Strategic Income Portfolio

First Quarter | 2018

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Market Overview

After gaining 7 percent to start the year, the broad U.S. equity market (as measured by the Russell 3000® Index) traded lower (-0.8 percent) in the first quarter for the first quarterly loss since 2015. A spike in volatility triggered the selling, followed by fears over potential regulation of many of the market's best-performing technology stocks. The selling intensified as news from Washington centered on new tariffs against China, sparking fears over a potential trade war endangering a $600 billion relationship. This quarter also featured new Federal Reserve Chairman Jerome Powell leading his first increase in the Federal Funds rate; Congress passing a spending bill; and oil prices trading higher, further increasing inflation concerns.

The domestic bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, fell 1.46 percent in the first quarter. Treasury yields spiked due in part to market concerns that stronger economic growth will finally spur higher inflation, leading to a faster pace of interest-rate increases by the Federal Reserve. The implications of rapidly rising interest rates finally stifled investor demand for risk assets and increased market volatility mid-quarter.

The yield on the benchmark 10-year U.S. Treasury rose more than half of one percent in less than two months and reached a multi-year high of 2.95 percent in February. In March, however, some of the apprehension over growth and inflation subsided as several important economic measures – along with inflation data – failed to meet market expectations. Government bond prices went up as investors migrated toward their relative safety over growing risks presented by President Donald Trump's proposed tariffs.

Our view for resistance around 3.0 percent held as the yield on the 10-year note declined to finish the quarter at 2.74 percent: 0.33 percentage points higher since December 31 but 0.21 percentage points off its year-to-date high.

Fear of proposed tariffs spiraling into a global trade war weighed heavily on corporate bonds. Corporate-credit spreads continued to widen in March, ending the quarter at 1.09 percent vs. 0.93 percent at the beginning of 2018. The corporate-bond sector was the worst-performing major sector with a negative total return and underperforming duration-matched Treasuries. Government-related securities and structured products fared slightly better than corporate bonds (on a total return basis) but still posted negative total returns.

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. Our taxable Strategic Income Portfolio (SIP) accounts also underperformed hypothetical 50/50 split of the S&P 500 and Bloomberg Barclays Capital Municipal Bond 7 Year indices.

During the quarter, we shifted the bond and cash allocations of Strategic Income Portfolio (SIP) accounts. The stock weighting remained 55 percent; meanwhile, we moved from 40 percent bonds and 5 percent cash to 35 percent bonds and 10 percent cash.

There was a noticeable correlation between stocks and bonds as the markets moved downward over the last couple of weeks. Consequently, we believed it was prudent to take some bond risk off the table by moving into a higher cash position (in keeping with our models) until there is more clarity in the marketplace. Additionally, the move allows us to have cash available if the market presents what we believe are good buying opportunities.

Equity Performance Review[1,2]

The equity portion of the Strategic Income Portfolios underperformed (on a gross basis) during the quarter. Positive stock selection within information technology, utilities, real estate, energy, and telecommunication services helped performance. Meanwhile, stock selection within consumer sectors, healthcare, financials, materials, and industrials hurt performance.

The S&P 500 had a strong January before volatility returned in February and March. Generally, we would not expect to outperform in this environment given our high-quality bias. Most of the underperformance in the equity sleeve for the quarter happened in January. In February and March, on the days when the S&P 500 was down, our equity sleeve was down less (in aggregate).

The dividend headwind of last year continued into 2018. Non-dividend paying stocks within the S&P 500 generated positive quarterly returns while dividend paying stocks, those we strive to own in the Strategic Income Portfolios, were negative.

Taxable Fixed Income Performance Review[1,3]

The taxable fixed income portion of the portfolios underperformed the Bloomberg Barclays Intermediate Government/Credit Index for the quarter. The strategic underweight position in Treasuries and overweight position in corporate bonds was a headwind to performance. Within corporates, our conservative duration positioning lead to outperformance. Selection within Treasuries and Agencies was a positive contributor for the quarter, as was the overweight allocation to structured products.

Municipal Market Performance Review[1,3]

Municipal bonds in tax-advantaged portfolios underperformed the Bloomberg Barclays 7 Year Municipal Index for the quarter. State allocation was a positive contributor to performance as, outside of Puerto Rico, the higher-risk states underperformed. The barbell portfolio structure was a negative contributor to performance for the quarter, as longer duration bonds underperformed the short end of the curve. Sector selection underperformed; specifically, the underweight allocation to the transportation sector.

Outlook

The U.S. stock market entered 2018 looking a lot like 2017: low volatility, a broad advance led by large technology stocks and optimistic (if not complacent) investors. But something changed around mid-January. Volatility resurfaced with a vengeance. The proximate cause of the early downdraft in stocks was growing concerns about inflation and interest rates. But as the quarter unfolded, volatility continued, new concerns arose about a trade war with China and there was real questioning of some large-cap tech companies' business models added to the mix. Consequently, the U.S. market recorded its first quarterly decline since 2015.

The volatility and concerns continue as we enter the second quarter. But stepping back from the day-to-day ups and downs of the market, we continue to believe that the underlying fundamentals are sound. None of the normal, historical precursors of recession and bear markets are present. Economic growth is solid almost anywhere one looks around the world. In the United States, we expect gross domestic product (GDP) growth to improve from the approximately 2 percent annual rate it has been stuck at since the financial crisis now nearly 10 years in the past. After years of underinvestment, domestic capital spending is poised for acceleration. Led by surging employment growth and abetted by somewhat better wages and lower taxes, household incomes are growing again. Housing construction activity, which historically has been a key driver of U.S. economic growth, is set to accelerate based on demographics and underinvestment since the crisis in 2007-2008. Earnings growth this year

Top 10 Equity Holdings

Microsoft
Cisco Systems
JPMorgan Chase
Lockheed Martin
Pfizer
3M
Procter & Gamble
Cinemark
Crown Castle
Wells Fargo

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should approach 20 percent, boosted by the recently enacted tax bill and faster GDP growth.

To be sure, there are concerns on the horizon … but there always are. The Federal Reserve likely will continue to normalize interest rates this year. There is a grand debate about how many times the Fed will raise rates. We continue to see moderate economic growth but it is far from the lofty expectations laid out at the start of the quarter. We view the proposed protectionist policies of the administration as a negative development that will add to market volatility. We will also be entering a negative "comp" landscape in the next few months and would not be surprised if year-over-year data weakens. Employment continues to be a bright spot although sustained wage gains have not materialized.

Inflation expectations have begun to wane as realized inflation has failed to keep pace. The core personal consumption expenditures (PCE) index reading for February was 1.6 percent year-over-year. This was slightly better than previous months but well shy of the Fed's 2.0 percent target. Financial conditions have finally begun to tighten and the yield curve is back on its flattening trend. We view these indicators as signs for caution and it appears the market does as well. Discounted prospects for breakneck growth and inflationary pressure in the near-term should restrict rates from moving too high. There are concerns regarding the increased supply of Treasury debt needed to fund increased government spending for the recent budget deal and tax cuts.

Our position is informed by the straightforward observation that gradually rising interest rates – from a low level, impelled by stronger economic growth – historically have not been an impediment to higher stock prices. We believe there is still enough slack in the global markets for goods, commodities and labor to keep inflation at or below most central banks' 2 percent target.

It is possible to paint a dire picture based on a spreading trade war with China and that possibility cannot be ruled out completely. But, in our experience, it is wiser to position portfolios for the most likely outcome and not for a high-risk-but-low-odds result. We believe that, in spite of some real economic concerns and grievances, the impending "trade war" is mostly political posturing and neither side would benefit from a significant escalation. That said, we have to acknowledge leaders make irrational mistakes and, until the air clears, this concern likely will weigh on stocks. Further, it may prevent stronger earnings growth from being fully translated into higher stock prices.

Market corrections such as the ongoing one often have ushered in a change in market leadership. We believe it is quite likely that the technology sector – and especially social-media companies – may struggle for a while. Business models are being questioned if not attacked outright, valuations seem extreme and the sector is approaching the same share of the market's capitalization that it held during the "internet bubble" that disastrously ended in 2000. A commonly referred to grouping of the most popular technology stocks (a social-media stock, the world's largest online retailer, an online entertainment company and the world's largest search-engine company) sell at 133 times current earnings and 73 times 2018 estimates. That compares to about 17 times earnings for the S&P 500. These four stocks also comprise nearly 8 percent of the S&P 500's market capitalization.

We expect, on the other side of this correction, a much more "democratic" market with many more stocks and sectors showing good performance on the basis of earnings and attractive valuations. We believe a reversal of the dominance of growth stocks compared to value stocks may well be under way. Also, we would expect an attraction to companies with growing dividend streams to re-emerge in a still-low interest-rate environment.

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.

[2] Source: FactSet.

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