Victory INCORE Total Return Bond Fund Quarterly Commentary

As of March 31, 2019

Economic Perspective

The extreme volatility experienced in late 2018 seems a distant memory as global financial markets benefitted from central bank dovish policy pivots, lower volatility, lower interest rates and muted inflation in the first three months of 2019. Recession, yield curve inversion and rate cuts were hot topics during the quarter and typically do not immediately result in higher asset values. Federal Reserve Chairman Powell's dramatic reversal from "auto-pilot" to "patience" in the span of three weeks on January 4th set the stage for a rally in risk assets as investors gained confidence the Fed was now on hold, if not done with the current tightening cycle. Additionally, the European Central Bank put rate increases on hold for 2019 while announcing another round of long term financings for their banks and the People's Bank of China remains in policy easing mode. Despite missing the March deadline for an agreement, trade negotiations with China appears to be progressing positively and additional tariffs have been sidelined, at least temporarily as a result, thus providing another source of optimism to investors. The end of the Mueller investigation late in the quarter removed an element of political risk for the Trump administration, however with the Presidential campaign season just around the corner headline risk from Washington remains elevated. Not every cloud cleared in the first quarter; as delayed economic data from the government shutdown trickled in, U.S. growth was slowing as was growth both in China and Europe. Finally, BREXIT remains unresolved as the March deadline has now been extended to October for an agreement with the EU. Prime Minister May's tenure in the U.K. parliament appears precarious at best. While the details of the BREXIT outcome remain uncertain, we are convinced that an agreement of some form will be reached.

The dovish pivot from the FOMC in the first quarter signals a fundamental shift in the way the Fed formulates policy under Powell's stewardship. Historically the Fed has moved slowly and methodically (some would say stubbornly) absent a crisis, yet the abrupt pivot in early January and ultra-dovish policy statement following the March policy meeting underscores a reaction-function that appears faster and perhaps more willing to glean input from the financial markets and not as heavily reliant on historical economic models. Powell acknowledged not consistently achieving the committee's inflation objective is a disappointment and to have downward pressure on inflation is "one of the major challenges of our time." From a policy perspective, it is likely easier to fight inflation rather than deflation, particularly when overnight rates are half of what one would consider normal and the Fed's balance sheet is more than three times the size it was prior to the financial crisis. So, while the FOMC's outlook on the economy remains generally positive, the persistent low levels of inflation have caused them to rethink their strategy, the initial results of which we saw unfold at their March meeting. Announcements included a lower dot plot (now zero rate increases in 2019), lower growth and inflation forecasts and a larger balance sheet, the combination of which put the exclamation point on 'patience and flexibility.' In fact, the market's interpretation was so dovish it went so far as to start pricing in an interest rate cut later in 2019. While a truly flexible, data dependent Fed cannot rule this out, investors must also include a level of patience in their equation as a significant amount of hard economic data would need to support that view.

U.S. GDP grew 2.2% in the fourth quarter of 2018, resulting in growth of 2.9% for the full year.

This was the strongest growth achieved since 2005 and matched growth rates in 2015 and 2006. Economic data in the first quarter was mixed and many data series were delayed for weeks due to the government shutdown. Outside of the weak February reading, payroll growth remains solid, the unemployment rate remains near cycle lows and wages have been growing comfortably above 3% on a year-on-year basis for eight straight months. Readings on personal consumption and manufacturing were on the weaker side, while the health of the service sector remains strong. As noted previously, both the headline and core personal consumption expenditures indices remain below the Fed's 2% target rate, underscoring their concern with muted inflation at this stage of the economic cycle. Outside of the U.S., growth in Europe and China slowed with particular concern about some late March data showing sharp weakness in the German manufacturing sector. Investors' focus on slow growth in Europe is due in part to the concern that President Trump could slap additional tariffs on those economies if trade negotiations don't progress. If this were to occur it would likely begin with auto tariffs on German cars, further pressuring their manufacturing sector and the European economy more broadly.

We expect U.S. growth to revert to the 2% area and believe that the Fed can orchestrate a soft landing with their increased flexibility with interest rates and their balance sheet. Despite the recent slowing, many areas of the U.S. economy remain healthy and financial conditions have eased significantly since the end of the year (lower interest rates, higher equity markets, tighter credit spreads, low inflation, solid wage growth). We are closely monitoring the growth outlook outside the U.S. and its potential impact on our economy. While a recession is always possible, we do not feel it is probable over the near-term given a more accommodative stance from global central banks.

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Market Summary

The Fed pivot stoked a risk-on rally in the first quarter with the S&P 500 up over 13%, investment grade credit up over 5% and high yield bonds up over 7%. Interest rates were generally stable, trading in a tight range until the March FOMC meeting. The ultra-dovish outcome led to a decline in interest rates that was further fueled by weak economic data in Germany a day later. As the German 10-year Bund yield turned negative on this data for the first time since October 2016, global yields declined at a faster pace. The U.S. yield curve continued to flatten and the yield spread between 3-month Treasury bills and 10-year Treasury notes inverted for the first time since 2007. This relationship is often seen as a barometer for impending recessions and was the source of much debate about the state of the economy late in the quarter.

Our view is that an inversion of the yield spread between 2-year Treasury notes and 10-year Treasury notes that lasted for some time would be more indicative of heightened recession risks. Intermediate interest rates declined between 21 and 27 basis points during the quarter, most of which occurred during the final eight trading days of March. After returning a paltry 0.01% for 2018, the Bloomberg Barclays US Aggregate Index returned 2.94% in the first quarter of 2019. The combination of lower rates and tighter credit spreads drove returns as investors cheered the new Fed on-hold policy.

Reversing course from the final quarter of 2018, all primary sectors of the Bloomberg Barclays US Aggregate Index generated positive excess returns relative to U.S. Treasuries in the first quarter. Corporate bonds were the standout performer within the Aggregate Index generating excess returns of 2.73%, as the option-adjusted spread (OAS) of the Bloomberg Barclays U.S. Corporate Index tightened from 153 basis points at year-end to 119 basis points at the end of March. This move recouped 34 of the 47 basis points of widening experienced in the fourth quarter of last year as solid corporate earnings, lower interest rates and strong demand all drove the tightening in credit spreads. Excess returns in the structured sectors were positive as well, albeit significantly lower than those of corporate bonds. Commercial mortgages lead the way with 1.18% in excess returns followed by asset-backed securities at 0.40% and mortgage-backed securities with 0.28%.

The municipal bond market, as measured by the Bloomberg Barclays Municipal Bond Index, kept up with its taxable counterpart over the 1st quarter with a return of 2.90%, bringing its 1-year return to a respectable 5.38%. The risk-on environment led to stronger returns from longer maturities and lower rated bonds. The 1-year segment returned .81% for the quarter vs 3.85% for bonds 22-years and longer. Looking at credit quality in 5-year munis, high-yield bonds returned 2.76% vs 1.94% for AAA rated bonds and 1.86% for 5-year Treasuries. The municipal yield curve, as measured between 2-yr and 10-year bonds, has flattened beyond the trough of late 2017 to the flattest we've seen since 2007.

At 39 basis points, the 2yr-10yr muni curve provides some additional steepness over the Treasury curve, which ended the quarter at 14 basis points, but investors aren't getting paid much to extend out. Despite a 17% increase in issuance over the 1st quarter from 2018 levels, net issuance (the amount of newly issued bonds minus bonds called and matured out of the market) remained negative throughout the quarter. Combined with 25 billion dollars that poured into municipal bond mutual funds over the quarter and you have a recipe for a nice string of performance, but also a very expensive asset class. The yield on 10-yr AAA rated municipals stands at the tightest ratios relative to Treasuries that we've seen since 2010. With wealthy investors from high-tax states losing their SALT deductions, munis could continue to trade at these ratios for some time. As we head through tax-time and absorb the recent changes in the tax code, munis are likely to benefit as a continued haven from the IRS.

Market Positioning

We began 2019 with an underweight allocation to investment grade credit, yet began to add exposure back in January. We ended the quarter with a modest overweight allocation to intermediate BBB-rated corporate bonds relative to the index. While valuations have become richer, fundamentals and technicals (corporate supply, foreign demand, fund flows) remain supportive of risk and we will remain positioned accordingly until our signal changes. Additionally, we were overweight agency mortgage-backed securities as a source of additional carry relative to Treasuries. Yield curve positioning and duration will be tactically managed as opportunities arise.

Global economic data, inflation trends, central bank policy and trade negotiations will all be focal points as we navigate the quarter ahead.

Attribution

Victory INCORE Total Return Bond Fund: The Fund underperformed the Bloomberg Barclays U.S. Aggregate Index in the first quarter. The underperformance was driven by an underweight position in high yield, BBB rated investment grade corporate bonds and an overweight allocation to agency mortgages and agency collateralized mortgage obligations. Both duration and curve positioning contributed negatively to relative performance, particularly in March given our shorter duration positioning as rates declined following the FOMC meeting that month.

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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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