Active Fixed Income Quarterly Commentary

2Q16

Philosophy

Fort Washington believes in using a broad range of fixed income strategies in its Multi Sector Fixed Income portfolios. The philosophy underlying the strategies is that measuring and allocating risk on a valuation-driven basis provides the best opportunity for excess return.

Process

Fort Washington employs a disciplined investment process designed to maximize risk-adjusted returns. The portfolio management process begins with an assessment of rate, spread, and volatility risk on a macro basis. Target exposures to these risks are determined. We then consider sector allocation within a relative value and risk-adjusted framework. Individual securities are selected with rigorous fundamental research, and portfolios are constructed with risk exposures scaled to reflect client risk budgets and the conviction of our opinions for each risk.

Investment Professionals

Timothy J. Policinski, CFA
Senior Portfolio Manager
38 Years Experience

Daniel J. Carter, CFA
Senior Portfolio Manager
20 Years Experience

Performance

The bond market, as represented by the Barclays Aggregate Index, returned 2.21% in the second quarter with YTD performance now at 5.31%. The strategy outperformed the benchmark during the quarter and has underperformed YTD. The composite's largest constituent is managed against the Barclays Intermediate Aggregate Index, ultimately giving the composite a short interest rate bias versus the Barclays Aggregate Index. During the quarter, interest rates continued to fall with the intermediate and long end of the curve experiencing the largest moves. Risk premiums on non-Treasury sectors decreased during the quarter and have reached record lows. Though the latter part of the quarter was marked by volatility due to Brexit, investment grade and high yield sectors both outperformed Treasuries for the quarter.

Growth in the U.S. continues to expand at trend (~2.0%) with underlying fundamentals, including the labor market and wage growth, remaining steady. Financial conditions continue to be generally supportive of economic growth, and eased slightly throughout the quarter as credit spreads remained stable and global central bank policy continued to be very accommodative. Oil climbed and settled around $50/barrel as concerns over growth in China assuaged. Additionally, the Fed continued to walk back commitments to take action and raise rates due to a very poor jobs report in May and as a reaction to the Brexit surprise. The potential destabilization in Europe weighed on the Fed's decision with markets removing the possibility of a rate hike for a least two more years.

Factors Contributing to Performance

The strategy actively managed interest rate positioning during the quarter, which was a positive for performance. Investment grade credit outperformed Treasurys as spreads tightened in the second half of the quarter. As a result, the strategy's slight overweight position to and security selection within investment grade credit contributed to outperformance. The Fund's allocation to High Yield was also additive as it outperformed Treasurys and other spread sectors. Security selection within Structured Securities, particularly ABS and CMBS, contributed to performance as well.

The strategy's position in Treasury Inflation Protected Securities (TIPS) detracted from performance due to a decrease in market-based inflation expectations. The team continues to find TIPS attractive as inflation expectations remain extremely low relative to core realized inflation.

Overall Market Commentary 2Q 2016 and Outlook

Highlights

- Government bond yields have plummeted worldwide to record lows following the British referendum to leave the European Union (EU), which has added to worries about the global economy. This development contributed to outsized returns for U.S. bonds in the first half of the year, while the U.S. stock market was range-bound during the second quarter.
- Market participants currently are assessing the fallout from Brexit. While some observers contend it is largely a non-event outside the U.K., we believe the ramifications will be felt throughout Europe over the next few years.
- The main factor supporting risk assets is the expectation that the Federal Reserve will refrain from tightening monetary policy, while the Bank of England and European Central Bank (ECB) are likely to ease monetary policies. However, we are skeptical about their ability to bolster the respective economies.
- Looking ahead, the key event that could impact markets in the remainder of this year is the U.S. Presidential election. While elections often have only a limited impact on markets, this year's contest could have major repercussions. With U.S. equities fully valued, we have been reducing risk in our stock portfolios.

Global Bond Yields Set New Lows

During the first half of the year there was a marked decline in government bond yields worldwide to record lows. By mid-year the yield for 10-year U.S. Treasuries had fallen by 82 basis points, while those for comparable U.K. gilts, German bunds, and Japanese Government bonds fell by 104 basis points, 67 basis points, and 52 basis points, respectively. Long-term bond yields throughout much of continental Europe and Japan are now negative.

The plunge in yields occurred in two phases. The first was at the beginning of this year, when worries about the Chinese economy and plummeting oil prices fueled a flight to quality in which risk assets such as equities and high yield bonds sold off. These assets subsequently recovered, as fears about China's economy proved to be exaggerated while oil prices rebounded close to $50 per barrel after having fallen below $30.

The second wave of yield declines occurred after the British electorate surprised market participants by opting to leave the EU at the June 23 referendum. Initially there was a flight to quality as the British pound sank to a three decade low against the U.S. dollar, while equity markets around the world sold off subsequently. Thereafter, equity markets rallied, as investors anticipated that the Bank of England, ECB and Bank of Japan would ease monetary policies, while the Federal Reserve would refrain from tightening.

Brexit Fallout for the UK and EU

Amid these developments investors are now assessing the consequences of Britain's vote. The most visible impact thus far has been a steep 13% drop in sterling versus the U.S. dollar to a three decade low. However, following a two-day selloff, the FTSE index rallied with other global equity markets following suit. Accordingly, some observers have proclaimed Brexit to be a non-event outside the UK.

Our own assessment is that it is premature to form such a conclusion, as the fallout will be felt for several years to come. In order for Britain to initiate proceedings to leave the EU, it first needs to form a new government at a time when all major political parties are in shambles. According to the Financial Times, The Conservative Party is in the throes of its bloodiest upheaval since the fall of Margaret Thatcher, while Jeremy Corbin of the Labor Party was compelled to sack his shadow cabinet, and Nigel Farage recently stepped down as leader of the U.K. Independent Party. Once the initiative to leave is launched it will take two years to renegotiate new trade, financial, and security arrangements with the EU.

Meanwhile, Britain's economy, which ranked as the most vibrant in Europe, is bound to feel the adverse impact of increased uncertainty on business investment and consumer spending. The financial community will be particularly hard hit as multinational institutions shift their location from London to other financial centers.

Proponents who favor the decision to leave the EU contend the UK economy will become more vibrant over time, and some believe Britain will be able to negotiate favorable terms with the EU. This seems far-fetched, however, as the EU must be cognizant of the effect that its negotiations with the UK will have on other member countries. In our view, the most likely outcome is the British economy will flirt with recession this year and possibly next, with the magnitude unclear at this time.

The impact is also adverse for the EU, especially on the political front, where Brexit may be a forerunner for events to come in other member countries. In Italy, the populist Five Star Movement has emerged as the country's leading political party in recent opinion polls, overtaking Matteo Renzi's ruling Democratic Party. Five Star is led by an Italian comedian, Beppe Grillo, who has called for a referendum on ditching the euro. Some observers have warned that defeat of a referendum on constitutional reform called by PM Renzi could lead to a collapse in the government this fall. Next year, the focus of attention will shift to the French elections, where National Front leader Marine LePen has campaigned on an initiative to leave the EU.

Kenneth Rogoff, professor of economics at Harvard, sums up the European economic and political scene very well when he writes (Financial Times, July 1):

> "The biggest economic risk from the Brexit vote is that it turns out to be the start of a vicious cycle of low growth and populist policies that lead to still lower growth and even more populist policies across the west…
>
> If global stock markets want to be blasé about the coming wave of political uncertainty amid a retreat from globalization, that is their business. But policymakers should understand the magnitude of the economic risks. There is certainly no room for complacency."

Central Banks to the Rescue (Again)

For their part central banks understand the risks that are entailed. The Governor of the Bank of England, Mark Carney, has indicated that he favors easing monetary policy to help cushion the blow to the British economy. The ECB is also expected to continue pumping liquidity into financial markets. However, it faces several challenges. One is that there are limits to how negative interest rates can go before investors hoard cash. The other is that financial institutions in Europe are not as well capitalized as those in the U.S., and an environment of low or negative interest rates undermines their profitability. As a result, European bank stocks have come under intense pressure, with the Euro Stoxx banks index testing new lows. The spotlight currently is on the health of the Italian banking system, which has a high portion of non-performing loans, and on Deutsche Bank, whose share price has fallen to an all-time low.

For its part, the Federal Reserve is likely to postpone any action to tighten monetary policy for the foreseeable future. Prior to the Brexit vote, market participants were anticipating one or two moves by the Fed in the second half of this year. However, following the vote, market expectations were that tightening might be delayed until 2018. Even following the stronger-than-expected jobs report for June, the market is not expecting a rate increase until late 2017.

The U.S. Presidential Election: A Potential Game-Changer?

Meanwhile, one event that could have an overriding effect on financial markets is the U.S. presidential election. Most of the time U.S. elections have not had a long-lasting impact on financial markets, because policy changes have been marginal. Therefore, investors have been wise not to overreact to the outcome.

However, there are certain times when elections have had a lasting impact. For example, Margaret Thatcher's election as British Prime Minister in 1979 is generally credited with the improved performance of Britain's economy in ensuing decades. Similarly, Ronald Reagan's election in 1980 (coupled with a transformational change in U.S. monetary policy under Paul Volcker) coincided with the end of high inflation and a weak dollar and the beginning of an era of strong economic growth and lower tax rates, declining inflation and falling interest rates.

The forthcoming election has the potential to be a game-changer should Donald Trump defeat Hillary Clinton, as there is considerable uncertainty about what he would do as President. Trump has campaigned on the theme of making America great again, and his supporters are hopeful he could prove to be another Reagan with a pro-growth agenda. The risk, however, is that his signature agenda – namely, his hostility to global trade, especially with China and Mexico – appears to many to be know-nothing protectionism. It is hard to know whether his protectionist stance is mere rhetoric that is part of a negotiating strategy or is something he would carry out that could undermine the global economy at a time when it is vulnerable to external shocks.

Fixed Income Portfolio Outlook/Tactics

- Over the near-term, interest rates are at risk to rise due to strength of realized inflation and full valuation. However, we see the rise in rates as muted due to uncertainty of the global economy and stance of Central Bank policy outside the U.S. In the medium-term, we feel rates are poised to remain low given the tepid outlook and renewed global risks. Global factors will be watched closely for any broader impact which might influence economic outlook and affect the strategy's allocation to risk assets.
- We view market-based inflation expectations (expressed in the TIPS market) as much too low given realized inflation due to encouraging signs to recent underlying fundamentals, including growth in labor markets and wages. However, inflation implied in the TIPS market is still below the Fed's 2% target for the foreseeable future.
- The post-Brexit rally has removed Fed tightening for at least the next 2 years. However, it is still too early to be discussing a rate cut. In spite of this, the U.S. economy continues to be resilient given the pessimistic global landscape. We continue to believe the likelihood of a U.S. recession is slim given the current domestic outlook and accommodative financial conditions, providing an opportunistic environment for risk assets.

On our part, we plan to:

- Maintain a neutral bias in terms of interest rate exposure relative to the benchmark, but will actively trade to capture short-term opportunities.
- Maintain increased allocation to TIPS as we feel inflation expectations currently priced into the TIPS market are too low.
- Maintain the overweight to risk assets, including investment grade corporate bonds, and other sectors as opportunities arise. Our objective is to use target 45% of our risk budget in portfolios.

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