market is attempting to force the Fed's hand – pricing in over 100 basis points of cuts – as the market believes the Fed Funds Rate is now too restrictive. The Powell-led Fed has come around to the market noting that "the one overarching goal is to sustain the expansion." **If you're still counting, the scoreboard is now: Fed 1 | Market 2+.**

Theme 2: The Fed

We are impressed with Powell's ability to verbally support the markets and believe this was a prudent move: "The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, *but uncertainties about this outlook have increased. In light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion."* A supportive Fed further aids our view that the foundation of the economy will remain intact and when the uncertainties subside – mainly trade resolution – we will be back on track. **As we enter the back half of 2019, we look for resolution on trade, stabilization of global growth, and a normalization of inflation.** As growth and inflation normalizes, the Treasury market has the potential to overreact in the other direction. **In the near-term rates will continue to play off the growing consensus view of a slowing global economy.**

The Fed is clearly communicating that it is focused on sustaining the expansion. Additionally, the Fed has been studying the impact of "makeup strategies," essentially letting inflation rise above the target to "makeup" for past inflation shortfalls. Sustaining the expansion through the current bout of volatility, an economy that is growing at 2%, sitting near full employment and expected to return to its inflation target plays nicely into our 2019 view. **Inflation – via hard data, wages, and expectations – will rise as we enter 3Q. Combine this with a newly accommodative Fed and we expect to see the 2-year UST to 30-year UST curve steepen as the market once again adjusts to a new landscape. One that is not as dire as Treasury markets priced-in throughout the second quarter. Curves historically steepen into Fed cuts with the front-end pegged to the Fed Funds Rate and long-end rates move higher in yield due to growth and inflation expectations. We believe the market is underestimating both the potential Fed path forward as well as structural longer-term inflation pressures.**

Theme 3: Credit

Much like equities, credit spreads have moved down materially from the December wides, reflecting what we see as a more stable outlook and global central bank support. Investment Grade and High Yield spreads via the Bloomberg Barclays Index are 38 basis points (bps) tighter and 149 bps tighter year-to-date (YTD). **Many segments of the credit market have returned to the tights registered prior to the Q4 2018 correction**. This obviously raises questions around risk and reward. While we believe that volatility will be with us for 2019, the recent move from the Fed has been positively received by credit markets. **What is now the second relief rally this year gives investors the opportunity to revisit those investments that caused them the most heartburn – bank loans, high yield,**

private credit, and levered strategies. Caution is still warranted as an accommodative Fed and flat curves can cause investors to complacently reach for yield. **We continue to selectively allocate to improving fundamental credit stories. The spread tightening in risk assets, in light of growing recession fears, feels inconsistent to us yet highlights the ongoing search for yield in the global marketplace.**

Theme 4: Curves

Curves within both credit and Treasuries remain flat and, in some cases, inverted as investors move out the curve in search of yield. This has been more pronounced in the first half of the year within the front-end (3-year UST to 5-year UST inverted to 2year UST) due to U.S. Fixed Income offering an attractive yield in a slowing global environment. The inversion between 10yr Treasuries and 3-month Treasuries has raised questions again around future recession risk. With the combined flat curves, there are consequences for both interest rates and fixed income risk assets. Investors will need to consider the drawdown risk associated with limited yield pickup as they move out the curve. **Similar to 2018, we believe that the front-end offers some of the most compelling risk-adjusted returns. The long end should be monitored closely for opportunities**. **We remain cautious with a significant allocation to short duration credit.**

Theme 5: CEO/CFO Behavior

We continue to watch management teams' behaviors, actions, and capital allocation decisions as these are the main drivers of corporate spreads in the long run. **Given the large moves in rate markets, as well as the recent tightening in spreads, we anticipate opportunity to witness just how committed management teams are to debt reduction plans**. Low all-in rates could again tempt some management teams to revisit debt-funded share repurchases or participate in less credit-friendly activities.

There are many companies, however, that have started the journey toward stronger capital structures via debt reduction. In this camp, for example, AT&T (T) has not only committed to paying down debt but quite uniquely its board has also incentivized the CEO to prioritize and execute on such by tying compensation to debt reduction. As in this case, some are following the path of deleveraging though some are not.

Kraft Heinz (KHC) is one example where, despite communicating its focus on deleveraging, detailed fundamental analysis of the business reveals that deleveraging is likely a very difficult task. As we highlighted in our paper on CEO/CFO and Board Behaviors', specifically toward KHC and its deleveraging plan in general, many deleveraging stories can appear reputable on the surface but actually have limited options around execution. Since writing the initial paper, KHC has been downgraded as the rating agencies began to recognize some of the concerns we have held. Despite some of KHC's actions, we see the company as fighting an uphill battle to address its less-than-prescient capital allocation decisions of the past. And finally, its ability to execute on a credible deleveraging plan has little margin for error.

These risks highlight the importance of peeling back the underlying layers for every company, which we consider an integral component of our fundamental credit analysis. Ultimately, one of the main jobs of a CEO is the allocation of cash flow generated by the company he or she leads. **We watch this with acute attention to detail. In volatile markets, similar to the present, paying attention to actions and behaviors as opposed to commentary can be crucial. Imperatively, in times like these, we consider security selection and security avoidance ever more amplified.**

Theme 6: Washington

The longest government shutdown in history ended back in January. The Treasury is taking extraordinary measures to avoid the debt limit (as of March 1, 2019) and the President released his deficit-laden budget proposal (March 11, 2019). Secretary Mnuchin announced that lawmakers agree on raising the debt ceiling but remain far apart on spending. Trade negotiations between China and the U.S. remain slow. **Event-driven volatility from Washington remains high and will be ever-present as we continue to work through the Trade Wars and Budget negotiations with a Budget resolution needed by the end of September to avoid another shutdown.** Let's not forget that the current administration will also start positioning for re-election shortly, while at the same time the opposition will need to narrow down their long list of candidates. In what promises to be another contentious election, we only see greater volatility on the horizon. Unfortunately for markets, Washington seems to thrive on public drama and volatility.

Theme 7: Active Fixed Income Management

Our expectations around "what could go right" have largely played out so far this year. Year-to-date returns in the equity markets look more like annual expectations. The swift recovery in credit was a welcome development for many – especially issuers and those feeling offsides in both December 2018 and May 2019. However, we think the return environment looks much more challenging going forward. And we believe that volatility will be high. With the duration of the Bloomberg Barclays US Aggregate Index (a representation of the bond market as a whole) getting longer, the risk of not actively managing both what type of bond you own and where on the curve you own it, has become much higher.

Conclusion:

Complacency will **NOT** be an investor's friend in this environment; it's time to know your fixed income manager, know how they invest and how they think about preserving capital. The indices and closet index managers have been graced with a period of time when Treasury yields have declined and credit spreads have tightened. These two dominant risk factors have served fixed income investors well year-to-date. However, we envision a more challenging path ahead for those not actively managing these risks.

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