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U.S. Fixed Income Quarterly Market Summary

SECOND QUARTER 2016

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2Q 2016 Brexit - Political Risk Drives Markets

- In a historic decision, the UK voted to exit the European Union (EU). Despite polls showing a close race, markets were surprised by the “leave” decision and sold off sharply. The pound dropped 12% to a 30 year low. Global stock markets also suffered large corrections, with many British banks initially losing 30% of their valuations. Meanwhile, global rates saw immediate flight-to-safety moves with the 10-Year U.S. Treasury yield touching 1.40% and German 10-Year yields reaching negative 0.16%.

- In U.S. markets, the dollar, U.S. Treasuries, and equities saw the greatest price impacts following the Brexit vote, but they rebounded quickly as fears faded that Brexit was a new “Lehman moment”. Financial stocks in the S&P 500, which fell nearly 10% initially, largely recovered and the S&P 500 is up 3.12% year-to-date. Central banks stepped in to backstop risk by providing ample liquidity to the market, but the 10-Year U.S. Treasury yield remains below 1.5%, 30 basis points (bps) below where it was pre-Brexit, reflecting the significant uncertainty that still hangs over the market.

- The Brexit vote exposes the structural challenges facing the EU and raises questions about the likelihood of future EU reforms. Member states were already sharply divided over further fiscal integration and other structural measures needed within the Eurozone to support the monetary union. A renewed federalist push post-Brexit could split the EU further given rising popular discontent and anti-EU sentiment. If current squabbling over how to structure future talks with the UK is any guide, it is unclear whether EU members have the political will to reach agreement on the tough reforms that are necessary to bolster growth and ultimately keep the bloc together.

- Beyond the financial and economic implications of Brexit, the vote highlights the rise of populist anti-establishment movements. Motivated in part by frustration with persistently low and unevenly distributed growth, along with concerns about immigration, populist candidates have gained momentum beyond the UK and are challenging status-quo political parties. Rising political risks will likely continue to challenge markets in the short-run and broader support for protectionist policies does not bode well for the global growth outlook.

Our View: The uncertainty surrounding the difficult path ahead for the UK will weigh on markets and may also have broader global consequences that will take time to manifest. Global spillover effects could dampen risk appetite, leading to tighter financial market conditions and a broader deleveraging across markets. The strengthening dollar and the potential for a Chinese RMB devaluation, which has been the impetus for a market sell-off over the past few years bears watching. In this environment, central banks will likely remain cautious and accommodative though with much less scope to help out should a downside scenario materialize.

2Q 2016 Low Rates and the Quest for Yield Temporarily Overpowers Fundamentals

The conditions surrounding the Brexit vote are emblematic of a challenging dynamic that markets are currently facing. On one side there are fundamental events, weak data, or other macroeconomic variables that should create volatility. However, offsetting that pressure are aggressively accommodative central banks and yield-hungry investors providing support to markets. While those forces are roughly in balance at the moment, as long as volatility stays low, the fundamentals may get worse while the ability of central banks to support markets will decline. When the scale gets sufficiently out of balance, a forced deleveraging is likely, and the longer markets remain in balance, the more dramatic that deleveraging is likely to be.

Fundamental	Technical
Weak U.S. growth with increased recession risks	Ever more expansive quantitative easing programs – larger size, lower quality, more varied security types
Slowing global growth provides little support for the U.S.	Negative rates abroad encourage reallocation to positive yielding opportunities in the U.S.
Corporate leverage exceeds pre-crisis levels while profit growth and earnings are declining	Large amounts of uninvested cash in investment vehicles helps to buffer downturns
Rising defaults and downgrades	Low rates force investor risk-taking in a search for yield
Build-up of liquidity risks as trades are crowded and dealers retreat from the market	
Inflated asset prices from years of zero interest rates	

Our View: With nearly 50% of global fixed income securities yielding 1% or lower, the search for yield has driven investors into riskier assets and overshadowed worsening fundamentals. At some point, we believe that fundamentals will take over, leading to a deleveraging in credit markets. In anticipation, we remain defensively positioned, waiting for better valuations in "bendable assets" while avoiding "breakable" assets that are more likely to restructure.

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2Q 2016 Mounting Risks Challenge the U.S. Economy

- Even before the Brexit vote, mixed data on the U.S. economy pointed to increased risks and potential weakness. While the consumer proved resilient this quarter, this wasn't necessarily indicative of broader strength in the economy. For example, during the 2001 economic downturn, consumer spending actually increased 2% on a year-over-year basis. Seen in this light, the weak payrolls report in May and the declining trend in the Labor Market Conditions Index are concerning and point to a slowdown in job growth that could reflect broader economic weakness even though consumer data is strong.

- Meanwhile, both market and survey based measures of U.S. inflation expectations have dropped this quarter. The 10-Year breakeven rate, which compares the yield on the U.S. 10-Year Treasury against its inflation-adjusted equivalent, declined to 1.43%, the lowest level since February. The University of Michigan survey of U.S. household's long-term inflation expectations fell to 2.3% in June, the lowest on record. Core personal consumption expenditures, the Fed's preferred measure of inflation is projected to reach 1.6% by year end and 1.8% by end-2017. The data may call into question whether inflation will return to the Fed's target of 2% as quickly as anticipated.

- Another indicator that economic activity may be slowing over the next 12 months is the flattening of the Treasury yield curve. Currently the spread between the 2-Year Treasury note and the 10-Year is 85 bps, the lowest level since 2007. In contrast to previous episodes of curve flattening, which were driven by Fed rate hikes in the front end, this instance of curve flattening has been driven by a rally in 10-Year rates. Regardless of the cause of the moves, a flat curve still weighs on banks' willingness to extend credit, which is likely to act as a drag on domestic growth.

- Amid worries about jobs growth and low inflation, the Fed opted to hold off on a rate hike at the June meeting. Bringing their views more in line with market expectations, the Fed revised their forecast for growth in 2016 from 2.2% to 2% and lowered projections of future rate increases. As of the June meeting, most members still anticipated two hikes, though a greater number of officials forecasted just one increase.

Our View: Given the results of the Brexit vote, the Fed is likely in a holding pattern until at least the end of the year. While we expect the Fed will remain dovish and has no intention of surprising markets, if the effects of Brexit on the U.S. economy are limited and economic data improves, market expectations can change rapidly and the FOMC may be forced to move more quickly than currently anticipated.

2Q 2016 Investment Grade and High Yield Review and Outlook

- The rally that started mid-February continued through the second quarter, with investment grade (IG) and high yield (HY) returns outpacing Treasuries by 93 bps and 411 bps respectively as the looming Brexit vote and outcome did not seem to deter investor appetite for U.S. credit. IG spreads widened out only 5 bps points following the vote and have since retraced, while HY credit widened 48 bps but at 602 bps, spreads still remains far from the levels that were reached during the sell-off in January.

- Corporate issuers took advantage of the low overall yield levels, which were supported by a dovish Fed and further levered their balance sheets. Issuance reached nearly $650 billion this year, with volumes hitting historically high levels in May alone as $176 billion of new debt came to market. Similar to last quarter, proceeds were largely used for M&A activity, including the Dell acquisition of EMC ($20 billion) and the Abbvie acquisition of Stemcentryx ($7.8 billion).

- The high yield market returned an impressive 5.18% for the quarter and 15% since mid-February, supported mainly by the recovery in energy and commodity-related sectors as oil prices stabilized from their Q1 lows and inflows remained strong. Despite this performance, credit quality has deteriorated and leverage has risen over the quarter, even when stripping out energy. Thus far in 2016, 35 companies defaulted, impacting nearly $42 billion in debt and exceeding the pace of defaults in 2015.

- Lofty balance sheet leverage and weakening covenant protection among high yield issuers have led to a declining trend in recovery rates on defaulted bonds. While average recoveries for energy and commodity related bonds are weighing down overall high-yield recovery rates, the significantly lower than average starting point suggests even more challenges for the high yield market in a more severe deleveraging environment.

Our View: Despite corporate and high yield bond prices recovering much of the decline experienced at the beginning of the year, and the Brexit vote creating little overall volatility, we remain cautious on both investment grade and high yield credit. Late cycle dynamics are still evident and periodic bouts of volatility are likely. We continue to look for opportunities to take advantage of market dislocations, being cognizant of the potential for a larger scale deleveraging in the near future.

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2Q 2016 MBS and ABS Review and Outlook

- Agency MBS started the quarter outperforming Treasuries supported by low volatility and slightly higher interest rates. But as U.S. Treasuries rallied in June on the back of ongoing global challenges, agency MBS ended the quarter slightly behind. The anticipated wave in prepays brought on by low rates did not materialize but given the ongoing market turmoil related to Brexit and the commensurate rally in safe-haven U.S. Treasuries, prepay concerns will continue to weigh on the MBS market.

- Non-agency MBS performance rebounded in the second quarter as prices were supported by a strong bid for risk assets along with continued strength in the underlying fundamentals. Latest sales data of existing homes released by the Census Bureau and the National Association of Realtors confirms a sustained and broad-based U.S. housing recovery. Inventories remain tight across the country further bolstering performance as evidenced by S&P/Case Shiller Home Price Index, which is up 5.15% year over year as of March 2016. Lastly, the payment of the long awaited $8 billion Countrywide Settlement to investors in June is expected to further strengthen the demand for non-agency MBS as cash returned to investor hands.

- CMBS also outperformed Treasuries by 30 bps over the quarter. Despite positive performance, issuance of private-label CMBS continues to decline. This adds to the existing concerns regarding liquidity in the sector, especially as trading volumes have declined. Moreover, primary dealer holdings of private label CMBS fell this quarter to $6.5 billion, the lowest since 2013 when the Federal Reserve began collecting data. These factors raise the risk that volatility could lead to outsized price moves and impede market functioning.

- ABS continued to generate positive returns in the second quarter, outperforming Treasuries as the sector provides a relatively stable safe haven from market volatility given its high quality and favorable liquidity characteristics. In June, though no rating actions were taken, Moody's did publish their methodology for rating FFELP ABS and placed an additional $45 billion of bonds on downgrade watch. The market did not react to the news in part due to the complexity of the methodology and a lack of clarity around its application.

Our View: We continue to favor structured products, which provide the best risk-adjusted value in the fixed income market. Non-agency MBS remains compelling due to the available yield, potential for price upside, and solid fundamentals, though allocations will likely continue to drift lower as prices rise. Though future downgrades are likely on FFELP student loans, these loans may offer good value and make a compelling buying opportunity once the uncertainty surrounding rating agency action has dissipated given that principal and interest payments remain guaranteed by the U.S. government.

2Q 2016 Core and Core Plus Strategy Positioning Summary

Given the lack of fundamental support for the rally in market prices since February, expectations are for a more significant deleveraging as we move forward. As such, the strategy remains defensively positioned, with a bias to add opportunistically in bendable asset classes as spreads widen.

Characteristic	Positioning	Comments
Duration	Approximately 0.6 years shorter than the Index	• Stay short duration as long as rates remain very low • Look to extend duration as rates rise
Curve	Mostly neutral exposure	All parts of the curve bear some risk of rising rates
Governments	Underweight with an emphasis on on-the-run securities	• On-the-run securities provide greater liquidity for a small give up in yield • May look to Treasury futures market to further enhance liquidity
MBS	• Agency MBS – underweight, bias to add • Non-Agency MBS –overweight with bias to trim	• Focus holdings in lower coupon and low loan balance pools given more stable duration profiles • Given the decline in roll specialness, look to swap TBAs for specified pools, particularly new production issues (see sector highlight) • Maintain emphasis on higher quality, shorter duration, currently amortizing bonds • Continue to optimize relative value within the non-agency MBS sector as additional loan data becomes available
ABS	Overweight	• Hold short duration, high quality credit card and auto issues to boost liquidity, and top of the capital structure CLOs • Maintain student loan position with bias to add if forced sellers emerge
CMBS	Overweight	• Maintain similar weighting to agency CMBS and non-agency CMBS, with an emphasis on single asset single borrower deals • Favor seasoned issues and select more recent issues with better structures and collateral
Credit	Underweight – bias to add	• Emphasize financials with a preference for large U.S. banks and select well capitalized European institutions • Maintain significant underweight in industrials with emphasis on defensive sectors like pharmaceuticals, food & beverage, and communications, as well as airline EETCs which benefit from solid asset coverage • Underweight non-corporate credit, particularly non-U.S. issues
High Yield	Small allocation	Prefer defensive, relatively high quality credits away from volatile sectors like energy, metals, mining, and transportation
Emerging Markets	Minimal allocation	Slowing growth in the developed markets, currency volatility, and susceptibility to changing liquidity conditions suggest caution is warranted

Portfolio characteristics and holdings are subject to change at any time.
The sources of all information presented in this presentation are Bloomberg, Barclays, and TCW.

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