Eagle **Insight**

EAGLE Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Strategic Income **Portfolio**

Third Quarter | 2018

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Equity Income investing is based upon the identification of companies that possess both moderate growth rates as well as higher-than-average and consistent dividend distributions. There are risks associated with dividend investing, including that dividend-issuing companies may choose not to pay a dividend, may not have the ability to pay, or the dividend may be less than what is anticipated. Dividend-issuing companies are subject to interest rate risk and high dividends can sometimes signal that a company is in distress. Historically, dividend yields have been relatively constant and therefore have created a cushion for investors when stock prices have declined. However, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. The biggest risk of equity investing is that returns can fluctuate and investors can lose money. estment-grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

Market Overview

The broad U.S. equity market (as measured by the S&P 500 Index) delivered a total return of 7.7 percent during the third quarter. This brings total year-to-date performance to 10.6 percent. As strong as the market has been, the strength has been limited to U.S. stocks. Corporate profits remain strong with consensus estimates for third-quarter earnings per share up 21 percent year-over-year. The labor market remains tight as unemployment stayed just below 4 percent and the surveys of consumer and business confidence levels continue to show economic health. While trade is still a potential risk, it appears the market has discounted the effects from any significant escalation.

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 that 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.

Portfolio Allocation Review

Eagle taxable Strategic Income Portfolio (SIP) accounts outperformed a hypothetical 50/50 split of the S&P 500 and Bloomberg Barclays Capital Intermediate Government/Credit indices on both a gross and net basis. Our municipal Strategic Income Portfolio accounts also outperformed a hypothetical 50/50 split of the S&P 500 and Bloomberg Barclays Capital Municipal Bond 7 Year indices on both a gross and net basis.

In aggregate, dividend-paying stocks outperformed non-dividend-paying stocks during the third quarter, reversing a trend that had persisted since the beginning of 2017. In addition to the favorable dividend payer trends, our stock selection was particularly strong.

We entered the third quarter with an asset allocation of 50 percent equities, 47 percent bonds, and 2 percent cash. As a result of one allocation shift, we ended the quarter at 55 percent equities, 43 percent bonds, and 2 percent cash.

Indicators in our models have stabilized above 50 percent for the target allocation to equities. We are entering a seasonally strong time period for equities on a historical basis, and trends have been improving for dividend-paying stocks – the stocks we

purchase in the Strategic Income Portfolio accounts – since the start of the third quarter. Additionally, we anticipate an acceleration in stock buybacks in the later stages of the year as more buybacks have been announced than executed.

Equity Performance Review[1,2]

The equity sleeve of the Eagle Strategic Income Portfolios outperformed the benchmark S&P 500 Index during the quarter. Our selection of dividend paying stocks was particularly strong as they outperformed the average dividend-paying stock in the S&P 500. Stock selection was strong across the board with notable outperformance in the newly formed Communications sector, Industrial, and Healthcare. Stock selection within Utilities and Materials proved to be slight detractors for the quarter.

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 underweight allocation to treasuries and selection within corporates were the two largest positive contributors for the quarter. Our slight overweight allocation to duration was the biggest detractor for the quarter.

Municipal Market Performance Review[1,3]

Municipal bonds in the tax-advantaged portfolios underperformed the Bloomberg Barclays 7 Year Municipal Index for the quarter. Our sector allocation was a positive contributor for the quarter; however, our high quality bias worked against us as lower quality credits underperformed higher quality credits during the quarter.

Outlook

As widely expected, Federal Reserve members voted to increase the federal-funds target range for the third time this year at the September 25-26 Federal Open Market Committee (FOMC) policy meeting. The removal of language from the post-meeting statement describing monetary policy as "accommodative" was somewhat confusing. 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 and 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 hike in December have increased 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's nothing 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)

Top 10 Equity Holdings

Cisco Systems
JPMorgan Chase
Pfizer
Lockheed Martin
Microsoft
Procter & Gamble
Crown Castle International
Cinemark Holdings
AT&T
Merck

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was flat at 2.0 percent on a year-over-year basis. Inflation expectations also remain well anchored, indicating investors are not worried 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 to sort out than just one month, 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 hikes without a commensurate move in the 10-year yield before we see jitters in the market over a possible inversion.

Ever since the current bull market and economic recovery began back in 2009, our generally positive outlook has been informed by three basic factors: (1) the economic recovery, once begun, would continue until interrupted by policy mistakes or a major, unexpected exogenous event, (2) no bear market was likely until the economy showed signs of entering a recession, and (3) the valuation of the U.S. market was attractive, especially compared to fixed-income alternatives.

Nearly ten years later, with the S&P 500 up nearly four hundred percent from the lows of March 2009, our view remains the same. The economic recovery is showing signs of acceleration as the benefits of lower taxes and deregulation continue. Employment, credit, manufacturing, earnings and housing all point to continuing growth. Given the myriad of positive economic and fundamental data, the odds of a bear market in stocks anytime soon are low.

Valuations remain supportive of the market with the price/earnings (P/E) ratio on the S&P 500's estimated 2019 earnings standing at just over sixteen times (16x), only slightly above the long-term average for this indicator. And as we have continually noted, compared to yields available in the fixed income markets, the valuation of equities remains quite attractive on an historical basis.

As for trade, the Trump Administration has embarked on a policy never before seen by investors or modern day policy makers, for that matter. Instead of embracing large, one-size-fits-all multilateral trade deals, the administration is focusing on a country-by-country approach. The "carrot and stick" philosophy is on full display; despite some scary headlines and some possibly ill-advised tweets, it seems to be working. The old NAFTA agreement which the Trump Administration had abandoned has now been reworked with palpable benefits to the United States. European agreements are in the works and new agreement with South Korea has been struck with Japan next in line. China remains difficult but we doubt that a full-on trade war is likely, since each side has too much to lose. With the U.S. market roughly ten times as important to China as the Chinese market is to the United States, we would not be surprised to see some kind of a "deal" by year end. It is likely that the markets will applaud even more than they did for the U.S./Mexico/Canada accord, which was agreed to on the last day of the third quarter.

The more or less steady climb in stock prices over the past ten years has been occasionally interrupted by brief bouts of panic selling. We estimate there have been over thirty of these incidents, with the causes ranging from European credit concerns, to changing Federal Reserve policy, to Brexit, to a brief U.S. government shutdown. Each of these "crises" has worked to keep investors nervous and – most importantly – underinvested. Investors should be prepared for more of these unstable periods from time to time; however, we believe continuing earnings growth, reasonable valuations and the United States' attractiveness as an investment venue will prevent periodic dislocations from becoming more substantial.

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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3. Source: FactSet