Brandes Corporate Focus Bond Fund

Fund Commentary

During the quarter, the Brandes Corporate Focus Bond Fund delivered positive absolute performance, but marginally underperformed its benchmark, the Bloomberg Barclays U.S. Intermediate Credit Bond Index.

The Federal Reserve surprised the markets with a shift to a decidedly dovish monetary posture. After four interest-rate hikes in 2018, the market was prepared for fewer rate hikes in 2019. However, following its late-March meeting, the Fed indicated that the fed funds rate is likely to remain unchanged in 2019 and forecast the likelihood of a single rate hike in 2020.

Consequently, the bond and equity markets cheered the Fed's policy shift, with all taxable fixed-income asset classes registering positive returns and the S&P 500 Index posting its best quarterly return in a decade.

The extent to which the Fed's change in stance surprised the markets is illustrated in Exhibit 1. Investor sentiment turned markedly from a near certainty of at least one fed funds rate *hike* in 2019 to a near certainty of at least one fed funds *cut* this year:

Exhibit 1: 2019 Fed Funds Futures Probability

As of Date	2019 Hike Probability	2019 Cut Probability
11/30/2018	95.3%	0.0%
12/31/2018	10.8%	12.8%
3/29/2019	0.0%	69.5%

Source: Bloomberg World Interest Rate Probability

The other notable — perhaps *concerning* is a better word — observation from the March Fed meeting is that the central bank now believes its monetary policy is back to normal. By any historical benchmark, however, the Fed's monetary policy remains highly stimulative. As of March 31, the current real fed funds rate, which is the rate adjusted for inflation, was at approximately 0.25%, a sharp drop compared to the 40-year real fed funds rate average of 2%. Consider that at the end of the Fed's last tightening cycle in 2006, the real rate was 2.75%.

Additionally, the Fed announced that it would stop shrinking its balance sheet at the end of September, which at quarter end stood at about $3.5 trillion (about $3 trillion above the pre-financial crisis level). Perhaps this is the *new normal* for Fed policy?

What should give investors pause, in Brandes LP's view, is that a low nominal and real fed funds rate, not to mentiona massive balance sheet, could limit the Fed's ability to respond to the next crisis.

On the fiscal side, the state of affairs is no less concerning. The U.S. Government budget deficit and debt continue to grow to unprecedented levels. The average annual budget deficit over the past decade has been $872 billion. For context, the average annual budget deficit over the previous 50 years was $104 billion. Currently, the total U.S. public debt outstanding stands at an all-time high of $22 trillion, with interest payments averaging more than $1 billion per day.

The market has not only seemingly paid little attention to the federal debt explosion over the past decade, but the new economic theory *du jour* — Modern Monetary Theory — posits that government deficits don't matter at all. Time will tell if this theory is also the *new normal.*

As somewhat of an aside, but indicative of many investors' sanguine view of debt levels and market risks, Greece returned to the public markets in the first quarter and was able to issue a €2.5-billion 10-year bond at a yield of 3.90%. This represented the first 10-year bond offering since before the 2011-2012 Greek debt crisis.

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Positive Contributors

Relative performance was led by corporate bond holdings in telecommunications and energy.

Within telecommunications, Frontier Communications primarily boosted returns. The company posted revenue that showed some stabilization after a continued pattern of subscriber losses following its large acquisition of Verizon assets in California, Texas and Florida in 2016.

The company also took positive steps to address balance sheet concerns. First, it purchased $56 million of its debt in the open market below par value during the quarter. Second, Frontier was able to issue $1.65 billion first-lien bonds maturing in 2027. Proceeds from the issuance were used to refinance a term loan set to mature in 2021. This issuance helps lengthen the company's runway to build on its operational stabilization. Importantly, with the refinancing, there are a total of $316 million in bonds set to mature before the September 2021 term-loan maturity. Given that the company is generating positive free cash flow, bond prices reacted favourably during the quarter.

Within energy, performance was led by Chesapeake Energy and Range Resources. Both companies reported positive fourth quarter earnings that beat expectations, but the bonds' performance was more likely a correction from the fourth-quarter decline, which felt more like technical selling than anything fundamentally related to the credit profile.

Performance Detractors

Select holdings in banking and metals and mining hurt returns.

JPMorgan and Wells Fargo detracted from performance as their bond prices were little changed in a market where rates fell and thus bond prices broadly increased. Both securities are perpetual floating rate notes with coupons that reset over 3-month LIBOR each quarter. LIBOR rates fell during the first quarter, meaning these two securities could potentially see their coupons reset downwards next quarter. However, JPMorgan and Wells Fargo still offer attractive coupons even at modestly lower rates and remain long-term core holdings.

Given the sharp rally in rates downwards, the Fund's duration positioning toward the lower end of our duration-controlled band also detracted from returns.

Select Buy & Sell Activity

Activity was limited as Brandes LP struggled to find value opportunities due to the strong performance of risk assets. Brandes LP added a new position in Ford Motor Credit (8.125% coupon, maturing January 2020, rated Baa3/BBB) and Goldman Sachs (3.00% coupon, maturing April 2022, rated A3/BBB+). These purchases are consistent with Brandes LP's recent theme of favouring shorter-maturity corporate bonds until a more attractive value proposition returns to the market.

Current Positioning and Outlook

The risk party that has been raging for more or less a decade now received a new shot of adrenaline courtesy of the Fed in the first quarter. In December 2018, Fed Chairman Jerome Powell described the central bank's balance sheet wind-down as on "autopilot." As markets threw a tantrum toward year end, Powell not only walked back that comment in early January of 2019, but the Fed also made a decidedly dovish pivot at its March meeting.

Bond and stock markets have grown to love accommodative central banks and appear to be sanguine about rising fiscal debt levels. The current markets are reminiscent of the old Wayne's World quote: "Party on Wayne. Party on Garth."

Maybe the investmnet committee is old fashioned or a bit curmudgeonly, but it feels it's difficult to believe Fed policy is currently normal and that debt levels don't matter. Therefore, it continues to bias the Fund in what it believes is a defensive manner.

In this environment, the Fund continues to favour shorter-maturity corporate bonds and those that exhibit strong, tangible asset coverage, in Brandes LP's view. The Fund is underweight agency mortgage-backed securities and managing duration toward the shorter end of its duration-controlled range. The Fund has a higher allocation to U.S. Treasuries that Brandes LP will look to redeploy thoughtfully and efficiently — if and when market uncertainty and volatility cause credit fundamentals to become mispriced from Brandes LP's estimates of intrinsic value.

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About Brandes LP

In the 40-plus years since Brandes LP was founded, its goal has remained the same: pursue above-market gains to help investors move closer to their long-term investment objectives. Brandes LP believes that its unwavering commitment to value investing will lead it to attractively priced, fundamentally sound companies worthy of inclusion in the Fund.

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Fundamentals

	FUND	INDEX
Average Quality	A	A-
Average Maturity	10.57	4.73
Average Duration	3.45	4.13
Average Coupon	3.93%	3.47%
Average Price	$ 97.28	$ 101.23
Average Yield to Maturity	4.15%	3.17%
Current Yield	4.04%	3.43%

	FUND	INDEX
AAA (includes cash)	35.3	10.6
AA	7.0	9.9
A	11.8	36.1
BBB	21.7	43.4
<BBB	24.2	0

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Quarterly Additions/Deletions

Additions	Deletions
Ford Motor Credit 8.125% Jan 15/20	Israel Electric Corp. Ltd. 7.25% Jan 15/19
Goldman Sachs Group 3.00% Apr 26/22	Cloud Peak Enrgy Res Fin 6.375% Mar 15/24
	Goldman Sachs Group Inc. MTN 7.5% Feb 15/19
	Arizona Public Service Co. 8.75% Mar 01/19

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