Roosevelt Current Income Portfolio | Fourth Quarter Commentary

Thoughts from our Domestic Fixed Income Team

Market Overview

The Federal Reserve Open Market Committee (FOMC) maintained its slow and steady approach to normalize interest rate levels when it announced an increase to the federal funds target rate during its December 2017 meeting. This move marks the Fed's third rate hike over the course of 2017, and expectations remain high for further rate hikes during 2018. ***Nevertheless, domestic interest rates remain stubbornly low by historical standards, namely those assigned to conservative vehicles such as bank savings offerings and US Treasury notes.*** While broad-based inflation statistics have also remained quite tame, economic barometers of general pricing pressure do not include the more volatile components of food and energy, nor do they reliably reflect monthly stresses faced by most individual savers and consumers to meet more basic needs such as rent, groceries, and tuition bills.

The extended hunt for yield that began after the financial crisis continues to exert extraordinary pressures on fixed income yields, pricings, and the interdependence between credit markets. ***Demand for investment grade assets to produce the highest possible current income has led to a persistent flattening of the US Treasury yield curve, while yield spreads between US Treasury and US corporate issues continue to tighten.*** Just two years ago, the US Treasury 2-year note traded at 1.05% yield to maturity, while the US Treasury 10-year note traded at 2.27% yield to maturity. At the conclusion of 2017, the same two issues were priced at 1.88% and 2.41%, respectively. While the Federal Reserve's tightening monetary policies have effectively increased short-term interest rates, nearly doubling the market yield on the 2-year note, the 10-year note has barely budged.

Put another way, the US Treasury 2-10 year yield curve has flattened from 123 basis points (1.23%) at the end of 2015 to just 53 basis points (0.53%) at the end of 2017. ***For conservative income-oriented investors, the compression of yields available from investment grade corporate bonds over the same time has been even more pronounced. The 2-10 year yield curve of the domestic corporate bond market has collapsed to 113 basis points (1.13%) – nearly half of the 207 basis points (2.07%) steepness that existed along this yield curve two years ago – dramatically reducing the availability of potential current income levels***. There are myriad explanations for such dramatic movements along these yield curves, but the bottom line effect is one and the same: investors have been steadily offered less income incentive to extend the maturities of their investments while simultaneously being left to assume more credit risk to obtain the same returns available to them two years prior.

The double whammy of a flattening US Treasury yield curve and a concurrent tightening of credit market yield spreads has not, however, been without recent benefits. Last year, despite the Federal Reserve Board's monetary policy changes, domestic credit market indices produced significant total rate of return performances versus government-based indices. For instance, the ICE BofA Merrill Lynch 1-10 Year US Treasury

Index produced a paltry 1.08% total return over 2017, while the ICE BofA Merrill Lynch 1-10 Year US Corporate Index produced 4.08% total return over the same period. As more risk was assumed, the rewards were further multiplied over Treasuries. The longer overall duration ICE BofAML

US Corporate Index, which contains 1-30 year maturities, produced a 6.48% annual total return for 2017, while the ICE BofA Merrill Lynch Fixed Rate Preferred Securities Index returned 10.58% over the same period. As satisfying as this relative outperformance may have been for some investors, there may be a ceiling on the extent to which the same forces at play can influence further relative outperformance. ***With lessening yield curve protection and diminished credit spread advantages, there may be fewer opportunities for future relative return enhancements without assuming greater risk.***

Outlook

As previously noted, expectations remain high for further target rate increases during 2018, as well as the potential for more to follow in 2019. These rate hikes may work to alleviate some of the pressures for a more normalized rate environment that have been building among income-investors. ***In order to benefit from these potential changes on the horizon, fixed income portfolios will have to be allocated properly among various maturities to maximize the opportunities afforded by higher nominal interest rates, should they become available.*** As such, investing in short- to intermediate-term investment grade maturities may prove beneficial for income investors seeking consistent levels of annual cash flows and portfolio stability in rising rate environments.

Preservation of capital while maximizing current income remains a hallmark of prudent investment practices, and one of the governing tenets of the Roosevelt Current Income Portfolio Strategy. ***As pressures on fixed income investing have changed the market environment, innovations in the bond market are increasingly tailored to meet the demands of both lenders and borrowers to address the challenges of transitioning from a historically low interest rate environment to a potentially more normal landscape***. One such development has been the growing issuance of fixed-to-floating rate preferred securities, which allow investors to earn initial fixed rate coupons for five to ten years while offering buyers the comfort thereafter that the issuer may either call the bond at par value or switch the coupon to a generous yield spread floating over money market rates. As highlighted last quarter, we believe that these securities offer a number of advantages, given the Current Income Portfolio's fundamental objectives of current yield enhancement and principal safety. We continue to seek inclusion of these securities, as we deem appropriate, as well as other investment grade opportunities that may develop, in order to maximize income levels for our clients while preserving principal for future yield enhancement.

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ICE BofA Merrill Lynch Fixed Rate Preferred Securities Index tracks the performance of fixed rate U.S. dollar denominated preferred securities issued in the U.S. domestic market. Securities must have an investment grade rating (based on an average of Moody's, S&P, and Fitch) and must have an investment grade rated country of risk (based on an average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings).

ICE BofA Merrill Lynch 1-10 Year US Corporate Bond Index is a subset of the BofA Merrill Lynch U.S. Corporate Index including all securities with a remaining term to final maturity less than 10 years.

ICE BofA Merrill Lynch 1-10 Year U.S. Treasury & Agency Index is a subset of the BofA Merrill Lynch U.S. Treasury & Agency Index including all securities with a remaining term to final maturity less than 10 years.

ICE BofA Merrill Lynch U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. Securities must have an investment grade rating (based on an average of Moody’s, S&P, and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

Barclays Capital U.S. Intermediate Government/Credit Index is composed of approximately 3,500 publicly issued corporate and U.S. government debt issues rated Baa or better, with at least one year to maturity and at least $1 million par outstanding.

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