Eagle Insight

EAGLE Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Strategic Income Portfolio

Second Quarter | 2019

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Equity Income investing is based upon the identification of companies that possess both moderate growth rates as well as higher-than-average and consistent dividend distributions. There are risks associated with dividend investing, including that dividend-issuing companies may choose not to pay a dividend, may not have the ability to pay, or the dividend may be less than what is anticipated. Dividend-issuing companies are subject to interest rate risk and high dividends can sometimes signal that a company is in distress. Historically, dividend yields have been relatively constant and therefore have created a cushion for investors when stock prices have declined. However, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. The biggest risk of equity investing is that returns can fluctuate and investors can lose money. Investment-grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

Market Overview

Despite an escalation in the U.S.-China trade conflict and a slowing global economy, the U.S. equity market, as measured by the S&P 500, grew 4.3% during the second quarter. We believe the main catalyst was a perceived shift in the Federal Reserve's outlook regarding interest rates, signaling that no more rate hikes are expected this year, or perhaps even a rate cut if economic conditions deteriorate. This reduced the concern for a major policy mistake and raised the appetite for equities. Cyclical sectors performed best during the quarter, including financials, technology and materials. Defensive sectors, including healthcare, utilities and REITs posted positive returns but lagged most sectors.

The domestic bond market, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, gained 3.08% in the second quarter for a total return of 6.11% year-to-date. The second quarter was marked by the continued drop in yields as demand grew for U.S. government bonds amid weak global economic and inflation data, escalating geopolitical tensions, and the rising probability the U.S. Federal Reserve (Fed) will cut interest rates in coming months.

Economic data, especially manufacturing reports, both in the United States and abroad have rolled over just when it seemed like the bottom of the global economic slowdown was at hand. Meanwhile, inflation expectations hit a multi-year low as the 10-year break-even inflation rate sank by 0.17 percentage points during the quarter to 1.7%. Moderate and slowing growth, along with little fear of rising inflation drove the yield on the benchmark 10-year U.S. Treasury note to its lowest level since the 2016 U.S. presidential election at 2.01%, compared to 2.41% at the end of March. Although interest rates fell broadly, the steeper decline on the longer end caused the yield curve, as measured by the 3-month U.S. Treasury bill and the 10-year note, to invert to -0.09% at quarter-end.

Investment-grade corporate bonds, as measured by the Bloomberg Barclays U.S. Corporate Bond Index, gained 4.48% in the second quarter and are up 9.85% for the year. The majority of the gain in corporate bonds was due to falling interest rates as corporate credit spreads were only slightly tighter during the period, ending at 1.15% compared to 1.19% at the end of March. Spreads trending flat-to-down is still impressive, considering the reasons that yields on government debt around the world are much lower. Usually corporate credit spreads widen when Treasuries and other relatively safe assets rally. Investors appear to be optimistic about the ability of central banks to orchestrate a reacceleration of economic growth – or at least a decisive bottom – through coordinated easing.

Investors remaining constructive on risk pushed corporate bonds to be the best-performing sector for the second consecutive quarter on both a total return and excess return basis (over duration-matched Treasuries). Government-related securities also posted positive returns and outperformed Treasuries while structured products were the worst-performing sector, ending up 2.04% but adding no value relative to Treasuries.

The second quarter of 2019 was positive for municipal investors as municipal bonds continued their rally, albeit at a slower pace. The Bloomberg Barclays Municipal Bond Index rose 0.37% for the month of June, resulting in a 2.14% gain at quarter-end. Municipals year-to-date are up 5.09%. The AAA general obligation curve experienced a bull flattener over the quarter, with intermediate and long maturities outperforming short maturities. Over the quarter, the 1-year and 5-year Barclay's Municipal indices gained 0.76% and 1.66% respectively, while the 22+ year index was up 2.89%. The first half of the year was characterized by constrained supply, healthy and steady demand, including a record pace of inflow to tax-free mutual funds. All these factors contributed to strong municipal performance.

Portfolio Allocation Review[1,2]

Despite being overweight stocks at the expense of bonds, both the taxable and municipal Strategic Income Portfolios (SIP) underperformed their blended benchmarks in the second quarter. In other words, our asset allocation proved beneficial, but the selection of stocks and bonds within the portfolios still underperformed.

In April, we made one asset allocation shift, moving from a target allocation of 57.5% equities, 40.5% bonds, and 2% cash to a target allocation of 60% equities, 38% bonds, and 2% cash. While we could have distributed the proceeds across all of our current equity positions, we took a precise approach by investing in a historically low beta operator in the food & staples industry in the consumer staples sector.

The model indicators that we follow have progressively moved more bullish in favor of equities. Trend, momentum, and liquidity indicators have continued to improve in recent weeks. Certain fundamental indicators such as unemployment gains and dividend growth have grown more bullish in favor of stocks. Moreover, bond yields have compressed significantly from their highs in the fall of 2018, reducing the relative attractiveness of bond yields compared to stock dividends.

Equity Performance Review[1,2]

While the stocks in the Eagle Strategic Income Portfolios were up on an absolute basis, they underperformed the benchmark S&P 500 Index during the quarter. Strong stock selection in industrials, real estate, healthcare, and utilities added to returns. Weak stock selection in energy, consumer staples, and communication services, as well as an underweight to information technology, were the largest detractors.

Taxable Fixed Income Performance Review[1,3]

Taxable bonds in the taxable portfolios performed in line with the Bloomberg Barclays Intermediate Government/Credit Index. A modest overweight to duration in our U.S. Treasury, agency, and corporate bond holdings was the largest positive contributor as bonds rallied, particularly on the intermediate and long end of the yield curve. The largest detractor was our allocation to structured products, which underperformed the broader bond market.

Municipal Market Performance Review[1,3]

Municipal bonds in the tax-advantaged portfolios underperformed the Bloomberg Barclays 7 Year Municipal Bond Index. An underweight allocation to states with weak financial positions in favor of states with strong pension funding ratios was the largest relative detractor to performance, as riskier states outperformed given the risk-on backdrop. In the same vein, our underweight allocation to BBBs – bonds that are just one step above a "junk" rating – was the second-largest detractor as these bonds outperformed higher credit quality municipal bonds.

Outlook

The U.S. economy just entered the longest expansion on record. July will mark the 121st month of growth since June 2009, when the last trough ended, as determined by the National Bureau of Economic Research (NBER). The previous record was 120 months of economic growth from March 1991 to March 2001.

Does that mean we should be concerned that the expansion is about to end? We do not believe so. Economic expansions don't just die of old age; something has to happen to end them. Usually this would either be an external shock to the economy, or an asset bubble popping, or because the Federal Reserve may cause a slowdown or a recession by raising rates too much. We don't see any asset bubbles currently, and it looks like the Fed is on hold with rate hikes for now, so we believe this economic expansion still has legs.

More worrisome for investors in the near-term might be the recent slowing in manufacturing activity, which has been a weak spot for the U.S. and global economies as escalating trade concerns and tariffs have put downward pressure on the sector. Consequently, corporate earnings are expected to decline slightly versus last year in the second and third quarters of 2019. Fortunately, employment data has so far been unaffected and remained solid, but we will continue to monitor it closely. We expect earnings growth to gradually improve by year-end, which should be good news for equities in general.

We feel confident about the way we have positioned our strategy, regardless of how long the current economic expansion continues. An overweight allocation to high-quality dividend growth stocks should allow us to participate in the upside if economic conditions remain stable or surprise to the upside. However, if economic conditions deteriorate, the low beta profile of the stocks we own should give us a chance to protect on the downside relative to broad stock market returns. Furthermore, we believe the high-quality investment-grade bonds that we own should provide stability to returns regardless of market conditions.

1. References to specific securities are intended to illustrate the types of securities Eagle may hold in this portfolio. They are not intended as representations of specific investment recommendations that would have been profitable to an investor. Past performance is not a guarantee of future results. Opinions and estimates offered constitute Eagle's judgment and are subject to change without notice as are statements of financial-market trends, which are based on current market conditions. Investing involves risk, including the possible loss of principal.

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3. Source: FactSet