INCOME RESEARCH + MANAGEMENT

IR+M UPDATE

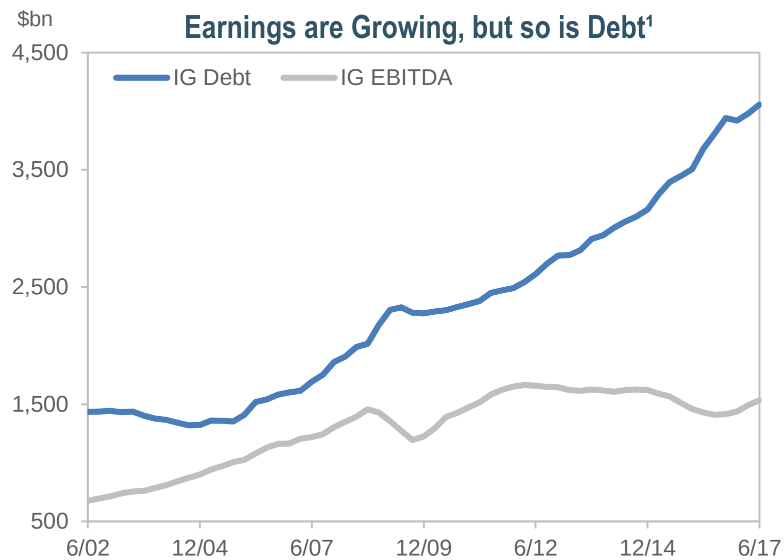
US Investment Grade Credit Market

September 20, 2017

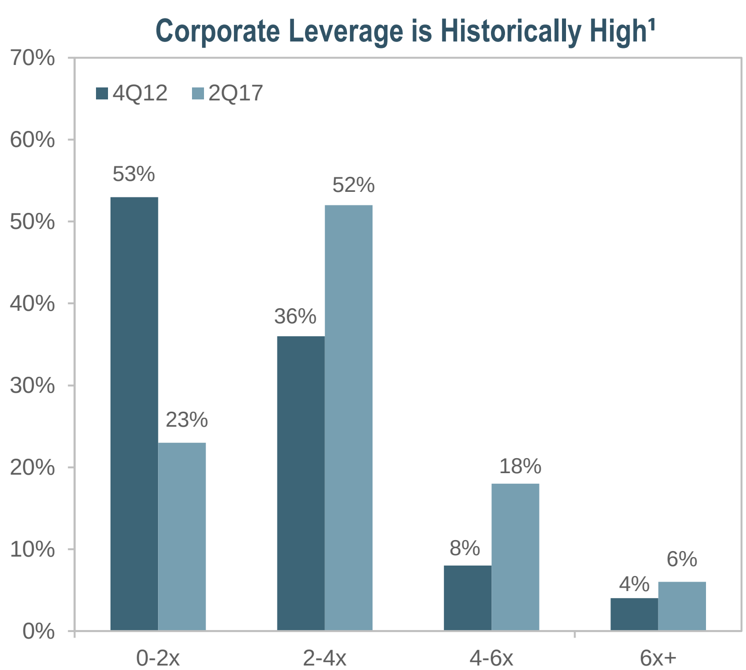
Over the past year, the US economy has continued its prolonged recovery, which has been characterized by modest growth, low interest rates, and subdued inflation. While companies are reporting strong top and bottom-line growth, they are also more levered and more sensitive to slowing growth. At IR+M, we remain cautiously overweight corporate bonds in our broad market strategies. Concurrently, we recognize the importance of income in this low rate environment. We believe that our disciplined bottom-up security selection and sector rotation will help us deliver excess returns for our clients.

Strong Operating Results Enable Borrowing

Corporate earnings have improved this year. Companies have reported solid revenue and EBITDA growth for five consecutive quarters, as well as high profit margins.[1] Yet the positive headlines may be masking a concerning trend – the seemingly unabated growth of debt. Although the impact on corporate spreads has been muted, we are wary of companies' increased leverage. Robust earnings and a favorable economic environment have provided an opportunity to strengthen balance sheets. However, many companies have failed to capitalize. Instead, leverage remains at historically elevated levels – a trend that we do not see changing in the near term, given low borrowing costs.



Debt Levels are High and Growing



Low interest rates and suppressed credit spreads have incentivized companies to issue debt rather than equity. We believe that investors have been too distracted by healthy earnings to focus on these mounting debt burdens. Years of record-setting issuance have led to approximately 25% of companies facing balance sheets with four or more turns of leverage.[1] We are concerned because these companies may be more susceptible to slowing growth. Leverage, which typically peaks during or after a recession, could reach extreme levels in a slowdown. We feel that current spreads, which are near post-crisis tights, do not reflect these risks. As such, we are positioned defensively, recognizing that while earning income is important, corporate leverage could become problematic if financial conditions worsen.

[1]JPMorgan as of 8/24/17. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research & Management.

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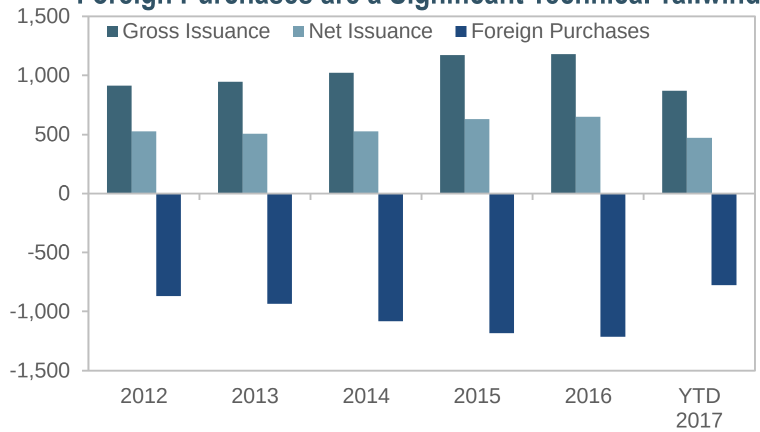
Technicals are Supportive, but Market Behavior is Concerning

We believe that market technicals reflect investors' aggressive buying and insufficient regard for valuation. There are numerous market forces working together to push spreads tighter:

+ Investors are reaching for yield by moving lower in quality and further out the curve
+ Fund flows to US credit remain robust with over $200 billion of inflows year-to-date[2]
+ Foreign buying is relentless; overseas investors may account for over $1 trillion of demand this year[3]

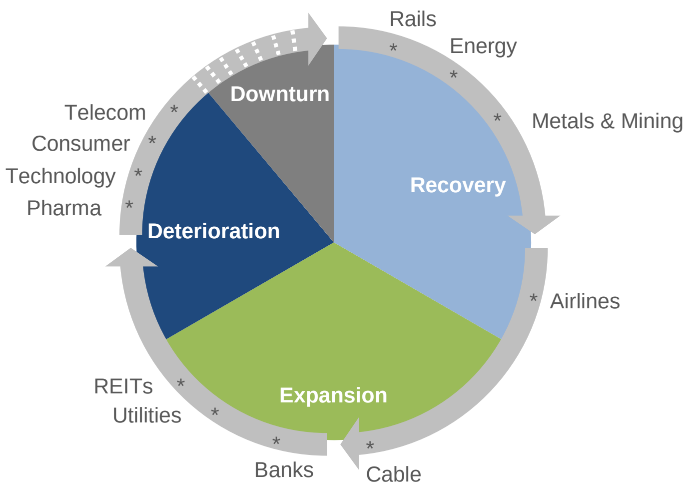
Foreign Purchases are a Significant Technical Tailwind[3]



These three phenomena have helped to push spreads tighter, towards levels not seen since before the Global Financial Crisis. Due to strong demand, new issue concessions have often been negative, which we believe underscores the importance of selectively participating in the primary market. At IR+M, we have invested in less than 20% of all new deals this year. We believe that our ability to pass on unattractive deals is a competitive advantage.

IR+M Approach and Positioning

Fundamental Divergence Across Sectors Provides Opportunity[4]



At IR+M, we are cautiously overweight corporates in our broad market strategies, and emphasize those bonds that generate high-quality income. While we continue to modestly reduce our overweight to corporates, on a subsector level, we have increased our allocation to the banking sector. Specifically, we have invested in major US moneycenter banks that have repaired their balance sheets and enjoy healthy capital ratios and solid earnings. We maintain overweights to defensive industries that tend to exhibit resilience under difficult financial conditions, such as transportation and utilities. We are also overweight industries such as communications, which may adequately compensate us for late-cycle risks. With investment grade spreads near post-crisis tights, and leverage at elevated levels, we believe that security selection is paramount. We will continue to monitor corporate fundamentals and take what the market gives us.

At IR+M, we believe that our experience as bottom-up security selectors allows us to exploit opportunities as they arise. We intend to stay selective and defensive in credit, while searching the market for overlooked opportunities. Although corporate leverage has increased, and spreads remain tight, we are confident in our ability to uncover value in this challenging environment.

[2]BofA Merrill Lynch Global Research as of 8/31/17. [3]Federal Reserve as of 6/30/17. [4]IR+M as of 8/31/17. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research & Management.

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