PVG Asset Management - Bond Market Commentary

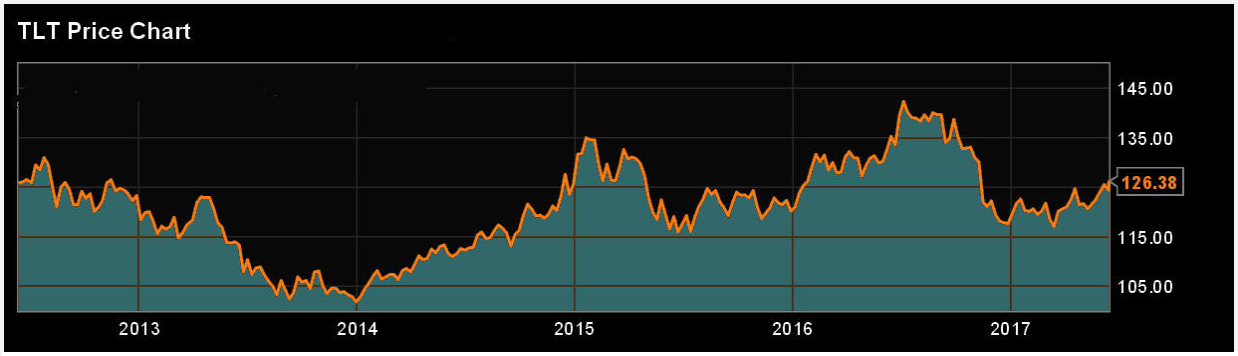
Timothy J. McIntosh, Corporate Bond Portfolio Manager – June 15, 2017

Index	YTD
Barclays Aggregate	2.7%
Barclays Global Aggregate	4.5%
Barclays U.S. Municipal	4.0%
Barclays U.S. Corporate	4.2%
Barclays U.S. Corporate High Yield	5.1%
Barclays U.S. Treasury	2.4%
Barclays TIPS	1.8%
Ryan 10-yr Treasury	3.8%
Ryan 30-yr Treasury	7.2%
A Rated Bonds (S&P)	3.3%
BBB Rated Bonds (S&P)	4.0%
BB Rated Bonds (S&P)	5.1%
CCC Rated Bonds (S&P)	6.0%
Lipper High Yield Funds Average	5.1%
Lipper Corporate Rated Funds Average	3.7%
Europe High Yield	3.7%

The PVG Flexible Corporate Bond portfolio *seeks a high monthly income, viable total return, as well as protection from turbulent financial markets.*

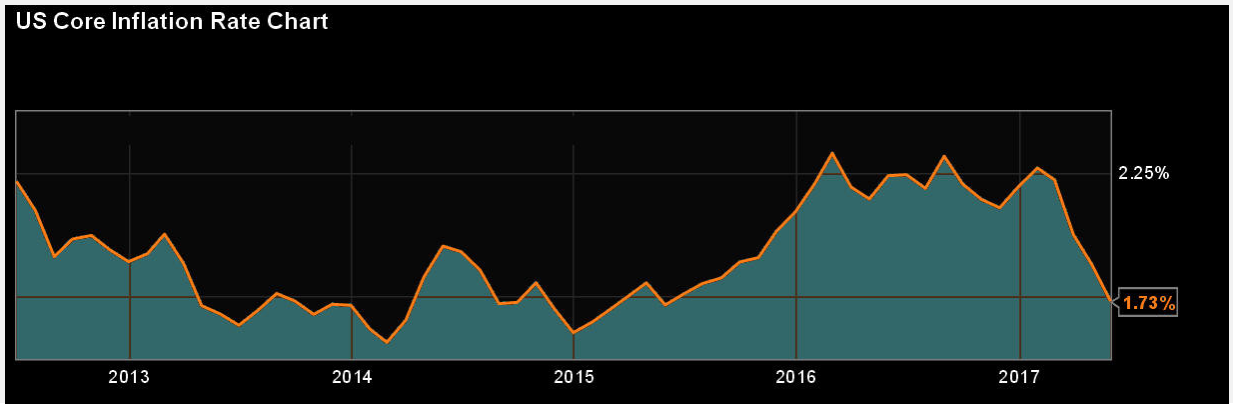
According to the Commerce Department report yesterday, May's retail sales numbers were low-grade, dropping by 0.3% in May. Core CPI advanced just 0.1% in May verses +0.2% expected. Core CPI has now declined for a fourth straight month. The weak news was slightly offset by upward revisions to both the March and April Core CPI figures. These revisions indicate that preceding gains were stronger than expected which increased the three-month annualized growth rate up just a touch.

The latest negative data point on retail sales joins a growing chorus of unconstructive news. We outlined in our last commentary the poor readings in the MNI Chicago Business Barometer and the negative figures on home sales in April. We also noted that the vital Pending Home Sales Index also dropped by over 1% and was down a stark 3.3% from last year's reading. This data has supported our case that from the beginning of the year that the economy is on a much weaker standing than most economists believe. Due to our negative outlook on growth, we initiated a small position in January in long-term Treasury bonds as we felt the odds of a quick legislation growth package passage was low; while economic reports continued to be feeble.



Source: YCharts

Since the beginning of the year, the best measure of long-term Treasury securities (TLT) has risen from $119.13 to $126.50, or over 6.5% return with interest. With retail sales stuck and core CPI decelerating, the Federal Reserve is in quite a hot spot in our view. Many believed that the slow first quarter was just a typical reading and the Fed would be ready to move quickly by June as GDP growth accelerated. However, the slowdown in various economic figures has continued into the late spring.



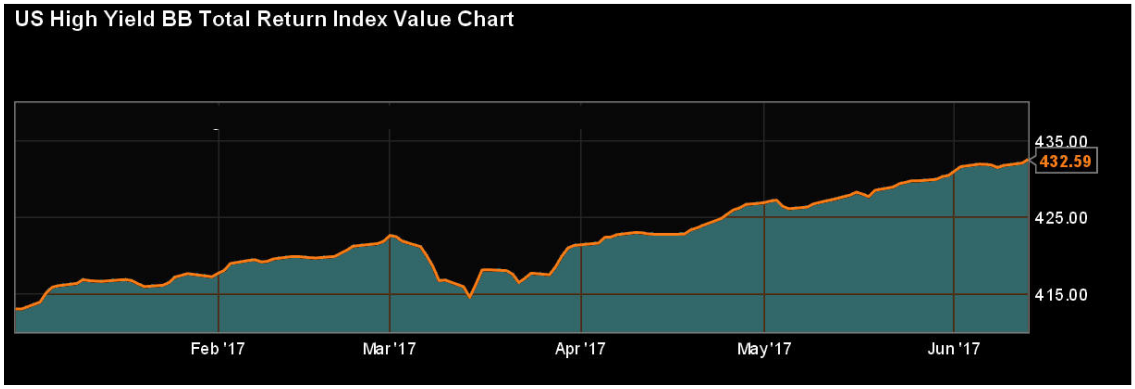
Source: YCharts

The PVG Flexible Corporate Bond portfolio *is suitable for income oriented investors who seek appreciation, but are uncomfortable with substantial bond market risks.*

Research is primarily focused on broad macro-economic data and credit and interest rate risk. 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 and interest rate hedges may be added to mitigate risk and to take advantage of interest rate trends.

Along with the CPI data release, The Federal Reserve approved its second rate hike of 2017 yesterday. The Fed also provided enhanced information on how it will ultimately unwind its very large balance sheet of $4.5 trillion. The new range for Federal Funds will be 1 to 1.25%. Chairman Yellen indicated that inflation is well below its 2 percent target, especially given the latest data. We felt the testimony was a bit on the "hawkish" side as the Fed remarked it will continue on its stated path of three interest rate increases along with initiating the process of reducing its balance sheet at year-end. We think with softer data and a flattening 2-10 yield curve, this policy is overly ambitious. The 2-year Treasury note now yields 1.34%, the highest yield since November 2008 while the 10-year Treasury bond remains at the lows of the year at 2.15%. Flatter yield curves are not good signs of a healthy economy.

As for corporate bonds, yield spreads continued lower in the first two weeks of June. The highest quality non-investment grade bonds rated BB saw the average yield drop to 4.13%, a ten basis point drop from the end of May. Meanwhile, AA rated bonds now have an average effective yield of 2.66%, 3 basis points above that of two weeks ago. Thus there is a continued flattening of yields between investment grade and high yield bonds. We are finding less and less value among those bonds rated BB and below as the price rise has escalated since the beginning of the year (*see chart*). Investors seem to agree as much more money poured into investment grade bonds than high yield. According to Lipper, corporate investment-grade bond funds had large net inflows of $2.6 billion the week ending June 6th. Corporate high-yield funds saw a mere $255 million of inflows, substantially less than their investment grade counterparts.



Source: YCharts

We are now positioned more defensively, reducing our stake in both BB and B rated corporate bonds. We have increased our exposure to single A rated bonds. We are maintaining our small position in long-term Treasury bonds as we expect yields to fall further towards two percent. At that point, we feel the risks will be balanced. We are concerned that any positive news before August concerning the passing of tax cuts or repatriation could send Treasury yields back upwards towards 2.5%.

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