Eagle Insight

EAGLE Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Fixed Income

Third Quarter | 2018

James Camp, CFA
Managing Director and
Portfolio Manager

Joseph Jackson, CFA
Portfolio Co-manager

SMA Only:
Burton Mulford, CFA
Portfolio Manager

Sheila L. King, CFA
Portfolio Co-manager

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 overall domestic bond market, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, was flat in the third quarter with the intermediate part of the market up slightly at 0.11 percent. Interest rates generally advanced higher in September, pushing U.S. government bond prices lower and erasing the market's prior gains for the quarter. Investor demand for the relative safety of Treasuries faded during the last month as concerns over trade tensions, geopolitical issues and the economic outlook outside the United States eased. At the same time, investors shed Treasuries while positioning portfolios to make room for an increase in new corporate bond supply. The yield on the benchmark 10-year U.S. Treasury note broke through the psychologically important 3.0 percent level (which had held since May) and ended the quarter at 3.06 percent. The increase in yields on the longer end of the curve prevented further yield curve flattening with short-term rates rising due to the much-predicted increase in the Fed funds rate.

The corporate bond market sprung at the slightest bit of good news in the final weeks of the quarter. The risk-on approach seemed driven by easing emerging-market concerns, which allowed investors to focus on strong U.S. economic data and the upcoming corporate earnings season. Corporate credit spreads, which generally move inversely with interest rates, shifted to the tight end of their recent range despite one of the heaviest months of the year for new bond issuance. Spreads ended the quarter at 1.06 percent, compared to 1.23 percent at the end of June. Spread tightening led the corporate bond sector to outperform the broader market on both a total return and excess return basis. Government-related securities also posted a positive total return and outperformed duration-matched Treasuries while structured products were marginally down for the period.

Fed Update and Outlook

As widely expected, Federal Reserve members voted to increase the Fed funds target range for the third time this year at the September 25-26 Federal Open Market Committee (FOMC) policy meeting. There was confusion over the removal of language from the post-meeting statement describing monetary policy as "accommodative". Normally this edit would be interpreted as dovish; however, as Fed Chair Jerome Powell later highlighted in his press conference, the target rate is still below officials' projected longer-term rate, and therefore still accommodative.

Likewise, the distribution of Fed officials' forecasts in the dot plot, improved projections for real gross domestic product (GDP) growth (3.1 percent vs. 2.8 percent prior), and core inflation (2.0 percent vs. 1.9 percent prior) for year-end 2018 suggests a continuation of gradual interest rate increases. Market expectations for a fourth increase in December have risen in probability to 71.3 percent at the end of September compared to 63.3 percent at the end of August.

It is now possible that the third quarter will mark a record-setting ninth consecutive quarter of accelerating GDP growth on a year-over-year basis – barring an unexpected shift in economic results for September. The fourth quarter of 2017 is when we really saw a meaningful boost throughout the economy; therefore, our view remains that U.S. economic data will be unable to continue accelerating against the ever-increasing tough "comp" environment. Economic growth outside the United States remains soft and the uncertainty surrounding trade policy is

not helpful. Fed officials did not include their views on the impact of trade tariffs on the United States in their official statement, but Chair Powell did mention concerns in his press conference.

Wage growth is expected to gather momentum from a labor market at or near full employment, but there is nothing in our view to indicate that inflation should not remain modest. The headline reading for the August personal consumption expenditures (PCE) price index decelerated from the previous month, while the core reading (excluding food and energy) was flat at 2.0 percent on a year-over-year basis. Inflation expectations also remain well anchored, indicating investors are not worried either that the pace of realized inflation will continue to speed up. The 10-year breakeven inflation rate, a market-based measure of expectations for annual inflation over the next 10 years, was 2.14 percent – largely in line with its six-month average of 2.13 percent.

Lacking strong conviction that economic growth and inflation will continue accelerating through the end of the year, and avoiding head-fake headlines about Italy or other issues that will probably take longer than a month to sort out, we remain skeptical that a sustained rise in the 10-year yield is the most likely scenario. Our base case remains for longer-term rates to remain range-bound in the near term, with the yield curve slope compressing further as the Fed is set to raise short-term rates again in December. The spread in yields between the three-month Treasury bill and the 10-year Treasury note – one measure of the yield curve – was at 0.86 percent, so in our view, the Fed still has room for two or three more interest rate increases without a commensurate move in the 10-year yield before we see jitters over a possible inversion.

Corporate Market Review

Investment-grade corporate bonds, as measured by the Bloomberg Barclays U.S. Corporate Bond Index, gained 0.97 percent during the third quarter. Easing fears that emerging-market turmoil will not upend U.S. growth and some relatively positive headlines regarding trade policy drove the strength in credit. Investors seemed pleasantly surprised when the Trump administration announced in mid-September initial tariffs of 10 percent on $200 billion worth of Chinese goods. This rate is scheduled to increase to 25.0 percent in 2019. The market reacted positively since investors were bracing for the 25.0 percent level upfront. However, this move is a clear escalation in the trade war with China and trade policy, and in our view, remains a concern over the near-term.

Companies will soon be reporting their third-quarter results, and another quarter of expected solid earnings growth will be a tailwind for improving credit fundamentals. Expectations remain high and valuations are not cheap, so the risk-reward of stretching on credit seems to be to the downside, especially if earnings growth peaked last quarter and forward guidance is not as robust or as clear as investors may hope. We are still comfortable with our current positioning, having reduced corporate bonds earlier in the year, but we will continue looking to opportunistically add issues that fit our risk-return criteria.

Municipal Market Review

The municipal bond market posted negative returns during the third quarter 2018. The Bloomberg Barclay's Municipal Bond Index was down 0.15 percent for the third quarter. This negative performance brings year-to-date return to -0.40 percent. In September we saw investors flock to short-dated municipals amid concerns around rising interest rates, making the short end of the curve (one- to three-year maturity) more expensive relative to the prior month. However, on a quarterly basis, we have seen cheapening across the curve. Other highlights this quarter include: weakened demand amid constrained supply, a much anticipated increase in short-term rates and a hurricane that caused significant damage to the coast of the Carolinas.

Municipal bonds cheapened significantly this quarter, with yields down roughly 0.15 to 0.45 percentage points across the curve, with the shorter parts of the curve (1-3 year) cheapening the most. The 10-year municipal AAA yield moved the least, down 0.15 percentage points from the end of the second quarter. At this time, we are currently finding value in the longer part of the curve (15+ years) where the Municipal to Treasury ratios are in the mid 90's to low 100's. We have taken advantage of these valuations and are currently buying bonds in those attractive maturity ranges and selling intermediate maturity or weaker credits. While cash has been elevated in our municipal programs for most of the quarter, we have begun reinvesting cash as opportunities have arisen, primarily in shorter maturity bonds.

Demand for municipal bonds – offset by light supply – has tapered off this quarter. According to the Federal Flow of Funds report, ownership of municipal bonds by banks declined by 4.7 percent year-to-date (2Q18), while we saw a slight uptick by life insurance companies of 1.5 percent. Household investor holdings remained relatively flat since last year. Offsetting this, new issue supply is down 15 percent this year versus the same period in 2017. We saw $84.2 billion in issuance in this quarter, bringing year-to-date issuance to $249 billion. The 30-day visible supply is extremely light at roughly $3.3 billion.

Fixed Income

Third Quarter | 2018

Flows into municipal funds have been net positive this quarter, resulting in net inflows of $11 billion this year. We have experienced fund outflows in two of the last four weeks, primarily from national and long-term funds. We will continue to monitor fund flows as it relates to investor sentiment concerning the Fed.

This quarter, the Carolina coast experienced flooding and destruction from Hurricane Florence with damage estimated at $17 billion to $22 billion or even higher. We do not expect to see material negative impact to credit ratings as much of the cost will be mitigated by Federal aid, insurance and reserves. According to Moody's, natural disasters have not been the cause of a single default in U.S. municipal bond history. In fact, while hurricane Katrina caused roughly $120 billion in damage to the state of Louisiana in 2005, New Orleans and other local governments were still able to pay their debt obligations. Eagle's exposure is limited in these areas and we will continue to monitor the situation.

Over the last several years we have been underweight the State General Obligation sector as states struggled to recover from the Great Recession. We have since seen state tax collections recover, reserve funds be replenished, increased pension transparency and long-term plans to reach adequate pension funding levels. As active managers, we are continually looking for opportunities within the municipal market to deploy capital strategically. A recent adjustment to our current strategy is investing in lower investment-grade credits that are stable or have upside potential. Within our municipal bond programs, we have been underweight BBB credits (1.0 percent of our holdings), compared to the Bloomberg Barclay's Municipal Bond Index (8.6 percent of index) which has softened performance relative to our respective benchmarks. We will look for short-term opportunities across the investment-grade rating spectrum.

Overall we remain overweight in revenue bonds versus general obligation bonds. Revenue bonds have outperformed general obligation bonds by 41 basis points over the last 12 months. We remain overweight in the transportation, leasing, and special tax sectors.

Vertical Income Portfolio Review[1,2]

Eagle Vertical Income Portfolios outperformed (on a gross basis) while underperforming (on a net basis) the benchmark Bloomberg Barclays Investment Grade Corporate Bond Index in the third quarter. Strong returns from our dividend-oriented equity positions were largely offset by the underperformance of our preferred securities. The increase in interest rates on the longer end of the curve – especially in the final weeks of the quarter with the yield on the 10-year U.S. Treasury note breaking through the 3.0 percent level – was a major headwind. The slight lag in our corporate bonds relative to the benchmark was the deciding factor in performance for the quarter. We generally had portfolios positioned with 61.5 percent in corporate bonds, 21.0 percent in preferred securities, 15.0 percent in equities and 2.5 percent in cash in the third quarter. During the period we decreased our equity exposure and increased our position to corporate bonds. The changes are a natural outcome of the relative movements of yield-producing securities as interest rates have increased.

[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.

This information is not intended to serve as investment, tax, legal or accounting advice. It should not be considered a recommendation to engage in or refrain from taking a particular course of action and is not an endorsement, recommendation or sponsorship of any securities, services or other investment property. It has been prepared for informational purposes only and you should consult your own investment, tax, legal and/or accounting advisors before engaging in any transaction. Any discussion of tax matters contained herein is not intended or written to be used, and cannot be used, for the purpose of avoiding any penalties that may be imposed under federal tax laws. The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients or any of its or their respective affiliates. Views expressed are as of the date indicated and may change based on market and other conditions. The accuracy of the content and its relevance to your particular circumstances is not guaranteed.

[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 conversionfeatures.

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 thepotential 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 paymentsfrom 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.