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SHORT & INTERMEDIATE DURATION FIXED INCOME | 3Q2018 MARKET & STRATEGY COMMENTARY

Outlook & Current Themes

- **GDP** - Global growth diverges with the U.S. economy's momentum continuing to be driven by the strong labor market and stimulative fiscal policy, whose impact is expected to slightly diminish over the next year. Pace of domestic growth will fade in 2019 but will remain in the 2.5% to 3% range, well above the post-crisis average. Business and government spending assume greater importance in sustaining higher real GDP growth while consumer spending component remains stable. Impact of tariffs, other trade-related issues and a slowdown in the housing market could weigh on the positive growth outlook.

- **Employment** - Unemployment rate expected to drift lower barring a substantial upward move in the labor force participation rate. U.S. labor market remains historically tight by most indicators. The number of job openings exceeds the amount of job seekers for the first time, which has translated into higher wages given the shallow job pool of qualified job applicants. The seasonally-adjusted U.S. Quits Rate has reached 17-year highs, further evidence of employee confidence. Average hourly earnings data understates strength in weekly earnings growth data for non-supervisory and production workers.

- **Consumer** - Strength of consumer spending sustained by the increased pace of wage growth and low unemployment. Consumer confidence, which is highly correlated with the stock market, continues to rise, reaching multi-decades highs. U.S. real medium household income has reached a record level. Should energy prices spike higher or tariffs begin to push prices of consumer goods up significantly, the pace of spending growth may ease.

- **Business** - Corporate fundamentals continue to benefit from solid economic growth, which has produced stronger revenue growth, expanded operating margins and generated higher pre-tax earnings. Readings from confidence measures like the NFIB Small Business Optimism Index and CEO Confidence signal business cycle is likely to extend further. Potential for adverse outcomes arising from the unfolding trade and tariff actions supports our preference for U.S.-centric issuers. Late-cycle corporate behavior evident in selected non-financial subsectors as companies ramp up M&A activity and seek to increase shareholder returns through share buybacks and increased dividend payouts, which supports our more defensive approach in underweighting or avoiding selected non-financial sub-sectors. Production bottlenecks and supply chain disruptions coupled with selected labor shortages could pressure operating margins in coming quarters.

- **U.S. Monetary & Fiscal Policy** - Strength in the economy and financial markets as well as firming inflation will enable the Fed to carry on with its normalization program. The rates market has become more closely aligned with the Fed's dot plot forecast for rate hikes through the end of 2019. Recent and prospective changes in the makeup of the Fed as well as among member regional bank presidents is not expected to tilt the hawk/dove balance over the near term. Continued gradual removal of monetary policy accommodation combined with stimulative fiscal policy remains positive for the U.S. dollar despite forthcoming growth in federal deficits and looming ramp-up in Treasury issuance.

- **Inflation** - Despite late-summer dip in core CPI, U.S. inflation is expected to remain on a gradual upward path due to mounting wage pressures, higher energy prices and eventual flow-through impact of tariffs on imported consumer goods. Year-over-year core PCE has reached the Fed's 2% target. University of Michigan one-year consumer inflation expectations have risen from 2016-2017 levels. Changing costs for shelter, medical and education remain key factors of core service inflation, components which are not expected to decline.

- **Residential / Commercial Real Estate** - With the inventory of existing homes available for sale remaining at low levels, housing prices should continue to move higher, albeit at a slower pace. Consumers continue to benefit from rising take home pay via higher wages and reduced tax rates, although tax law changes create affordability challenges for higher priced homeowners in those states with higher income and property tax rates. Overall housing starts have slowed, with notable weakness in the multi-family sector. We do not see this as a reversal of the trend toward rental housing, as current levels of starts are in line with longer-term averages and vacancies remain near historic lows. With new supply peaking, commercial property vacancy rates should remain stable for most subsectors although lower quality retail properties may face challenges.

- **Central Banks / International** - Central banks are moving in the direction of less accommodation. The ECB's plan to finally halt QE at year-end and potentially undertake its first rate hike next summer is a precursor of higher global interest rates. Uncertainty over Brexit is likely to persist and foster market volatility but its ultimate impact is expected to be minor. Favorable developments on the trade front in terms of their relationship with the U.S. for North America and South Korea contrast with others such as China and the E.U. which could lead to adverse outcomes impacting currency valuations or the willingness to hold U.S. Treasuries. Emerging market volatility experienced in particular by Argentina and Turkey has subsided, stalling contagion into the broader EM market.

Third Quarter 2018 Summary and Strategy

Treasury/Rates/Curve

Treasury yields moved higher in the third quarter as the Fed followed up its June rate move with another rate hike in September and offered additional commentary to suggest another quarter-point boost in December is likely. Economic and inflation data over the quarter continued to be generally firm and were supportive of the Fed's efforts to stay on their monetary policy normalization path into 2019. Following it latest meeting, the Fed removed its reference to monetary policy being accommodative from its statement, a sign that perhaps that monetary policy is shifting to a more neutral stance and may become more data dependent going forward. At this stage a strong labor market, firming inflation, steady growth and untroubled financial conditions support Chairman Powell's desire to maintain the one hike per quarter pace we have seen since late-2016 with the exception of September 2017 when the Fed skipped a quarter. The two-year Treasury yield closed the quarter at 2.82% (+29 basis points); the five-year Treasury yield ended at 2.95% (+21 basis points) and the 10-year Treasury yield finished the quarter at 3.06% (+20 basis points). With these moves, the Treasury curve flattened further as the five-year less two-year Treasury interest rate differential closed the quarter at 13 basis points, 8 basis points flatter from the end of the second quarter while the longer-dated ten-year less two-year differential flattened 9 basis points to a differential of 24 basis points. Following the Fed's September hike, the three-month Treasury bill rate moved higher to 2.20% from 1.91% at the end of the prior quarter while the three-month Libor rate rose 6 basis points to 2.40%. At quarter-end the spread between the two-year Treasury yield and the three-month Treasury bill was flat on a quarter-over-quarter basis at a differential of 62 basis points.

At this point any acceleration in economic growth and/or inflation could begin to encourage the market to price one additional rate hike in 2019 bringing it in line with the Fed's three rate hike dot plot estimates for 2019. As liquidity conditions evolve moving forward with the Fed's balance sheet set to shrink further and Treasury issuance slated to climb higher, we believe conditions are in place for increased market volatility. Another catalyst for increased volatility is the growing divergence between the Fed's monetary policy and many other central banks like the ECB, which remain decidedly accommodative, for now. This more volatile backdrop should set up markets over the next year to be a bit of a departure from the more placid environment we have enjoyed throughout much of the past two years.

With the two-year Treasury's third-quarter move higher in yield, it has moved almost a hundred basis points higher year to date. In our view the biggest rate moves are likely behind us, leaving us more comfortable in reducing our duration underweight and positioning our portfolios to better capture yield carry and take advantage of the steepness at the front end of the yield curve. We note that the Fed's dot plot forecast for the federal-funds rate and the market's consensus estimates have become more closely aligned, which lends support to our view that a good chunk of the Fed's rates hikes are now more fully priced in in the front end. We initiated our shift to a more neutral position or less short overall duration posture by adding exposure in the 2-3 year part of the curve and trimming some of our short-dated and floating-rate securities as well as selling some of our longer-dated fixed-rate bonds to also move to a more bulleted yield curve posture centered on what we see as the most attractive region of the yield curve. In short, we added to the 2-3 year part of the curve in the front end and

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created a more bulleted positioning due to the flatness of 2's/5's yield curve and our Fed policy call. The two-year vs. five-year Treasury differential stood at 13 basis points at quarter-end, fairly limited compensation in terms of yield pickup for extending out the curve from our standpoint. By contrast, we favor the two-year part of the curve as we find the steepness between the three-month Treasury-bill and two-year Treasury notes as offering sufficiently attractive yield pickup and carry when looking at extending out from floaters or Treasury-bills at this steepest part of the yield curve with the two-year Treasury versus three-month Treasury-bill differential finishing the quarter at 66 basis points, higher than the pickup we saw last year. Regarding our Treasury Inflation-Protected Securities holdings, five-year TIPS break-even spreads closed the quarter a few basis points lower at 2.03%. We continue to favor maintaining our TIPS exposure as the Fed's preferred inflation indicator, the PCE deflator, remains above 2% with the backdrop of tight labor markets, potential trade and tariff concerns, and rebounding energy prices expected to drive inflation expectations higher as we move forward.

Performance Attribution: Positive
Our underweight exposure to the Treasury sector contributed positively to third-quarter performance while all spread sectors provided positive excess returns relative to Treasuries this quarter. Our modest duration underweight was a neutral factor over the quarter in terms of excess return and our slight curve flattening positioning represented a small source of positive performance. Our overweight TIPS positioning was a small detractor from performance as inflation expectations edged a little lower as quarter-end approached.

Investment Grade Credit

Over the third quarter we saw credit spreads experience an occasionally bumpy but generally sustained move tighter, though not quite to the post-financial crisis tights reached in the first quarter. Spreads were helped by supportive corporate fundamentals, a lukewarm new issue calendar against continued solid demand, higher interest rates and somewhat better news on the trade front, while troubles in emerging market countries like Argentina and Turkey failed to spill over into domestic credit markets. In the third quarter, excess returns across credit were strong and broad-based as our bellwether front-end credit index, the ICE Bank of America Merrill Lynch ("BAML") 1-5 Year U.S. Corporate Index, posted an excess return and total return of +0.70% and +0.75%, respectively, for the quarter, benefiting from income carry and spread tightening while the drift higher in rates tempered total return. August's choppy excess returns (negative for longer-duration credit but slightly positive for short-duration credit) were bookended by strong performance in July and September with the quarter-over-quarter option-adjusted spread (OAS) on the 1-5 year U.S. Corporate Index declining from 86 basis points to 68 basis points. On a subsector basis in front-end credit, Communications, Energy and Consumer Non-cyclicals were the key drivers of excess return while Consumer Cyclicals and Capital Goods lagged. The market anticipated a significant increase in primary activity in September on the heels of a uninspiring summer calendar, with benchmark issues coming from AbbVie, Cigna, Nestle, Interpublic Group and Pfizer but this was well-telegraphed and investors set up ahead of time by raising cash balances, so the post-Labor Day spike in issuance was readily digested. The second-quarter earnings season concluded with many companies posting strong double-digit year-over-year EPS growth (25.2% for the S&P 500 Index's constituents) due to the lowered corporate tax rate and solid economic growth backdrop. Those strong earnings and the incentives around repatriation of foreign earnings and cash held offshore have prompted companies to return cash to shareholders
Sources: Barclays; Bank of America

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at a record rate this year despite near-record high equity prices in the U.S., a trend we see continuing over the next few quarters. We view these buybacks as unlikely to lead to a deterioration in credit metrics in an environment where favorable fundamental tailwinds support our belief that the credit cycle will extend beyond 2019. Conversely, current spread valuations are at or near January's post-crisis lows, leaving little room for meaningful incremental tightening. Unless hedging costs spike dramatically, we envision foreign demand for U.S. investment grade credit will remain strong given our market's attractive all-in yields, solid issuer fundamentals and consensus view calling for further firming in the value of the U.S. dollar. Inflows to investment grade credit are expected to continue into year-end, especially for short duration funds given the flatness of the yield curve out past two years.

In our strategies over the third quarter, our overweight to the Banking subsector again drove across-the-board positive excess returns in investment grade credit. Most of the other subsectors provided uneven excess returns with few noteworthy standouts outside of our Health Care holdings and some municipal/hospital issues that were strong performers and categorized as corporates. Banking subsector bonds continue to be helped by their heightened liquidity in a spread tightening market, having lagged performance-wise over the first half of the year. Our defensive positioning in a number of non-financial subsectors like Pharmaceuticals, Retailers and Technology exposed to operating headwinds or heightened event or M&A risk detracted from performance over the quarter, most notably in some of our longer-dated strategies.

Regarding portfolio positioning, we maintain our overweight to investment grade credit. We continue to see corporate credit fundamentals as trending favorably, supported by resilient U.S. economic growth with no clear evidence that the credit cycle is nearing an end. Given the relatively tight valuations cited above, we maintain a somewhat defensive positioning, particularly in industrials with longer tenors, mainly limiting our exposure to Communications, Food and Beverage, Health Care, Energy/Pipeline and Utility subsector issuers. Our Banking overweight continues, due to further improvement in fundamentals and reduced exposure to event risk relative to industrials. We see the overall sector as offering a well-protected source of carry at increasingly attractive all-in yields. Given the move higher in interest rates, we swapped out of many of our floating-rate corporates and longer-dated holdings and moved into two to three-year bullet maturities, given the steepness in that segment of the yield curve. The new issue calendar also offered a few opportunities for us to purchase attractively-priced two-year and three-year issues.

In contrast with the investment grade credit market's somewhat erratic performance so far this year, the High Yield market continues to power ahead as the ICE BAML 1-5 Year U.S. High Yield Index OAS tightened another 53 basis points over the quarter. The index generated a total return of +2.25%, outperforming the overall corporate market index's +0.96% total return. With valuations in High Yield looking stretched, we will continue to limit our purchases to shorter tenor issues.

Performance Attribution: Positive

Our overweight to investment grade credit contributed positively to third-quarter performance as credit spreads tightened, most importantly for our Bank exposures. While all sub-sectors generated positive excess returns, there was wide dispersion therein, with Health Care and Hospitals making larger contributions than Pharmaceuticals, Technology and Retail.

Agencies

U.S. dollar-denominated supranational, sovereign and agency (SSA) fixed-maturity securities generated positive excess returns in the third quarter as spreads tightened by 4-5 basis points relative to comparable Treasuries. Government-sponsored enterprise (GSE) debt saw spreads tighten by 2-3 basis points over the same period. The move in SSA spreads was mostly driven by supranationals with the International Bank for Reconstruction and Development (IBRD) an outperformer. Credit spreads on debt of Canadian provinces such as Ontario and Quebec tightened by one basis point. Fannie Mae (FNMA) and Freddie Mac (FHLMC) released second quarter 2018 earnings in August with FNMA reporting net income of $4.5 billion for the quarter, up from $4.3 billion in the first quarter, and FHLMC reporting net income of $2.5 billion, down $0.4 billion from the previous quarter. FNMA reported net worth at $7.5 billion while FHLMC recorded a net worth of $4.6 billion and both will make a required dividend payment to the Treasury of $4.5 billion and $1.6 billion, respectively. On the legal front, lawsuits challenging the “net-worth sweep” of $125 billion in excess FNMA and FHLMC profits to the U.S. Treasury saw some positive progress for shareholders of the two GSEs. A September 28 ruling in a Washington D.C. federal court allowed breach of implied contract claims to proceed, thus challenging the propriety of the $125 billion in FNMA and FHLMC profits having been swept and hinted that the court found the 2012 net-worth sweep to be arbitrary and unreasonable. The court will likely schedule a date in the fourth quarter for discovery related to the lawsuit.

We remain underweight the Agency sector overall, however we have seen pockets of value throughout the various subsectors that we added to over the quarter. As lack of supply in U.S. agency fixed-maturity bullets caused spreads to trade only two basis points over Treasuries and in some cases flat, we found better value in deeply discounted callable Agency securities with Bermudan quarterly call structures as their spreads widened significantly over recent months and offered attractive yield pickup over a matched-maturity bullet bond. Agency floaters also appear to be attractive, especially new issues that are coming to market with concessions and are indexed to the Secured Overnight Financing Rate (SOFR), the expected future replacement for LIBOR. In the secondary market we purchased FNMA’s inaugural SOFR floater and also participated in IBRD’s initial SOFR floater new issue, which came at a coupon of SOFR plus 22 basis points.

In terms of our outlook, we expect recent funding trends in the SSA market to continue. The sharp tightening in cross-currency basis has made it more advantageous for SSA issuers to tap the euro-denominated market (with significantly lower yields) and swap the proceeds into USD. We expect these conditions to persist into the fourth quarter and believe this will weigh on USD-denominated SSA issuance for the remainder of the year. Given our expectation of a further supply decline, our outlook calls for SSA spreads to incrementally tighten relative to Treasuries. We will continue to opportunistically increase our allocations to the various agency subsectors as valuations become attractive. We anticipate continuing to avoid GSE fixed-maturity bullets as they are trading at year-to-date tights and do not offer value.

Performance Attribution: Positive
Our allocations to the various Agency subsectors and security selection were positive contributors to performance over the quarter, led by our positions in callables and SSAs.

ABS

Short-tenor asset-backed spreads moved tighter over the course of the third quarter. Spreads for AAA-rated three-year tranches of credit card, prime and subprime auto moved two, four, and three basis points tighter, respectively, having recovered from the year-to-date wide levels seen at the end of the second quarter. In contrast, three-year floating-rate FFELP student loan tranches were flat on spread over the quarter. We attribute the relative underperformance of short FFELP tranches as a temporary pause after the spread tightening seen in that sector during the second quarter.

Over $53 billion of new issue ABS deals came to market in the quarter, compared to only $46 billion in the same period last year. Year-to-date issuance stands at over $179 billion, an increase of over 9% compared to the $164 billion issued by this time last year. As usual, the auto sector was predominant with over $79 billion of auto deals coming to market. That was followed by credit cards ($31 billion) and “miscellaneous” ($26 billion), a catch-all subsector that includes other less common asset-backed sub-sectors such as structured settlements, insurance premium payments, aircraft leases, cell phone payment plans, whole business securitizations and timeshare deals. So far this year, 16% of new issuance has come to market as floating-rate securities, comparable to that seen at this time last year.

Credit card performance remains solid with charge-off and delinquency rates stable and close to all-time lows. Monthly payment rates continue to rise, with the monthly payment rate on the Wells Fargo Credit Card Index increasing 52 basis points over the quarter to 28.4%. Payment rates have risen consistently since the financial crisis (the Wells Fargo index saw rates fall below 16% in 2008) as the post-crisis cardholders remaining in the collateral trusts have shifted credit card usage to be more transaction-oriented rather than utilizing their credit cards as a source of revolving credit. In our view, with the economy strengthening, these cardholders are likely benefiting from the healthy jobs market and improving income growth. Over the quarter, charge-offs on the Wells Fargo index declined 12 basis points and 60+-day delinquencies declined by 7 basis points.

Auto credit performance continues to show signs of stabilizing with the Fitch auto ABS indices showing prime 60+-day delinquencies ending July at 0.30%, flat month-over-month, and subprime 60+-day delinquencies ending July at 4.47%, up only 6 basis points from June’s level. Notably, following the trend we saw at the end of the second quarter, both 60+-day delinquencies and annualized net loss rates for both indices continue to show year-over-year improvement. As we mentioned in our second quarter commentary, we attribute the improving auto metrics to the strength of the labor market and, in particular for subprime, a trend towards marginally better underwriting for recent vintage deals compared to their 2015 and early-2016 vintage counterparts. September’s auto sales numbers came in at 17.4 million SAAR (seasonally-adjusted annual rate), compared to estimates of 16.8 million SAAR. Auto sales have trended lower over the year after reaching a twelve-year high of 18.5 million SAAR in September of last year in the wake of last year’s hurricanes. Used vehicle prices remain strong with the Manheim Used Vehicle Index printing at 139.7 in August, a 6.4% increase from year ago levels and a record high for the index over its more than 20-year history. Manheim noted that used cars are enjoying an abnormal summer bounce in prices which they attribute to a combination of the strong economy and affordability challenges for the consumers who favor buying used cars over new vehicles. On a year-over-year basis, most major market segments saw price gains with more affordable vehicles seeing the greatest increase in value.

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During the quarter we maintained or modestly reduced our overall ABS exposure across most strategies. With interest rates at higher levels, we also took the opportunity to reduce our floating-rate and other very short duration holdings (primarily credit cards and prime autos) in favor of longer duration fixed-rate tranches. To implement this strategy, we were active in both the primary and secondary markets. Notable secondary market trades include the purchases of a AAA-rated, 2.5 year fleet lease tranche and a AAA-rated, 1.8 year credit card tranche. In the new issue market we participated in subprime auto deals, a prime auto lease deal and an equipment deal.

The tone of the annual ABS East conference in Miami was generally positive, with most market participants comfortable with ABS performance due to the strong economy and healthy jobs market. The market's credit concerns have generally moved from subprime auto ABS where underwriting has tightened and performance is improving to focus on more esoteric asset classes like consumer loans. We generally share this view and, going forward, anticipate maintaining our portfolio exposure to ABS while continuing to reduce our lower yielding credit card holdings in favor of higher yielding alternatives, including subprime auto tranches. However, despite the market's sanguine consensus around subprime, we see no reason to change our long-term strategy. We will continue to focus on shorter tenor bonds from a select group of established issuers who have demonstrated prudent growth and have a history of successfully operating through multiple credit cycles.

Performance Attribution: Positive

In line with tighter benchmark spreads, our ABS positions added to portfolio performance over the third quarter. Within ABS, our fixed-rate auto and credit card holdings were the best performers after accounting for their duration and yield curve positioning. Our weakest performers were our floating-rate credit card positions which were generally flat or just slightly positive.

CMBS

Short tenor commercial mortgage-backed securities' spreads tightened over the quarter. Compared to like-duration Treasuries, three-year and five-year AAA-rated conduit tranches ended the quarter at spreads of 40 and 53 basis points, 12 and 9 basis points tighter, respectively. Similarly, three and five-year Freddie Mac "K-bond" tranches ended the quarter at spreads of 23 and 50 basis points, 18 and 2 basis points tighter, respectively. We attribute the better performance of three-year agency tranches relative to five-year agency tranches to investor preference for shorter duration assets during a period of rising interest rates.

The quarter saw over $20 billion of new private label CMBS and almost $39 billion of new agency CMBS come to market. This compares to $28 billion and $39 billion, respectively, in the third quarter last year, representing a decrease of roughly 28% for private label deals and flat year-over-year issuance for agency CMBS. We attribute the decline in private label deals to the shrinking volume of 2018 maturities as the market moves beyond the peak originations from the crisis years. In notable transactions during the quarter, Brookfield Asset Management disclosed in August that it had acquired a 100% leasehold interest in New York City's 666 Fifth Avenue building from Kushner Cos. This transaction concludes the Kushner's troubled investment in the Manhattan office

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property. The purchase price was not disclosed but the transaction resulted in the payoff of $1.1 billion of A-notes held in several 2007 vintage conduit deals.

Over the quarter, the continued resolution of distressed legacy loans and the steady pace of new securitizations combined to push the CMBS delinquency rate lower. The Trepp 30+-day delinquency rate fell 23bps in September to 3.41%, another record low. The rate has now fallen for six straight months and for 14 of the last 15 months with the rate of decline accelerating in September. The all-time high on the rate of 10.34% was reached in July, 2012. Multifamily loans were the best performing sector with a 1.95% 30+-day delinquency rate. Trailing that sector was the lodging sector with a 2.27% 30+-day delinquency rate. Retail property delinquencies dropped 46 basis points in September but, despite the decline, remained the worst performing major property type.

Commercial property prices ended the quarter with strong momentum. The September release of the RCA CPPI National All-Property Index showed price gains accelerated in August after five months of slowing growth. Prices rose 7.7% year-over-year through August with the index reaching 133.2, another record high, driven by gains in secondary and tertiary markets. Prices rose 8.3% year-over-year in non-major metro areas compared to 6.1% in the six major metros. While the pace of price growth has slowed over the past year in the major metros, it has accelerated for non-major metros. In particular, RCA noted that apartment properties were the top performer with prices up 1.2% in August and 12.3% year-over-year with growth in the sector driven by gains in non-major metros. Suburban office properties were the next best performers with prices up 0.7% in August and 9.1% year-over-year. Central business district office and retail properties are showing the slowest year-over-year growth, with prices up 1.7% and 2.1%, respectively. We expect office and industrial properties to show continued growth going forward due to the support of tax cuts and an expanding economy. The performance of retail properties is likely to become increasingly bifurcated in our view. High-end properties will do well while lower quality properties will continue to struggle.

Our portfolio CMBS exposure declined modestly over the quarter as our new purchases did not match pay-downs and maturities on our existing holdings and the sale of some positions. Notably, we sold some very short tenor fixed-rate conduit tranches and a floating-rate single-asset, single-borrower transaction to fund the purchases of longer duration bonds both in CMBS and other spread sectors.

Looking ahead, we continue to favor 1.5-2 year conduit tranches over like-duration agency alternatives due to their spread advantage. We remain opportunistic, generally looking for matching positions in the secondary market to add to existing holdings rather than participating in new issue deals. In our view, the smaller tranche sizes in current new issue conduit deals limits their liquidity relative to similar tranches from prior vintages as the newer tranches are not large enough to generate meaningful secondary market trading activity. We remain content to pass on most of the floating-rate SASB bonds currently coming to the market due both to relatively tight spreads and borrower-friendly deal structures.

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Performance Attribution: Positive

After adjusting for their duration and yield curve exposure, our CMBS positions added modestly to performance over the quarter. Our fixed rate conduit tranches were the best performers due to the combination of coupon income and tighter spreads in the sector. In addition, our agency CMBS positions and our floating rate SASB holdings were both slightly positive over the quarter.

RMBS

Generic agency residential mortgage-backed spreads posted mixed performance relative to comparable Treasuries in the third quarter. With rates rising in response to Fed hiking actions, shorter duration 15-year collateral outperformed 30-year collateral. At the end of the quarter, bonds backed by 15-year mortgages were 8 basis points tighter to five-year Treasuries at a spread of 29 basis points and bonds backed by 30-year collateral were flat, ending the quarter were they began at a spread of 71 basis points over Treasuries. In a continuation of the pattern we saw during the second quarter, we attribute the better performance of 15-year mortgages to investor preference for shorter duration assets in a rising interest rate environment. Short tenor non-agency spreads moved tighter over the quarter as investors found the higher yields attractive despite slower prepayment speeds, which was reflected in the performance of that sector.

The housing market saw signs of slowing throughout the third quarter. While home prices are still strong, the S&P Corelogic Case-Shiller 20-City Home Price Index was up 5.9% year-over-year growth in July, below expectations for a 6.2% increase and the lowest pace of growth since August of last year. This was the fourth consecutive monthly deceleration in the rate of annual gains and, in our view, is reflective of the combined headwinds from high home prices, recent tax law changes and rising mortgage rates. The seasonally-adjusted report showed monthly price declines in New York (-0.47%), Boston (-0.21%), Chicago (-0.15%) and Dallas (-0.13%). Thirteen cities showed monthly gains, led by Las Vegas (+1.14%), San Francisco (+0.90%), Cleveland (+0.75%) and Phoenix (+0.46%). The National Association of Home Builders (NAHB) sentiment index came in flat, with September's reading matching that of August, the lowest level since last September. In August, NAHB Chairman Randy Noel noted that builders are reporting strong demand for new housing fueled by steady job and income growth but they are also facing challenges from rising construction costs and shortages of skilled labor leading to affordability issues. We expect residential construction costs to moderate going forward as lumber prices fell dramatically over the quarter. Home sales numbers appear to be cooling with the latest existing home sales coming in flat while new home sales came in ahead of expectations for the first gain in three months (rising 3.5% versus the 0.5% increase anticipated by economists). Despite the pop in August's numbers, prior months' new home sales numbers saw downward revisions. Even with these signs of slowdown, the housing market is still finding support from low levels of inventory, a healthy economy and jobs market and rising consumer confidence. The Freddie Mac 30-year fixed rate mortgage commitment rate ended the quarter at 4.72%, 17 basis points higher over the quarter, and the highest level since April 2011. Rising rates have dampened mortgage applications, with the latest numbers showing the lowest level of mortgage refinance applications since 2000. The primary/secondary mortgage spread remained relatively stable (decreasing only 2 basis points) as originators passed most of the cost of higher interest rates through to borrowers. With rates at current levels, we expect mortgage refinance activity will remain muted.

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In September the Federal Housing Finance Agency (FHFA) issued a notice of proposed rulemaking on the Uniform Mortgage-Backed Security (UMBS), representing the culmination of several years of discussion around the Single Security Initiative, a plan for the reorganization of the GSEs securitization businesses around a common platform. The proposed rule would codify various mandates that the FHFA has placed on Fannie Mae and Freddie Mac and represents the beginning of the formal launch of the UMBS, targeted for June 2019. The rule focuses on aligning GSE programs, policies and practices that affect the prepayment rates of TBA-eligible MBS and is designed to enhance the liquidity for UMBS. The rules cover a large range of GSE business activities and seek to align items like guarantee fees, underwriting standards, servicer requirements and buyout practices.

During the third quarter our exposure to RMBS declined slightly as our new purchases were outpaced by pay-downs on existing portfolio positions. With rates moving higher, we have been projecting slower prepayments on RMBS tranches and have been selective in purchasing new securities for our portfolios. For example, during the quarter we purchased a 3.0% coupon 2.3 year front sequential tranche from a Freddie Mac CMO. This bond was collateralized with seasoned mortgages that have been outstanding for an average of 65 months and have a weighted average mortgage rate of 3.55%. With rates at current levels, these borrowers are unlikely to refinance and accordingly the collateral has been paying at a slow pace for the last year. In our view, the current 2.3 year average life of the bond likely reflects most of the extension risk that we expect in the security; should rates drop and prepayment speeds pick up, the portfolio's yield will benefit from the bond's discount purchase price.

As we have noted in prior commentaries, we have been limiting exposure to agency RMBS due to the Fed's plan to cease MBS reinvestments for its mortgage portfolio. However, at current spreads and with the market adjusting to slower prepayment speeds and longer average lives on MBS tranches, we are becoming more comfortable with the sector in general. We would look to add agency positions with stable average life profiles similar to the Freddie sequential mentioned above. In non-agencies, with market pricing payment speed assumptions becoming more realistic, we find value in certain front sequential tranches from deals that came to market in the past two or three years. With the benefit of time, prepayments on many of these deals have reduced the outstanding deal balances and mitigated extension risk in the current pay short-tenor tranches. In addition, we maintain our positive credit outlook for this sector based upon our view that limited housing inventory will support moderate home price appreciation for the foreseeable future.

Performance Attribution: Positive

After accounting for duration and yield curve exposure, our RMBS positions added modestly to portfolio performance in the third quarter. Our non-agency positions were generally our top performers, benefitting from both tighter benchmark spreads and the income advantage of their relatively high coupons. Our specified pool positions were flat or slightly positive over the quarter, whereas our agency ARM and CMO holdings were all flat or slightly negative.

Municipal

Primary issuance in the overall municipal market in the third quarter was $88 billion, down over 10% from the second quarter. Year-to-date total issuance of $249 billion is $40 billion lower from comparable issuance last year. Third-quarter taxable issuance of $8 billion nearly matched second-quarter issuance, but the taxable year-to-date total of $21 billion lagged 2017 figure by $4 billion. This tepid pace of issuance, combined with the $4 billion in municipal bond mutual fund inflows, provided a strong technical backstop for municipal bonds. Due to the back-up in interest rates, both taxable and tax-exempt municipals posted negative absolute returns in the broad market over the quarter but still outperformed Treasuries on a relative basis, according to the ICE BAML indices. On the front end of the maturity spectrum, taxable municipals outperformed Treasuries, whereas tax-exempt municipals slightly underperformed.

With state and local tax ("SALT") deductions now capped at $10,000 for U.S. households under the new tax code that went into effect January 1, 2018, the SALTs represent a greater burden on constituents living in high-tax states and municipalities. On July 17, New York, Connecticut, Maryland and New Jersey filed a lawsuit against various arms of the federal government, seeking to invalidate the new $10,000 cap on the federal tax deduction of SALTs. The plaintiffs believe that capping the SALT deduction will place a disproportionate financial burden on residents of their states and that home values will decline as a result. Additionally, states such as New York, New Jersey and Connecticut have implemented charitable workarounds for their residents, allowing them to make charitable donations (which are still fully deductible on federal tax returns) to newly created organizations in lieu of paying property taxes. On August 23, the IRS said these charitable workarounds are not acceptable to the federal government. We anticipate the lawsuits against the federal government and the measures to circumvent the $10,000 cap on SALT taxes will ultimately fail, and people impacted in these high-tax states will inevitably be forced to pay higher taxes in the end. Congress has adjusted (both expanding and limiting) SALT deductibility over the years, and we have no reason to expect the most recently imposed $10,000 limit will be found to be unconstitutional.

In 2016 the Federal Reserve stated that it would allow state and municipal bonds that "meet the same liquidity criteria that currently apply to corporate debt securities" to qualify as high-quality liquid assets ("HQLA") for banks holding them on their balance sheets. In May, Congress passed the bipartisan "Economic Growth, Regulatory Relief and Consumer Protection Act of 2018" requiring the Federal Reserve, the FDIC and OCC to treat municipal obligations as HQLAs under their liquidity coverage rules if the obligation is considered both "liquid and readily marketable" and "investment grade". Importantly, the 2018 law does not restrict municipal bond HQLAs to only include General Obligations, as the 2016 guidance stated. Near the end of August, all three federal banking agencies issued a rule that will take effect upon publication in the Federal Register to amend the agencies' liquidity rules concerning certain eligible municipal securities, making it official that municipal securities will be classified as HQLAs under bank liquidity rules. While we do not expect municipal bonds to rally significantly on the heels of this news, this favorable official classification for municipal bonds on bank balance sheets should make these bonds a more attractive holding at the margin.

The most high-profile credit story of the quarter, if not the entire year, in municipal credit has been associated with the nuclear power reactors currently under construction in Georgia. Both of these reactors, originally expected to cost $14 billion and be operational by 2017, have run into a series of delays and cost overruns, and

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Westinghouse, the contractor, filed for bankruptcy in 2017. Jacksonville, Florida's local utility, JEA, entered into an agreement with plant co-owner Municipal Electric Authority of Georgia ("MEAG") to cover 41% of its construction costs, as well as to purchase 41% of MEAG's energy generated by the reactors for the first 20 years of operation. (MEAG also offloaded 25% of the construction costs and 20 years of generation output to PowerSouth Energy Cooperative while retaining 34%, but MEAG remains the sole owner of its 22.7% share of the project.) JEA has wanted to halt construction and abandon the projects as the construction costs are now projected to total $27 billion, with the cost of energy generated from the nuclear plants, once completed, expected to be three-times the current market price of other energy sources (i.e. natural gas, coal). However, JEA's agreement with MEAG does not include voting rights with respect to decisions on construction and MEAG, along with the other owners, have voted to continue building the reactors. On September 11, JEA and MEAG filed lawsuits against each other; JEA is trying to nullify its contract with MEAG, and MEAG filed for declaratory judgement and injunctive relief. While this legal wrangling has caused spread widening on JEA and MEAG debt, we ultimately believe the contract will be upheld and both entities will continue to pay their debt service, regardless of the project's costs or completion date. Even if the owners decide to abandon construction, both JEA and MEAG would be responsible for paying debt service on financing costs incurred to date. At this point, we do not expect the unique problems facing JEA and MEAG to impact other issuers within the Public Power subsector or the municipal market in general.

Regarding portfolio strategy, our Healthcare, Transportation and select Utilities holdings continued to perform well overall in the third quarter. The spread weakness we saw out the curve in the Healthcare subsector has stabilized and the spreads on the majority of our Healthcare holdings maturing inside of ten-years tightened over the quarter. Due to the tight spreads in the primary and secondary markets, our buying activity was light and primarily focused on ultra-short maturity bonds for our strategies. In the beginning of September, we sold a handful of municipal bonds across our accounts that were scheduled to mature within a year and used the proceeds to execute duration extension trades in other sectors.

Going forward, we have not seen a comprehensive federal infrastructure plan that would involve municipal issuance nor have we seen any other impetus for municipal supply to increase. Absent a significant increase in supply or broad credit concerns that would cause spreads to widen, we do not anticipate adding significantly to our municipal holdings. We still favor Healthcare and Public Power bonds and do not believe isolated struggles at hospitals or nuclear power construction sites will lead to contagion risk across those subsectors. We also expect bonds backed by sales tax and transportation-related revenues to perform well given the economy and confident consumers. We will become even more selective when it comes to adding Higher Education exposure as we do not expect college applications or subsequent enrolment numbers to increase, while potential applicants have more high-quality alternatives at their disposal in this strong economy. Additionally, we will avoid adding exposure to state and local issuers struggling with pensions and budgets, as current spreads are largely not reflective of the risks.

Performance Attribution: Neutral

Performance of our municipal holdings over the third quarter ranged from slightly negative to marginally positive across our strategies. On an excess return basis, some of our better performing municipal subsectors included State and Local Appropriation and Higher Education. Several bonds within the Housing subsector underperformed and performance within the Public Power subsector was mixed, with some names outperforming while others underperformed like-duration Treasuries.

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