Victory INCORE Investment Quality Bond Fund Quarterly Commentary

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As of September 30, 2018

Economic Perspective

A picturesque U.S. economy outweighed the global trade and geo-political risk (or headlines) that continued to linger over the financial markets. The Trump administration's efforts to put America first are straining relationships with our global trading partners. While an all-out global trade war appears less likely given the agreements reached with Mexico and Canada in the third quarter, the U.S.-Chinese trade relationship is deteriorating by the day. In addition to successfully renegotiating the NAFTA agreement, Washington indicated it would not impose auto tariffs on the EU or Japan while those negotiations are ongoing. Political tensions between Italy and the EU increased throughout the quarter, which if unresolved, could become problematic given the size of the Italian bond market. Finally, U.S. dollar strength continues to create headaches for some emerging markets. On the domestic front, the upcoming mid-term elections will have investors' attention in the fourth quarter. Should the elections result in a split House and Senate, the fiscal spigot likely slows to a trickle and we are back to gridlock in Washington until the next Presidential election. We've seen this movie many times and it generally has little impact on the economy and financial markets.

Despite the uncertainty generated by these events, risk assets posted solid returns. All three major U.S. equity indices returned in excess of seven percent for the quarter and fixed income indices squeaked out modest gains in the face of higher interest rates. Clearly investors have become somewhat numb (or complacent) to the theatre in Washington and the ever present political risk in Europe and emerging markets so long as the economic outlook at home remains favorable. To be sure, the fiscal stimulus and regulatory relief delivered to U.S corporations and consumers is having the desired impact on growth. This coupled with the transparent and thoughtful policy path of the Powell Fed has provided confidence to the markets that the near-term economic prospects for the U.S. remain positive.

Second quarter GDP growth came in at a robust 4.2%, the strongest level of growth since the third quarter of 2014. A sharp rebound in personal consumption (3.8%) in conjunction with solid contributions from business investment and net trade propelled the strong quarter. Virtually every corner of the U.S. economy looks healthy heading into the end of the year. With three quarters of 2018 in the books, payrolls are averaging monthly gains of 208,000 and the 3.7% unemployment rate sits at a 49-year low. Wage gains have remained tempered throughout this recovery, yet recent trends in the NFIB Compensation Plans index indicate stronger growth may be on the horizon. Furthermore, the services ISM index reached an all-time high in September while the manufacturing ISM index remains elevated as well, both signaling solid growth ahead. Personal consumption should be supported by the robust job market, modest levels of inflation and record level of consumer confidence. As the third quarter closed, the Atlanta Fed's GDPNow model was forecasting growth of 3.6% for the current quarter.

The Federal Open Market Committee (FOMC) executed their third rate hike of 2018 at the September policy meeting, consistent with their published forecast. Importantly, their updated 'dot plots' indicated that 12 of the 16 members were forecasting a fourth increase this year, an outcome many investors were skeptical of at the beginning of 2018. The committee also removed the 'accommodative' characterization of policy in the September release, yet Chairman Powell was quick to communicate that this did not signal a change on the policy path but rather an unknown as to where policy becomes restrictive in the current cycle. We've often said the neutral rate is a bit ambiguous and we believe this underscores that point. The committee continues to see three increases in 2019 and one in 2020, consistent with last quarter. Interestingly, their September forecast included the first look at 2021, which is flat to their view of 2020, implying the committee, on average, does not anticipate they will be in easing mode three years out. Their expectation that growth moderates back into the 2.0%-2.5% over the next couple years coupled with inflation hovering around their 2% target should allow them to remain on their gradual path of increases as advertised. The tightness of the labor market and potential for tariffs and/or stronger wage growth are worth closely monitoring as this could alter that outlook and the rate path. It's difficult to disagree with their view that the overall growth outlook remains favorable over the near-term.

Market Summary

While volatile over the last three months, interest rates continued their slow grind higher. Intermediate rates increased approximately 20 basis points (0.20%) while short rates were up closer to 30 basis points (0.30%), resulting in further flattening of the yield curve. The yield differential between 2-year and 10-year Treasury notes declined to 24 basis points at quarter end, remaining at lows not seen since 2007 when the yield curve was last inverted. In contrast to the previous quarter, credit spreads tightened in the face of higher interest rates helping to offset the negative impact higher rates have on the value of fixed income assets. The Bloomberg Barclays US Aggregate Index produced a total return of 0.02% for the quarter, which brings the year-to-date return to -1.60%. All primary sectors in the Aggregate Index generated positive excess returns relative to U.S. Treasuries while only Treasuries and agency mortgage-backed securities posted negative absolute returns. Corporate bonds led excess returns, most notably in the industrial sectors, as fundamentals continue to show stability given the economic strength and investors cheered the successful NAFTA renegotiation. Continuing the trend from the second quarter, high yield credit handily outperformed investment grade credit on an excess returns basis while also posting positive absolute returns year-to-date. Additionally, the securitized sectors, mortgage-backed, commercial mortgage-backed and asset-backed securities, all showed positive excess returns for the quarter led by CMBS. Year-to-date, CMBS is the top performing sector within the Aggregate Index on an excess returns basis.

The municipal bond market earned -.15% over the 3rd quarter bringing its year-to-date return to -.40%, according to the Bloomberg Barclays Municipal Bond Index.

In the absence of significant municipal market events over the quarter, munis followed the lead of the Treasury market to higher rates and a flatter yield curve. The 2- to 10-year municipal yield curve ended the quarter at 61 basis points, and while that is steeper than the lows seen at the end of 2017, the curve is very close to the flattest is been since 2008. Issuance remained light and continues to trend 15% lower than last year, with a 50% decline in refunding activity leading the drop, while municipal bond funds continued to see positive flows. Lower rated municipal bonds continued to outperform this quarter with 5-year maturity BBB's earning .35% vs -.30% for AAA's.

Market Positioning

As a result of the tightening in credit spreads in the third quarter, we maintain our cautious view on risk. Our allocation to risk sectors remains well below a maximum position, yet we continue to trade credit tactically based on trends in the movement of BBB-rated option adjusted spreads (OAS). Currently, the flatness of the yield curve and credit spreads nearing their recent tights cause us to view the risk/reward relationship as less favorable. Yield curve positioning and duration will be actively managed based upon our proprietary signals and changes in the shape of the yield curve.

Attribution

Victory INCORE Investment Quality Bond Fund: The Fund (class A shares at net asset value) underperformed the Bloomberg Barclays U.S. Aggregate Index in the third quarter. The underperformance was driven largely by the duration positioning given the sharp rise in rates late in the third quarter. Security selection also detracted from relative performance as positive contributions from agency MBS and industrials were not enough to offset negative selection in the ABS sector. Sector allocation was positive as the underweight allocation to Treasuries and overweight position in credit outweighed negative allocations effects from agency CMOs and ABS.

Performance quoted represents past performance and does not guarantee future results.

Risks Associated with Investing in the Fund: There is no guarantee that the Fund will achieve its objective. All investing involves risk, including potential loss of principal. Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates. When interest rates rise bond prices fall. To the extent the Fund invests a greater amount in any one sector, the Fund's performance will depend to a greater extent on the overall condition of that sector, and there is increased risk to the Fund if conditions adversely affect that sector. A significant portion of the Fund is invested in mortgage-backed securities, which are subject to higher prepayment risk than corporate bonds and notes, particularly in periods of declining interest rates, and are subject to the risk that an unexpected rise in interest rates will extend the life of the security beyond the expected repayment time, typically reducing the security's value. In addition, the Fund invests in to-be announced (TBA) and dollar-roll transactions, which involve the risk that the security will decline in value between the purchase date and the delivery or issue date, the risk that value of the security the Fund is required to buy will be less than an identical security, and the risk that the counterparty will fail to deliver. The Fund invests in credit default swaps, which involve the risk that small price movements can result in substantial gains or losses. The Fund also invests in dollar-denominated securities of foreign issuers, which involve additional risks due to foreign economic and political conditions, and differences in financial reporting standards. The return of principal in bond funds is not guaranteed. Investments in below-investment-grade debt securities ("junk bonds") may be less liquid and are subject to a greater risk of loss than investment-grade securities. Such securities may experience greater price volatility and higher default rates during periods of adverse market conditions.

Indexes Defined: The Bloomberg Barclays U.S. Aggregate Bond Index measures the performance of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable rate mortgage (ARM) pass-throughs), asset-backed securities and commercial mortgage-backed securities. Securities indexes assume reinvestment of all distributions and interest payments and do not take into account brokerage fees or taxes. Securities in the Fund may not match those in the index and performance of the Fund will differ. Direct investment in an index is not possible.

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