2Q 2019 | Fixed Income Market Review

EXECUTIVE SUMMARY

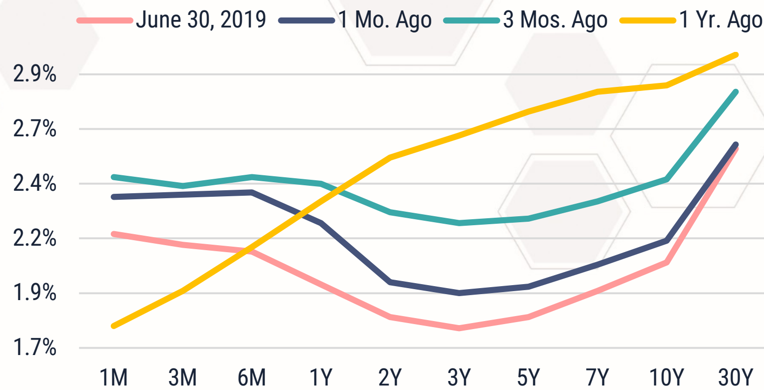
Lifted by the risk selloff in May, bonds in June were no worse for the wear even as that sell-off reversed (down 6% in the prior month, the MSCI ACWI rallied 6.6% to close the quarter up 3.8%). "An ounce of prevention is worth a pound of cure," to quote Fed Chair Jay Powell, and it was worth at least 2% to global bond investors in 2Q. Bond yields fell as central banks swept in with further accommodation and stimulus, extending gains from May and bringing the quarterly global aggregate bond return to 3.29% and the year-to-date figure to 5.57%.

While the US (+6.11% as measured by the Bloomberg Barclays US Aggregate Bond Index) is the year-to-date leader in core, the 3.08% quarterly gain modestly trailed ex-US bonds, which rose 3.42% during 2Q. Developed Eurozone sovereigns posted a full 4.33% in June and added 4.49% for the quarter as European Central Bank (ECB) president Mario Draghi argued the ECB's range of options in counteracting continued economic deterioration. The German yield curve sank further as sovereigns rose over 3% in June alone, while Italian bonds rallied over 560 basis points.

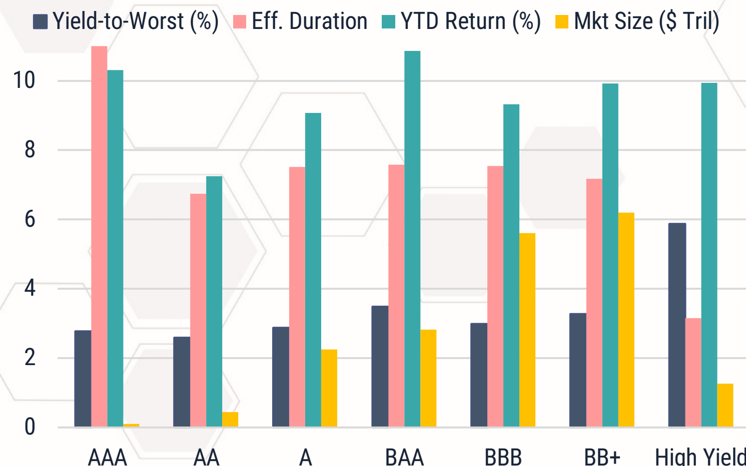
The dollar weakened slightly during the month, paving the way for a +3.11% June return for emerging markets sovereign debt (which, thanks to currency headwinds, was one of very few bond sectors in the red during May).

US Treasury yields sank during the quarter; in May the 10-year yield marked its ninth-largest monthly decline (in percentage terms) in forty years. Among broad indices the current 10-year index is the runaway leader on a trailing 1-year basis, up over 10.3%. While parts of the US yield curve have been inverted since 4Q 2018, May's shift saw the 10-year slip below the yield on the 3-month T-bill, marking a depth that seemed to command investor attention even as views evolve on the predictive power of this indicator relative to economic recession.

Shifts in US Treasury Yield Curve



US Credit Segments & Indices as of June 30, 2019



Index Total Returns (%)	1 Mo.	3 Mo.	YTD	1 Yr.
BBg Barc Global Aggregate	2.22	3.29	5.57	5.85
BBg Barc Global Aggregate ex-US	2.98	3.42	4.99	4.10
BBg Barc US Aggregate	1.26	3.08	6.11	7.87
BBg Barc US Intermediate Aggregate	0.95	2.39	4.73	6.73
S&P Global Dev. Sov. ex-US Bond Index	1.15	1.85	3.88	4.47
S&P Eurozone Dev. Sovereign Bond	4.33	4.49	5.04	3.21
S&P Pan-Europe Dev. Sovereign Bond	3.73	3.40	4.97	2.84
ICE BofAML Emerging Markets Sov. Bond	3.11	2.03	5.16	6.96
S&P U.S. Current 10-Year Tsy Bond Index	1.32	4.03	7.29	10.32
BBg Barc US Floating Rate Notes (<5 Yr)	0.29	0.92	2.41	3.07
S&P US Treasury TIPS	0.77	2.62	5.82	4.64
BBg Barc Municipal Bond Index	0.37	2.14	5.09	6.71
BBg Barc Global Aggregate - Corporate	2.75	3.93	8.25	7.81
BBg Barc US Corporate (AA)	1.84	3.43	7.24	9.03
BBg Barc US Corporate (BBB)	2.31	4.29	9.33	10.37
BBg Barc US Corporate High Yield	2.28	2.50	9.94	7.48
S&P/LSTA Leveraged Loan	0.18	1.58	6.76	4.18
BBg Barc Global Agg Securitized - US MBS	0.72	1.96	4.17	6.22
BBg Barc Global Agg Securitized - US ABS	0.42	1.67	3.17	4.98

Key Rates (%/ bps)	Current	1 Mo. Change	3 Mo. Change	YTD Change	1 Yr. Change
US 3 Month	2.12	-23	-28	-33	+20
US 2 Year	1.73	-22	-53	-77	-79
US 5 Year	1.75	-18	-49	-75	-97
US 10 Year	2.00	-14	-42	-69	-85
US 30 Year	2.53	-6	-30	-49	-46
1 Month USD LIBOR	2.40	-3	-10	-10	+31
3 Month USD LIBOR	2.32	-18	-28	-49	-2
6 Month USD LIBOR	2.20	-32	-46	-68	-30
12 Month USD LIBOR	2.18	-33	-53	-83	-59

Credit Spreads (bps)	Current	1 Mo. Change	3 Mo. Change	YTD Change	1 Yr. Change
US Corporate OAS	61	-9	+1	-22	-9
US Corp. High Yield OAS	377	-56	-14	-149	+14

Key Indicators	Current	1 Mo. Change	3 Mo. Change	YTD Change	1 Yr. Change
10 Yr-2-Yr Tsy Spread (bps)	27	-5	+12	+8	-6
WTI ($/ bb)	$58.42	-$10.32	-$1.77	+$13.27	-$15.71
Core CPI	262	+.4	+1	+2	+5
Brk. Inflation: 5 Yr %/ bps	1.84%	+0	+2	+24	-26
Brk. Inflation: 10 Yr %/ bps	2.12%	+3	+0	-4	-5

US credit has enjoyed a strong position in recent months, performing well in equity sell-offs as well as in Fed-driven rallies. The highest-quality (and longest-dated) corporates have posted double-digit returns, surpassing high yield. After months of fretful association with excessive debt-to-GDP figures and diminishing quality, the outsized BBB (just-above-junk) segment has found its footing, outperforming some higher-quality investment-grade as well as high yield. Although it underperformed investment-grade, high yield posted a quarterly return of 2.50% and spreads touched 350 basis points before closing out the quarter at roughly 377 – the 30th percentile relative to index history.

Source: FactSet for all index and market data, shown in USD as of June 30, 2019. For index & data definitions, please see notes & disclosures. In chart at left, each credit segment is represented by the Bloomberg Barclays Index for that credit rating; high yield is represented by the Bloomberg Barclays US Corporate High Yield Index.

2Q 2019 | Credit Select Risk-Managed Review

WST CAPITAL MANAGEMENT

PERFORMANCE & POSITIONING

In 2Q 2019 the Credit Select Risk-Managed (CSRM) strategy returned 1.35% gross (1.11% net) versus a Bloomberg Barclays High Yield Index that added 2.50% and a Bloomberg Barclays US Aggregate Bond Index that added 3.08%. For the trailing one-year period, CSRM has returned 4.40% gross (3.40% net) versus the high yield index up 7.48% and the US aggregate up 7.87%.

CSRM opened 2Q just as it closed the prior quarter – fully invested in a mix of high yield securities including core as well as strategic beta with modest duration and quality tilts. That positioning held throughout April as equity multiples expanded, junk yields fell and core bonds took a breather.

With risk-asset investors spooked by trade hostilities and other economic headlines, early May saw the model begin to de-risk (initially at 50/50 exposure, balanced between core high yield and cash) gradually while diversifying the risk-off allocation between investment-grade and a mix of T-bills and intermediate Treasuries. The strategy completely exited high yield for several sessions in mid-May and then again in early June before returning to a fully invested position to close out the quarter.

By way of refresher on strategy mechanics: the model issues its high yield allocation signal – or high yield "risk budget" – based off a proprietary market trend series. While the trend series drives model decision-making, that decision is "calibrated" according to spread conditions. Drawdown potential is heightened when spreads are narrow and in such an environment the model's allocation decision will be more sensitive to short-term price movements. While spreads are looser than observed prior to the sector's sharp capitulation in 4Q 2018, they remain narrow and the strategy is poised to rapidly exit the asset class when short-term trends turn negative.

Source: FactSet for all index and market data, shown in USD as of June 30, 2019. For index & data definitions, please see notes & disclosures. The Credit Select Risk-Managed Strategy has an inception date of March 31, 2006. Please see related notes and disclosures in following pages. Source for strategy allocation information: WST, Orion.

Annualized Returns
as of June 30, 2019

	2Q '19	YTD	1 Yr	3 Yrs	5 Yrs	Since Incep
CSRM Strategy (Gross)	1.35	4.45	4.40	3.51	3.03	8.39
CSRM Strategy (Net)	1.11	3.95	3.40	2.50	1.95	6.95
BBg Barc US Corp HY Index	2.50	9.94	7.48	7.52	4.70	7.42
BBg Barc US Agg Bond Index	3.08	6.11	7.87	2.31	2.95	4.38

OBSERVATIONS & OUTLOOK

Results in 2Q reflect the model's effort to navigate opportunity and manage risk in a market where any nascent or established trends have proven vulnerable to forces that manifest quickly, in tweets and press conferences. Lack of sustained trend is a challenge for trend-following in general and high yield, further, continues to inhabit a narrow-spread regime that our strategy is designed to tread carefully.

As it relates to our outlook, high yield continues to occupy an interesting place between two markets (stocks and bonds) that are leveraged in substantively different ways to the same factor that is rallying them both – the Fed. By quarter-end (and still at press-time) markets appeared satisfied that the Fed will cut rates in July, supporting equities through the promise of revived economic expansion and collapsing bond yields on the notion of further rate cuts and quantitative easing by the ECB. Fed action, as expected, benefitted high yield both from a rate perspective as well as by bolstering an already-strong perception of fundamental strength.

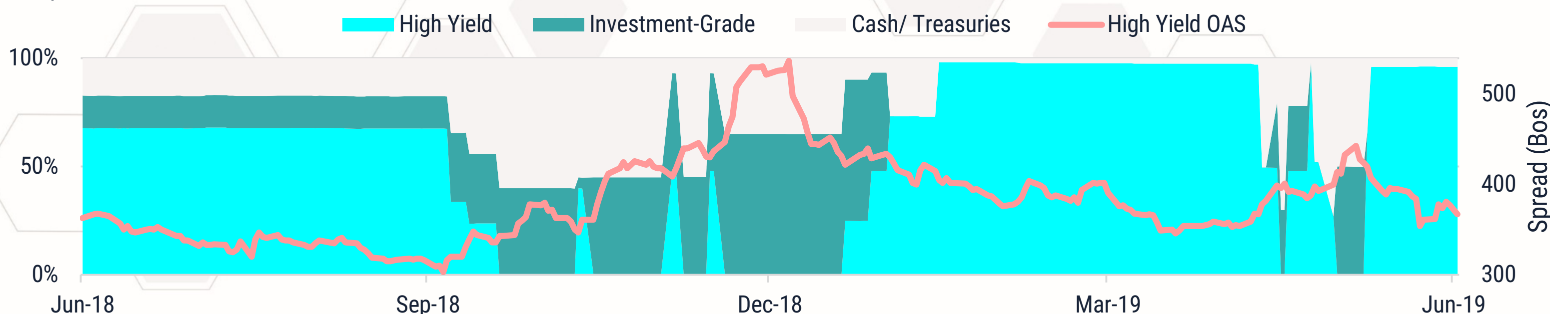
Thus, just as we stated last quarter, in the near term continued spread-tightening is a fairly intuitive scenario. Further narrowing even appears justified as a relative value matter, as the junk index continues to yield around 6% (noting that the share of negative-yielding debt in the global aggregate has reached 20%).

We do, however, continue to argue for tactical on the basis of volatility patterns over the last 18 months and especially given the potential for a credit risk selloff even if developed market bonds continue to rally and broad-markets hold steady. Year-to-date, high yield has slightly underperformed longer-dated, higher-quality credit even as the Fed has lit burners under risk assets. While results have been robust, upside may have been limited by the segment's shorter-dated characteristics. Meanwhile, Fed policy changes have restored the risk-off shine to bond markets, undermining the unique support that high yield enjoyed in various sell-offs in 2018. While correlation between high yield and equities have been muddled in recent years by unique interest rate dynamics, we see potential for high yield to clearly decouple from bond market tailwinds if economic concerns continue to mount, upsetting equity markets.

After a drought in late 2018 and 1Q, junk bond issuance picked up in June, with strong demand affirming the appetites of newly optimistic risk-asset investors. We note, however, that per Barron's most of these bonds were sold by companies in the highest-rated tiers and none by the lowest-rated companies; furthermore, all issuance was reportedly refinancing of short-term debt. This moderation in leveraging activity generally speaks to late-stage economic expansion as well as a late position in the credit cycle, perhaps suggesting a sense among issuers that the Fed won't be enough to prop up the expansion. We believe that fading confidence in the Fed or the Fed exhausting its policy tools combined with a major structural risk narrative from 4Q 2018 – i.e., the BBB-segment overhang – could lead to a significant retracement in high yield.

While we offer no views on timing or magnitude, we expect that at some point economic reality will re-enter market calculus around the sustainability of credit market returns. As a risk-managed investment solution, Credit Select Risk-Managed is designed to mitigate drawdown in such a scenario. We appreciate your confidence in our strategy and welcome questions.

CSRM Allocations vs. High Yield Option-Adjusted Spread
Daily, 1 Year Ended June 30, 2019



Notes & Disclosures

WST CAPITAL MANAGEMENT

Index Returns – *all shown in US dollars*

All returns shown trailing 6/30/2019 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 & Indicators

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. 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.

Credit Select Risk-Managed: Strategy Definition & Disclosure

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.

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