DoubleLine® FUNDS

Economic Update

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2018 and Fourth Quarter 2018 Review

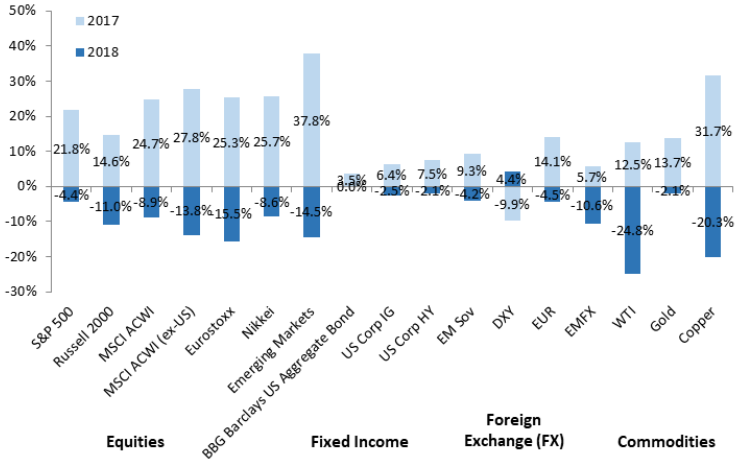
In many ways 2018 turned out to be the mirror image of 2017. In 2017, financial market volatility reached generational lows with the majority of asset classes posting strong positive returns and the global economy was poised for a harmonious 'synchronized growth' regime. U.S. credit spreads reached cycle lows and equity valuations were at multi-cycle highs. Everything looked great! But 2017 sowed the seeds of 2018, a year in which almost all major asset classes suffered negative returns. No surprise that volatility reemerged in global financial markets. (Figure 1)

2018 started on a positive note with the S&P 500 posting the best January return since 1997. But higher interest rates, a new Fed Chairman, and increased probability of trade wars, spooked equity markets. In March and June the Federal Reserve (Fed) continued to hike interest rates and reduce the size of its balance sheet according to their announced plans. By August, U.S. equities recouped their February losses. Global equities, however, slumped as trade war fears rose, global economic data decelerated (particularly in Europe and China), and the U.S. dollar rallied.

In October, the yield on 10 year U.S. Treasuries rose to the highest level in seven years on hawkish Fed comments and concerns of growing U.S. budget deficits and the rapid rise of public debt outstanding. The Fed increased policy rates again in September and the new Federal Reserve Chairman, Jerome Powell, later claimed that they "were still a long way from neutral" on October 3. Many investors took that comment as a hawkish signal and de-risked and reduced leverage as both bonds and equities sold off in unison. The stronger dollar led to tightened financial conditions and hurt emerging market equities. Powell's comments and a steep decline in energy prices dampened inflation expectations. (Figure 2)

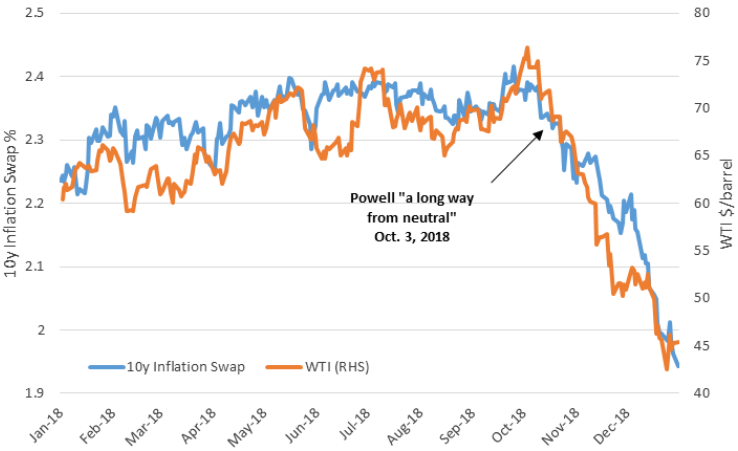
Market participants hoping for a Santa Claus rally were again slapped with an unsympathetic Fed in December. During the December Federal Open Market Committee (FOMC) meeting, the central bank hiked for a fourth time for the year, indicated further hikes were likely, and most importantly stated that its balance sheet normalization program was set on autopilot. Risk assets collapsed with the S&P 500 posting the worst December performance -9.0% since 1931 and the largest drawdown since the global financial crisis. In addition, credit markets experienced record outflows in high yield and bank loan funds. The market seemed to have come to the conclusion that the Fed was making a policy mistake by taking an aggressive policy stance and started to price in the possibility of recession and Fed cuts in 2019 and 2020.

Figure 1: The Mirror Image: 2017 vs. 2018 Performance of Asset Classes



Source: Source: Bloomberg, DoubleLine. WTI—West Texas Intermediate Crude; Gold and Copper are based on futures. EUR - EUR/USD; JPY: JPY/USD

Figure 2: U.S. 10y Inflation Swap and West Texas intermediate (WTI)



Source: Bloomberg, DoubleLine

In 2018 asset managers were left with very few places to hide. U.S. treasuries didn't offset equity and credit risk until the last two months of the year. The Bloomberg Barclays U.S. Aggregate Bond index ended the year flat, hardly offsetting the -9.0% decline in global equities. The U.S. dollar was an outlier with the U.S. Dollar Index (DXY) +4.4% for the year. The stronger dollar hindered emerging market equities, -14.5%, and most commodities sectors were down for the year. 2018 was a year of capital preservation.

Outlook

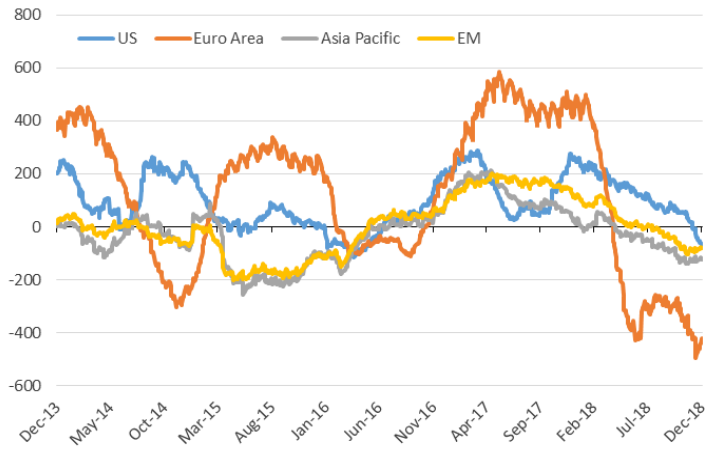
Will 2019 be another year to hunker down and preserve capital?

The health of the economy will be the important factor driving risk assets over the coming quarters. Economic momentum across the globe, as measured by the Citi Economic Data Change Index,[1] has decelerated over the last 12 months. (Figure 3) While data in the U.S. has deteriorated on the margin, with weakness sprouting up in housing, auto manufacturing, and ISM manufacturing, the overall real economic data is still signaling expansion. The Conference Board Leading Economic Indicator is still implying a low probability of recession over the near term. As of December, sentiment measures for both businesses and consumers remains elevated but has softened sharply. (Figure 4) On the positive side, the labor market looks to be in good shape with decades low unemployment rate and wage inflation that has started to outpace headline inflation. The economic data may also take a hit in Q1 with negative effects from the government shutdown.

Will the U.S. consumer continue to drive the economy while facing these headwinds?

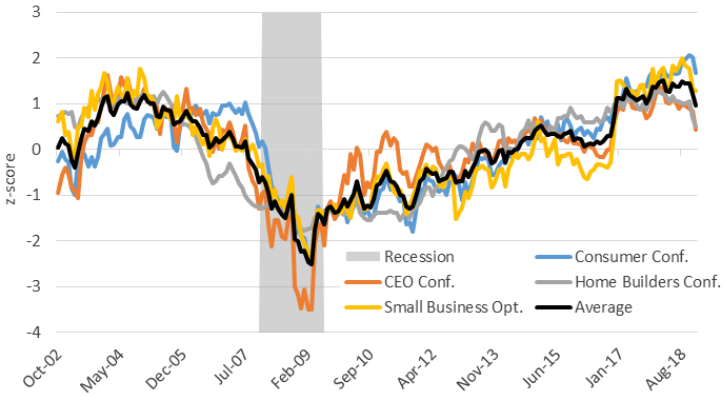
Central bank monetary policy is another important macro driver. Many central banks have started to increase key policy rates. (Figure 5) The Fed has tightened monetary policy through a combination of rate hikes and balance sheet normalization. The European Central Bank has also tightened monetary policy on the margin by ending its monthly asset purchase program at the end of 2018. It does not seem like a coincidence that global risk assets started to feel the pressure in early 2018 when central banks in aggregate started to taper asset purchases.[2] (Figure 6) As central banks continue to move away from easing policies, global risk assets may have a hard time moving higher. The increased market volatility could undermine consumer and businesses sentiment in a negative feedback loop that ultimately feeds through to the real economy. As Ben Bernanke pointed out in January 2019 during a panel with Former Fed Chairman Janet Yellen and Fed Chairman Jerome Powell, "But as Janet says, expansions don't die of old age. I'd like to say they get murdered, instead."

Figure 3: Economic Momentum by Region
(as measured by the Citi Economic Data Change Indices)



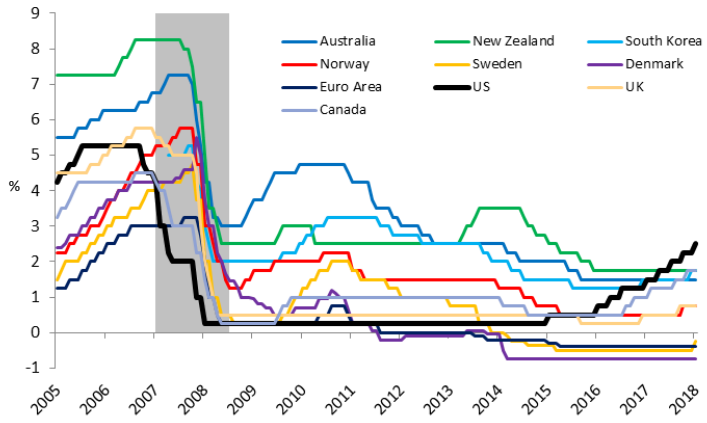
Source: Bloomberg, DoubleLine

Figure 4: Measures of Business and Consumer Sentiment



Source: Bloomberg, DoubleLine

Figure 5: Central Bank Policy Rates



Source: Bloomberg, DoubleLine

[1] The Citi Economic Data Change Indices measure economic data relative to past 1 year averages. A positive reading means that economic data have been better than before and a negative reading means that economic data have been worse than before.

[2] G4 central banks includes the Federal Reserve, European Central Bank, Bank of England, and Bank of Japan.

Outlook (cont'd)

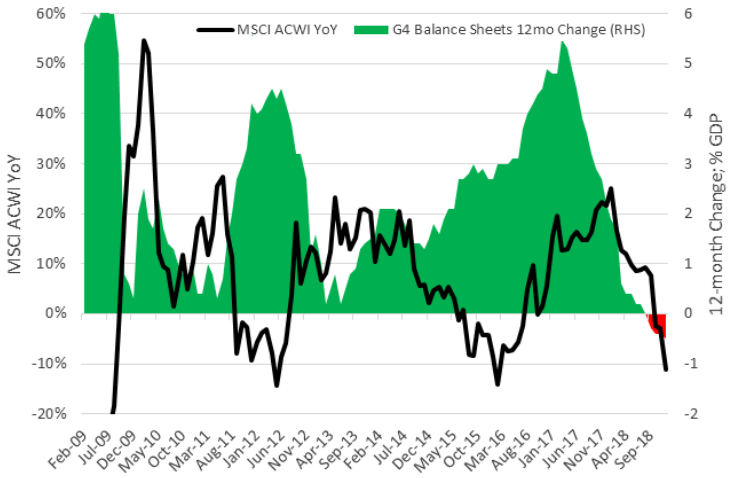
Interest Rates

As we have discussed in the past, the fundamental backdrop for U.S. Treasuries remains poor with U.S. government debt outstanding growing at an alarming rate. In 2018, total U.S. Treasury debt outstanding grew by $1.48 trillion, more than 7% of Gross Domestic Product (GDP). In the fourth quarter, U.S. Treasury debt outstanding increased by an annualized rate of $1.83 trillion, almost 9% of our GDP! Even more alarming is that this massive debt binge is occurring during a period of economic expansion, a time when Federal budget deficits usually decline as tax revenues increase. As can be seen in Figure 7, U.S. tax receipts in 2018 are lower than in 2017 despite greater than 5% nominal GDP growth over the last four quarters.

This raises the question of what will happen to the Federal budget deficit if we enter a recession in coming years?

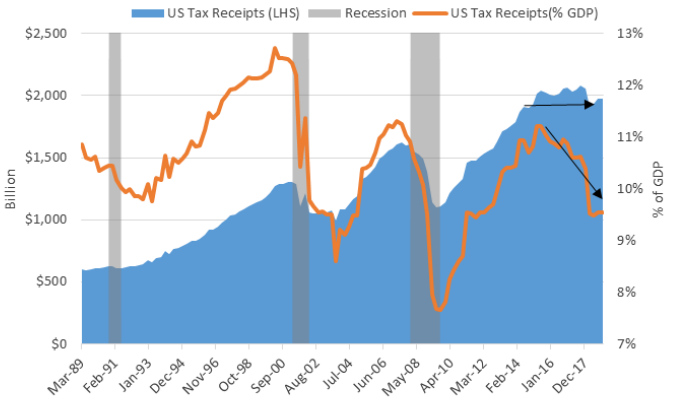
Looking back at the last seven recessions, the budget deficit has increased an average of 4% of GDP, rising as much as 8.8% during the 2008 financial crisis. (Figure 8) If we use the Congressional Budget Office (CBO) projections for the Federal budget deficit for 2019-2023 and apply a 4% of GDP adjustment based on recession then the budget deficit would increase to $1.8 trillion in 2020, or 8.6% of GDP.[3] (See Figure 9 on following page) At the same time the Federal Reserve is expected to reduce its U.S. Treasury holdings, although this would likely change if the economy entered recession. While U.S. Treasuries may find temporary support from bouts of risk aversion in financial markets, over the medium term bond yields should move higher.

Figure 6: G4 Central Bank Balance Sheets and Global Equities



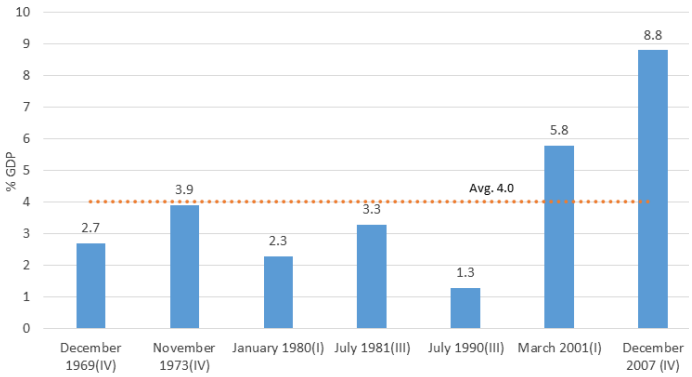
Source: Bloomberg, DoubleLine

Figure 7: U.S. Tax Receipts



Source: Bloomberg, DoubleLine

Figure 8: Change in Federal Budget Deficit In the Three Years Following a Recession



Source: Bloomberg, DoubleLine

[3] Assumes nominal GDP growth of 2.0% annualized 2019-2023, roughly half of the CBO's estimate of 4.1% during the period. Recession adjustment of 4.0% of GDP is applied to CBO budget deficit forecast. CBO forecast as of April 2018. https://www.cbo.gov/about/products/budget-economic-data

Outlook (cont'd)

Corporate Credit

We continue to believe rising supply of U.S. Treasuries will be a headwind for U.S. corporate credit over time. According to a McKinsey report from 2018, global nonfinancial corporate bonds outstanding has increased 2.5 times from 2007-2017, growing from $4.3 trillion to $11.7 trillion.[5] But the quality of the debt has seriously declined. In the U.S., 50% of the investment grade corporate bond market is now rated BBB. That's up from 35% in 2007, 33% in 2000, and 22% in 1991.[6] (Figure 10) According to a Morgan Stanley report from October 2018, based on leverage (Debt/EBITDA[7]) alone nearly 45% of the corporate investment grade market would be rated less than investment grade, or junk status.[8]

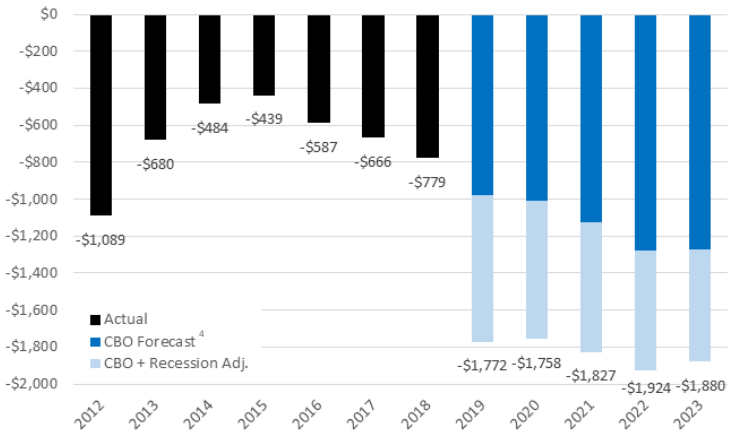
The key question is what happens to U.S. corporate debt market if we enter a recession?

U.S. Dollar

The growing budget deficit coupled with persistent current account deficits should represent a hurdle for the U.S. dollar. Historical evidence shows that growing twin deficits tend to put downward pressure on the trade weighted dollar. If the Federal Budget deficit balloons as the U.S. eventually enters a recession then the dollar will clearly be at risk as foreigner investors' confidence in the currency comes into question. Since 2009 the dollar has benefited from positive investment flows into the U.S. equity market as U.S. equities continued to outperform international equities. (Figure 11) If U.S. equities begin to underperform other global equities, then we could see inbound U.S. investment flows subside and the dollar decline. A lower dollar is one of our highly convicted views for 2019.

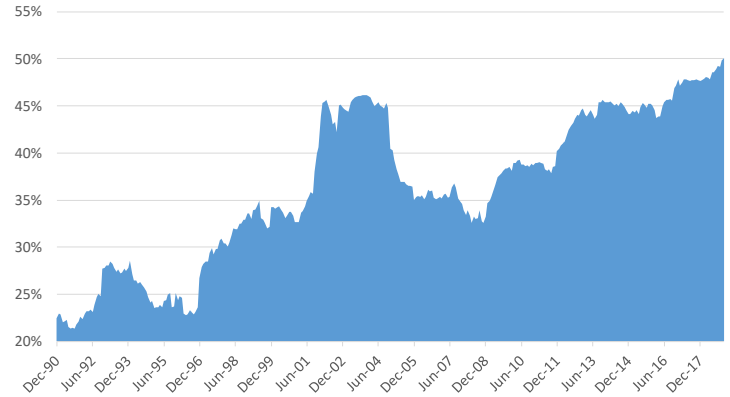
A lower dollar should have material impacts for other assets classes. Emerging market equities which have underperformed U.S. equities over the last eight years stand to benefit from a weaker dollar. We find it encouraging that emerging market equities outperformed during December when U.S. equities suffered their worst month since the financial crisis, even with a relatively stable dollar during the month. In our multi-asset portfolios we are overweight emerging markets equities vs. U.S. equities. Long gold is also attractive if the dollar is set to decline.

Figure 9: U.S. Budget Deficit



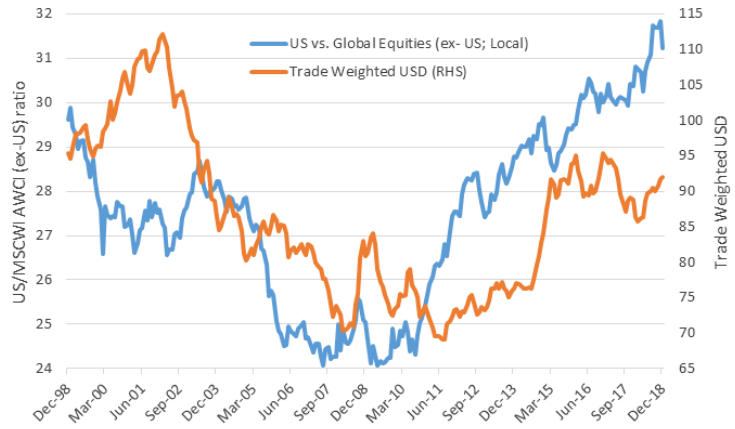
Source: Bloomberg, DoubleLine

Figure 10: BBB U.S. Corporate Debt as % of Investment Grade Market



Source: Bloomberg, DoubleLine

Figure 11: U.S. vs. Global Equities (ex-U.S.; Local) and Trade Weighted USD



Source: Bloomberg, DoubleLine

[4] Forecasts are inherently limited, may not come to pass and cannot be relied upon for investment decisions.

[5] McKinsey & Company. *Rising Corporate Debt Peril or Promise?* June 2018

[6] Based on ICE Bank of America Merrill Lynch BBB U.S. Corporate Index Full Market Value

[7] EBITDA - Earnings before interest, tax, depreciation, and amortization

[8] Morgan Stanley Global Macro Forum. *Equities and the 'BBBeast'* October 29, 2018

Outlook (cont'd)

The global growth outlook is not as rosy as it was 12 months, or even six months ago, but still remains in expansion territory, which is supportive for global equities. Central bank monetary tightening via rate hikes and reduction of balance sheets is a key headwind to risk assets. For now the Federal Reserve has calmed markets with the notion of 'patience', but the Fed still expects more rate hikes by the end of 2020 and the balance sheet is expected to decline throughout the year. U.S. Treasuries may find near term support from risk-off flows; however, the fundamental backdrop for U.S. Treasuries is poor with a rapidly expanding Federal budget deficit. Higher interest rates combined with rising leverage in the corporate sector creates significant risk in the asset class. Our view is that the dollar will weaken over the medium term, driven by growing twin budget and current account deficits. The weaker dollar should benefit emerging market equities and commodities sensitive assets, two areas we prefer to overweight. While still low, the probability of recession over the next 12-18 months has increased, which was reflected in many asset classes in December. We will continue to monitor the incoming economic data for any signs of slowing in real economic activity. The risks have definitely risen.

Good luck in 2019. ■

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Definitions of Select Terms

Basis Point - A basis point (bps) equals 0.01%.

Bloomberg Barclays U.S. Aggregate Bond Index - An index that represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Bloomberg Commodity Index (BCOM) - An index calculated on an excess return basis that reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector and group level for diversification. Roll period typically occurs from 6th-10th business day based on the roll schedule.

Citi Economic Data Change Indices - Measure data releases relative to their 1-year history. A positive reading means that data releases have been stronger than their 1-year average, and a negative reading means that data releases have been worse than their 1-year average.

Conference Board Leading Economic Index (LEI) - Phenomena, such as the unemployment and new construction rates, used by the Conference Board to predict the financial condition of a particular industry or the economy in general.

Credit Quality - Determined from the highest available credit rating from any Nationally Recognized Statistical Rating Agency ("NRSRO", generally S&P, Moody's, or Fitch). DoubleLine chooses to display credit ratings using S&P's rating convention, although the rating itself might be sourced from another NRSRO. The firm evaluates a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade. In limited situations when the rating agency has not issued a formal rating, the rating agency will classify the security as nonrated.

Dow Jones Industrial Average (DJIA) - A price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

DXY - A weighted geometric mean of the United States dollar's value relative to a basket of 6 major foreign currencies, including the Euro, Japanese yen, Pound sterling, Canadian dollar, Swedish krona and Swiss franc.

EM Sovereign Debt is represented by Bloomberg Barclays EM Sovereign TR Index—The Bloomberg Barclays Emerging Markets USD Sovereign Bond Index tracks fixed and floating-rate US dollar-denominated debt issued by EM governments. Country eligibility and classification as Emerging Markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classifications.

Eurostoxx 50 Index - A stock index of Eurozone stocks designed by STOXX, an index provider owned by Deutsche Borse Group and SIX group, with the goal of providing a blue-chip representation of Supersector leaders in the Eurozone.

G4 Central Banks - The Federal Reserve, the Bank of England, the European Central Bank, and the Bank of Japan.

Institute for Supply Management Purchasing Managers Index (PMI) - An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Investment Grade - Description of a bond considered eligible for bank investment. Such bonds are rated Baa or above by Moody's or BBB or above by Standard & Poor's.

ISM Non-Manufacturing PMI - An index made up of data from 400 non-manufacturing firms collected by the Institute of Supply Management (ISM).

Morgan Stanley Capital International All Country World Index (MSCI ACWI) - A market-capitalization-weighted index designed to provide a broad measure of stock performance throughout the world, including both developed and emerging markets.

MSCI Emerging Markets (MSCI EM) - An index that covers 23 Emerging Market countries and is designed to capture the large and mid-cap representation across those countries.

Nikkei 225 Index - A price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S.

Russell 2000 Index - An index that measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values.

S&P 500 Index - A market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value. The index is widely regarded as the best single gauge of large-cap U.S. equities.

Spread - The difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings and risk.

U.S. Corp IG - The Bloomberg Barclays U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

U.S. Corp HY - The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

An investment cannot be made directly in an index.

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DoubleLine is an active manager and will adjust the composition of client's portfolios consistent with our investment team's judgment concerning market conditions and any particular security. The construction of DoubleLine portfolios may differ substantially from the construction of any of a variety of bond market indices. As such, a DoubleLine portfolio has the potential to underperform or outperform a bond market index. Since markets can remain inefficiently priced for long periods, DoubleLine's performance is properly assessed over a full multi-year market cycle.

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