1290 Diversified Bond Fund

Fund commentary 3Q20

Market overview

Toto, I've a Feeling We're Not in Kansas Anymore

In the iconic scene from the Hollywood musical fantasy, "The Wizard of Oz," Dorothy realizes she has landed in a magical kingdom after being blown out of Kansas by a tornado. It might be an appropriate way to think about the global macro outlook.

The pandemic has blown the global economy into an unfamiliar place. Government budget deficits have mushroomed; public debt ratios have surged. The Organization for Economic Cooperation and Development (OECD) projects debt ratios 18 percentage points higher, on average, across the organization. This forecast could rise to 26%, depending on the fiscal response to a second viral wave. Central banks want higher inflation and are willing to fund the fiscal splurge. Risk assets have recovered in varying degrees, yet interest rates and bond yields remain at rock bottom and negative in some places. The Bank of England is the latest central bank to probe the possibility of negative rates. The FTSE World Government Bond Index yields 35 basis points (1 basis point = $1/100^{th}$ of 1%). Emerging country fixed income markets have been strong despite budget and monetary conditions that might have triggered a stampede out of them 10 or 20 years ago. The Federal Reserve (Fed) has promised no rate increases for years and wants inflation up. They have hinted at repressing rates and yields if the curve starts to steepen. Discussions are gaining traction about the central bank hosting individual e-accounts as a means to provide faster and more direct support for American homes and businesses. Gold has soared. However, the relatively meek decline in the U.S. dollar is not flagging any kind of impending monetary instability or imminent burst of inflation caused by the surge in the supply of fiat money.

In short, it feels like the pandemic has transported us to the magical world promised by Modern Monetary Theory (MMT). It is a free lunch smorgasbord of deficit spending and money printing without concern for how to repay debts. It is more than unfamiliar. It feels insane.

Importantly, MMT is working for now. And, we expect to see more of it. Re-openings plus all the policy support have produced V-shaped recoveries. The trend in the global economy continues to remain positive. U.S. household net worth is reaching new highs, housing activity is soaring, and real gross domestic product (GDP) is surprisingly close to its high-water mark based on private sector estimates. More than half of the U.S. private sector jobs lost in the initial wave of the pandemic have been recovered.

Despite these positive economic developments, there is no sign of policymaker largesse ending soon and no constituency for fiscal remediation. Even in Europe any residual Teutonic notions of sobriety have been smashed by the pandemic tornado. The Next Generation European Union (NGEU) fund—as in the next generation pays for it—is the latest manifestation. Born out of the crisis, the fund lashes together monetary and fiscal policy and could become the foundation for debt mutualization across the EU.

Governments and central banks remain laser-focused on the contraction in employment and nervous about the deflationary/low inflation consequences as the virus resurfaces in waves around different parts of the globe. Their concerns also extend to sundry other items, including but not limited to: worries about permanent jobs and businesses lost as government support begins to wane; volatility/potential violence surrounding the upcoming U.S. election; resumption of the trade war between the U.S. and China after the

Source: Brandywine Global

Market overview (continued)

election; and the nature of any societal shifts caused by the pandemic that could alter core organizational and economic structures. The latter includes the likes of a permanent move to remote work, tele-healthcare, or an acceleration in the shift from cash to digital currencies.

We do not believe in free lunches nor do we believe we are living in the land of Oz where all the investment norms have changed. The extremes we are witnessing in policy are a by-product of the extremes in the current macro profile. We analyzed this idea at length in our July commentary. In many ways, the rhythm of events has evolved as it would in any macro cycle. The world economy plunged in the first quarter and liquidity dried up. Policymakers responded in the second quarter in classic counter-cyclical fashion by expanding liquidity and relaxing markets. The economy has been accelerating since. We expect the latter to continue this year and next.

What is different this time is the scale of the events and the starting point. Prior to the pandemic, the lower-for-longer debate centered on the case for secular stagnation. Technology and competition boost supply. Shrinking populations depress demand. These tendencies have fostered the low inflation/deflationary trends in the world and the drift in capital markets toward the zero bound. It has been the main story in Japan for 30 years. There, inflation has averaged 0.2% and the budget deficit 6% of GDP over the last 20 years. With interest rates in Japan at zero, the monetary transmission link has been through fiscal deficits as the offset to the spending drag of an aging and contracting population. Under Abenomics, the shift to MMT came as policymakers realized the only path to higher nominal GDP was through more government spending, and they could fund it without a lenders' revolt by printing money. Yield curve control was implemented as a backstop against discretionary fixed income investors fed up with no return. However, the balance sheet expansion really slowed in 2018 and 2019, suggesting there were not many of those investors left, and the yen has been firm as well. Arguably, this approach probably has kept Japan from deflation. With the pandemic tornado ripping through Japanese and global nominal incomes, the Bank of Japan has launched its own internal review of strategy while the rest of the world catches up. Stay tuned. Helicopter money that bypasses debt issuance in some form may be around the corner in Japan.

The one country in the world where things are getting back to a kind of pre-virus normal is China. China's authorities have been able to enforce quarantines and lockdowns unlike the authorities in the West's open societies. Correspondingly, Chinese bond yields have renormalized to where they started at the beginning of the year. From a longer-term perspective, China has been following the MMT playbook ever since the Global Financial Crisis. The collapse in U.S. household borrowing laid bare China's massive excess savings. Since 2008, China has used its domestic bank lending program as a surrogate for fiscal spending in an economy where low government bond yields provide a subsidy to predominantly state-owned borrowers. The consolidated budget, once in surplus in 2008, has fallen into deficit at a national level of close to 15% of GDP; its debt-to-GDP ratio has been continuously increasing. Lastly, China's labor force has peaked. Society may grow old before getting rich. Deflation would be rampant were China's authorities to redress its fiscal imbalance anytime soon. Furthermore, whenever they do worry about leverage, deflationary forces surface quickly.

The Fed completed its own policy review during the quarter and concluded that it was wrong about the macro environment for most of the last 12 years. They seem to have accepted that the world is closer to the zero-bound than they thought; they have concluded the Phillips Curve model for guesstimating inflation has not worked too well given these longer-term forces; and they have openly called on the government for more fiscal support. That is a politician's dream and will be part of any policy platform regardless of political affiliation.

The near-term risk is of a stronger economic recovery than currently expected that causes the U.S. yield curve to steepen. Most investors expect the pace of the global recovery to slow from the V-shaped re-opening phase. Based on the slope of the curve, the implied probability of the yield on 10-year Treasuries staying flat or falling further is close to 70%. It seems that even a modest normalization in yields is priced at close to tail-risk levels.

Market overview (continued)

Our base case has been and remains that the U.S. and the world will learn to live with this disease and/or discover a treatment/vaccine. Tailwinds to growth are gathering: the accumulation of hundreds of rate cuts around the world, the lagged influence of falling bond yields, increases in household net worth, and cheap energy. All this should imply a gradual rise in bond yields and steepening of the curve. How high they go is a different question. Equity market multiples, one of the drivers, or rising household net worth could be very sensitive to this trend and act as a governor on the pace of the increase.

Monetary policy is a clumsy policy lever. The hit to GDP, led by services and the surge in personal savings, has produced an interest rate that is a subsidy to economic sectors less affected by the pandemic, like housing. Who thought in March that a lock down would result in people reacting in a way that created a housing boom? Is something similar possible in the service sector? As we learn to live with the disease and/or overcome it, the growth upside could come more quickly than expected, especially if a vaccine or therapy emerges that results in people feeling safer. We continue to think of the shock from the pandemic as more like a natural disaster than a classic economic recession. Consequently, we view this upside risk as fairly significant. If the curve begins to steepen, which would be normal under these circumstances, there is open speculation that the Fed would adopt some form of yield curve control to limit the upside. The central bank has altered its operating strategy and says it is prepared to let the economy run hot in order to reach an average inflation rate of 2%. Policy rates at the front end of the curve are unlikely to change for the foreseeable future, but the curve could gradually steepen.

The longer-term risk to rock-bottom rates is inflation.

Surging money supply growth around the world has ignited worries about inflation. That is not our view, at least for the time being. There remains unusual excess capacity in land, labor, and capital. It is possible that inflation could perk up as savings rates drop and the velocity of money increases if people become confident enough to re-open the service sector and start flying in airplanes again. The prevailing tail-risk attitude that this will not happen anytime soon is something to which we have been giving a lot of thought, particularly with monetary and fiscal policy in the land of Oz. If that turns out to be more real than imaginary, today's central bank reaction functions and the tools being deployed will provide the roadmap on what would evolve in that environment.

Fund overview

The 1290 Diversified Bond Fund seeks to maximize total return consisting of income and capital appreciation. Under normal circumstances, the Fund invests at least 80% of its net assets, plus borrowings for investment purposes, in a diversified portfolio of U.S. and foreign bonds or other debt securities of varying maturities and other instruments that provide investment exposure to such debt securities, including forwards or derivatives such as options, futures contracts or swap agreements.

The flexibility of the guidelines allowed the portfolio managers to nimbly position the Fund to take advantage of tactical opportunities and reallocate when risk on/risk off sentiment presented itself.

For the third quarter of 2020, the Fund outperformed the Bloomberg Barclays U.S. Aggregate Bond Index, the Fund's benchmark. During the period, bond allocations were additive on a relative basis while currency exposures were slightly negative.

Source: Brandywine Global

Fund highlights

What helped performance during the quarter?

- Like last quarter, U.S. investment grade corporate bond allocations finished as the top contributor for the period. Robust investor demand, and the Fed’s ongoing support, provided tailwinds to overall investment credit markets.
- A number of the Fund’s bond exposures in Europe were also additive for returns, as European leaders agreed to an historic €750 billion recovery fund in July, with grants for the countries hardest hit by the pandemic. As such, the Fund’s allocation to Italian BTPs was rewarded.
- A number of the Fund’s emerging market bond positions were also beneficial for results. Over the quarter, Chinese economic data improved and commodity prices moved higher, leading to positive investor sentiment. This period also proved to be a positive environment for the Fund’s bond positions in, Mexico and Indonesia.
- Lastly, The Mexican peso was buoyed by hopes of less aggressive central bank monetary easing.

What hurt performance during the quarter?

- Exposure to the Russian ruble detracted from performance, which was weighed down by surging COVID-19 cases within the country and geopolitical risks.
- The Fund’s exposure in French OATs was a modest headwind for performance, as its COVID-19 cases rose within the country during the quarter.
- The Brazilian real tumbled as its economic headwinds remain and the pandemic pushed Brazil's public sector debt to a record 86% of gross domestic product in July.

Source: Brandywine Global

For more information, call **(888) 310-0416** or visit **1290funds.com.**

An investor should consider the investment objectives, risks, charges and expenses of the Fund carefully before investing. To obtain a prospectus containing this and other information, please call 1-888-310-0416 or download the file from 1290funds.com. Read the prospectus carefully before you invest.

1290 Diversified Bond Fund seeks to maximize total return consisting of income and capital appreciation. Performance may be affected by one or more of the following risks. Fixed income investments are subject to credit risk and interest rate risk. The fund is subject to the risk that the issuer or guarantor of a fixed income security, or the counterparty to a transaction, is unable or unwilling, or is perceived as unable or unwilling, to make timely interest or principal payments, or otherwise honor its obligations, which may cause the Fund's holding to lose value. In addition, changes in interest rates may affect the yield, liquidity and value of investments in income producing or debt securities. When interest rates rise, the value of the Fund's debt securities generally decline. Conversely, when interest rates decline, the value of the Fund's debt securities generally rises. Investments in foreign securities involve risks in addition to those not associated with investments in U.S. securities. Foreign markets may be less liquid, more volatile and subject to less government supervision and regulation than U.S. markets, and it may take more time to clear and settle trades involving foreign securities, which could negatively impact the Fund's investments and cause it to lose money. Security values also may be negatively affected by changes in the exchange rates between the U.S. dollar and foreign currencies. Differences between U.S. and foreign legal, political and economic systems, regulatory regimes and market practices, as well as trade barriers and other protectionist trade policies (including those of the U.S.) governmental instability, or other political or economic actions, also may adversely impact security values. There are greater risks involved in investing in emerging market countries and/or their securities markets, and investments in these countries and/or markets are more susceptible to loss than investments in developed countries and/or markets.
Past performance is no guarantee of future performance.

Bloomberg Barclays U.S. Aggregate Bond Index covers the U.S. dollar denominated investment-grade, fixed-rate, taxable bond market of securities. The index includes bonds from the Treasury, government-related and corporate securities, agency fixed rate and hybrid adjustable mortgage pass through securities, asset-backed securities and commercial mortgage-backed securities. **FTSE World Government Bond Index (WGBI)** is a broad index providing exposure to the global sovereign fixed income market, the index measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. It comprises sovereign debt from over 20 countries, denominated in a variety of currencies. Individuals cannot invest directly in an index.

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