Eagle Insight

EAGLE Asset Management
An Affiliate of Carillon Tower Advisers

Strategic Income Portfolio

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Market Overview

The U.S. stock market (as measured by the S&P 500 Index) closed at all-time highs, gaining 4.5 percent during the third quarter. That was the eighth consecutive quarterly gain for the S&P 500. Overall, the market is up 14.2 percent from the beginning of the year. Crude oil traded higher (up 12.2 percent) as inventory continues to decline and investors begin to question additional supply from U.S. shale. Resiliency continues in the market but questions surrounding the economic impact from several hurricanes that impacted the U.S. Gulf Coast and Puerto Rico, rising global geopolitical tensions and the U.S. Federal Reserve's announcement that it will begin to unwind its balance sheet were the focus in the headlines. Surprisingly, volatility (as measured by the Chicago Board of Exchange VIX index) remains extraordinarily low.

The domestic bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, gave back some of its earlier gains from July and August in the final weeks of the third quarter to finish with a 0.85 percent total return. Factors that contributed to September's weakness included stronger-than-expected economic data, easing fears over North Korea, renewed hopes for tax reform and anticipation leading up to the U.S. Federal Reserve's announcement of balance-sheet normalization. The yield on the 10-year U.S. Treasury note trended lower for the first two months and broke to a year-to-date low of 2.04 percent at the beginning of September; however, it quickly snapped back to finish slightly up for the quarter at 2.33 percent. Yield-curve flattening continued with the intermediate- and long-term part of the curve outperforming as short-term rates pushed higher due to the Fed's refusal to back off its near-term rate-increase projections despite tepid core inflation readings. As such, corporate-credit spreads, generally moving inversely with interest rates, fell 0.08 percentage points in September to 1.01 percent: hitting a new multi-year low. Regaining momentum in September for the same reasons listed above (as well as expectations of a positive third-quarter earnings season), corporate bonds were the top-performing sector for the quarter. Interest-rate-sensitive utilities led corporate bonds followed by the financial sector and then industrials. Government-related bonds and structured securities also posted solid total returns. All major sectors outperformed duration-matched Treasuries.

Fed Update and Outlook

The Fed left the federal funds target range unchanged at the Sept. 19-20 Federal Open Market Committee (FOMC) meeting and announced that balance-sheet runoff will start in October: nearly nine years since the Fed initiated quantitative easing. Both announcements were widely expected. Less so was the Fed's reaffirmation that it expects to raise rates one more time by year-end. The market probability of a rate increase in December was as low as 22.0 percent at the beginning of September, based on fed fund futures. However, it had climbed to nearly 64.0 percent following the FOMC meeting. The near-term projections did not change but the Fed made changes to its longer-term views, according to the "dot plot." The median Fed path now suggests just more than two rate increases in 2019 instead of the previously expected three or four. In addition, the long-term average funds rate declined to 2.75 percent from 3 percent (at the June meeting). The Fed's economic outlook stayed generally the same with risks to the outlook "roughly balanced" but the post-meeting statement acknowledged weakness in inflation. Chair Janet Yellen herself admitted that the Fed could not fully explain the reasons for the weakness. However, the Fed continues to hold the line that whatever the reasons are for the weakness, they will prove to be transitory.

It is interesting to see Fed officials maintain their hawkish position regarding future rate increases despite the core PCE Price Index – the Fed's preferred inflation gauge – moving further away from

their 2 percent target. Likewise, earnings growth remains muted and inflation expectations have been basically flat for the past few months. With the risk markets' relatively tolerant initial reaction to the announcement of balance-sheet normalization behind us, we restate our view that this process will have a minimal effect on the overall economy. Intermediate- to long-term interest rates may continue to gradually move higher from current levels, especially if policymakers in Washington get more traction on a proposed tax-reform plan. But as we have seen before from Washington, tax reform will not be easy and there are other items that will need to be addressed (e.g., such as government funding, which expires later this year). Also, benign inflation and global central banks still in stimulus mode on the aggregate should keep a lid on how high interest rates go. Our near-term outlook thus remains that interest rates will be range-bound for a while longer.

Portfolio Allocation Review

Eagle taxable Strategic Income Portfolio (SIP) accounts underperformed a hypothetical 50/50 split of the S&P 500 and Bloomberg Barclays Capital Intermediate Government/Credit indices during the quarter. Our municipal Strategic Income Portfolio program similarly underperformed a hypothetical construct of the S&P 500 and Bloomberg Barclays Capital Municipal Bond 7 Year indices.

During the quarter, we changed the target allocation of SIP accounts from 50 percent equities, 40 percent bonds and 10 percent cash to 55 percent equities, 40 percent bonds and 5 percent cash.

We noticed – after an extended period in which quantitative signals were range-bound – a change in the signals that suggested we become more bullish on stocks in the near term. Specifically, more than 70 percent of stocks were trading above their 30-week moving averages: an historically bullish signal for equities. We also noticed a few favorable inflections within the monetary, fiscal and exchange rate-based indicators as well.

Consequently, we believed it was an opportune time to add a few undervalued, higher-dividend paying stocks to the portfolios while adding to existing positions in higher-yielding stocks. We also purchased a new position in a financial-services company that recently had announced a 36 percent quarterly dividend increase.

Equity Performance Review[1,2]

The equity portion underperformed (on a gross basis) the benchmark S&P 500 Index during the third quarter. Positive stock selection within the energy, industrials and real-estate sectors contributed to performance. Meanwhile, stock selection within consumer discretionary, consumer staples and financials proved weak. Allocation also detracted from performance due to an underweight position in information technology as well as an overweight position in consumer staples.

Taxable Fixed Income Performance Review[1,3]

The taxable fixed income portion of portfolios outperformed (on a gross basis) the Bloomberg Barclays Intermediate Government/Credit Index. The strategic underweight position in Treasuries and overweight position in corporate bonds was value-additive as Treasuries were the worst performers of the major bond sectors. Our portfolios' corporate bonds – dragged down by a high-quality bias – underperformed the overall index. The allocation to structured products outperformed relative to one- to five-year U.S. Treasuries.

Municipal Market Performance Review[1,3]

Municipal bonds in tax-advantaged portfolios outperformed (on a gross basis) the Bloomberg Barclays 7 Year Municipal Index. State allocation was the largest detractor, led by an underweight position in New Jersey. An extended barbell-

Top 10 Equity Holdings

Cisco Systems
Microsoft
Procter & Gamble
Lockheed Martin
JPMorgan Chase
Pfizer
3M
Wells Fargo
Altria Group
Johnson & Johnson

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duration strategy proved to be accretive as the curve flattened. Sector selection was the largest contributor to performance; specifically, an overweight allocation to the leasing-revenue sector was a top performer.

Outlook

Economic activity generally improved around the world during the third quarter, with leading U.S. economic indicators ending the quarter near cycle highs. We believe the U.S. economy will continue to chug along at a moderate pace and we do not see a recession on the horizon. Deregulation and prospects of tax reform have increased optimism among business owners. The percentage of small-business owners planning to make capital expenditures recently reached its highest level since 2006, according to the National Federation of Independent Business (NFIB). We expect corporate earnings to improve in 2018 and we anticipate consumer spending to remain healthy due to continued job growth, relatively low oil prices and a pickup in manufacturing activity. Despite the potential for additional modest increases in short-term rates from the Fed, long-term interest rates will probably remain relatively low due to dormant inflation and low global bond yields.

Today's valuations may be slightly above the long-term historical average but they are well within normal range considering the low level of interest rates. We also believe it is important to consider where we are in the business cycle as equity valuations tend to follow the path of leading economic indicators, which are still improving. Some sectors of the market have become somewhat expensive but others still appear very attractive and that is where we focus most of our attention.

The positives in the market and economy are encouraging but we remain mindful of a number of risk factors that could negatively impact investor sentiment. Those include geopolitical uncertainty, unwinding of quantitative-easing programs by global central banks and political gridlock in Washington, D.C. Weighing the data, we believe the most probable scenario is for the U.S. economy to maintain its slow, but sustainable, growth.

Dividends paid for the S&P 500 Index for the four quarters ending Sept. 30 were the highest level ever. We believe we are likely to continue to see steady and rising dividends for a while since dividend-payout ratios are still well below the long-term average. Consequently, we view our strategy of investing in high-quality, financially strong companies that pay above-market dividends and have cash resources to increase dividends regularly as well-positioned to benefit from this trend.

[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] Source: FactSet.

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