1290 Diversified Bond Fund

Fund commentary 1Q21

Market overview

America's U-Turn

The U.S. economy has not had a really big economic boom since the Reagan tax cuts in the early 1980s. However, 2021 is shaping up to be another one, especially if the COVID-19 vaccinations succeed and the variants spreading around the world fail to produce more setbacks. The economy is snapping back, but politicians are drunk on free money and boiling with populism. Unprecedented levels of macro support remain in place. Last year's extraordinary bust shows many signs of morphing into this year's extraordinary boom.

We are not sure how it all plays out in the long run, particularly given the higher tax regime that lies ahead. However, the current stimulus supercharges an economy already rebounding from last year's widespread lockdowns. The March U.S. employment report offered a whiff of what could be in store. A million jobs were created in one month (including revisions). Importantly, the biggest gains were in the leisure and hospitality sectors, which were the hardest hit by last year's lockdowns and the main cause of the scale of the bust. At this rate, the unemployment rate would be back to pre-pandemic levels by the end of the year. The economic script continues to rhyme with the rapid rebound that occurs after a natural disaster, not the protracted recovery following a more traditional recession.

The rebound is playing out around the world, notwithstanding the timing and management of vaccine distribution in various countries. Global import volumes have completely recovered and are above pre-pandemic levels. Purchasing manager indexes are soaring. Europe has struggled with its vaccination programs, but the economic surprises are positive, the data stronger than expected. European fiscal policy is beginning to line up for something very different. Maastricht rules look likely to be suspended this year, and money from the €672.5 billion Recovery and Resilience Facility will start to deploy this year. Even in Japan, a new fiscal urgency is beginning to emerge. Kozo Yamamoto, who played a key role in crafting Abenomics, is readying proposals for Prime Minister Yoshihide Suga, saying Japan needs another big dose of fiscal medicine that is as ambitious as the aid bill just passed in the U.S. Asian industrial production is surging while Australian employment is almost back to its high-water mark.

The outstanding exception to these policy trends continues to be China. Circumspect in its use of monetary and fiscal policy during the crisis, China's authorities gained control of the virus early, which allowed for a faster economic recovery. The authorities say they do not want to hit the brakes, but they are throttling back. The credit impulse is rolling over, fiscal stimulus is in retreat, interest rates have risen, and the authorities are looking to cool down the property sector.

It is in this context that the selloff in the global bond market has been no surprise to us. We have advised and positioned for it since last August. We purchased a very large basket of corporate bonds starting in mid-March 2020 and in August hedged the duration risk through a strategic short position in 30-year Treasuries. The world economy is renormalizing and long-term interest rates with it. The Chinese economy was the first to renormalize and long-term rates followed accordingly. U.S. real GDP effectively recovered to its high-water mark during the first quarter with bond yields returning to pre-pandemic levels. Even repressed markets like Japanese government bonds and German bunds saw some normalization.

Source for all figures above: Brandywine Global

Market overview (continued)

The rise in global bond yields has been fairly gradual so far, notwithstanding the jump in yields during the first quarter. The bear market, which reflects the rise in equilibrium yields attendant a renormalizing world economy, has not been restrictive. This view is supported by the behavior in global equities. Here, capital is rotating from long-duration, large-cap growth stocks to deep-value, cyclical sectors. Overall multiples have remained steady as the earnings outlook increases in lockstep with economic prospects and yields. Similarly, despite their third worst loss in 40 years, U.S. investment grade corporate bond spreads remained relatively flat, indicating no financial tightening or economic stress. Higher U.S. yields pulled up emerging market sovereign bond yields, but credit default swap (a financial derivative or contract that allows an investor to "swap" or offset his or her credit risk with that of another investor) (CDS)) and solvency risks have remained low.

What's Next?

Asset price trends and surveys show that most investors expect the world economy to improve. Reflation is the new buzzword. Renormalization has resulted in global bond price profiles moving to neutral or slightly undervalued currently from extremely overvalued a year ago. This change means that the next big move in long-term rates would be driven by a macro surprise, with the tailwind of mean reversion now spent.

As the previous discussion suggests, we think the bond market selloff has further to run on the back of what we believe could be the biggest economic boom in decades. The boom is likely to include at least an inflation scare. Photos of the mega-container ship Ever Given aground in the Suez Canal provide a visual perspective on backlogs and disruptions in the global supply chain. This problem gets worse before it gets better as economic activity rebounds. Policy stimulus will supercharge the rebound, inventories are already low, orders are backlogged, commodity prices have risen, and breakeven inflation rates are breaking out: the 5-year breakeven inflation rate is higher than any time since before the global financial crisis (GFC). Correlation analysis implies core personal consumption expenditures (PCE) will move well above the 2% inflation threshold over the next 6-12 months.

Another sign of the momentous nature of the current regime shift and the near-term bias to higher inflation is the orientation of the Fed, from forward to backward looking. Fed Chair Powell argues that the failure of the central bank to achieve an average inflation rate of 2% over the last 12 years was due to preemptive targeting. The new approach is to be late: aim for an unspecified level of inflation above 2% for an unspecified period but keep expectations anchored. So far, the market believes the Fed. Short-term breakeven inflation rates have risen above long-term measures for the first time since the GFC, but the 5-year forward inflation rate is still below levels of a few years ago. The weak demographics, technological disruptions, and globalization forces that were driving secular stagnation before the pandemic have not gone away. Japan is the poster-economy for the effects of these forces and what is possible with macro policy. What is different is that the whole world seems to have embraced the Japanese government's policies of running big budget deficits and central bank balance sheet expansion. It is one thing when one country does it; it is another thing entirely when the whole world follows, and most market participants have no experience with rising inflation.

The biggest uncertainty is the savings rate. The initial surge in the household savings rate coincided with last year's collapse in bond yields and spike in unemployment. Since then it has been sustained partially by the relief checks sent during the course of the pandemic. Renormalization has lifted yields since, but if savings rates retreat to pre-pandemic levels, the impact on economic growth will be explosive. If the stock of cash savings accumulated during this period of high savings rates is also spent, the effect would be to drive nominal GDP as far above potential as it fell in 2020. One way of gauging the potential effect of this dispersal of cash is by estimating the impact on GDP of a bounce back in the velocity of money to pre-pandemic levels. By some estimates, this increase would boost nominal GDP 15% above potential.

Source for all figures above: Brandywine Global

Market overview (continued)

Risks

There are probably three main risks to the view of a boom in the world economy lifting bond yields higher and steepening the curve, beyond the threat of an explosion in virus variants hobbling the recovery through widespread lockdowns.

The first is that bond investors panic, and the rise in yields becomes disorderly, resulting in broad-based equity market weakness and a subsequent slump in growth. At some point if economic traction really starts to take hold and policymakers do not react, the bond market vigilantes may go on strike and provoke growth-inhibiting turbulence.

A second risk is a policy mistake that feeds back into a stronger dollar. The dollar is only marginally below its pre-pandemic level despite massive money printing and policy regime shifts. The absence of weakness relative to the scale of the monetary flood speaks to an extraordinary demand for dollars, which we associate with the crisis and the high savings rates. Our economic view implies this demand for dollars should retreat, paving the way for higher nominal GDP and rates. The policy risk is that the Fed begins to taper before the demand for dollars really falls off, which would support the currency and weaken the case for a material rise in bond yields from current levels. Related to this risk is the macro policy orientation of China. There, policy conditions have already become less accommodative. Our expectation is that the Chinese economy may slow a little in the second half of the year but remain firm. The tail-risk event is that conditions become too restrictive and China begins to slow. China is too big for a downshift in its growth rate not to be felt in the world economy, which could create feedback in the form of a stronger dollar.

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 first quarter of 2021, the Fund outperformed the Bloomberg Barclays U.S. Aggregate Bond Index, the Fund’s benchmark, though returns were slightly negative on an absolute basis. During the period, the Fund’s bond allocations were negative on an absolute basis while our currency positions were mostly flat.

Fund highlights

What helped performance during the quarter?

- A significant contributor on both an absolute and relative basis was the Fund’s U.S. Treasury allocations, which consist of short-term floaters and short futures on longer-term notes. This combination did well during the rising yield environment within the period.
- Another notable among the outperformers was the shorting of U.K. gilts through futures. Yields rose on the underlying even though sentiment regarding the U.K. economy has been positive given the country’s successful vaccine rollout thus far.
- Some select shorts within the Fund’s currency allocations, such as the Swiss franc and Japanese yen, produced positive returns for the quarter, The decline in both currencies can be attributed to investors who preferred the higher yielding U.S. dollar as a safe haven with higher economic growth prospects for the United States compared to Switzerland and Japan.
- per cent of GDP, has rattled investors.

Source for all figures above: Brandywine Global

Fund highlights (continued)

What hurt performance during the quarter?

- The Polish zloty position was a notable detractor since the start of the year as the pandemic situation within the country worsened and new restrictions had to be implemented during the period.
- Among bond positions, yields in Mexican bonos rose as its vaccine efforts and handling of the coronavirus, including news that President Lopez Obrador contracted COVID-19 in January, continued to be challenged within the country.
- Brazil, another Latin American emerging market allocation, detracted as the country has turned into a global epicenter of the pandemic due to the government's mishandling of COVID-19. The political crisis over President Jair Bolsonaro's opposition to lockdowns, in conjunction with the increase in government debt which is hovering around 90 per cent of GDP, has rattled investors.

Source for all figures above: 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. The Fund is subject to the risk that the securities markets will move down, sometimes rapidly and un-predictably, based on overall economic conditions and other factors, which may negatively affect Fund performance. 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. The Fund's investments in derivatives may rise or fall in value more rapidly than other investments and may reduce the Fund's returns and increase the volatility of the Fund's net asset value. Investing in derivatives involves investment techniques and risk analyses different from, and risks in some respects greater than, those associated with investing in more traditional investments, such as stocks and bonds.

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. Individuals cannot invest directly in an index.

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