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CAPITAL MANAGEMENT

Core Fixed Income Commentary

Q1 2017

MARKET REVIEW

The first quarter of the year was remarkably calm following mostly negative returns for the fourth quarter of last year, the worst quarter for fixed income since the bull market in bonds began over 35 years ago. Bond volatility declined during the quarter after a spike higher during the U.S. Presidential election last November. The ten-year Treasury yield remained within a narrow 30 basis point band during the first quarter, after trading within a 125 basis point range last year. Returns for the quarter were positive, but muted as the Bloomberg Barclays U.S. Aggregate index gained 0.8%, U.S. Treasuries returned 0.7%, investment-grade corporate bonds returned 1.2%, and mortgage-backed securities added 0.5%.

As the quarter began, the consensus once again was for interest rates to continue to rise, particularly after the Presidential election, strong employment gains in January and February, and rising headline inflation. Consumer confidence soared after the election, consistent with a potentially significant increase in household spending, while the NFIB survey of small business optimism rose to its highest level since December 2004. However, the optimism faded toward the end of the quarter as economic growth remained subdued, and doubts began to emerge over the new administration's ability to get its agenda through Congress.

Before the enthusiasm waned, however, the FOMC managed to reassert some measure of control over the fed funds market by raising the rate 25 basis points at their March meeting despite initial skepticism from investors. The increase in fed funds also lifted other short term rates, however two-year Treasury yields increased only 7 basis points for the quarter, while ten-year and thirty-year yields declined 6 basis points. As a result, longer duration bonds outperformed shorter duration, as the two-year Treasury gained 0.3%, while ten-year and thirty-year bonds returned 0.8% and 1.3%, respectively. Credit risk was also rewarded as investment-grade corporate bonds outperformed similar duration Treasuries by 38 basis points. Lower credit quality outperformed higher quality as bonds rated AA and above returned 0.9%, while BBB rated bonds gained 1.5%, and high yield bonds returned 2.7%. Among investment-grade corporate bonds, the best performing industries included many cyclicals, such as Basic Industry, Paper, Metals, Packing, and Home Construction. Industry laggards included Telecom, Retailing, Integrated Oil, Refining, and Transportation.

PORTFOLIO REVIEW

First quarter bond returns were muted as interest rates remained within a narrow range and credit spreads tightened only 6 basis points. Even though the returns were quite modest, many investors were surprised that they were not negative following the FOMC rate hike in December and the anticipated reflationary policies of the new administration. Since the portfolio had a slightly lower duration than the index, interest rates had a –6 basis points impact on performance, however the change in the shape of the yield curve contributed +3 basis points to performance. The portfolio has continued to hold an overweight to credit, which was the largest positive contributor to performance as investment-grade corporate bonds outperformed Treasuries, adding +13 basis points to the portfolio return. Although the overweight to corporate credit was a positive, some individual issues lagged, including Macy's, Verizon, Ensco, and Anheuser Busch.

PRODUCT OVERVIEW

The Core Fixed Income strategy seeks to benefit from opportunities arising from changes in interest rates, volatility, credit and sector spreads and the shape of the yield curve in constructing a portfolio that seeks to outperform the Barclays U.S. Aggregate Bond Index over time. Our process is based on the belief that fixed income markets are inefficient and that active management which emphasizes sector and security selection can generate superior long-term results.

TOP FIVE CONTRIBUTORS (%)

Security	Portfolio Impact	Excess Return Contribution
Oklahoma Gas & Electric Co.	0.04	0.038
El Paso Energy Corp MTN	0.03	0.018
Georgia Pacific	0.03	0.015
Capital One Bank	0.03	0.012
Enterprise Prods Oper	0.03	0.012

TOP FIVE DETRACTORS (%)

Security	Portfolio Impact	Excess Return Contribution
Macy Retail Holdings	(0.02)	(0.029)
Verizon Communications	0.00	(0.020)
Ensco PLC	0.00	(0.009)
Anheuser Busch	0.01	(0.007)
Halliburton Co.	0.01	(0.007)

CHARACTERISTICS

	Portfolio	Benchmark
Average Maturity	6.53 yrs	7.69 yrs
Effective Duration	5.20 yrs	5.84 yrs
Average Quality	Aa3	Aa2
Yield to Maturity	2.78%	2.56%
Average Coupon	3.53%	3.05%

Data for the above commentary is from Bloomberg and Barclays as of March 31, 2017.

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Information presented for Top Contributors and Detractors is based on a representative account within the Core Fixed Income Composite, and on a trade date basis. As of March 31, 2017, the composite consists of equal to or less than ten accounts, and represents 3.72% of the total firm assets. The minimum portfolio size for inclusion in the composite is $3 million. The benchmark for the composite is the Barclays Capital (BC) U.S. Aggregate Bond Index, which is composed of U.S. securities in Treasury, Government-Related, Corporate, and Securitized sectors. All securities included in the index are of investment-grade quality, have at least one year to maturity, and have an outstanding par value of at least $250 million. Benchmark returns do not reflect the deduction of advisory fees, custody fees, transaction costs, or other investment expenses. The benchmark returns assume the reinvestment of dividends and other earnings. An investor cannot invest directly in an unmanaged index.

Specific securities identified and described do not represent all of the securities purchased, sold or recommended for advisory clients, and you should not assume that investments in the securities identified and discussed were or will be profitable. Please call (800) 582-4734 or write to contactus@highmarkcapital.com to obtain the calculation methodology for contributors and detractors and a list of every holding's contribution to the overall representative account's performance.