CONGRESS ASSET MANAGEMENT COMPANY

Fixed Income Outlook

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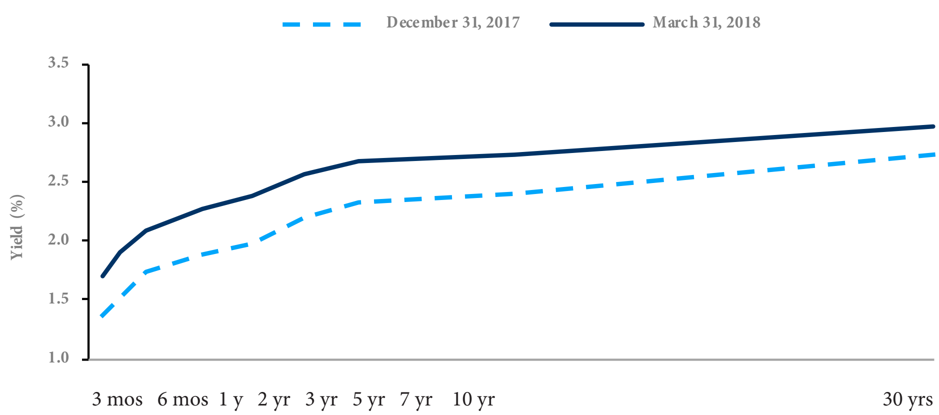
Second Quarter 2018

The U.S. Treasury yield curve shifted up during the first quarter of 2018, yet the curve remains remarkably flat. A single Fed Funds rate hike helped to push up the short end while investors moved the long end upwards with a healthy dose of newfound volatility. The flatness of the curve reflects the market's expectation of continued low inflation readings while the shift upwards is an acknowledgement that the Federal Open Market Committee (FOMC) is intent on raising interest rates multiple times in 2018.

U.S. Treasury Yield Curve



Source: Bloomberg Barclays

The flat shape of the curve stems from a disconnect between forecast inflation and measured inflation. Any acceleration in inflation data would markedly move the long end up. Instead, a recent Core PCE deflator reading of 1.6% and a Core GDP deflator reading of 1.5% reveal tepid inflation levels and keeps the long end down. At the same time, the FOMC's predictions of future inflation has the committee raising the Fed Funds rate preemptively, inviting higher short-term yields. These two counteracting views are the main drivers that are keeping the curve flat today.

Overall, the U.S. economy is performing modestly well as GDP was reported at 2.9% for the fourth quarter of last year. Unemployment remains steadfastly low at 4.1% and the broader "underemployment" rate, one that includes part-time workers seeking full-time jobs as well as unemployed workers, fell to a paltry 8.0% in March. By these two measures alone the economy is in good shape before one even considers growing wage reports, a rebounding housing market, and strong durable goods figures.

The stock market started the year off in positive territory but then fell as the calendar moved into the second half of the quarter. Despite positive economic data points, the market was responding to geopolitical concerns emanating from North Korea, Russia, and Washington D.C. The pressures of nuclear weapons, a new cold war, and tariff threats made for choppy going, particularly in March.

Fixed income investors, like equity investors, saw declining returns in the first quarter as yields rose across the curve. Unlike the equity market, the bond market trailed in January and February only to recover in March. Markets were focused on not only inflation data and rate hikes but also on uncertainty over the new FOMC chairman, Jerome Powell. Investors showed some doubt as to whether he would continue the hawkish tone set by outgoing chair Janet Yellen. Ultimately, Powell seems prepared to follow the path laid out by his predecessor, hinting in recent speaking engagement remarks that investors can expect three hikes in calendar 2018.

U.S. Government guaranteed issues outperformed corporate bonds in the first quarter. Corporates, which has previously been a seemingly perennial winner, traded off and trailed in performance. Lower-quality issues were generally worse off than higher-quality issues within the investment grade space. This reversal from the previous strong trend in performance was driven less by default concerns and more by investors reallocating to other assets.

The first quarter witnessed our first portfolio allocation strategy change in many years. Our Fixed Income Investment Policy Committee, which oversees our strategies, decided to de-emphasize corporate bonds in our portfolio allocations. The committee deemed that credit spreads, the additional yield investors require to compensate for default risk, were no longer appealing when compared to U.S. Government issues. We expect this change to be incorporated in our clients' portfolios as the year progresses.

We continue to believe that our clients are best served by holding high-quality, investment-grade bonds in their portfolios. Despite the low level of interest rates we do not believe that this is an opportune time to "re-risk" by purchasing low-quality assets to try and reach for higher yields. Our strategic goal remains the construction of portfolios that provide liquidity, carry high-quality ratings, and favor principal protection.

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