FUNDMARKET INSIGHT REPORT

Lipper Research Series – Fixed Income Summary Quarter-End Analysis

JUNE 30, 2019

Fixed Income Funds Carry Their Momentum Through Q2

Executive summary

It was another solid quarter for bond funds as the asset group posted an average increase of 2.33% for the second quarter on the heels of a 3.34% gain in Q1. The positive results were across the board, as for the second quarter in a row all of Lipper's fixed income macro-groups recorded gains, led by World Income Funds (+3.40%) and Investment Grade Corporate Bond Funds (+2.54%). The fixed income peer groups were near perfect as well, with 50 out of 51 posting increases for the quarter. The Emerging Markets Local Currency Debt Funds (+5.32%) and General U.S. Treasury Funds (+4.19%) classes led the charge in Q2, spurred on by a weakening U.S. dollar and falling Treasury yields. The Specialty Fixed Income Funds classification (-1.01%) was the only peer group to finish the quarter in the red.

To the benefit of bond funds, the Federal Reserve Board has done a complete 180-degree turn in respect to interest rates over the last six months. In December 2018, the Fed stated that considering the economic environment, it foresaw two additional interest rate hikes in 2019. This news was not received well by the markets (bond or equity), as bond funds finished the fourth quarter off 0.33% on average. The tide turned for bond funds in January of this year as the Fed backed off its forecast of two rate hikes and stated it would need to see evidence (rising inflation) that an interest rate increase was needed before it acted, which sparked the Q1 rally for bond funds. The Fed became even more accommodating in Q2 as not only were rate hikes still off the table, but a reduction in rates is now a real possibility. This year's bond rally grew even stronger in June as it became apparent that the Fed was considering cutting interest rates for the first time since December 2008. While the Fed kept rates unchanged at its June policy meeting, the group did forecast its intentions for future cuts, as the Fed stated that its goal was to sustain the current economic expansion and that it felt that economic uncertainties had increased. These statements led the market to speculate that at least a 25-basis-point rate decrease was likely at the Fed's next policy meeting in July.

Federal Reserve Chairman Jerome Powell indicated that the continuation of the U.S./China trade war will factor into the Fed's decision on the future direction of interest rates. There are concerns that as the dispute lingers on it will have a cumulative impact on both the U.S. economy and global growth. The Fed became more concerned with this situation when failed talks between the two countries in May led the U.S. to raise its tariffs on goods from China.

Second quarter highlights:

- The World Income Funds macro-group (+3.40%) was the best performing group of the quarter, paced by the Emerging Markets Local Currency Debt Funds (+5.32%) peer group.
- Investment-grade corporate bond funds posted an increase of 2.54%, led by Corporate Debt Funds BBB-Rated Funds (+3.95%).
- Government/Treasury funds gained 2.26% on average, as General U.S. Treasury Funds appreciated 4.19%.
- General domestic taxable funds were up 2.00% in Q2 thanks to General Bond Funds (2.80%) and Flexible Income Funds (2.70%).
- Municipal debt funds were up 1.98% overall as single state muni funds (+2.00%) slightly outperformed national muni funds (+1.94%).

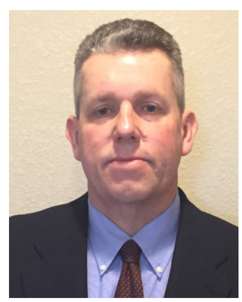

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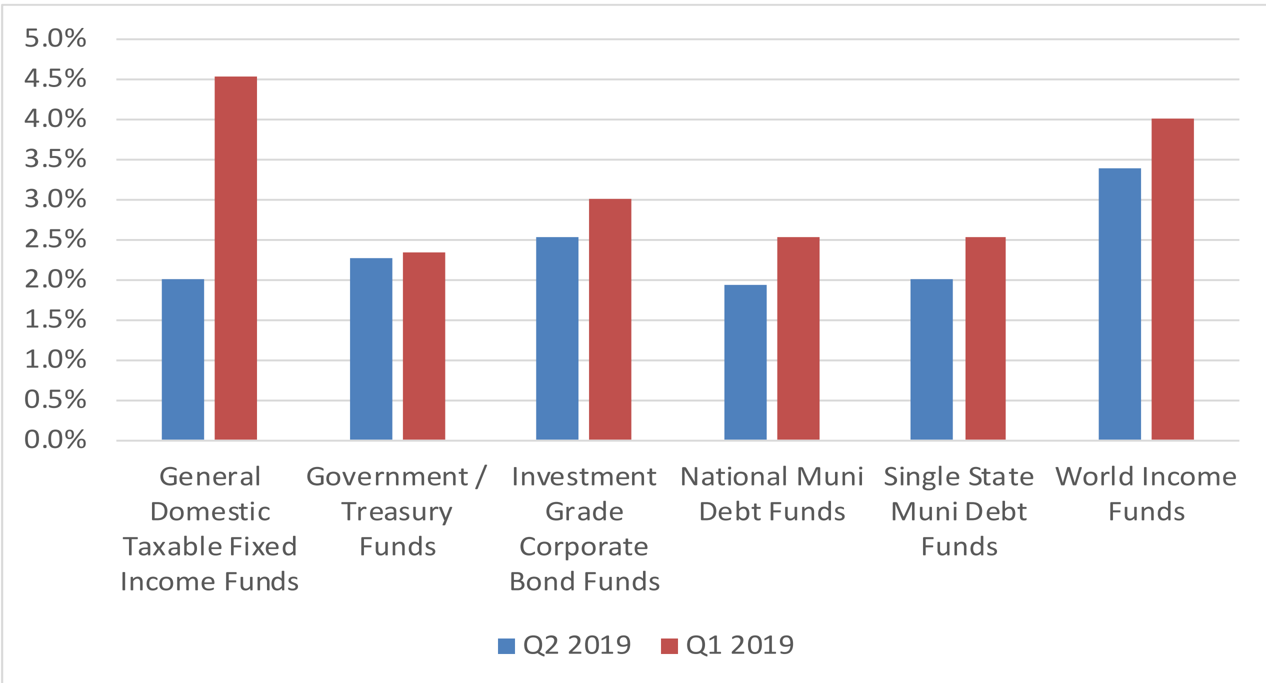
FIGURE 1 **LIPPER FIXED INCOME MACRO GROUP RETURNS, SECOND QUARTER 2019**



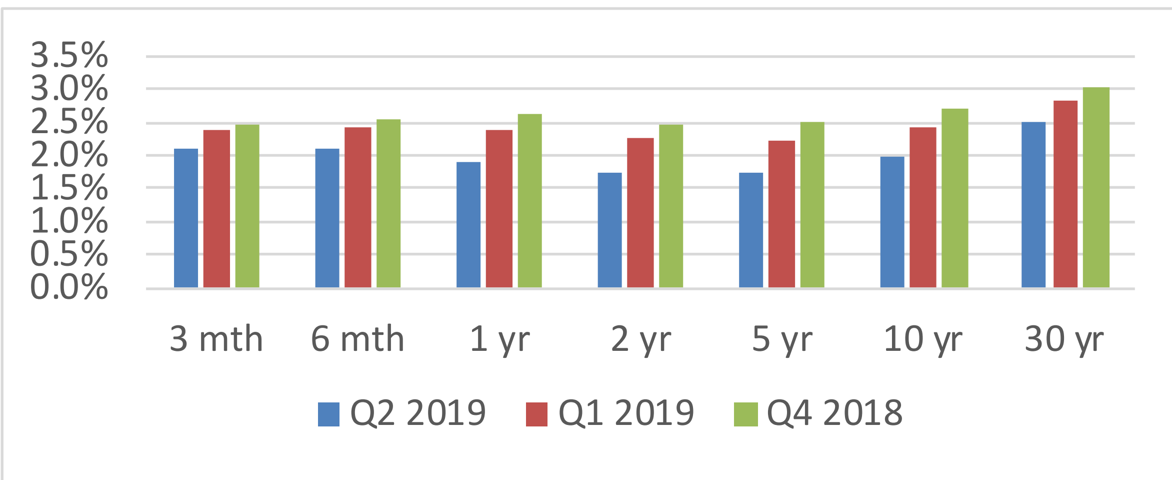
Source: Lipper

Government/Treasury funds summary

The Fed's statements on interest rates also contributed to pushing government bond yields down further. As shown in the Treasury yields table below, yields declined at all maturities. The two-year Treasury note experienced the largest drop (52 bps) among the group, while the important 10-year note also continued to decline, closing the quarter at 2.00%—down 41 bps. The yield on the 10-year is important because it is used as a benchmark for a wide range of lending rates.

The government/Treasury funds macro-group gained 2.26% on average in Q2, slightly off its 2.33% return for Q1. All of the peer groups experienced increases for the second quarter, led by General U.S. Treasury Funds (+4.19%). The remainder of the peer group all turned in solid performances with gains of greater than 1%--General U.S. Government Funds (+2.68%), Inflation Protected Bond Funds (+2.35%), Intermediate U.S. Government Funds (+2.31%), Short-Intermediate U.S. Government Funds (+1.34%), Short U.S. Government Funds (+1.23%), and Short U.S. Treasury Funds (+1.13%). All of the peer groups improved upon their Q1 performance except for Inflation Protected Bond Funds, which fell by 76 bps. The drop in this classification's performance makes sense when considering that inflation has consistently been lower than the Fed's target rate (2.00%) and is projected to be so for the near term. There is additional evidence of investors turning away from Inflation Protected Bond Funds from a fund flows perspective, as the group suffered net outflows of $1.6 billion for the quarter—the worst among the macro-group. Conversely, General U.S. Treasury Funds took in the most net new money (+$12.0 billion) in the quarter for the group, aligning with their top return numbers.

FIGURE 2 TREASURY YIELDS



Source: U.S. Department of the Treasury

Investment-grade corporate bond funds summary

The Investment-Grade Corporate Bond Funds group gained 2.54% on average in Q2, down from the group's 3.00% return in Q1. All of the peer groups posted increases in Q2, but they were also down from their Q1 results. The best returns in Q2 belonged to the Corporate Debt BBB-Rated Funds (+3.95%) and Corporate Debt A Rated Funds (+3.75%) peer groups. The Corporate Debt BBB-Rated Funds group also suffered the worst period-to-period decrease at -0.96%. This macro-group took in more net new money for the quarter (+43.2 billion) than all of the other groups combined, driven by the Core Bond Funds (+17.3 billion) and Core Plus Bond Funds (+$9.0 billion) peer groups.

General domestic taxable bond funds summary

This macro-group, while up for the quarter (+2.00%), experienced the largest decline in average return from Q1 (-2.90%). Despite almost all of the peer groups recording positive gains in Q2, they all suffered a quarter-to-quarter drop in performance, with High Yield Funds taking the biggest hit (-4.15%). The returns among the macro-group for the second quarter ranged from +2.80% to -1.01%, with the General Bond Funds and Specialty Fixed Income Funds peer groups serving as the bookends. The Loan Participation Funds peer group (which benefits from rising interest rates) suffered the worst quarterly net outflows (-$9.1 billion) among the entire fixed income universe, while the Multi-Sector Income Funds classification posted the best net inflows numbers (+$6.8 billion) among the peer group.

World income funds summary

The U.S. dollar weakened in Q2 as measured by the Trade Weighted U.S. Dollar Index. The index fell by 1.21% in Q2, driven lower by the Fed's direction on interest rates. A weaker dollar is favorable for ex-U.S. debt, especially emerging markets debt. The World Income Funds macro-group had both the largest return among the macro-groups (+3.40%) and the peer groups (Emerging Markets Local Currency Debt Funds, +5.32%) for Q2. This quarter's gain for Emerging Markets Local Currency Debt Funds represents a 2.12% increase from Q1, which is also the highest among the fixed income peer groups. The other World Income peer groups also recorded increases in Q2 as Emerging Markets Hard Currency Debt Funds, Global Income Funds, International Income Funds, Global High Yield Funds, and Alternative Currency Strategies Funds were up 3.92%, 3.28%, 2.85%, 2.59%, and 0.79%, respectively.

Municipal debt funds summary

Municipal debt funds were up 1.98% in Q2, off somewhat from the group's 2.54% gain in Q1. The average increase from single-state muni peer groups (+2.00%) and national muni peer groups (+1.94%) were basically the same, with High Yield Municipal Debt Funds (+2.56%) and California Municipal Debt Funds (+2.44%) accounting for the best quarterly returns among the peer groups. While the group's overall average return was the worst among the macro-groups in Q2, it did attract attention from investors as it has taken in $44.2 billion in net new money for the year to date (including $18.3 billion in Q2), which is the best consecutive two quarter total in the group's history.