Loss avoidance is a key to long term investment success. We deem certain risks profitable, to be exploited with sound research, while other risks are inherently unprofitable and should be avoided.

Our Risk Management Tenets

- A rigorous top-down approach to forecasting liquidity conditions is an essential ingredient in fixed-income risk management
- Active management of interest rate risk within modest limits is a cornerstone of successful fixed income portfolio management
- Extreme variation from benchmark duration is counter-productive
- Yield curve, sector positioning and careful employment of credit risk offer attractive cyclical opportunities to add relative value
- Opportunistic and modest employment of high yield and international debt elements can add significant value to a core investment grade mandate

Monetary Policy and Liquidity Conditions

The Fed’s Federal Open Market Committee (“FOMC”) raised the Fed Funds rate 25 basis points (bp) on June 14 to a 1.00-1.25% range, the second 25 bp increase this year, following the March FOMC meeting; and the third since last December. That makes +75 bp since December and +100 bp since the Fed’s first increase this cycle in December 2015. The Fed took a year off from the normalization cycle last year due to sluggish global economic conditions, particularly in the U.S.; but has been doubling down since November with the tail-wind of high hopes in the markets for better growth policies from the Trump Administration.

Those growth expectations have faded some lately, as the U.S. economy appears to have hit yet another soft patch; and as the mostly self-inflicted political distractions have pushed the Trump growth agenda aside. The political arena is extremely polarized and the loyal opposition has adopted an obstructionist front that is not conducive to a functioning democracy producing major legislation such as tax reform. Nevertheless, the U.S. economy appears to be in at least minimally decent shape and global conditions are slowly improving. Serious cabinet secretaries at Treasury and Commerce, among others, are busy rolling back the regulatory over-reach that stifled growth in recent years.

Aside from a few isolated instances of market stress, e.g., signs of peak dynamics in auto sales and multi-family housing, and rising property taxes in some locales as a result of swollen unfunded municipal pension liabilities; there are few signs of brewing systemic stress that could destabilize the markets and/or the U.S. economy. With the U.S. approaching full employment conditions and household balance sheets largely restored to health from persistent consumer frugality in recent years, the economy should continue to benefit from at least modest consumption and capital spending. Our expectation is that the FOMC will continue to pursue the normalization agenda and achieve most if not all of the projected additional +100 bp in the Fed Funds rate by December 2018.

Our assessment is that the Fed’s projection of its intention to raise the Fed Funds rate to 2.0-2.5% over the next couple of years is a relatively benign outlook. A 2.0% Fed Funds rate would still be relatively low compared to inflation trends, which have been running a little under 2.0%; to be precise 1.7% over the last 12 months through April, and 1.5% apart from the volatile food and energy components; both measures drifting lower in recent months. The Fed projects that inflation trends will firm up to 2.0% or so in the year ahead, based on the relatively full utilization of labor and production resources in the U.S. economy, which we concur is a reasonable expectation. If the Fed Funds rate and inflation...
CURRENT RISK ASSESSMENTS

- Duration strategies modestly short vs. intermediate benchmarks

**ATTRACTION SECTORS:**
- 5-7 Yr Treasuries for optimum roll-down returns
- Investment grade Finance credits
- Super-senior commercial mortgage-backed securities
- High quality Municipals with no pension funding challenges

**UNATTRACTION SECTORS:**
- Modestly defensive within Investment Grade credit, tilted to higher quality
- Emerging Market credit
- Developed Market credit exposure
- High Yield corporate bonds

are both in the vicinity of 2.0% a year or two out, the resultant inflation-adjusted, or real, Fed Funds rate would be zero. Historically a zero real Fed Funds rate would not qualify as threatening to liquidity conditions or potentially destabilizing to economic activity. In 2007 for example, the real Fed Funds rate exceeded 3.0% before the tight money policy began to bite and derailed the economy.

This cycle has been highly unusual, mainly related to the extensive asset value destruction that occurred in the crash in 2008 and the widespread deleveraging that has followed in its wake. One of the key benchmarks for whether the Fed Funds rate reflects easy or tight liquidity conditions is the so-called equilibrium Funds rate, for which there is no conventional formulation but which 300 economists at the Fed work hard to estimate. Fed Chair Janet Yellen has referenced the equilibrium rate estimates several times in post-FOMC press conferences in the last year, in the context of communicating to the markets her view that the equilibrium Funds rate has declined precipitously in this historically sluggish economic recovery, and that normalization will only result in moving the Fed Funds rate up to approximate the equilibrium rate, neither easy nor tight conditions. She is essentially communicating that a zero real Fed Funds rate is approximately the equilibrium rate. We are inclined to agree.

Nevertheless, we continue to monitor signals that the equilibrium rate may be lower than that estimated at the Fed and that liquidity conditions may be tighter than generally assumed. The essential ingredients of that scenario are that the Fed has raised the Fed Funds rate 100 bp in the last 18 months, the Dollar is strong and imparting deflationary pressures, market-based measures of inflation expectations have been declining since February; and, while 2-year Treasury yields have also risen 100 bp along with the Fed Funds rate, longer Treasury yields have declined about 50 bp since March, reflecting a substantial flattening of the Treasury yield curve. This case is inconclusive at this point, however our sanguine outlook for the year ahead is accompanied by continued vigilance and attention to our observations that the economic cycle is displaying a variety of signals of a maturing economy and peak behavior in several micro contexts.

**Federal Open Market Committee projections for the Fed Funds Rate:**

![Image of Federal Open Market Committee projections for the Fed Funds Rate]

INTEREST RATE OUTLOOK AND DURATION STRATEGY

The shorter duration segments of the maturity spectrum have incorporated the FOMC’s Fed Funds projection to a significant extent. The 2-year Treasury yield today of 1.35% implies a Fed Funds rate 2 years out in a range around 1.85%, shy of the FOMC’s projection of 2.50% by mid-year 2019, but pricing in several additional rate increases in the next year. Accordingly, we are positioning short duration strategies at 105% of benchmark duration.

Our expectation for intermediate and longer term yields is more neutral, and our view is that 10-year Treasury yields are at the lower end of an expected 2.0-3.0% trading range over the next year, today at 2.30%. Consequently, intermediate and longer taxable and tax-exempt strategies are targeted at 95% of benchmark duration.

U.S. TREASURY AND AGENCY BONDS

Treasury returns have been strong through the first half of this year, as yields on longer maturity bonds could not hold their elevated post-election levels. The six-month non-annualized return on the Barclays U.S. Treasury Index was 1.87%. 30-yr. Treasuries have returned 5.61% this year. Despite the ongoing gradual pace of increases to the Fed Funds rate, which implicitly signals that the Fed views the economy as being on course, investors have gradually grown less optimistic regarding the potential for a near-term lift to economic growth. The pro-growth, anti-regulatory Trump agenda seems to be hopelessly entangled in the political machinery, and has mostly been priced out of intermediate to long bond yields. The Federal Reserve Bank, while cautious, seems eager to reach a point where it can hand off the policy baton and move ahead with balance sheet reduction. The Fed’s schedule for allowing Treasury bonds to mature and not be reinvested should not be terribly disruptive in its initial stages. The timing for when that process begins remains an unknown, though it is expected before year end. Based on the evolution of the economy, there will be adequate opportunities to recalibrate the process to avoid creating restrictive monetary conditions. In the absence of a pronounced improvement in the inflation outlook, upside risks to longer rates include the potential for Treasury issuance of long bonds (+50yrs), a faster recovery in the Euro area, which accelerates an end to QE, or a swift rebound in oil prices. Any positive momentum on the political front regarding taxes, health care, or infrastructure could also produce upside momentum. Downside risks to Treasury yields include a continued decline in the price of oil, which would likely produce credit market stress (selling). Also, if history is a guide, a chaotic debt ceiling debate/government shutdown episode could spook the market and induce a flight to quality rally. Longer term inflation expectations are unlikely to fall significantly at this juncture, so any further decline in 10-yr. Treasury yields will present a better selling opportunity, rather than buying opportunity. The ideal spot along the yield curve to pick up duration is the 5 to 7 yr. maturity range, where yields remain a bit higher and are not factoring in the
possibility that the Fed Funds normalization process could take longer than the Fed currently envisions. A slightly overweight allocation to Government bonds (including U.S. Agency debt) is appropriate.

AGENCY MORTGAGE BACKED SECURITIES (MBS)  
Gilbert Braunig, CFA®  
Senior Portfolio Manager

Over the past few months, spreads on MBS have been gradually increasing, as risk in the market has picked up slightly. Home price appreciation continues to churn higher, as inventory levels, particularly for existing homes, remain quite low relative to demand. Mortgage rates have fallen, helping to keep affordability in check. Investors are growing increasingly interested in how quickly and smoothly the Fed can extricate itself from the mortgage market, which has prompted some anticipatory selling in the sector. In spite of wider OAS spreads presenting more attractive yields, we judge that it’s no longer preferable to be overweight MBS and are returning to a neutral weighting to the sector. A continuation of the curve flattening we’ve recently experienced seems to be the most likely trend for the Treasury curve. In that environment, we anticipate that MBS will underperform, though we still like the safety/liquidity of the sector, particularly in relation to more expensive corporate bonds. With the rollout of balance sheet reduction tentatively scheduled for later this year, spreads seem at risk of widening further. Perhaps that’s already priced in, but in general the Fed’s involvement in the MBS market is greater than for Treasuries on a percentage of outstanding bonds basis, so the potential for disruption seems higher. For the most part 30 year MBS have outperformed 15 year MBS this year. In contrast with our recent preferences, today we view 15 year MBS slightly more positively given the flatter yield curve. Swaps from 30-yr. 3% coupons to 15-yr. 2.5% coupons make sense here. Additionally, call protection stories, which produce more stable average life/cash flow forecasts and are priced at a premium, should be looked at as sell candidates in this environment.

CORPORATE BONDS: INVESTMENT GRADE AND HIGH YIELD  
Ronald MacWillie  
Portfolio Manager

Corporate bond returns once again outpaced the broader market this quarter. The reach for yield was evident as lower-rated issues outperformed higher-rated issues again. Year-to-date investment grade issuance through June 26 set a record, and issuance of BBB-rated bonds significantly exceeded that of A-rated bonds. Investment grade issuer leverage declined from the prior quarter, but remains at a high level typically associated with an earnings trough. This implies that leverage ratios could rise to unprecedented levels if a recession occurred. Investment grade credit spreads as measured by the Bloomberg Barclays U.S. Intermediate Credit Index are at a historically tight level of 82 bp over comparable duration Treasuries. All of the above are evidence that investors are complacent regarding credit risk and are willing to accept increasingly lower quality, higher risk bonds at lower yields. We continue to have an underweight allocation to investment grade credit within our portfolios. Presently there is
nothing stopping spreads from continuing to tighten, but we believe the market lacks value and offers a poor risk-return opportunity.

High yield bonds are the best performers of the year, due primarily to the higher coupons they sport in comparison with investment grade bonds, but also on account of moderate spread tightening. The decline in oil prices from ~$53 on March 8 of this year to approximately ~$48 on March 14 has been cited as the driving factor in the high yield sell-off that occurred in March. Reviewing the high yield technicals in March, we note that a confluence of negative factors, including the highest monthly issuance and highest monthly investor outflows in twelve months, played a meaningful role in the short term sell-off.

The sector is once again being tested, as oil prices have fallen further and are now in a bear market. Thus far the technicals have been more supportive of high yield prices. High yield issuance in the second quarter was down substantially both consecutively and from the same quarter last year. There are some signs that investors potentially are becoming more cautious, which we view as a healthy development. Demand has slowed late in June, and new issue prices have been weakening as investors are more frequently demanding price concessions from issuers. Absent a strong reversal in these factors, high yield spreads are biased for some additional widening. In any case, we believe that valuation in the high yield market is stretched. We currently maintain no allocation to high yield credit, preferring to wait patiently to see blood in the streets before buying.

MUNICIPAL BONDS

Intermediate maturity municipal bond yields have declined 0.35%, outpacing the decline in intermediate Treasury rates thus far in 2017. Municipals are now expensive in both relative and absolute terms. Low supply, high demand, record maturities and reduced prospects for lower tax rates have conspired to richen valuations. During the second quarter of 2017, intermediate municipals provided the best risk-adjusted returns in the investment grade fixed income universe (below table). Though no action has been taken yet, we are prepared to reduce our interest rate risk (average portfolio maturity) if municipals become just slightly more expensive or if the fundamental outlook tilts more negatively.

| 6/30/17, Risk Adjusted Returns: Sectors Ranked by Return per Unit of Duration |
|-----------------------------|----------------|---------------|--------|--------|---------|---------|
| YTD                        | QTD             | 1 YR           | RPUD   | Dur    |
| Muni 1-10 Yr               | 2.58%           | 1.50%          | 1.81%  | 0.72%  | 3.6     |
| IG Corp 1-10 Yr            | 2.77%           | 1.50%          | 1.81%  | 0.65%  | 4.2     |
| Mortgage Backed            | 1.37%           | 0.90%          | -0.03% | 0.36%  | 3.8     |
| Treasury 1-10 Yr           | 1.46%           | 0.62%          | -1.25% | 0.30%  | 3.8     |

Source: Bloomberg & Bank of America Merrill Lynch Indices

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Full municipal valuations, predicated on strong demand, should encourage an increase in municipal issuance in the coming months, creating more supply for the market to digest. An improvement in the prospect for lower personal tax rates is possible, which could reduce the tax advantages of owning municipals. A shift toward less accommodation by central banks both domestically and abroad is probable, which could push both taxable and tax-exempt yields higher. Finally, the sustained creation of net new U.S. jobs at levels sufficient to pull people back into the labor force is likely and should push economic growth and inflation marginally higher. These are a few of the factors we are watching that may signal a correction in municipal bond prices is imminent. So far, these risks do not seem to be priced into the municipal market. Based on our assessment of valuation and risk, we anticipate that the municipal market will experience a period of weakness at some point during the second half of 2017 and we plan to respond accordingly.

In 2017, our municipal strategy has been to focus on the short part of the yield curve, prioritize higher credit quality issuers, and position duration just slightly short of tax-exempt benchmarks. The strategy has allowed us to achieve near market like returns with less credit and interest rate risk than the broader market. However, at this point the excess returns produced by short-term municipals have almost certainly run their course. In this environment, we have been reducing short municipal exposure and substituting short term corporates bonds. We have been able to add short corporate bonds at yields that are nearly 2 times the yield provided by short term municipal bonds, which more than makes up for the lack of tax advantage.

INTERNATIONAL BONDS: NON-U.S. DEVELOPED AND EMERGING MARKET DEBT

Emerging (EM) and Developed Market (DM) fixed income experienced solid 2nd quarter returns. EM sovereign and credit market excess returns were driven by local currency appreciation. During the quarter, local currency based EM fixed income returned 2.55%, a 1.10% advantage over the broad U.S. investment grade fixed income market. U.S. Dollar-denominated EM credit spreads tightened enough to provide roughly 0.30% of excess return relative to U.S. investment grade fixed income. However, EM corporate debt provides scant compensation relative to EM sovereign debt (below chart), so we are not keen on EM corporate credit.

Source: Bloomberg, June 30, 2017
Going forward we expect that EM currency strengthening can continue to contribute positively to performance. Compared with our recent outlook, we are more willing to consider taking a position in local currency sovereign EM bonds, if we observe a good entry point. At the moment, however, we are maintaining our 0% tactical allocation to EM fixed income.

In contrast to local currency sovereign EM debt, the prospects for non-U.S. DM fixed income returns remain bleak. Prior to when the Federal Reserve Bank began purchasing long-term Treasuries in 2011 (Operation Twist) and the start of the European Central Bank’s (ECB) Quantitative Easing program in the first quarter of 2015, 10-yr. German Bunds typically had yields that were very close to those of U.S. 10-yr. Treasuries (below chart). Today 10-yr. German Bunds yield a whopping 1.85% less than 10-yr. U.S. Treasury bonds. As the ECB becomes less accommodative, German Bunds and other DM interest rates are expected to rise significantly more than U.S. interest rates, where the U.S. Fed is well underway in the process of normalizing interest rates to levels more appropriate in a post-recessionary environment.

During the 2nd quarter, non-U.S. developed market, government yields rose by roughly 0.10% and produced a total return of 2.34%. Almost the entirety of the asset class return was attributable to currency appreciation. Going forward, our view is that non-U.S. DM debt represents a currency play rather than a fixed income proposition. We have been absent from this sector for some time now, and will be steering clear of non-U.S. DM bonds for the foreseeable future.
Sector Yields are displayed as part duration-adjusted Treasury yield and part option-adjusted yield premium (credit spread) over Treasuries. Absolute yields and spread yields are also displayed as percentile ranks from the last ten years’ data. Spread ranks appear low to mid-range; however, absolute yields are very low. The very low level of absolute yields suggests further credit spread compression may be minimal. Finance spreads have narrowed relative to Industrials and Utilities, reflecting improved credit quality.

Current and historical yield and yield spreads across fixed income asset classes.

Source: Citi, Capital One Asset Management
*Percentile ranks based on historical period from 6/30/2007 to 6/30/2017
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This is only an opinion and not a prediction or promise of events to come.

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