3Q18 BHMS Bond Commentary

"Bull markets don't die of old age, they die of fright and are most afraid of recession." – Sam Stoval, CFRA

3Q18 MARKET REVIEW: Investors marked the tenth anniversary of the Financial Crisis with sustained enthusiasm for risk assets. A desire for total return overcame concerns of macro economics, venomous politics, and global central banks intent on transitioning from QE to QT. While bond yields in the U.S. continued a gradual upward drift that left most fixed income market segments in single-digit territory, equities enjoyed strong returns in 3Q18 with the S&P 500 gaining 7.2%, the Dow Jones Industrial Average advancing 9.01%, and the Nasdaq Composite rising 7.4%. The Bloomberg Barclays Aggregate Index generated a 0.02% return.

THE ECONOMY, INTEREST RATES & THE FED: With the support of continued strength in GDP and employment, along with a modest increase in domestic inflation, the U.S. Federal Reserve raised the key Federal Funds Rate another 25bps in September. It was the eighth rate hike since December 2015, and with the "Dot Plot" forecast of more increases next year, the target range is now 3.00-3.25% by year-end 2019. The 2yr/10yr UST yield curve ended 3Q18 at +24bps, 9bps flatter versus 2Q18 and now the flattest since 2007.

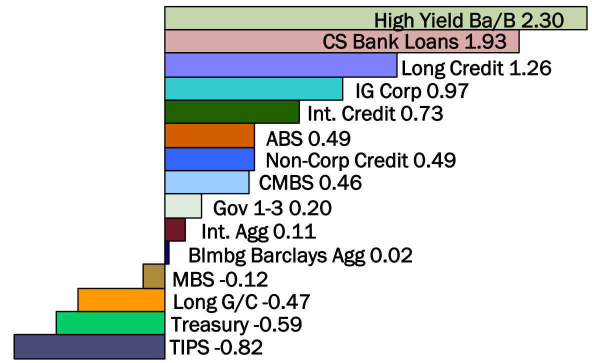
INVESTMENT GRADE CREDIT: IG Credit enjoyed a solid rebound from a disappointing 1H18, as strong investor flows and improving fundamentals contributed to a narrowing in yield spreads relative to U.S. Treasury (UST) issues. The fears of massive repatriation of corporate cash held overseas proved misguided as the lack of wholescale selling in the front end of the corporate curve failed to materialize. The homecoming of this cash also had a positive impact on reduced new issue supply. The net result was positive nominal and excess returns in Credit.

HIGH YIELD: High Yield bonds (Ba/B rated) enjoyed the same support of fund flows and better credit fundamentals as IG during 3Q18, generating the best returns of all Credit sectors. Further improvement in credit metrics, a decline in default rates, and favorable supply/demand technicals contributed to narrower spreads.

AGENCY MBS, ABS & CMBS: Concern over rising rates, a further decrease in buying by the Federal Reserve, and muted sponsorship from both domestic banks and foreign investors weighed on Mortgages (MBS) during 3Q18. Mortgage rates are now at the highest levels of the past seven years, suppressing both new purchase mortgage originations and refinance activity. Asset Backed (ABS) and Commercial Mortgage Backed Securities (CMBS) both generated positive nominal and excess returns, as investors found value in high quality structured products at competitive yields relative to short maturity corporate alternatives.

LONG CREDIT & LDI TRENDS: As in 2Q18, the upward drift in long UST rates generated increased interest in long duration assets by investors seeking both yield and liability hedging benefits. Yield bogeys became more appealing for LDI investors, contributing to spread narrowing and strong excess returns relative to short and intermediate credit sectors.

Bloomberg Barclays Index Returns 3Q 2018 (%)



				2018	
				YTD	YTD
Yields & Spreads	12/31/17	6/29/18	9/28/18	High	Low
3 Mo. T-Bill	1.38%	1.91%	2.20%	2.20%	1.39%
2 Yr. Treasury	1.88%	2.53%	2.82%	2.84%	1.92%
10 Yr. Treasury	2.41%	2.86%	3.06%	3.11%	2.45%
30 Yr. Treasury	2.74%	2.99%	3.21%	3.25%	2.79%
Yld Curve 2-10 Yr.	52	33	24	78	19
Yld Curve 2-30 Yr.	86	46	39	109	34

Blmbg Barclays Sectors				
	Total Returns(%)		Excess Returns(%)*	
Sep. 28, 2018	3-Months	One-Year	3-Months	One-Year
High Yield Ba/B	2.30	2.18	2.40	3.19
Industrials	1.07	-1.09	1.90	1.07
Financials	0.93	-1.18	1.35	0.52
IG Credit	0.89	-1.10	1.57	0.86
ABS	0.49	0.51	0.31	0.53
Non-Corp. Credit	0.49	-0.67	0.94	0.90
CMBS	0.46	-0.58	0.77	1.47
Utility	0.23	-2.13	1.44	0.38
MBS	-0.12	-0.92	0.17	0.18

*Blmbg Barclays Indices calculates the excess return of various bond sectors by measuring the return above or below duration neutral Treasuries.

Source: Bloomberg Barclays

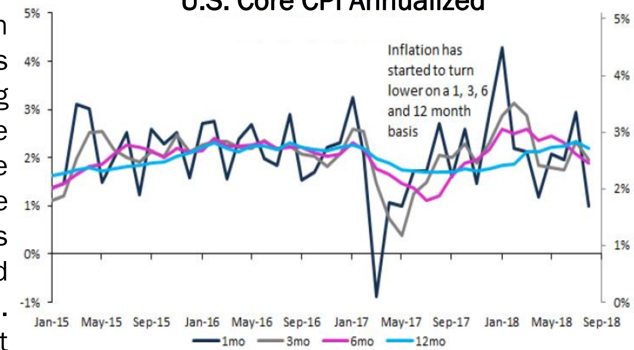
"A noticeable period of monetary deceleration, now synchronized globally, is consistent with lower, not higher, interest rates." – Milton Friedman

THE ECONOMY, INTEREST RATES & THE FED: Markets continued to shrug off concerns about global trade wars, Emerging Market (EM) stress, divisive politics in D.C., and continued Federal Reserve normalization policies to drive already expensive financial asset valuations even higher in 3Q18. Positive fundamentals in GDP growth, business investment, and consumer confidence supported the ongoing rally. Strong corporate earnings fueled a rise in both the UofM sentiment and ISM manufacturing indices to the highest levels since 2004, while small business optimism hit a record high in 3Q18. The Conference Board's confidence measure hit a post-2000 high, largely on continued strength in the job market, the fastest wage gains since the last recession, still-contained inflation, and much improved balance sheets versus pre-crisis levels. Not even a lift in U.S. Treasury (UST) yields to year-to-date (YTD) highs and a Fed intent on further rate hikes seemed to deter the euphoria, as monetary policy remains accommodative. With inflation-adjusted short rates still in negative territory, the Fed's transparent path toward further but slow rate hikes, and a predictable and deliberate trimming of the Fed's balance sheet, investors appear complacent about modestly higher rates.

While the U.S. enjoys a protracted "Goldilocks" era, overseas counterparts face increasingly serious desynchronization challenges. Foreign central banks must confront a continuing conundrum of internal versus external crosscurrents as they pursue their own normalization. Japan's economy is enjoying stronger growth with modest inflation, allowing the BoJ to continue their plan. The ECB's intended path now conflicts with slower growth, moderating inflation, and a slow-motion crisis of confidence in 3Q18. This crisis is centered in Turkish, Italian, and Spanish banks, some of which are already at risk from excessive loan exposure to deteriorating EM economies (which also account for ~59% of global GDP). If funds continue to flee those EU banks, much less accelerate, Mario Draghi's "what ever it takes" pledge might again be invoked to avoid a potential nightmare scenario for the Euro. This scenario could mandate a resumption of QE measures by the ECB as early as 2Q19, coincident with Brexit. Additionally, a stronger U.S. Dollar, a rapidly depreciating Turkish Lira, and rate volatility raise further concerns about the weak EU banking system. Meanwhile, Chinese tax reforms that target increased consumption and investment should stabilize growth, but reduced infrastructure spending and a potential trade war present countervailing headwinds. Contained inflation suggests BoC monetary policies may remain focused on currency manipulation to prop-up growth.

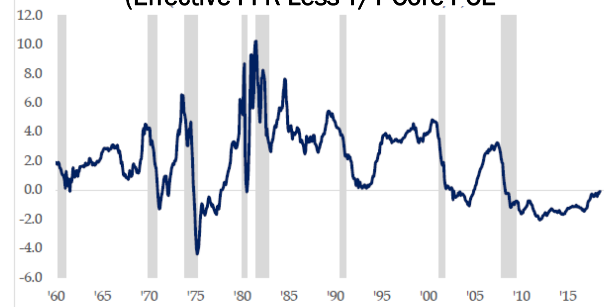
OUTLOOK: The Fed raised the Fed Funds Rate (FFR) 25bps at the September FOMC meeting, the third rate hike in 2018 and eighth since 3Q15. The current pace of domestic GDP, job and wage growth, and a gradual lift in inflation support the "dot plots" forecast of four more rate hikes by YE19 and a terminal FFR of 3.00-3.25%. Assuming Core PCE is near 2.00%, the inflation adjusted Real FFR target is ~1.00%. A more aggressive plan would jeopardize the fabled but rarely seen "soft landing". Absent an extreme steepening in the term premium, this path would further flatten the 2/10-Yr yield curve, which ended 3Q18 at +24bps. The wildcard for U.S. rates may be a potential destabilization of growth and slower corporate earnings resulting from trade tariffs. It remains to be seen how severe foreign market turbulence may become before the Fed ultimately reconsiders its path toward normalization.

U.S. Core CPI Annualized



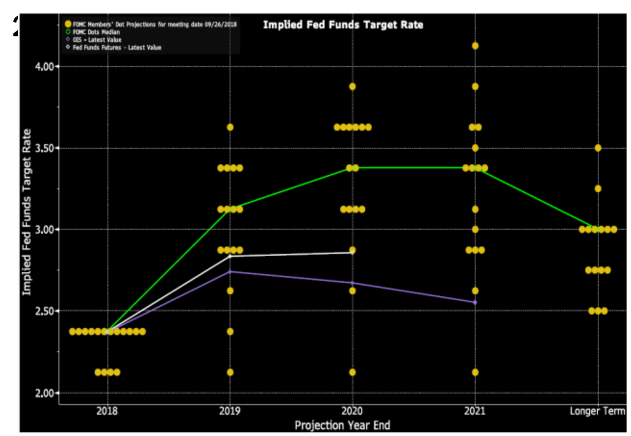
Source: DB Global Research

U.S. Real Fed Funds Rate
(Effective FFR Less Y/Y Core PCE



Source: DB Global Research

The Fed's "Dot Plots"



Source: Bloomberg, Federal Reserve

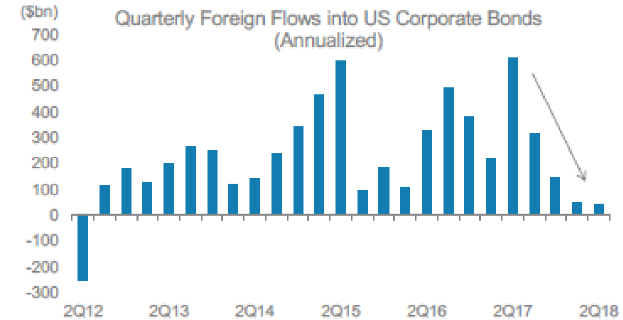
"Even when conditions seem placid, squalls can appear quite suddenly." – Randall Forsyth, Barron's

INVESTMENT GRADE CREDIT MARKET REVIEW: Investment Grade (IG) corporate bonds rebounded in 3Q18 from a disappointing 1H18 on continuing favorable earnings reports. The backlash from repatriation of corporate balance sheet cash that sparked a sharp spread widening of short maturity corporate paper in 4Q17-1Q18 on fears of wholescale selling by corporate treasurers, largely dissipated through 3Q18. Cash-rich multinational companies largely became passive versus massive sellers, allowing those investments to mature, or modestly transition into now higher yielding money market investments. Stabilization in LIBOR funding rates, even though the Fed continued to raise rates, also contributed to technical support for credit spreads. IG spreads closed 3Q18 at +100bps, 16bps tighter during the period, 11bps wider YTD, but well inside the +157bps average since 3Q1998. This spread improvement contributed to more favorable nominal and relative 3Q18 returns in IG Credit of 0.97% and 1.69%.

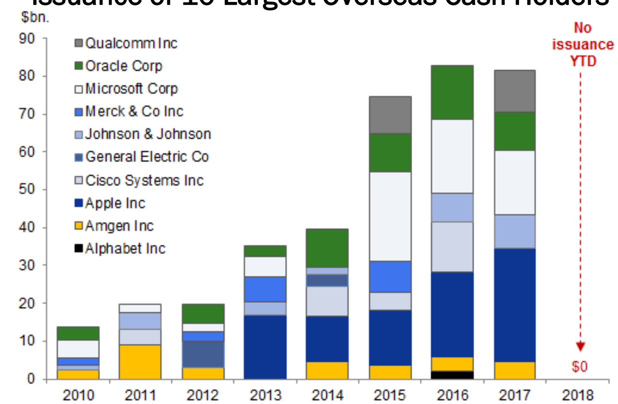
Repatriation had a material impact on 3Q18 and YTD18 supply/demand dynamics. Goldman Sachs reports six of the ten largest companies with sizeable offshore cash held in corporate bonds had issued ~$80B in debt per year (9.5% of the total annual IG non-financial supply) from 2015-2017 (money "borrowed against overseas liquidity"). Those same six companies have issued NO new debt in 2018. YTD18 issuance from the entire IG Technology sector (the largest among the offshore cash holders) has totaled only $23B, a fraction of the $116B issued during the same year ago period. This supply dynamic has been matched by a noticeable increase in demand for short maturity IG corporates. Most recent data reveal $25B in flows into Short corporates versus only ~$1B into long maturity paper. With 2-3 year paper now yielding 3.5%, the highest in several years, a reversal of "TINA" ("There Is No Alternative") via the strong bid for yield may remain for longer than expected, despite the continuing Fed tightening cycle.

Investors have also found some solace in improving credit fundamentals with the U.S. economy on solid footing and continued growth in corporate earnings. Debt service as measured versus EBIT is on pace to increase +7.5% in 2018 versus 2017. Barclays also reports market value-weighted Net Debt/EBITDA for U.S. Corporate Index (ex-Financials) remained flat y/y at 2.3X at the end of 2Q18 (most recent reporting period). Interest coverage at 11.6X is modestly lower y/y by 0.5X. These are healthy metrics in what many believe is the late stage of the current business cycle. However, the cautionary note is that debt service capability has not generated wholesale balance sheet deleveraging. In fact, the opposite has occurred. IG corporate debt outstanding has increased +65% over the past decade, much of it from outsized M&A activity, which hit a record $2.5T in 1H18. JPMorgan reports 29% of all bond issuance by non-financial companies from 2015 to mid-2018 has been for M&A purposes, with $750B in just the past 3.5 years. While projected benefits of revenue and cost synergies via M&A deals were touted for deleveraging of debt-funded deals, the results have been proven opposite. While revenue growth and earnings have provided a foundation for deleveraging, the actual event has been both modest and delayed. CreditSights reports gross leverage at both the median and weighted average level increased from 2.72X to 2.82X and 2.33X to 2.43X, respectively, during 1H18.

Fund Flows Low But Still Positive



Issuance of 10 Largest Overseas Cash Holders



Source: Citi Research

Balance Leverage Grinding Higher

Source: CreditSights, BofA & FactSet

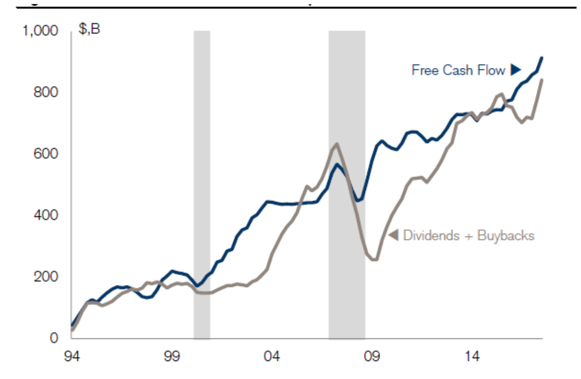
Debt rating agencies have also been somewhat complicit in this area. Many heavily levered transactions have not seen ratings adjustments that reflect the resulting balance sheet stress. Instead, the agencies have given borrowers a pass while awaiting ultimate integration/debt reduction efforts. The complacent, if not overly optimistic assessment of the agencies, may come to light as more highly levered deals that are driven by financial engineers versus strategic operating alignments face an uncertain “late-cycle” future. While the additional borrowing has helped companies fund growth through acquisitions, financial engineering remains one of the marvels of this market cycle. Time will tell if the hoped for financial synergies actually hit the bottom line and ultimately lead to balance sheet deleveraging.

OUTLOOK: Investors need to focus on earnings and cash flow needed to service the massive amount of debt on corporate balance sheets, not to mention, the wave of maturities that must be refinanced in the next few years. GDP is forecast to slow to 3.00-3.50% in 4Q18, and perhaps to 2.00-2.50% in 2019. While S&P 500 earnings are estimated to rise ~20%+ in 2018, they are also widely expected to encounter slower growth in 2019 as the benefits of tax cuts wane and fears of a trade war rise. EPS should get less of a boost from share buybacks as high valuations and rising interest rates begin to take effect. Profit margins are also at risk of being squeezed by wage pressures created by tight labor markets, the gradual lift in U.S. interest rates, and a correspondingly stronger USD. BCA estimates S&P 500 earnings are typically reduced 1% in the 12-18 months following a 5% appreciation in the trade-weighted USD as U.S. goods and services become more expensive to foreign buyers. The dollar has already risen 6.5% in 2018. Consequently, global growth is at risk of slowing in line with both the U.S. and the EM economies.

As noted earlier, the corporate bond market (measured by market value of outstanding securities) has grown ~65% in the past decade. As global interest rates lift under central banks’ normalization process, an increasingly critical issue over the next decade is not whether borrowers can service, but rather refinance that debt when it matures. That dynamic could generate a repeat of the classic 1970s’ petro-dollar movie “Rollover”. While the market may be receptive to refinancing, the most critical challenge could become the potentially higher cost of financing the massive wave of new debt supply.

BHMS STRATEGY: ***Maintain current de-risking profile that favors up-in-quality credit selection and lower over-all corporate duration.*** While the recovery in spreads during 3Q18 could continue into and through 4Q18, IG Credit may soon be facing a market transitioning from one favored by tailwinds of yield-seeking investors to one facing headwinds of negative total returns and investor outflows. These late-cycle challenges appear concentrated in tightening liquidity conditions as the Fed continues to pursue its normalization path while accelerating its balance sheet reduction, just as the ECB concludes its QE purchase program and other global central banks take on a more hawkish tone. As yields drift higher, the UST yield curve could resume flattening. As rising hedging costs again prove uneconomic for foreign investors, negative total returns could spawn selling pressures that send credit spreads wider and both nominal and relative returns into negative territory. Though a cyclical peaking in economic growth, earnings, margins, and credit quality is not imminent, the potential transition will warrant a more cautious approach to IG Credit exposure.

Free Cash Flow Serves ???



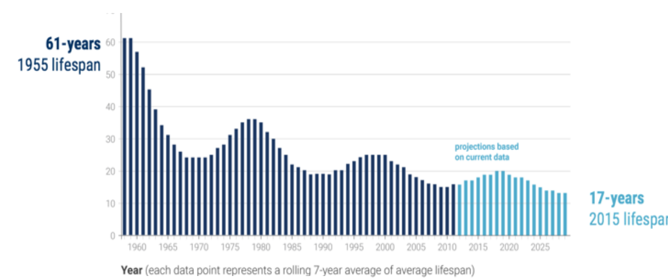
Source: S&P, NBER, FactSet, Credit Suisse

IG Spread Rally of 2017 Mostly Unwound

Source: J.P. Morgan

S&P 500 Universe Disappearing

52% of S&P 500 Companies have disappeared since 2003



Source: CBInsights/Richard Foster/S&P

““Have conviction in what you don’t own” - Barclays

HIGH YIELD MARKET REVIEW: High Yield (HY) bonds maintained their YTD performance lead over IG Credit during 3Q18. Returns were bolstered by continued improvement in credit fundamentals and very favorable supply/demand technicals, resulting in a total return for the Bloomberg Barclays BB/B Index of 2.30% during 3Q18. These results brought the YTD and trailing 12 months (TTM) returns to 1.80% and 2.18%, respectively. Spread compression generated strong excess returns of 2.40% in 3Q18, raising the YTD and TTM results to 2.57% and 3.19%, respectively.

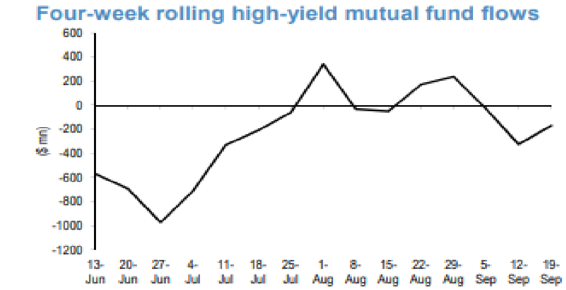
Fundamental income statement and balance sheet trends for the HY universe continued to help justify risk-on sentiment among investors. Leverage declined 12% YoY across the BB credit sector and 6% across single-Bs, sustaining the trend across the broad HY market which has existed since 2Q16. Excluding commodity names, this same trend has also continued to improve since 1Q17, with a noticeable step down in leverage in 2Q18. Interest coverage, even excluding commodity issuers, has also shown a similar trend, with consecutive quarters of improvement since 4Q16. Consequently, HY defaults have also continued to fall, with the trailing 1-year rate of 3.02% by issuer count at the end of 2Q18 now reading 2.57% (latest available as of 8/31/18). The improvement is similar whether or not commodity or energy companies are included, as most defaults are concentrated in Consumer Products and Retail sectors.

HY enjoyed even stronger spread compression than IG during 3Q18. The BB segment narrowed 47bps and the B segment 60bps during 3Q18. Comparing spread changes by quality ratings tells a varied story. Higher quality BB issues relative to BBBs have continued to tighten to near record lows, while overall BB vs. B and B vs. CCC spreads remain closer to historical averages. Regardless of ratings, absolute spreads are close to cycle tights, particularly in light of continued Fed tightening which tends to offset credit spread compression in the latter stages of an economic recovery. Perhaps the most significant driver of HY performance has been the lack of net new issuance YTD. While net supply after calls, tenders, and maturities totaled $37.1B and $55.4B in 2016 and 2017, respectively, 2018 has experienced a net-reduction in YTD supply of $11.8B. Limited supply and spread compression tends to be a recurring late-cycle theme in HY. However, in 2018 it has also coincided with improving technical support from HY bond fund flows as retail investor appetite improved through 3Q18.

OUTLOOK: Fundamental factors, including leverage and interest coverage, should continue to improve. Net supply may also remain a positive technical as issuers continue to favor the loan market. Retail flows also show signs of support. Continued M&A and rising LBO activity funded by leveraged loans may also contribute to limited supply. However, uncertainty over the extent to which tariff risks pulled growth forward into 2018 may prove to be a headwind as YE18 approaches. The risk-on sentiment, which has supported YTD performance in HY, may be more difficult to duplicate in 4Q18.

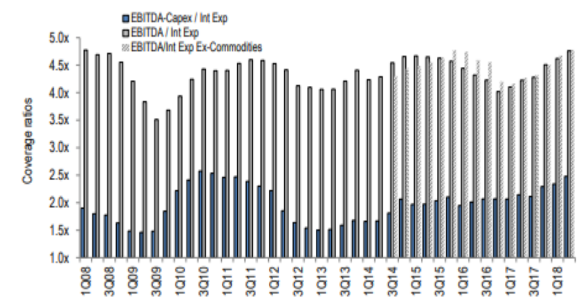
BHMS STRATEGY: ***Focus on fundamental credit quality and incremental income, with a look to selectively increase exposure on any material spread widening.*** Although YTD18 results have been rewarding, late cycle dynamics and valuations warrant caution in nominal exposure and increased selectivity in individual credits. While incremental yield remains important, a preference for issuers having credible evidence of an ability to maintain cash flow stability and deleverage will take precedence.

HY Market Retail Outflows Stabilizing



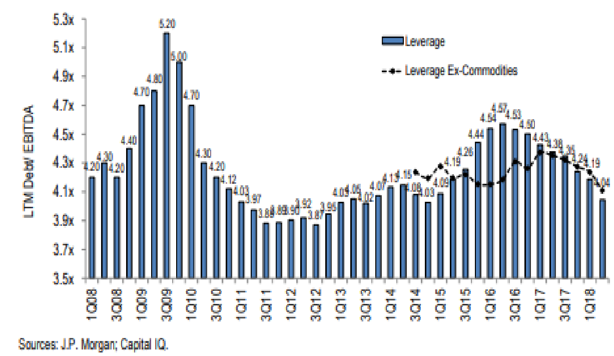
Source: JP Morgan

Coverage Improving....



Source: JP Morgan

...Along with Leverage



Source: JP Morgan

"Given where we are in the cycle, I would rather have seniority." – Krishna Memani, Oppenheimer

LOAN MARKET REVIEW: Bank Loans continued to outperform HY bonds through 3Q18, producing YTD returns of 4.35% versus 2.45%, respectively. However, 3Q18 data shows a deceleration in the pace of outperformance, as loans returned 1.97% compared to 2.31% for HY bonds. While the lack of call protection limits the potential for price upside in loans, 3Q18 saw a resurgence in the percentage of loans priced above par from a 19.6% two-year low to a four month high of 61.7% during 3Q18.

Investor demand was a positive factor during 3Q18 as retail inflows were strong, but CLO demand also helped buoy the asset class. YTD inflows now total $15.5B, likely spurred by rising 10Yr UST yields. New issue loan supply has been strong, with YTD gross issuance totaling $577B compared to $711B in the same period YoY. However, on a net basis, excluding re-financings and re-pricings, YTD new issuance is $225B, 22% above the same 2017 period. Much of this issuance has been concentrated in B-rated credits, with a larger shift towards acquisition financing from the prior year.

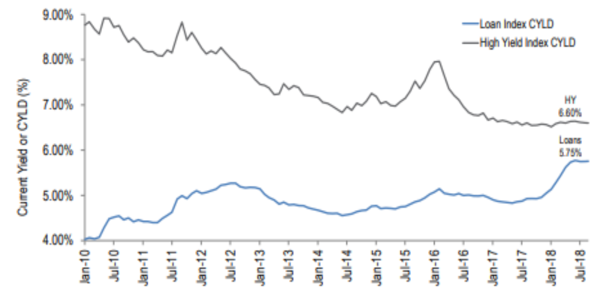
As investors have sought floating rate loans for protection against a higher rates, rising LIBOR rates have contributed to both the demand and outperformance of the asset class. While the average par-weighted coupon for HY bonds has fallen modestly from 6.38% to 6.34% YTD, the average loan coupon has risen alongside LIBOR's rise from 5.0% to 5.7%. As a result, the gap between loans and bonds is at the most attractive level since 2010, with the current yield of bonds at 6.60% and loans at 5.75%.

Use of proceeds in the new issue loan market has deviated materially from the pre-GFC period. The percentage of all leveraged loan financings used for LBO funding has grown consistently since 2012. This trend paused from 2014-2017, which helped portray a relatively conservative market that had not yet embraced traditional signs of late-cycle behavior, in which purely financial (versus strategic) private equity buyers were driving issuance. While LBOs have grown as a percentage of overall loan financings, it is important to note that regular corporate M&A activity has also grown at a similar pace, implying a less aggressive pace of corporate activity YTD compared to the last peak in 2007.

OUTLOOK: Loan buyers will continue to reach for incremental yield, and supply will continue to respond with an increasing mix of B-rated issuance. Buyers will have to accept a trade-off between covenant protection and yield. As inflows to the loan sector via retail investors and CLO creation continue, and if the economic backdrop and corporate balance sheet fundamentals remain supportive, we expect the mix to tilt further toward LBO funding as the cycle progresses.

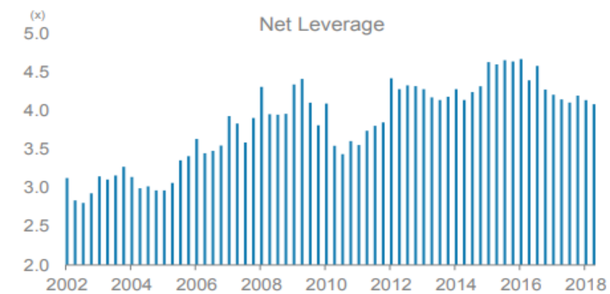
BHMS STRATEGY: ***We continue to build a portfolio by discerning industry headwinds and tailwinds, credit agreement protections, and quality of collateral and cash flow.*** As credit trades with a minimum degree of spread dispersion, future performance is dependent on selection. We remain committed to assessing relative protections and risks present in credit agreements, and are cautious of the risks of management exploiting the documentation. Our portfolio will continue to avoid broad sources of risk in loans that do not provide adequate yield compensation. We will seek to limit exposure to loan-only capital structures, while opportunistically seeking sources of potential alpha by casting a selective eye towards technical pressures and fundamentals.

Current Yield Gap between Loans and HY Closes



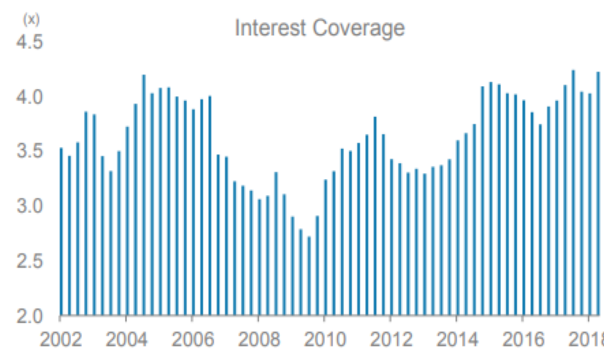
Source: JP Morgan Research

Loan Net Leverage Continues to Improve…



Source: Morgan Stanley

…as does Interest Coverage



Source: Morgan Stanley

3Q18 BHMS Bond Commentary

"We're at the stage of the policy tightening cycle where history suggests a higher likelihood of accidents in financial markets." – Deutsche Bank

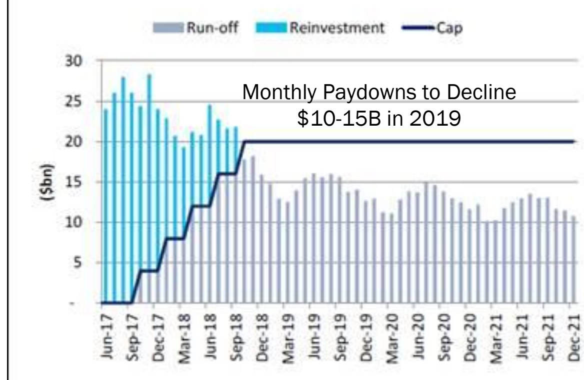
AGENCY MBS REVIEW: The mortgage sector (MBS) saw a narrow trading range in spreads in 3Q18. Supply pressures and the imminent retreat of the Fed as the largest buyer in the market, coupled with an increase in rate volatility, weighed on the sector. Despite renewed investor interest following September's 10Yr UST yield move back above 3.00%, and the resulting lower price/higher yield, 3Q18 ended with MBS generating a total return of -0.12%, bringing the YTD and TTM results to -1.07% and -0.92% respectively. On a total return basis, 15Yr maturities (-.03%) outperformed 30Yr (-.19%), and GNMAs outperformed Conventionals.

The recent move higher in UST yields lifted mortgage rates to levels not seen in over seven years. With the 30Yr mortgage rate now quoted at 4.70%, prospective home buyers have lost roughly 10% in purchasing power. Higher rates also meant 90% of existing borrowers are out of the refi window, where they are expected to remain (if) until rates fall back below 4.50%. Higher rates and rising home prices have also combined to drive purchase affordability and refi volumes to multi-year lows. As a result, the MBA refi index has fallen 25% to late-2000 levels. Rising rates have also lifted production coupons from 3.5% to 4.0%-4.5%, slowed prepayments, and extended the duration of the MBS index to 5.2 from 4.4 years. Additionally, the average price of the MBS market has declined from $103-00 to $99-16.

The MBS sector has faced mixed YTD18 supply/demand dynamics. Net supply of $183B is 14% below year-ago levels. A seasonal peak in housing activity saw a slowdown in issuance in July, which should continue through YE18. While issuance volume is lower than last year, the most notable decline has been in GNMA supply as most coupons now fail the FHA/VA required net tangible asset test at current rate levels. Reduced supply is a positive as the pace of Fed balance sheet tapering hits full speed ($20B per month) in 4Q18. Since the Fed taper began in October 2017, MBS holdings have shrunk by $71B. Money managers have been the biggest YTD buyer in the MBS market, purchasing $133B compared to $70B in 2017. This buying strength may signal an end to the relative value cycle, which has seen money managers prefer Corporates over MBS. While bank demand waned again in 3Q18 on slower growth in C&I loans and deposits, YTD foreign buying totaled $61B through June and bettered the $32B over the same 2017 period. Though the pace slowed in late-3Q18, Taiwan has been a consistent buyer throughout the year, while Japanese interest was sustained on the positive carry versus USTs and JGBs. MBS REIT purchases declined in 1Q18 as rates rose and MBS widened, but since 2Q18 REIT price to book ratios have been closer to 1:1, supporting positive fund flows.

BHMS MBS STRATEGY: *Maintain neutral exposure on improved valuations and market technicals.* BHMS broad market portfolios moved to a neutral MBS weighting in 3Q18 on more attractive spread valuations. We are positioned with a coupon barbell, buying seasoned discounts which exhibit faster prepays and premium coupons which offer call protection. With the majority of agency MBS borrowers now clearly out of the refi window, extension risk at current rate levels is more limited. Another 50bp sell-off could extend FNMA 3.5% option adjusted duration by only 0.5 years today versus 1.0 years at the start of the year. The expectation of favorable supply/demand factors through YE18 should support the sector.

Fed's Shrinking Agency MBS Holdings

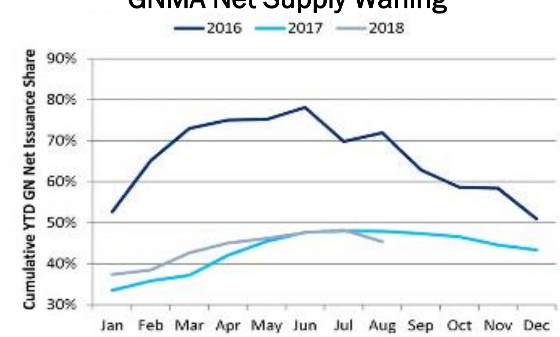


Source: Citi Research, Federal Reserve, Yieldbook

Fixed Rate Agency MBS Price Change

Source: Barclays Live

GNMA Net Supply Waning



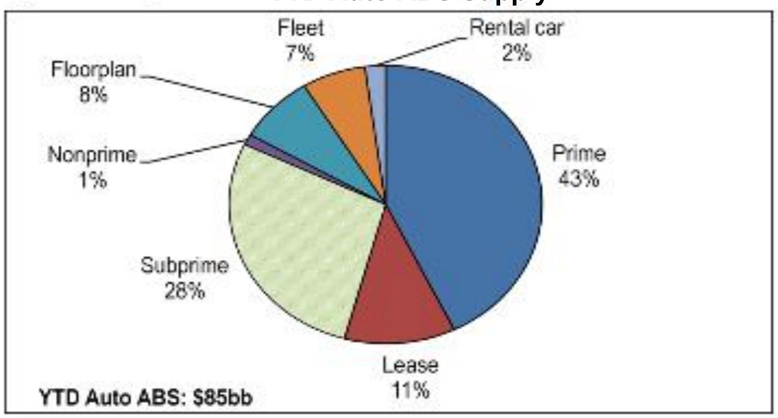
Source: Citi Research EMBS

3Q18 BHMS Bond Commentary

ABS MARKET REVIEW & OUTLOOK: Performance in ABS stands out among fixed income sectors, producing a positive 0.49% nominal return in 3Q18 and raising the YTD return to 0.52%. An increased appetite for risk has been the catalyst for the sector during 2018, contributing to tighter spreads across the board which resulted in 0.31% and 0.29% excess returns in 3Q18 and YTD, respectively. Spread tightening in 3Q18 favored shorter maturity “AAA” rated bonds and consumer sectors. Autos produced the best 3Q18 return of 0.55%, and within the sub-sector, auto lease outperformed prime auto issues. The lease sector is mainly rated “AAA” with a 15bp yield advantage versus prime auto issues, and offers high quality collateral and borrower FICO scores typically 20bps higher than prime autos. Unlike the extension in loan terms occurring in the prime space, lease terms are usually limited to 36 months. Residual risk is a factor, but recoveries remain stable. ABS also benefit from a flatter curve as extension trades to pickup yield and spread are not needed. ABS issuance is up 9.00% YTD versus the same period last year. Autos comprised 44% of issuance and subprime securitization is 30% higher versus last year. Other ABS asset classes like unsecured personal loans, private student loans, and equipment have substituted for the continuing shortfall in credit card supply, which now comprises only 18% of YTD18 issuance.

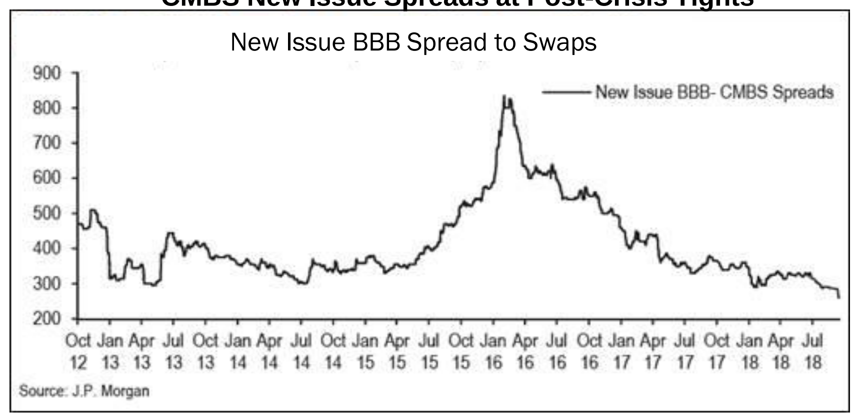
BHMS ABS STRATEGY: *Maintain an overweight on attractive valuations versus short corporates.* We expect the strong YTD performance trend to continue through YE18. A flat yield curve supports investment in short average life amortizing securities. We are defensively positioned in the sector with high quality, liquid issuers which offer a yield advantage versus comparable duration corporates. We also find value in the short maturity profile of ABS, as 75% of the issuance is inside three years, versus only 16% of corporate bonds. ABS also offers higher quality as 80% of issuance is rated “AAA” versus 2% of corporates.

YTD Auto ABS Supply



Source: Bloomberg

CMBS New Issue Spreads at Post-Crisis Tights



Source: J.P. Morgan

CMBS MARKET REVIEW: Spread tightening across the maturity curve produced a positive total return of 0.46% and an excess return of 0.77% in 3Q18. However, the tightening failed to bring YTD returns into positive territory, which now stand at -0.93%. The most dramatic spread tightening occurred in lower rated classes as investors looking for additional yield moved down the capital structure: “BBB” issues narrowed 195bps, while “A”, “AA” and “AAA” issues narrowed 55bps, 50bps and 9bps respectively. At +152bps, the CMBS credit curve is the flattest since 2011. The last time the yield curve inverted in 2005-2007, the conduit credit curve continued to flatten, which may also be the case going forward in this cycle. Issuance declined 13% in 3Q18 as refi activity has slowed since the 2017 maturity peak. Single Asset Single Borrower (SASB) deals, which are heavily skewed toward floating rate, grew 10% YTD. In contrast, the private label CMBS market has experienced negative net issuance as payoffs have exceeded new issue supply. CMBS delinquencies have also declined to the lowest level since November 2009, largely on continued resolution of 2006-2007 pre-crisis vintage loans. Property prices have climbed faster in the commercial sector rather than residential. Since peaking in 2007, CRE prices are up 25%, while residential prices are only 10% above their peak.

BHMS CMBS STRATEGY*: Maintain an underweight.* We continue to favor shorter duration, seasoned CMBS exposure. A near flat yield curve and the risk of higher interest rates in the front end provide little incentive for extending into longer issues. Security selection continues to focus on an analysis of underlying deal characteristics like geographic location, local economics, and property type that all heavily influence borrower behavior.

LONG CREDIT MARKET REVIEW: Higher long UST yields were offset by wider credit spreads during 3Q18. The Long Credit Index had a 1.26% total return and a 3.18% excess return in 3Q18. The positive performance broke the string of two straight quarters of negative performance, with carry and spread tightening overcoming the headwinds of rising interest rates. Within the Long Credit Index, Finance was the strongest performer, with spreads tightening 25bps. Among the other three sectors, Industrials spreads tightened 23bps, Non-Corporate Credit spreads tightened 17bps, and Utility spreads tightened 13bps.

PENSION ASSETS: Equity investments gained 5.1% during 3Q18, more than offsetting the 0.3% loss in bonds by the average pension plan. Alternative asset class returns were also positive. U.S. Equities had the largest gain during 3Q18, while Commodities posted the largest loss.

PENSION LIABILITIES & FUNDED STATUS: Pension liabilities were largely flat during 3Q18. Average discount rates rose with the 21bp rise in interest rates, but were partially offset by a 12bp tightening in corporate bond spreads. Funded ratios also improved with strong asset class returns. If funded ratios are maintained at current levels through YE18, it will mark the highest year-end valuation since 2007 when the average funded status was 105.5%.

CORPORATE PENSION TRENDS: The 2018 trend of significant voluntary plan contributions will likely wane. The incentive for plan sponsors to make pension contributions and use last year's 35% tax rate for deductions on 2017 tax returns expired on September 15. Higher funded ratios have continued to drive de-risking asset allocation shifts, moving pension investments increasingly to bonds from equities. We have also seen a trend in plan sponsors and consultants reevaluating LDI benchmarks to achieve tighter hedges.

Equity Return	Discount Rate Change (% pts): -2.00	-1.50	-1.00	-0.50	0.00	0.50	1.00	1.50	2.00
-20%	69%	71%	74%	77%	80%	83%	87%	92%	98%
-15%	71%	74%	76%	79%	82%	86%	91%	96%	102%
-10%	74%	76%	79%	82%	85%	89%	94%	99%	106%
-5%	76%	78%	81%	84%	88%	92%	97%	103%	109%
0%	78%	80%	83%	87%	91%	95%	100%	106%	113%
5%	80%	83%	86%	89%	93%	98%	103%	109%	117%
10%	82%	85%	88%	92%	96%	101%	106%	113%	121%
15%	84%	87%	91%	94%	99%	104%	109%	116%	124%
20%	86%	89%	93%	97%	101%	107%	113%	120%	128%

Source: BHMS; Bloomberg

Average Asset Allocation and 3Q18 Returns

Asset Class	Index	Allocation	Q3 Return
Equities		43%	5.1%
	65% Russell 3000		*7.1%*
	35% MSCI EAFE		*1.4%*
Bonds		38%	-0.3%
	75% Barclays Long Gov/Credit		*-0.5%*
	25% Barclays Aggregate		*0.0%*
Real Estate	*FTSE NAREIT Equity*	2%	0.5%
Other (Alternatives)		14%	1.9%
	45% HFRI Fund Weighted Composite		*0.6%*
	35% S&P Listed Private Equity Index		*5.9%*
	20% Dow Jones UBS Commodity Index		*-2.0%*
Cash		3%	0.5%
Total			**2.4%**

Source: BHMS; Bloomberg

BHMS Pension Funded Status Analysis

Business Sector/*Industry*	September 30, 2018
Overall	**90.5%**
Financials	101.9%
Banks	*109.0%*
Consumer Discretionary	91.2%
Consumer Staples	90.2%
Industrials	89.0%
Airlines	*75.0%*
Materials	88.4%
Utilities	88.1%
Real Estate	87.4%
Health Care	87.1%
Information Technology	87.0%
Energy	87.0%
Communication Services	83.1%

Source: BHMS; Bloomberg

DISCLOSURE

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