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INCOME OPPORTUNITIES FOR H2 2018... AND FACTORS THAT COULD IMPACT THEM

- An uncertain trade environment certainly dominated the headlines. Concerns seem to be putting somewhat of a lid on rate moves for now. Currency movements, specifically the dollar, should be watched.
- Interest rates in the U.S have upward inertia along the curve. Even as the yield curve has flattened, and the Fed is most likely to raise rates two more times this year, rates have been much more of a problem for the long-end exposure and should remain that way.
- While trade war concerns dominated the first half of 2018 and concerns about the economy may have picked up, similar positions to H1 are positioned to be most beneficial for income investors.

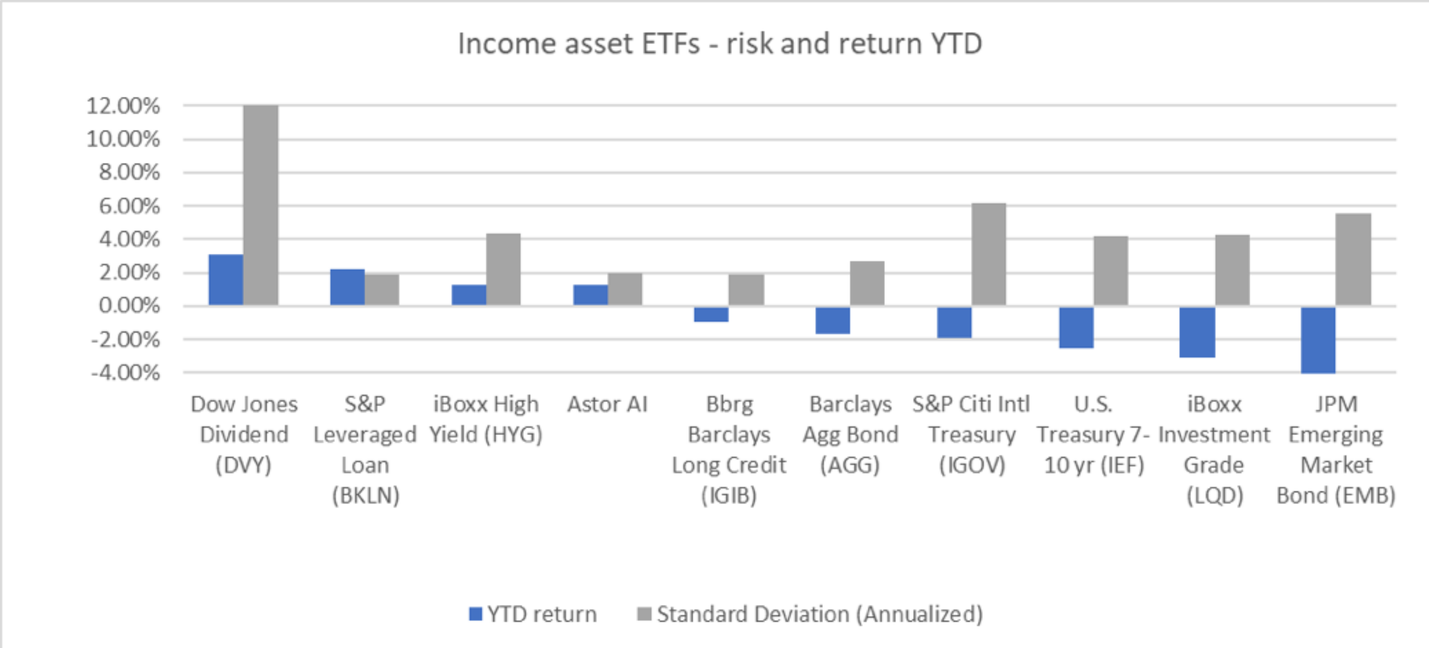
When the objective is to achieve the best yield for the risk, this requires a proper process and framework to analyze the capital market spectrum and market segments to identify where yield/opportunity outweigh risk, and where excess risk exists (i.e. risk that is not compensated for). The key drivers in the outcome requires properly setting portfolio duration and how much (or little) credit exposure to have. In income investing, where yields, returns and risk tolerance are generally lower, the choices can make a substantial difference.

Duration – This is interest rate risk. When rates are going up, something with more duration risk, all else equal, is more vulnerable to losses than something shorter in duration.

Credit Quality – This is credit risk. When market and economic risk go up, all else equal, lower credit quality bonds tend to underperform higher quality bonds.

Within the income-producing asset universe, there are various yield and risk profiles, which cause assets to behave differently, even within the same or similar asset group (i.e. treasuries, corporate bonds). Much of this can be explained by one of the characteristics above.

Thus far in 2018, we've observed a disparity in returns and volatility across fixed income and income producing market segments. You can see this visually in the chart below.



Source: Bloomberg, Astor Calculations

One area of the market that is a prime example of the forces at play are corporate bonds. Investment-grade bonds, represented by LQD (iShares iBoxx IG ETF) has a credit quality of A and a duration of ~8.5. High yield bonds, represented by HYG (iShares iBoxx HY ETF) has a credit quality of B and a duration of ~3.5. Comparatively, LQD has better quality (A vs. B) with a higher duration (~8.5 vs. ~3.5) than HYG.

YTD through the end of July, LQD was down -3.10% compared to HYG, which was up 1.25%. The factors that impacted this include:

- 10-year treasury yields went from 2.41% to 2.96% (yields go up, bond prices go down).
- Quarterly YoY GDP figures averaged 3.15% in H1 (2.2% and 4.1%, respectively in Q1 and Q2).
- The S&P 500 advanced 6.47% (risk markets were generally favorable).

This was a period of increasing growth that supported risk, including equities and lower-rated credit. Interest rates rose, negatively impacting high quality bonds that have sensitivity to interest rates.

Both HYG and LQD have corporate bond exposure. However, the YTD results demonstrate the impact broader market and economic themes have on the outcomes. Even though long end interest rates moved higher and began widening credit spreads, high yield was positive over this time horizon when treasuries were down. This was a perfect example of why investors need a broad, systematic framework when analyzing and assessing the broad economic and market factors that will impact returns and determining the proper allocation in a more dynamic income portfolio.

The result is a strategy that can compliment a core, strategic bond or income portfolio and can allow an overall portfolio to be proactive and nimble as the environment changes. For income investors, this can be especially important. Astor utilizes an approach that focuses on interest rate policy, yield spreads and rate movement, combined with analysis of credit spreads economic conditions.

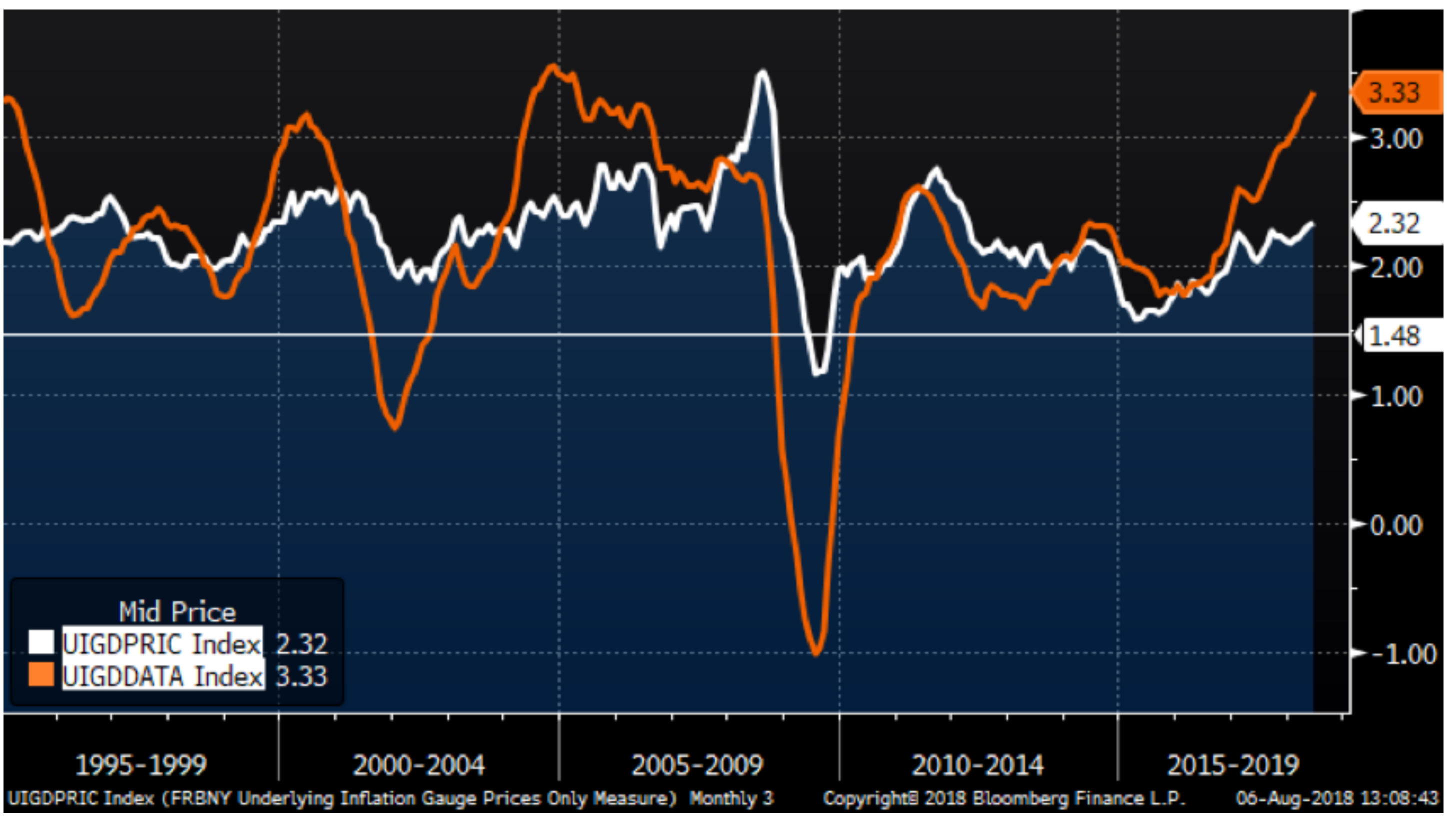
OUTLOOK FOR THE BALANCE OF 2018

With the broad Bloomberg Barclays Agg Bond Index, along with other high-quality bond funds and strategies negative for 2018 (through 7/31), investors are searching for ways to manage portfolio risk if rates move further, and also help support their portfolio income. This has required a patient view on rates and the economy as the prevailing trends have benefited some areas while hurting others (as discussed above).

There are some factors that will determine how the rest of this year unfolds;

1. **Tariffs –** Even in an income discussion, this topic is a salient topic. It's hard to forecast this one as talks ebb and flow, but tariffs are moving forward as of now, and look to intensify. Thus far the rhetoric has elicited a deflated response from most investors who would rather look to build on economic momentum of Q2. Earnings reports have been very good on balance, but a number have reported higher costs coming as a headwind for Q3.
2. **Inflation –** Pressure has been building slowly but modestly. The result is a flattening yield curve as short rates move higher in response to the Fed taking less inflation out of the long end. While core PCE (excluding volatile food and energy) sits just below 2%, other measures have a higher reading. The Fed should operate independently and continue course and the remainder of the year seems to be on autopilot (Sept and Dec hike) for the Fed as they upped their assessment of the economy at the last meeting. Their data dependency is high at this point and would respond if tariffs and trade have unintended consequences, like higher prices that will keep rates on a higher path for now.

To get a picture of where it appears inflation is possibly headed, below is a chart put out by the Federal Reserve Bank of New York, which looks to include more than just price measures in its gauge. The gauge is supposed to be a more accurate forecaster over different time horizons.



Source: Bloomberg, Federal Reserve Bank of New York

3. **Central Banks –** Along with the Fed, most central banks are on path to tightening, or less easing. It has been hit or miss, but long end rates have picked up simultaneously with trade concerns. The BoJ appears to be on a divergent path. They announced that they will keep rates low for longer, possibly until October 2019, when a consumption tax hits the economy. They are also dealing with easing inflation. In general, higher sovereign rates abroad could lead to higher rates on the long end in the US.

Potential outcomes – If the modus operandi fits somewhere in/near the range we've been dealing with in recent weeks/months, the rest of the year could follow suit. A positive economic picture, supporting dividend equities and credit, and a slow move up in rates as cost pressure increases as well. The X variables are how higher costs and rates could weigh on growth. In Q2 earnings calls, some executives eluded to higher costs already. We'll see how that actually impacts earnings and margins in the coming quarters. A deviation from this course to the positive (cooling of trade talks and implementations) would seem to favor the growth outcome and probably higher equity prices. The Fed would most likely keep pace on rate hikes. Long rates may not change course much as cost pressure could subside, with the wild card of growth and wages in a more certain economic light.

These were all topics discussed at the recent Astor Investment Committee meeting in early August. At this point in the year, we still favor exposure to credit through short duration high yield and senior loans. As we are still negative on duration (the path of rates is higher for now) we have maintained our short duration exposure in high quality bond positions, as well as floating rate components (which loans also provide). Equity dividend exposure is still favored as well. This has been consistent with our positioning in 2018 thus far. With exposure to a diverse group of assets, with the appropriate characteristics to benefit in the current environment, we believe we will be compensated appropriately for the risk level.

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