PVG Asset Management - Bond Market Bi-Weekly

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Index	YTD
Barclays Aggregate	2.3%
Barclays Global Aggregate	4.5%
Barclays High Yield 2%	4.7%
Barclays U.S. Corporate	3.4%
Barclays U.S. Corporate High Yield	4.7%
Barclays U.S. Treasury	2.4%
Barclays TIPS	1.8%
Ryan 10-yr Treasury	3.0%
Ryan 30-yr Treasury	5.3%
A Rated Bonds (S&P)	2.8%
BBB Rated Bonds (S&P)	3.4%
BB Rated Bonds (S&P)	4.3%
CCC Rated Bonds (S&P)	4.5%
J.P. Morgan Emerging Market Bond	6.6%
Lipper High Yield Funds Average	4.8%
Lipper Corporate Rated Funds Average	3.1%
Europe High Yield	3.7%
Merrill Muni	3.4%

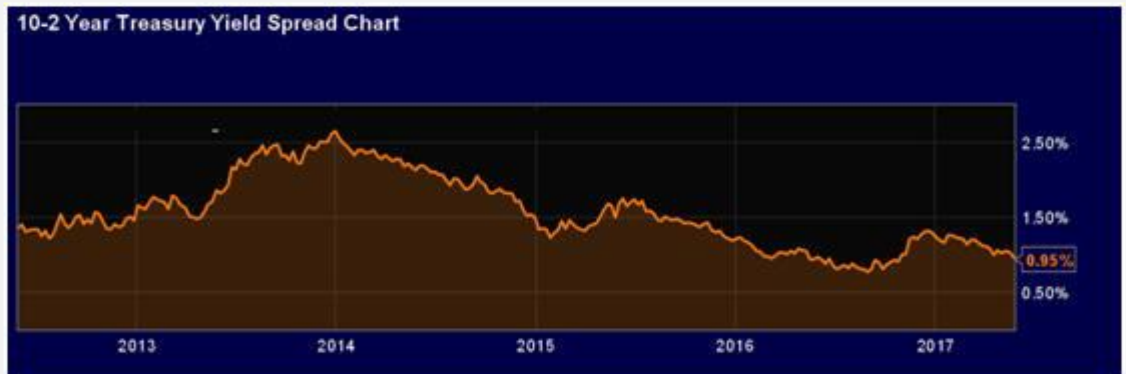
Treasury yields, as measured by the 10-year Treasury, were steady in the past week at 2.25% through June 1st. This is well below the 2.42% yield set on May 9th. Yields have collapsed from 2.62% on December 15th of last year. This is no surprise to our team as we thought rates would peak around the 2.6 level as data throughout early 2017 would remain weak. The Trump agenda, we felt, would take months to sail through Congress. With the additional uncertainty of the Russian allegations, it has put further pressure on getting bills through Washington before the August recess.

Since the election, economic data has been notably mixed while the planned tax cuts have been pushed out into late 2017, at best. The May Fed meeting minutes that were recently released indicated a continued "*modestly dovish*" stance. Weaker than expected first quarter growth, the Fed indicated, was most "*likely to be transitory*." Although first quarter GDP growth was revised upwards to a 1.2% annual rate instead of the 0.7% speed reported last month, it was the poorest performance since the first quarter of 2016.

Q1 growth in consumer spending (*two-thirds of U.S. economic activity*), climbed at a 0.6% rate. This was the slowest march upwards ever since the fourth quarter of 2009. This past week's release of the MNI Chicago Business Barometer decreased to 55.2 in May from 58.3 in April. This is the poorest reading since January. Optimism among companies regarding business conditions dropped for the first time in four months as well. Order Backlogs noticeably accelerated. Home sales in April dropped for the second successive month and are down year-over-year on a nationwide basis, according to the National Association of Realtors®. The Pending Home Sales Index, the key forward-looking meter based upon contract signings, fell 1.3%. Remarkably, the index is 3.3% below last year's reading.

The bond market is also picking up the weaker-than-expected inflation intelligence. The annual pace of the personal consumption expenditures (PCE) price index dropped to 1.7% in April from 1.9% in the preceding month. The Core PCE reading, which excludes food and energy, maintained a 1.5% year-over-year increase. This was the lowest since February of last year. Although the odds are still high for an interest rate hike in July, our Federal Reserve committee should be highly concerned with the recent weakness.

Source: Ycharts



In our opinion, hiking rates into weakening data and a flattening yield curve (*see chart above*) is never a good idea. The fact is despite the rhetoric of magical 3-4% GDP

growth on the horizon, bond market purchasers do not believe the hype. The yield curve topped out in early 2014 and it has been a straight line downwards ever since. It is now well under 1%. Why is the yield curve flattening when economic growth from the Trump agenda supposed to accelerate? Disbelief. With yields falling and the yield curve flattening, it indicates that bond market participants know this expansion is long in the tooth and that any growth package coming out of Congress will take both significant time and effort.

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

Investment and non-investment-grade corporate bonds, our specialties, have held up well this year. According to data from Standard & Poor's', investment-grade corporate bonds have generated a 3.4% year-to-date total return. High yield bonds have offered investors a 4.7% year-to-date return. Strong fund flows continue in 2017 in both nvestment-grade and high yield bond funds. According to Lipper, investment-grade corporate bonds saw $2.7 billion in in-flows for the week ended May 10. High yield in-flows came in at just over $1.7 billion. According to S&P Global Ratings, investment-grade composite spreads held steady at 161 basis points (bps) over U.S. Treasury bonds. For high yield, the spread remains at 428 bps. In scanning by individual rating, the AA rated bonds have a spread at 101 bps. The A spread expanded by one basis point in the week to 135 bps. The BBB spread held steady at 191 bps. In the non-investment grade category, BB spreads went up by two basis points to 302.

High yield bonds have been the best performing asset class since 2016. Last year, CCC-rated bonds by S&P returned an astounding 35.2% last year and 4.5% through the end of May. A- rated bonds returned a mere 2.4% in 2016 and are up 2.4% year-to-date. This has resulted in yield spreads collapsing sharply in the past eighteen months for the entire category. In the chart above, BB rated bonds now have an effective yield on average of 4.22%, a near 250 basis point drop since early 2016. The spread over U.S. Treasuries for the category is now about 2.45%, versus 4.2% at the end of 2015. In general, BB bonds will trade at a 3.5% premium above U.S. government bonds. CCC-

advantage of interest rate trends.

rated bonds are now trading at a mere 6.8% premium over U.S. government bonds, far below the average 10.1%.

Our supposition is higher yielding; lower-rated bonds are now trading at frothy valuations. We view investment grade securities to offer better value and risk protection. We have positioned our corporate portfolio more towards higher rated A and BBB rated bonds, and are maintaining a small position in long-term Treasury bonds as we expect interest rates to fall further towards 2%.

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