PVG Asset Management - Bond Market Report

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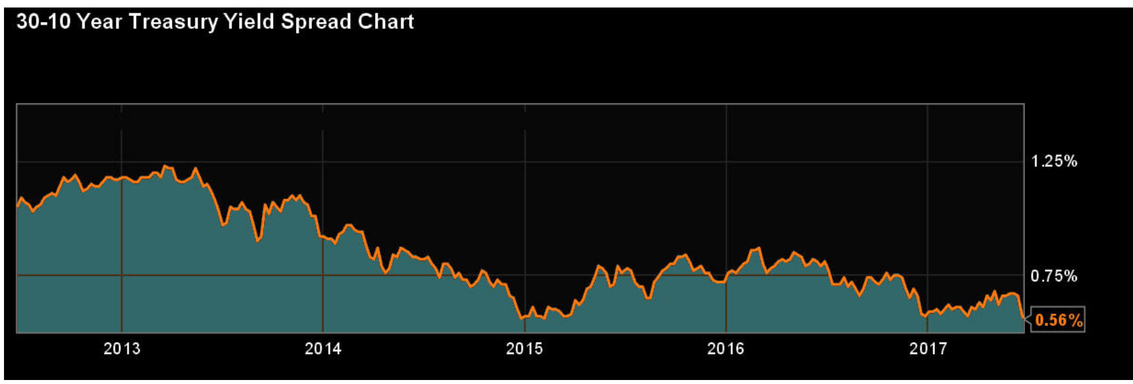
Index	YTD
Barclays Aggregate	2.9%
Barclays Global Aggregate	4.5%
Barclays U.S. High Yield Constrained	4.5%
Barclays U.S. Treasury	4.7%
Barclays TIPS	3.4%
Ryan 10-yr Treasury	1.8%
Ryan 30-yr Treasury	3.9%
A Rated Bonds (S&P)	9.2%
BBB Rated Bonds (S&P)	3.8%
BB Rated Bonds (S&P)	4.9%
CCC Rated Bonds (S&P)	4.8%
J.P. Morgan Emerging Market Bond	4.9%
Lipper High Yield Funds Average	6.8%
Lipper Corporate Rated Funds Average	4.5%
Europe High Yield	4.3%
Merrill Muni	3.9%

The Chicago Fed's National Activity index released yesterday morning showed a negative 0.26 figure in May, from an upwardly revised 0.57 reading in April. The May reading is the lowest since this past January, when a matching 0.26 was posted. The Chicago Fed index's three-month moving average shows poor economic growth, with a reading of negative 0.08 in May. Orders for durable goods were also released by the Commerce Department. Durable goods, or goods meant to last at least three years fell by 1.1% in May. This was the second straight monthly decline as well as the most in over eighteen months. Orders for capital goods fell by 0.2% in May.

Last week offered mixed data with the Kansas City Fed Regional Manufacturing Data coming in good measure. However, the Chemical Activity Barometer, which is produced by the American Chemistry Council, was flat in June. The barometer was up in both prior months. Obviously, despite mixed data over the past two months, many of the key economic reports have been below par.



Source: YCharts

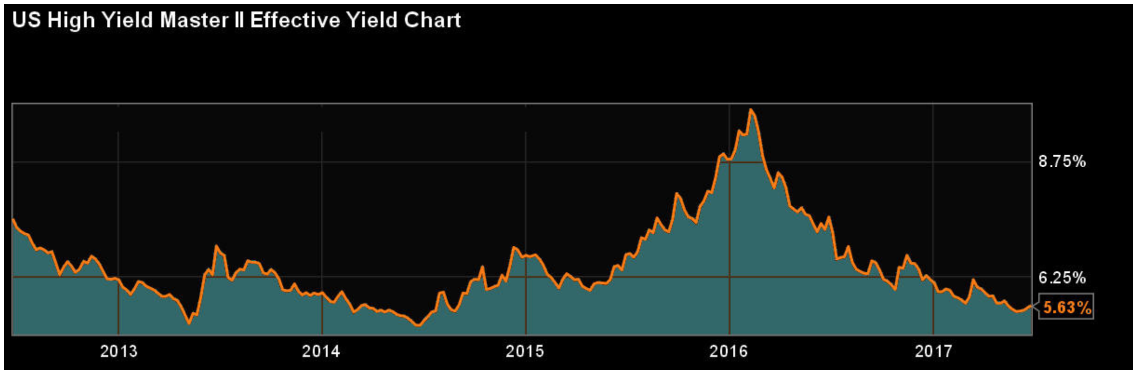
The latest popular GDPNow model from the Atlanta Fed is forecasting real GDP growth in Q2 of 2.9 percent. This is unchanged from June 16th. The next update is for June 30th, and this number may well come down again. The number has dropped a full percentage point in the last 30 days. We still think the forecasts are too ebullient. The bond market continues to believe that future growth will not be in the 3% range anytime soon for any extended period. The chart above presents the 30-10 Treasury Yield curve spread, which is now at a mere 0.57%. Obviously, bond market participants don't believe the projections by many economists of robust economic growth. Each week seems to provide new evidence that the economy has yet to reaccelerate.

In our last letter, we also focused upon poor reports from the MNI Chicago Business Barometer and the Pending Home Sales Index. Weak data combined with angst in concern to passing tax reform has resulted in the long-term Treasury securities ETF (TLT) running up from $119 to $128 since the beginning of the year. We feel at this point, bonds have run too far. One the key elements to the bond market is sentiment. Sentiment on bonds is now reaching extremes. The bond Daily Sentiment Index (DSI) moved over 80% this week. This reading is well into froth territory. Now that most participants believe that yields will fall further and that bonds will continue to rally, our team feels that it is more prudent to take a contrarian view.

The PVG Flexible Corporate Bond portfolio seeks a high monthly income, viable total return, as well as protection from turbulent financial markets. It is suitable for income oriented investors, who also seek appreciation, but are uncomfortable with substantial bond market risks.

Research is also focused on broader macroeconomic risks, including credit and interest rate risks. The issues within the portfolio will consist primarily of A, BBB, and BB rated corporate bonds that the portfolio manager believes are undervalued. Additional assets such as Treasury securities may be added to mitigate risk and to take advantage of interest rate trends.

We think with the large move up in Treasury bonds in the first half of 2017, bond yields have reached oversold levels. This does not mean that we think the economy will suddenly reaccelerate, but that the soft economic data is already priced into this market.



Source: Ycharts

Corporate bonds have also rallied strongly in 2017. The Barclays Credit index is now up just over 4.5% year-to-date. Higher yielding bonds, as measured by the Merrill Lynch High Yield Constrained index, have advanced by 4.75%. This is just slightly above their higher credit brethren. Much of this is due to the stark rise in lower rated CCC bonds last year. At present, the effective yield of the high yield market (*see chart*) is now at 5.63%, near the lows set in mid-2014. We feel there is little opportunity in the lower rated category still with these trifling yields.

The corporate bond markets have been very tame this year, with volatility far below that of 2016. Much of this is due to stability of the energy sector. Last year energy sector bonds were bludgeoned. Many investment grade energy bonds fell by 20% or more in price. This year these bonds have been stable and lower rated bonds have held steady in price. Credit spreads on some energy bonds have widened due to the fall in crude from $52 to $43 a barrel. Some retail bonds have also suffered due to the calamity in the sector. But overall, credit spreads have not widened and overall conditions look solid.

Outflows in exchange-traded and mutual funds declined for the fourth consecutive week in the high yield category. Many investors have cashed in their chips as just over $4 billion has been pulled from the category. One item that caught our attention recently was that $92 million was pulled from the SPDR Barclays High Yield Bond ETF (JNK) in the past seven days. With high yield bonds offering low historical yields, we are favoring investment grade securities. We anticipate that bond yields will either stagnate here at the 2%+ level or move back up towards 2.4% as bond sentiment on the long-side is very frothy.

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