Eagle Insight

EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Fixed Income

Fourth Quarter | 2017

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Separately Managed Accounts (SMA):

Taxable:
High Quality Taxable
Core Fixed Income
Managed Income Solutions

Tax-free:
High Quality Tax-Free
Special Fixed Income
Managed Income Solutions

Market Overview

The domestic bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, earned 0.39 percent in the fourth quarter, extending its gains for a 3.54 percent total return on the year. The yield curve continued its year-long trend of flattening. Shorter-term rates were fueled primarily by the Federal Reserve's three interest-rate increases in 2017 (the most recent one being at the end of this quarter) but longer-term rates indicate the market remains more cautious. The yield on the 10-year U.S. Treasury note has moved higher over the past few months due to stronger economic data and expectations of Congress passing tax reform but the pace has been leisurely and the absolute yield is still basically flat relative to the end of 2016. As such, the two-year/10-year Treasury spread finished just shy of its decade-lows set earlier in December. It's also worth pointing out that the 30-year U.S. Treasury yield actually finished lower for the quarter and the year. Meanwhile, corporate-credit spreads ended the quarter on a high note after widening out a bit in November. The market's focus on tax reform led spreads to a new post-crisis low of 0.93 percent, or 0.08 percentage points lower for the period. Regaining momentum in December, corporate bonds were the top-performing sector for the quarter. Generally longer-duration, interest-rate-sensitive utilities led corporate bonds followed by the industrial sector and then financials. Government-related bonds and structured securities also posted positive total returns and provided excess returns relative to duration-matched Treasuries.

Corporate Market Review[1,2]

Investment-grade corporate bonds, as measured by the Bloomberg Barclays U.S. Corporate Bond Index, gained 1.17 percent during the third quarter and 6.42 percent for the year. The market's focus on the passage of a tax bill drove corporate-credit spreads to a new post-crisis low. Favorable financial conditions and a positive U.S. and improving global economic outlook should continue to support corporate earnings. Meanwhile, many organizations are forecasting a drop in new corporate bond supply for 2018 due to additional capital likely to make its way into corporate coffers as a result of corporate tax cuts and a repatriation tax holiday. A decrease in supply while demand from overseas investors and pension funds remains favorable is another catalyst that could tighten spreads further. Credit fundamentals continue to improve and prolong the credit cycle with each successive positive earnings season. Recent improvement, however, has only stabilized overall credit quality and it will take more than a few quarters to fully reverse all the years of expanded leverage. Domestic and geopolitical risks remain elevated and merger-and-acquisition (M&A) activity is projected to increase in 2018. For now, valuations are dear and downside risks are still very much present. As such, we plan to maintain our current overweight exposure to corporate bonds while making small adjustments toward what we view as higher quality.

Municipal Market Review[1,2]

The domestic municipal-bond market (as measured by the Bloomberg Barclays Municipal Bond Index) was up 0.75 percent for the quarter ended Dec. 31. This brought year-to-date performance up to 5.45 percent. The curve flattened significantly over the quarter, with long maturities outperforming short and intermediate maturities. For example, the one-year index was down 0.38 percent, the seven-year index was down 0.22 percent and the 20-year index was up 1.78 percent. The quarter was characterized by political uncertainty surrounding healthcare and tax-reform legislation, record new issuance supply in December and continued net municipal mutual

fund inflows. Eagle used the quarter to ensure portfolios are well-positioned for the coming year. We raised cash levels temporarily as we entered the quarter, in anticipation of increased new issuance in December and a stronger 2018. Many issuers rushed to market new deals in the last few weeks of the year as it became clearer that advanced refundings would no longer be allowed after Dec. 31. We were able to reallocate cash into bonds at better prices with December's significantly increased supply.

The 10-year municipal AAA yields remained relatively flat, up 0.01 percentage points from Sept. 30. The largest swings occurred on the short and long end of the curve, with the two-year AAA yield up 0.54 percentage points and the 20- and 30-year down 0.20 percentage points and 0.28 percentage points, respectively. The municipal-to-Treasury yield ratios increased (cheapened) through seven years, with the 10-year municipal-to-Treasury ratio remaining relatively flat at 83 percent, while ratios declined on the longer end with the 20-year at 96 percent. As such our barbell strategy has proved beneficial to total performance.

Municipal issuance for the quarter totaled $144.6 billion, bringing year-to-date supply to $436 billion. Municipal issuance was down 2 percent from last year (due primarily to a decline in refunding deals) but December's issuance hit an all-time record high of $62.5 billion: up more than 200 percent from the prior year. We saw some smaller weekly outflows in December after a solid year of net inflows into municipal bond funds. However, net inflows totaled $5 billion for the quarter, increasing year-to-date inflows to $19 billion. We continue to see inflows from foreign investors and we will monitor fund flows as it relates to investor sentiment concerning the Fed.

In December, both the House and Senate passed the largest tax overhaul since 1986. Pertinent to the municipal market, this included a lower corporate tax rate, a cap on state and local tax (SALT) deductions at $10,000 and the elimination of advanced refunding bonds. The lower corporate rate will likely make municipal bonds unattractive to banks and insurance companies and will have a negative impact on the demand of municipal bonds as the these entities hold around 28 percent of outstanding municipal debt. However, it is our expectation that those individual investors in high-tax states will be looking for alternative tax havens given the SALT reductions. That may increase demand in states such as California, New York and New Jersey. Lastly, the elimination of advanced refundings is likely to reduce supply in 2018 by roughly 20 percent, propping up municipal bond prices through the year.

We do not anticipate credit issues as a challenge for 2018. Issuer fundamentals continue to improve and default rates remain extremely low. However, the past year was not without headlines related to a handful of credits, primarily those within the state and local general-obligation sector with pension-liability concerns. The median pension funding for U.S. states declined from 75 percent in 2015 to 68 percent 2016, according to Standard & Poor's. In addition, the 50 largest local governments reached an aggregate $456 billion in adjusted net pension liabilities in 2016, up from $390 billion the prior year, according to Moody's. As a result, we continue to monitor state and local government pension issues and avoid credits with significant pension-liability risk. Due to budget and pension issues, we are currently underweight the state and local general-obligation sector and prefer revenue bonds with dedicated streams of revenues that will not be impacted by pension-liability issues. On top of this, revenue bonds have outperformed state and local general obligations by roughly 0.76 percentage points this year. In terms of state exposure, we have overweight positions in Florida and Washington based on their improving fiscal positions and demographics.

Rates may rise modestly from here but we believe the bulk of the move is likely behind us. We believe municipal bonds will remain a defensive sector in a rising interest-rate environment given supply constraints and their relative attractiveness.

[1] References to specific securities are intended to illustrate the types of securities Eagle may hold in this portfolio. They are not intended as representations of specific investment recommendations that would have been profitable to an investor. Past performance is not a guarantee of future results. Opinions and estimates offered constitute Eagle's judgment and are subject to change without notice as are statements of financial-market trends, which are based on current market conditions. Investing involves risk, including the possible loss of principle.

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[2.] Sources: Investor Tools Perform and Yield Book

Investing in bonds involves risks that may adversely affect the value of your investment such as inflation risk, credit risk, call risk, interest rate risk and liquidity risk, among others. The two most prominent factors are interest rate movements and the credit worthiness of the bond issuer. Investors should pay careful attention to the types of fixed income securities that comprise their portfolios and remember that, as with all investments, there is the risk of loss of capital. A Real Estate

Mortgage Investment Conduit (REMIC) is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.

Asset-backed securities and mortgage-backed securities are created by pooling loans from a variety of sources and issuing bonds that are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates. Investment grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

Convertible securities and preferred stock combine the fixed-income characteristics of bonds with some of the potential for capital appreciation of equities and, thus, may be subject to greater risk than pure fixed-income instruments. Unlike bonds, preferred stock and some convertible securities do not have a fixed par value at maturity, and in this respect may be considered riskier than bonds. Convertible securities may include convertible bonds, convertible preferred stocks and other fixed-income instruments that have conversion features.

Investments in high-yield bonds and convertible securities are subject to the client's authorization, as set forth in the Investment Management Agreement. Such investments may be subject to greater risks than other fixed-income investments. The lower rating of high-yield bonds (less than investment grade) reflects a greater possibility that the financial condition of the issuer or adverse changes in general economic conditions may impair the ability of the issuer to pay income and principal. Periods of rising interest rates or economic downturns may cause highly leveraged issuers to experience financial stress, and thus markets for their securities may become more volatile. Moreover, to the extent that no established secondary market exists, there may be thin trading of high-yield bonds, which increases the potential for volatility.

Sovereign debt instruments are subject to the risk that a governmental entity may delay or refuse to pay interest or repay principal on its sovereign debt. A Real Estate Mortgage Investment Conduit (REMIC) is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.