1Q 2019 | Fixed Income Markets Review

WST CAPITAL MANAGEMENT

Executive Summary

Bond investors in 1Q 2019 were treated to falling yields and an equity-like credit rally as central banks worked to keep the economic plates spinning. The Bloomberg Barclays Global Aggregate Bond Index posted a total return of 2.20%, driven by US aggregate bonds (+2.94%) that marked their best quarterly result in three years and their second-best since 3Q 2011.

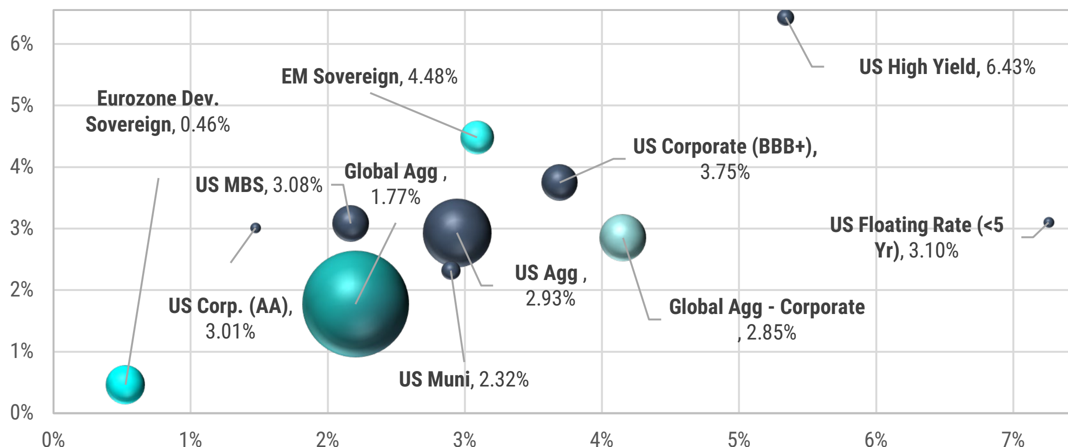
While bond investors received peripheral encouragement from mild inflation and economic data that – while articulating a global growth slowdown – was less negative than feared, the Fed was the overall driver of results across capital markets in 1Q. In November the Fed futures market was predicting three rate increases in 2019; by the end of March it was pricing in a 30% probability of a rate cut by the end of 2019 and a 70% probability of an easing by the end of 2020. This dovish shift in global monetary policy put a spring in the step of capital markets overall. By February, in fact, global bond prices were partially retracing gains on the fear that the Fed might reconsider its "patient" strategy in light of the bounce-back in asset prices, economic data and consumer sentiment. By March, however, policy was pointed firmly towards accommodation and global yields were falling once again.

For most of 1Q the US 10-year yield was range-bound despite all of the activity in capital markets, but March saw the measure break below 2.5% to end at 2.42% - the lowest level since 1Q 2018. Credit spreads rose, but only as a function of the 30 bp decline in the 10-year. High yield put up 7.26% in 1Q and, at +5.93%, is notably on par with the S&P 500 Value trailing one year. AA-rated bonds (+3.69%) enjoyed their best quarter since 2010.

Outside the US, European sovereigns rallied (+1.52%) on the ECB's plans to defer tightening until at least next year and in the meantime consider measures to support the banking sector and counteract the drag of negative rates. England – while in decent shape from a labor and activity perspective – nonetheless saw its central bank defer action pending resolution on Brexit. Emerging sovereigns (+3.09%) enjoyed the impacts of easing both domestically and globally, continuing to find encouragement in the currency tailwind implied by Fed action.

Fixed Income Market by Comparative Size, Yield-to-Worst & YTD Total Return

Labels Indicate Category & YTW as of March 31, 2019



Source: FactSet for all index and market data, shown in USD as of March 31, 2019. For index & data definitions, please see notes & disclosures.

Index Total Returns (%)	1 Mo.	YTD	1 Yr.
BBg Barc Global Aggregate	1.25	2.20	-0.38
BBg Barc Global Aggregate ex-US	0.71	1.52	-4.13
BBg Barc US Aggregate	1.92	2.94	4.48
BBg Barc US Intermediate Aggregate	1.39	2.28	4.33
S&P Global Dev. Sovereign ex-US Bond Index	1.40	2.00	2.40
S&P Eurozone Dev. Sovereign Bond	0.26	0.52	-7.01
S&P Pan-Europe Dev. Sovereign Bond	0.43	1.52	-6.29
ICE BofAML Emerging Markets Sovereign Bond	0.61	3.09	-1.23
S&P U.S. Current 10-Year Treasury Bond Index	3.01	3.13	5.79
BBg Barc US Floating Rate Notes (<5 Yr)	0.36	1.47	2.86
S&P US Treasury TIPS	1.82	3.11	2.85
BBg Barc Municipal Bond Index	1.58	2.90	5.38
BBg Barc Global Aggregate - Corporate	1.63	4.15	1.28
BBg Barc US Corporate (AA)	2.00	3.69	5.08
BBg Barc US Corporate High Yield	0.94	7.26	5.93
S&P/LSTA Leveraged Loan	-0.48	5.13	2.99
BBg Barc Global Agg Securitized - US MBS	1.46	2.17	4.42
BBg Barc Global Agg Securitized - US ABS	0.72	1.48	3.68

Key Rates (%/ bps)	Current	1 Mo. Change	YTD Change	1 Yr. Change
US 3 Month	2.39	-4	-6	+67
US 2 Year	2.27	-24	-23	+0
US 5 Year	2.24	-26	-27	-32
US 10 Year	2.42	-30	-27	-32
US 30 Year	2.82	-26	-19	-15
1 Month USD LIBOR	2.49	+0	-1	+61
3 Month USD LIBOR	2.60	-2	-21	+29
6 Month USD LIBOR	2.66	-3	-22	+21
12 Month USD LIBOR	2.71	-15	-29	+5

Credit Spreads (bps)	Current	1 Mo. Change	YTD Change	1 Yr. Change
US Corporate OAS	60	+1	-23	-5
US Corporate High Yield OAS	391	+12	-135	+37

Key Indicators	Current	1 Mo. Change	YTD Change	1 Yr. Change
10 Yr-2-Yr Treasury Spread (bps)	15	-6	-3	-33
WTI ($/ bb)	$60.19	+$2.98	+$15.04	-$4.68
Core CPI	261	+.4	+1	+5
Breakeven Inflation: 5 Yr %/ bps	1.78%	-6	+27	-14
Breakeven Inflation: 10 Yr %/ bps	1.88%	-7	+17	-17

1Q 2019 | Credit Select Risk-Managed Review

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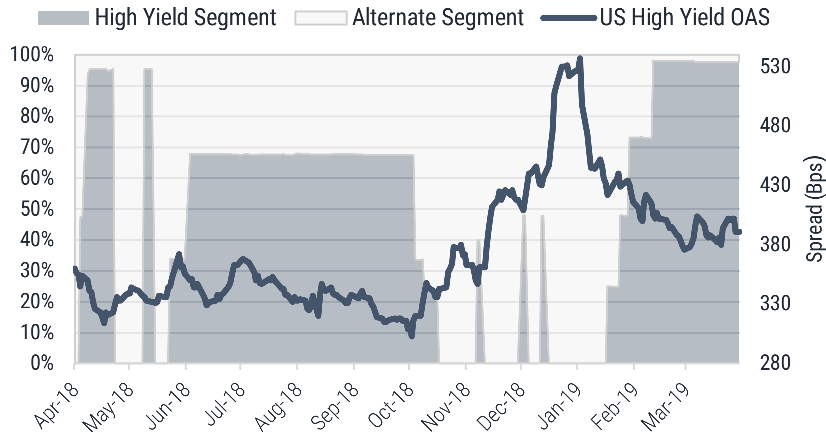
Performance & Positioning Recap

In 1Q 2019 the Credit Select Risk-Managed (CSRM) strategy returned 3.06% gross (2.81% net) versus a Bloomberg Barclays High Yield Index that added 7.26% and a Bloomberg Barclays US Aggregate Bond Index that returned 2.94%. For the trailing one-year period, CSRM has returned 2.54% gross (1.56% net) versus the high yield index up 5.93% and the US aggregate up 4.48%.

CSRM opened 1Q allocated between cash and short-term bonds – i.e., in the fully risk-off posture that it held for much of the prior quarter, during which time high yield capitulated to a sharp pullback in risk assets. In mid-January the strategy began to leg back into a rapidly recovering high yield market and by mid-February CSRM was fully allocated to a mix of market-duration passive high yield and strategic beta with modest duration and quality tilts.

To recap the past few months, CSRM began to unwind its high yield position as credit market conditions became choppy during 3Q 2018; by the fourth quarter the strategy was mostly risk-off and thus had a sideline view of the high yield meltdown in December, drawing down around 2% vs. 5% for the index. Leaving aside a couple of particularly dramatic trading sessions, the deterioration in market conditions was gradual enough to afford a trend. The 1Q rally, however, was the opposite; markets reversed at hyper-speed, delivering roughly 40% of overall upside within the first week of January and over half of the quarter's total return by the middle of that month. As a risk-managed strategy rooted in trend-following, CSRM behaved consistent with the intentions of its design and overall results fell in line with our principal objective of drawdown management and opportunistic participation.

CSRM Allocations vs. High Yield Option-Adjusted Spread
Daily, 1 Year Ended March 31, 2019



Observations & Outlook

A mix of factors drove high yield to its best quarterly result since 2009 and its fifth-best in index history. The "Fed put" was the major driver, of course, in that it rallied risk-asset markets overall, but it's worth remembering that as a low-duration, high-income asset class against a backdrop that was uniquely unfavorable to duration as a factor, junk spent most of 2018 in the sweet spot of bond markets. Furthermore, high yield is rarely worse for the wear in the tightening stage of the interest rate cycle. So while Fed green-lit a bond rally overall, high yield's big comeback was likely a function of multiple factors including the soothing implications for credit quality concerns that troubled investors in 4Q and, secondly, the impact of Treasury movements on perceived relative value in high yield.

Heading into 4Q valuations did feel a bit stretched thanks to unique and now-moot interest rate dynamics, but the asset class ended up oversold relative to credit concerns. Our views do not impact the model's signals, but we do maintain the view that high yield is fundamentally sound. Interest coverage ratios are high, and 1Q simply shored up the condition of high yield issuers through improving economic data and the Fed's policy shift. But in the short term, credit risk may be a diminished driver in this asset class.

It is worth unpacking the observation that in March, spreads rose but high yield posted nearly a percentage point in total return; the same relationship holds over the trailing one-year period. For most of 1Q the US 10-year yield was range-bound despite all of the activity in capital markets, but March saw yields break below 2.5% to end at 2.42% - the lowest level since 1Q 2018. In March alone the 10-year yield fell roughly 30 basis points – so steeply, in fact, that it widened the basic yield-to-maturity spread even as high yield prices continued to inch upward. Over the last twenty years there have been 33 months in which yields fell for both the 10-year and junk, but the 10-year yield fell faster - so this dynamic occurs frequently enough. However, March 2019's observation was noteworthy in that the difference in the rate of change (i.e., 24 bps considering -30 bps for the 10-year versus -6 bps for junk) was around double the average of that sample set. Furthermore, at roughly 2.71%, the starting 10-year yield was a full percentage point below the average initial Treasury yield for the sample set.

Point being? Now that the losses from 4Q's credit scare have been restored, going forward expanding OAS may speak as much to the Fed's impact on core bonds as it does to the fundamental picture for high yield. In the short term at least, credit risk seems more reasonably priced and junk may instead by driven up by interest rate volatility. As of the end of March, the Fed Futures market is pricing a 30% probability of a rate cut by the end of 2019 and a 70% probability of an easing by the end of 2020 – thus, continued spread-narrowing is a fairly intuitive scenario.

Given that possibility, we believe relative value assessment of high yield should take into account that the Fed hasn't actually resolved any structural concerns – i.e., the corporate debt-to-GDP ratio or massive BBB-rated (just-above-junk) segment looming over the high yield market. In 4Q investors were spooked by the notion that just a handful of BBB downgrades could flood the high yield market, resulting in a nasty correction. Should investors again sour on credit risk in the near term, they will do so with the index at its all-time high and with a trailing one-year return (+5.9%) on par with the S&P 500 Value.

Certainly it remains an interesting time for the asset class and in our view, the environment continues to argue for tactical. As always, we are grateful for your continued confidence in our strategy and we welcome your questions and feedback.

Source for performance & chart information: FactSet, Orion. Please see following page for notes & disclosures.

Notes & disclosures

WILBANKS SMITH & THOMAS
Asset Management, LLC

Credit Select Risk-Managed Commentary:
Chart source: FactSet, Orion. CSRM model daily allocations for the one-year period ended March 31, summarized by "High Yield" and "Alternate Segment" (investment grade fixed income and cash). Spread measure is the daily option-adjusted spread between Bloomberg Barclays US Corp High Yield Index yield-to-worst and the 10 Yr Treasury Yield.

Index Returns – *all shown in US dollars*
All returns shown trailing 3/31/2019 for the period indicated. "YTD" refers to the total return as of prior-year end, while the other returns are annualized. 3-month and annualized returns are shown for:

- The Barclay's US Aggregate Index, a broad based unmanaged bond index that is generally considered to be representative of the performance of the investment grade, US dollar-denominated, fixed-rate taxable bond market.
- The ICE BofAML Emerging Markets Sovereign Bond Index is a subset of The BofA Merrill Lynch World Sovereign Bond Index excluding all securities with a country of risk that is a member of the FX G10, all Western European countries, and territories of the U.S. and Western European countries. The FX G10 includes all Euro members, the U.S., Japan, the U.K., Canada, Australia, New Zealand, Switzerland, Norway, and Sweden.
- The Bloomberg Barclays Global Aggregate Index, which measures global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
- The S&P Global Developed Sovereign Bond index includes local-currency denominated debt publicly issued by governments in their domestic markets.
- S&P Eurozone Developed Sovereign Bond - seeks to measure the performance of Eurozone government bonds.
- The S&P Pan-Europe Developed Sovereign Bond Index is a comprehensive, market-value-weighted index designed to track the performance of local currency-denominated securities publicly issued by Denmark, Norway, Sweden, Switzerland, the U.K. and developed countries in the Eurozone for their domestic markets.
- ICE BofAML Emerging Markets Sovereign Bond - tracks the performance of US dollar (USD) and Euro denominated emerging markets non-sovereign debt publicly issued within the major domestic and Eurobond markets.
- The Bloomberg Barclay's US Corporate Bond Index (AA), which measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
- The Bloomberg Barclay's US Corporate High Yield Index, which covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market.
- Bloomberg Barclay's Global Aggregate Securitized- US Mortgage-Backed Securities, which is a component of the Bloomberg Barclay's US Aggregate Index and measures investment grade mortgage backed pass-through securities of GNMA, FNMA, and FHLMC.
- Bloomberg Barclay's Global Aggregate Securitized- US Asset-Backed Securities, which is a component of the Bloomberg Barclay's US Aggregate Index and includes the pass-throughs, bullets, and controlled amortization structures of only the senior class of ABS issues.
- The Blomberg Barclay's US Floating Rate Notes (<5 Yr) Index, measures the performance of U.S dollar-dominated, investment grade floating rate notes with maturities less than 5 years.
- The Bloomberg Barclay's Municipal Bond Index, which measures investment grade, tax-exempt bonds with a maturity of at least one year.
- The S&P/ LSTA Leveraged Loan Index is designed to reflect the performance of the largest facilities in the leveraged loan market.

Key Rates
Key Rates are shown for US Treasurys and London Interbank Offered Rate (LIBOR), the interest rate at which banks offer to lend funds (wholesale money) to one another in the international interbank market. LIBOR is a key benchmark rate that reflects how much it costs banks to borrow from each other. "Current" refers to the percentage rate as of 6/30/2018, while the rates of change are stated in basis points.

Credit Spreads
Credit Spreads shown comprise the Option-Adjusted Spread of the indices indicated, versus the US 10-Year Treasury Yield. "Current" refers to the spread as of 6/30/2018, while the rates of change are stated in basis points.

Key Indicators
Key Indicators correspond to various macro-economic and rate-related data points that we consider impactful to fixed income markets.

- 2s10s (bps)/ 10 Yr vs 2 Yr Treasury Spread, which measures the difference between yields on 10-Year Treasury Constant Maturity Securities and 2-Year Treasury Constant Maturity Securities.
- West Texas Intermediate, which is an oil benchmark and the underlying asset in the New York Mercantile Exchange's oil futures contract.
- Core Consumer Price Index, which measures the consumer price index excluding food and energy prices. Shown as of the prior month-end.
- Breakeven Inflation: 5 Yr %/ bps, which uses 5-Year Treasury Constant Maturity Securities and 5-Year Treasury Inflation–Indexed Constant Maturity Securities to derive expected inflation.
- Breakeven Inflation: 10 Yr %/ bps, which uses 10-Year Treasury Constant Maturity Securities and 10-Year Treasury Inflation–Indexed Constant Maturity Securities to derive expected inflation.

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Notes & disclosures

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The Credit Select Risk-Managed Strategy has an inception date of March 31, 2006 and consists of fee-paying, fully discretionary accounts under active management at WST that adhere to the Credit Select Risk-Managed strategy. The strategy has the flexibility to invest in any combination of high yield bonds, intermediate U.S. Government securities, and short-term treasuries, or 100% in short-term treasuries. This strategy is generally implemented through the trading of mutual funds or exchange-traded funds. Prior to January 1, 2011 accounts that used exchange traded funds were excluded from the strategy group of accounts, only accounts that traded open end mutual funds were included. Beginning January 1, 2011, the strategy group of accounts includes accounts using open end mutual funds and exchange traded funds. Eligible accounts are included in the strategy group of accounts in the month following the month of account inception. Closed accounts are included through the completion of the last full month. Prior to December 31, 2016, the Credit Select Risk-Managed strategy was known as WST Asset Manager – U.S. Bond. Prior to December, 2009, the Credit Select Risk-Managed Strategy was referred to by WST as the DAA High Yield Strategy, from December 2009 to December, 2012, it was referred to by WST as the WST Dynamic Total Return Strategy, and from December 2012 to May, 2013, as the Dynamic Portfolio Manager – Total Return Bond Strategy. Results portrayed reflect the reinvestment of dividends, capital gains and other earnings when appropriate. During the period(s) shown, there were no material market or economic conditions which affected the results portrayed. With the exception of several market corrections during the period(s), the overall market as measured by the S&P 500 was generally rising. If such trends are broken, the clients may experience real capital losses in their managed accounts. The performance results portrayed during the period: 3/31/2006 (strategy inception)-12/31/2010 relate only to a limited group of the adviser's clients selected based on suitability and risk tolerance. This factor would not have a material effect on performance but could lead to the termination of the strategy group of accounts in the event of significant outflows.

Comparison with market index – The Barclay's U.S. Corporate High Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. The index return assumes reinvestment of interest. You cannot invest directly in an index.

Comparison with market index – The Barclay's U.S. Aggregate Index is a broad based unmanaged bond index that is generally considered to be representative of the performance of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index return assumes reinvestment of interest. Comparative performance may also be expressed by reference to a ranking prepared by a mutual fund monitoring service or by one or more newspapers, newsletters, or financial periodicals. You cannot invest directly in an index.

Market indices are unmanaged and do not reflect the deduction of fees or expenses. You cannot invest directly in an index such as these and the performance of an index does not represent the performance of any specific investment strategy. We consider an index to be a portfolio of securities whose composition and proportions are derived from a rules based model. Market indices are unmanaged and do not reflect the deduction of fees or expenses. You cannot invest directly in an index such as these and the performance of an index does not represent the performance of any specific investment strategy. We consider an index to be a portfolio of securities whose composition and proportions are derived from a rules based model.

Investment advisory fees are described in Wilbanks Smith & Thomas Asset Management, LLC's Form ADV 2A. To illustrate the possible effect of fees on the total return of an account, what follows is an illustration: A client investing in the comparative index S&P 500 over the last 10 years (as of December 31, 2015) would have earned 7.31% return on an annualized basis. With the effect of fees at 2.00% per year, this client can then expect their net return to be 5.16% per year compounded over the same time period.