3Q 2019 | Fixed Income Market Review

WST CAPITAL MANAGEMENT

EXECUTIVE SUMMARY

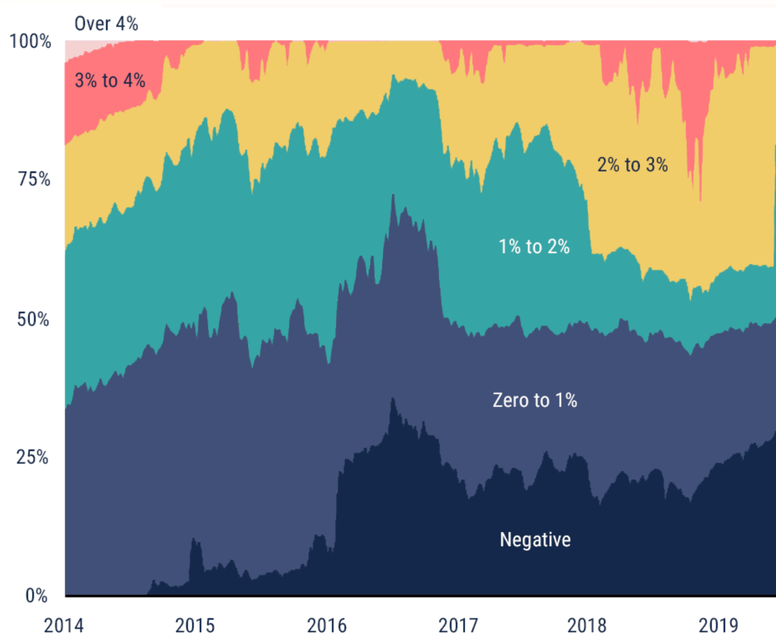
Global yields rose in September as key sovereign rallies partially retraced but with further easing and stimulus, bonds were up for the quarter overall (+0.71% for the Global Aggregate) and led by the US (+2.27% for the US Aggregate). Global fixed income bested global stocks, which – as measured by the MSCI ACWI – added just 10 basis points in USD terms.

The quarter opened with mixed, if largely muted, results for global bonds in July before a strong August showing, as equities sold off in response to escalating trade conflicts and macroeconomic headlines that continue to upset the global growth outlook. Risk-asset investors appeared to weigh the adequacy of a Fed-led global monetary pivot against mounting pressure from various trade skirmishes and structural headwinds globally. In August markets reacted, further, to the US 10-year yield slipping below the 2-year (the first such observation since 2007) and, separately, the Chinese government moving to devalue its currency through lending rate reform, leading the US to label the country a currency manipulator. US treasuries sustained an exceptional run, with the 30-year hitting an all-time closing low (just below 2%) in August before edging back to 2.12% to close the quarter.

Ex-US developed sovereigns posted mixed results country-by-country, with key European issues rallying sharply while the bonds of export-dependent Asian economies struggled from trade war implications and currency impacts. Italy and the UK each were up over 7% in local terms, while Germany and Spain added nearly 2%; on the flipside, the USD strengthened against most currencies, including a devalued Chinese renminbi, struggling Indian rupee, sliding Brazilian Real and free-falling Argentine peso. As in equity markets, dollar strengthening was a headwind across ex-US bond segments for most of the quarter, driving a negative result for emerging sovereigns (-0.73%) and blunting positive returns across major indices and at the country level. Developed ex-US sovereigns overall ultimately posted +2.18% in USD terms. As shown below, 3Q served to expand the share of negative-yielding debt and interest rates globally are now lower than they were in the crisis environment of 2008.

The run persisted for global corporate debt (+1.21%), including US high yield (which added 1.33% for the quarter and posted a positive return even during August's risk-off environment). Given strong fundamentals and still-substantial yield weighed against a ballooning share of negative-yielding debt among global bond supply, support levels even for the riskiest credit may have been redefined in the intermediate term.

Sub-Zero: Developed Sovereign Yield Distribution



Index Total Returns (%)	1 Mo.	3 Mo.	YTD	1 Yr.
BBg Barc Global Aggregate	-1.02	0.71	6.32	7.57
BBg Barc Global Aggregate ex-US	-1.42	-0.58	4.38	5.31
BBg Barc US Aggregate	-0.53	2.27	8.52	10.25
BBg Barc US Intermediate Aggregate	-0.23	1.38	6.18	8.05
S&P Global Dev. Sov. ex-US Bond Index	-0.63	2.18	6.15	7.66
S&P Eurozone Dev. Sovereign Bond	-1.31	-0.95	4.04	3.72
S&P Pan-Europe Dev. Sovereign Bond	-0.78	-0.34	4.61	4.24
ICE BofAML Emerging Markets Sov. Bond	0.36	-0.73	4.41	8.16
S&P U.S. Current 2-Year Tsy Bond Index	-0.16	0.55	2.87	4.18
S&P U.S. Current 10-Year Tsy Bond Index	-1.44	3.26	10.79	15.05
S&P U.S. Current 30-Year Tsy Bond Index	-3.03	9.54	22.09	27.50
BBg Barc US Floating Rate Notes (<5 Yr)	0.27	0.78	3.21	3.07
S&P US Treasury TIPS	-0.93	1.55	7.45	6.95
BBg Barc Municipal Bond Index	-0.80	1.58	6.75	8.52
BBg Barc Global Aggregate - Corporate	-0.77	1.21	9.55	8.62
BBg Barc US Corporate (AA)	-0.64	2.85	10.31	11.45
BBg Barc US Corporate (BBB)	-0.73	3.01	12.61	12.71
BBg Barc US Corporate High Yield	0.36	1.33	11.41	6.33
S&P/LSTA Leveraged Loan	0.68	1.33	8.21	3.43
BBg Barc Global Agg Securitized - US MBS	0.07	1.37	5.60	7.77
BBg Barc Global Agg Securitized - US ABS	-0.15	0.92	4.13	5.40

Key Rates (%/ bps)	Current	1 Mo. Change	3 Mo. Change	YTD Change	1 Yr. Change
US 3 Month	1.82	-16	-26	-58	-33
US 2 Year	1.62	+12	-12	-88	-119
US 5 Year	1.55	+16	-20	-96	-140
US 10 Year	1.68	+18	-32	-101	-138
US 30 Year	2.12	+16	-40	-89	-107
1 Month USD LIBOR	2.02	-7	-38	-49	-24
3 Month USD LIBOR	2.09	-5	-23	-72	-31
6 Month USD LIBOR	2.06	+2	-14	-82	-55
12 Month USD LIBOR	2.03	+6	-15	-97	-89

Credit Spreads (bps)	Current	1 Mo. Change	3 Mo. Change	YTD Change	1 Yr. Change
US Corporate OAS	57	-5	-4	-26	+1
US Corp. High Yield OAS	373	-20	-4	-153	+57

Key Indicators	Current	1 Mo. Change	3 Mo. Change	YTD Change	1 Yr. Change
10 Yr-2-Yr Tsy Spread (bps)	6	+6	-20	-12	-18
WTI ($/ bb)	$54.09	-$.98	-$4.11	+$8.94	-$19.07
Core CPI	265	+.4	+2	+5	+6
Brk. Inflation: 5 Yr %/ bps	1.39%	+1	-16	-21	-62
Brk. Inflation: 10 Yr %/ bps	2.06%	+1	-4	-2	-2

Source for above: FactSet for all index and market data, shown in USD as of September 30, 2019. Source for chart at left: BlackRock Investment Institute, with data from J.P. Morgan and Refinitiv Datastream, July 2019. Notes: The chart areas show the share of bonds by market value within the J.P. Morgan Global Developed Bond Index with yields in each range.

3Q 2019 | Credit Select Risk-Managed Review

WST CAPITAL MANAGEMENT

PERFORMANCE & POSITIONING

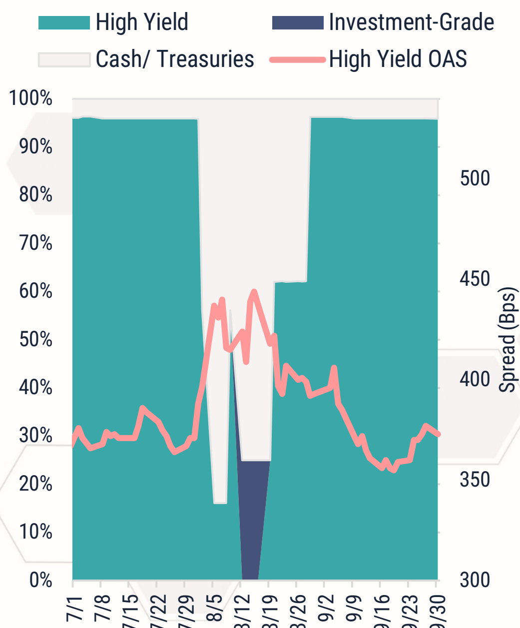
In 3Q 2019 the Credit Select Risk-Managed (CSRM) strategy returned 0.25% gross (0.01% net) versus a Bloomberg Barclays US Corporate High Yield Index that added 1.33% and a Bloomberg Barclays US Aggregate Bond Index that added 2.27%. For the trailing one-year period, CSRM is up 2.57% gross (1.60% net) versus the high yield index up 6.36% and the US Aggregate up 10.30%.

CSRM opened 3Q 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 July as equity multiples expanded, junk yields fell and core bonds took a breather. The risk-on mood devolved quickly in August, however, collapsing core yields and driving volatility in high yield; on August 2 the strategy reduced junk exposure to roughly 55%, de-risking further (to just 15% high yield) the following day. CSRM held this risk-off positioning for several sessions until reallocating, through two trades, in the last two weeks of August. The strategy was fully invested for all of September.

When allocated to high yield CSRM held its typical combination of "core" high yield ETFs – namely those larger, liquid names that best address the short-term market moves we aim to capture with short-term trading. That exposure is rounded out with more strategic beta with duration tilts (including floating-rate or shorter-term) or fundamental/ quality plays, such as an ETF focused on the "fallen angels" (issues recently downgraded from investment-grade ratings).

When out of the high yield market in 3Q, CSRM primarily held cash and short-term Treasuries, moderately extending Treasury duration and adding short-term investment-grade in the back half of August.

CSRM Allocations vs. High Yield OAS
Daily, 3Q 2019



Annualized Returns
as of September 30, 2019

	3Q '19	YTD	1 Yr	3 Yrs	5 Yrs	Since Incep
CSRM Strategy (Gross)	0.25	4.71	2.57	2.48	3.28	8.25
CSRM Strategy (Net)	0.01	3.97	1.60	1.49	2.22	6.82
BBg Barc US Corp HY Index	1.33	11.41	6.36	6.07	5.37	7.38
BBg Barc US Agg Bond Index	2.27	8.52	10.30	2.92	3.38	4.47

OBSERVATIONS & OUTLOOK

CSRM's busy trading activity in 3Q reflects the model's effort to navigate opportunity and manage risk in a market where – as measured by current spreads relative to long-term history – high yield is a tightly wound asset class offering relatively low risk premium.

As we often explain, the "quant" mechanics of our strategy are based off a proprietary market trend series focused on trading patterns in a universe of high yield ETFs and mutual funds. While the trend model drives 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 decision will be more sensitive to short-term price movements.

Taking into account these strategy mechanics and as evidenced in August especially, our risk-adjusted trend signal has been essentially on a knife-edge, with some allocation changes decided by single-digit spread moves. Opportunity cost has compounded quickly in fast-moving markets such as these, where reversals to the upside occur sometimes even faster than sell-offs. This dynamic has been articulated clearly in relative results over the last eighteen months.

Our outlook assumes that the global interest rate dynamic benefits high yield from a relative value perspective, as investors flee the tide of negative yield. Versus a Global Aggregate index yield-to-worst of roughly 1.3% and US Aggregate index yield of 2.3%, US corporate high yield currently pays investors roughly 5.7%. Even at narrow spread levels it remains one of few sources of robust carry among global fixed income assets; among major segments, only locally denominated emerging markets sovereign debt offers in-line yield, while emerging markets high yield offers an additional +200 basis points. Such assets, however, may not be in the typical yield-enhancement playbook for high yield fund investor base, which suggests that with equity markets at all-time highs and investors broadly starved for yield, major rotation away from high yield may be unlikely. Thus we believe near-term support for high yield may remain strong and continued spread-tightening is a fairly intuitive scenario.

We do see intermediate-term risks to the asset class, however, in terms of credit concerns that even the easiest Fed policy may be inadequate to address. As stated last quarter, we believe that fading confidence in the Fed 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. Historically the conversion (downgrade) rate of the BBB-segment has been roughly 12%; we are currently in a period of historically low conversion even as the segment swells and the economy slows. While high yield defaults remain near historic lows, according to JP Morgan, they have increased from 1.3% in 2017 to 2.5% while recovery rates have fallen from $0.53 (cents on the dollar) to $0.36 during the same period. Although junk issuance has picked up versus year-end, most of that activity is refinancing. Meanwhile, the CCC segment of high yield (the lowest-rated, which typically outperforms amid large positive moves in high yield) has significantly underperformed its broader universe year-to-date, an unusual dynamic that further suggests weaker confidence in the credit case for the riskiest junk issuers. We note the overall fundamental health of high yield issuers plus favorable economic conditions in the US relative to much more comprehensive slowdowns globally, but we do see potential for market scares based on credit-related headlines.

While the lack, or at least compression, of trends has been challenging for trend-following, we remain committed to executing on an objective signal that aims to capture market direction as indicated over multiple horizons – i.e., that has a longer memory than headline-driven markets. We continue to argue for tactical on the basis of volatility patterns and especially given the potential for a credit risk selloff even if developed market bonds continue to rally and broad-markets hold. As shown in the September Treasury sell-off, even "riskless" assets can sell off quickly in these conditions - our goal overall is to manage drawdown and deliver solid, stable total return through thoughtful security selection and opportunistic participation 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.

Source: WST, Orion, FactSet. The Credit Select Risk-Managed strategy has an inception date of March 31, 2006.

Notes & Disclosures

WST CAPITAL MANAGEMENT

Index Returns – *all shown in US dollars*
All returns shown trailing 9/30/2019 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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