DoubleLine® FUNDS

Economic Update

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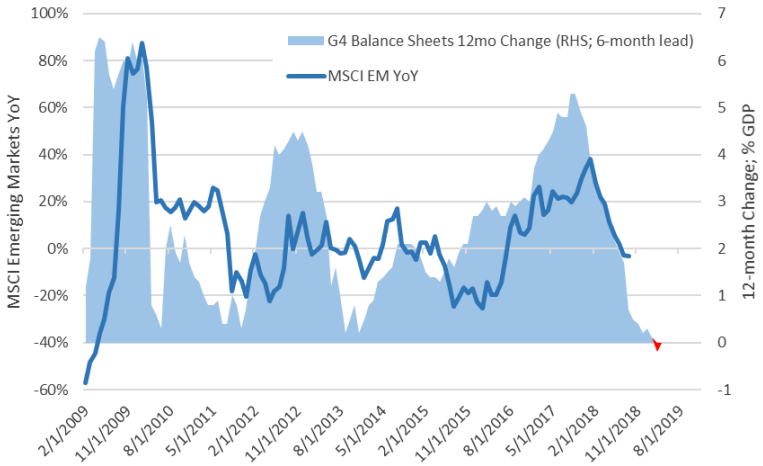
Third Quarter 2018 Review

Another quarter has come and gone with many of the same themes we identified in the second quarter remaining at the forefront. The Federal Reserve (Fed) continued to hike key policy rates and increased the pace of balance sheet reduction during the third quarter. The combined balance sheets for the Fed, European Central Bank (ECB), Bank of England (BoE), and Bank of Japan (BoJ) declined for the first time since coming out of the recession in 2009. This overall reduction in central bank accommodation increased concerns of tightening financial conditions leading to the underperformance of select asset classes, such as emerging markets (See Figure 1).

Trade tensions between U.S. and China remained at the top of many investor's minds as the Trump Administration moved forward with 10% tariffs on $200 billion of Chinese imports after the initial 25% tariffs on $50 billion and threatened to impose tariffs on an additional $267 billion of Chinese goods. In contrast, some progress on trade was made with a trilateral trade deal, called the U.S.-Mexico-Canada Agreement (USMCA), struck between the three countries in place of North American Free Trade Agreement (NAFTA).

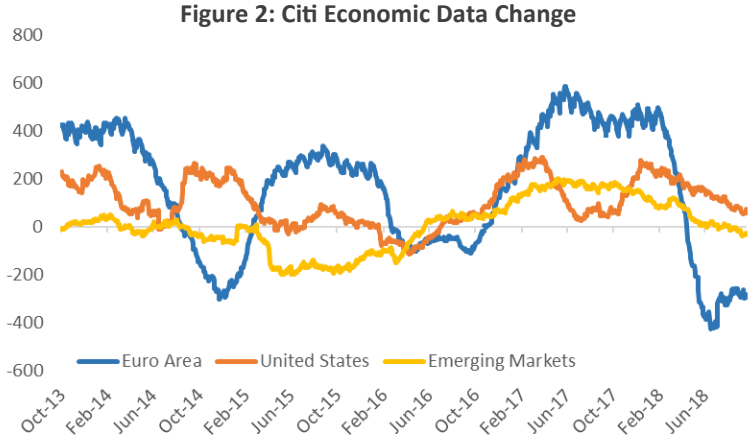
U.S. economic growth continued to outshine most of the developed world as the benefits from fiscal stimulus percolated through the market. Survey data remained at high levels with select measures at multi-cycle highs including NFIB Small Business Sentiment, The Conference Board Consumer Confidence Index, and Institute for Supply Management (ISM) Non-Manufacturing Purchasing Managers' Index (PMI). Meanwhile economic momentum for other developed and emerging countries continued to decelerate, as seen in the regional economic momentum measures (see Figure 2). U.S. headline inflation reached the highest level since 2012 and core inflation, which excludes food and energy prices, elevated to a post-crisis high (see Figure 3). Average hourly earnings also reached a post-crisis high at 2.9% year-over-year (YoY) in the third quarter.

Figure 1: Central Bank Balance Sheets and Emerging Markets Equities



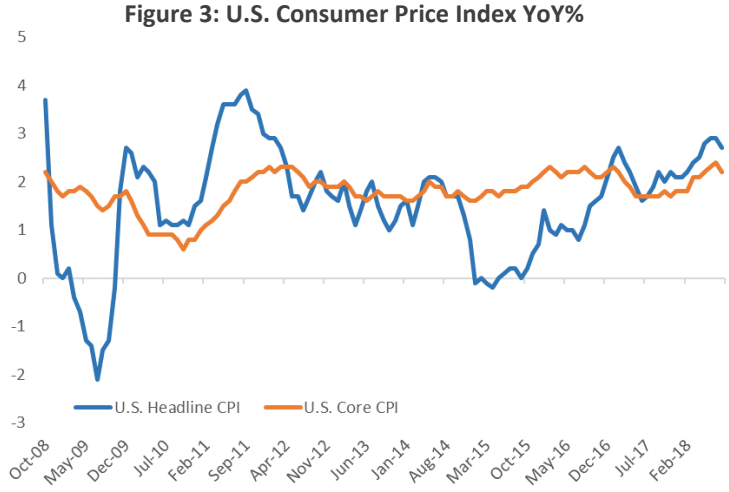
Source: Bloomberg, DoubleLine

Figure 2: Citi Economic Data Change



Source: Bloomberg, DoubleLine

Figure 3: U.S. Consumer Price Index YoY%



Source: Bloomberg, DoubleLine

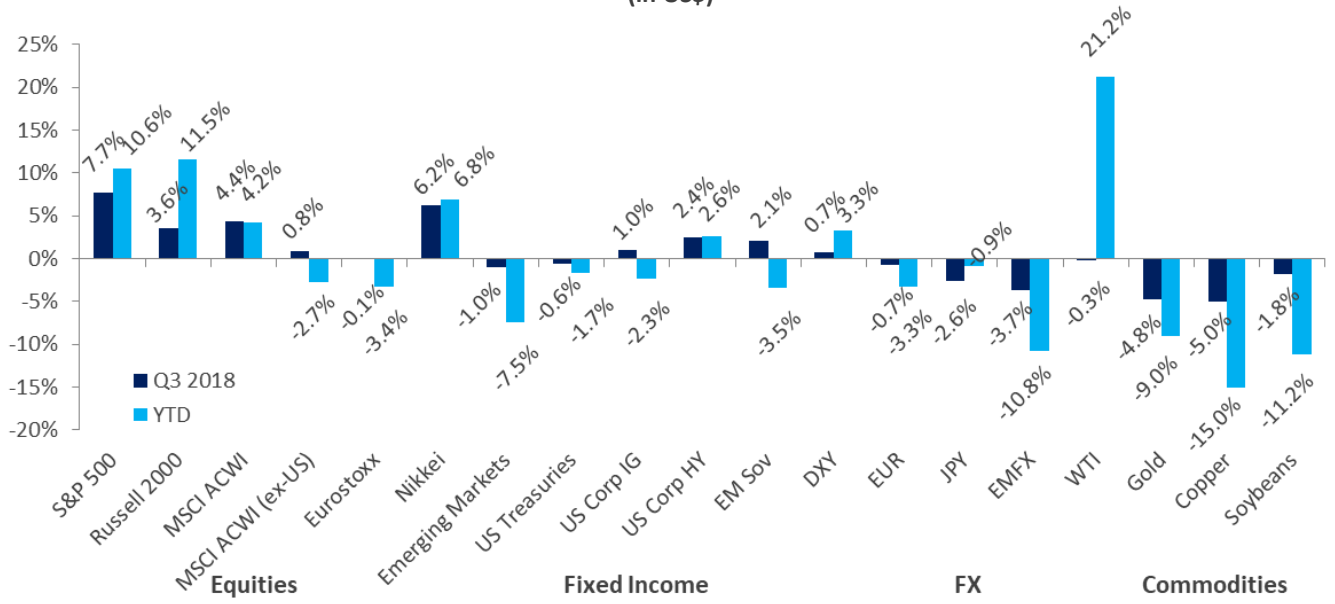
Third Quarter 2018 Review (cont'd)

U.S. equities significantly outperformed international equities in the third quarter with the S&P 500 gaining +7.7% versus Morgan Stanley Capital International All-Country World Index (MSCI ACWI) excluding U.S. which was up only +0.8%, in U.S. Dollar (USD) terms. Emerging market (EM) equities underperformed with the MSCI Emerging Markets Index -1.0% during the third quarter. EM equities were weighed down by a combination of a strengthening USD, primarily against EM currencies, growing U.S./China trade war tensions, a visibly slowing Chinese economy, and tightening monetary policy from the Fed. European equities underperformed, driven by rising political risk in Italy and Germany. Japanese equities performed reasonably well, with the Nikkei 225 up +6.2% in USD terms, on the back of a weakening Japanese Yen.

Within fixed income, U.S. Treasuries (UST) declined as the 10-year yield climbed 20 basis points (bps) during the quarter. Credit performed better with spreads on both U.S. investment grade and high yield corporate credit tightening during the quarter.

Commodities were generally lower in the third quarter with the Bloomberg Commodity Index (BCOM) declining 2.5%. West Texas Intermediate (WTI) was down 0.3%, while Gold was down 4.8% and Copper down 5.0% during the period (see Figure 4 for third quarter and year-to-date cross asset performance).

Figure 4: Performance of Asset Classes (in US$)



Source: Bloomberg, DoubleLine
FX - Foreign Exchange; WTI - West Texas Intermediate Crude; Gold, Copper and Soybeans are based on futures; EUR - EUR/USD; JPY: JPY/USD

Outlook

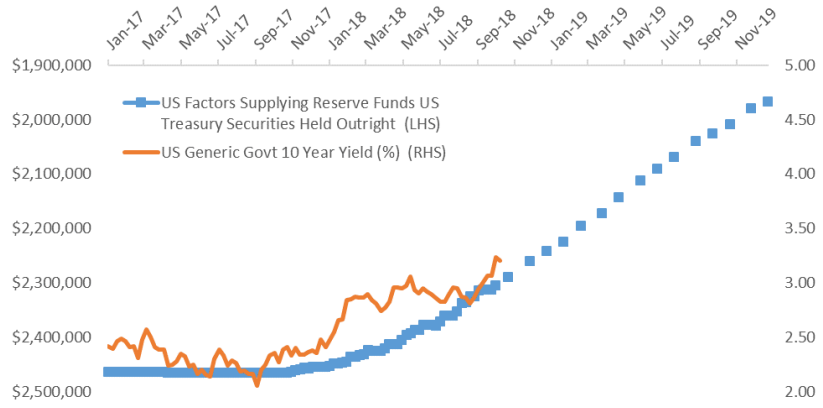
The path of UST yields will be crucial for financial markets over the coming months potentially affecting other asset classes. We believe we have reached an inflection point for U.S. government bonds, which could lead to an acceleration of higher global bond yields. The 30-year UST yield was the "last man standing" in the multi-decade bond bull market. We may be entering a different regime for bonds.

The fundamental backdrop for bonds is poor. The Fed will continue to reduce its balance sheet over the coming months (see Figure 5).[1] Demand for treasuries from Japanese and European investors has declined as the cost to hedge USD more than offsets the yield pick-up (see Figure 6). At the same time, the supply of UST will surge as the budget deficit grows. Many inflation measures are near post-crisis highs, including wage growth, and leading inflation indicators (see Figure 7).

Rising UST yields are a headwind for U.S. corporate credit, particularly investment grade, which has higher duration exposure. U.S. corporate debt outstanding has ballooned to an all-time high at about 46% of U.S. Gross Domestic Product (GDP) (see Figure 8). At the same time, spreads for both investment grade and high yield remain at post-crisis lows. **Within credit we prefer floating rate debt which should outperform as the Fed continues to hike rates.** We also continue to like securitized credit which performs better in a rising rate environment as amortizing principle can be reinvested at higher yields.

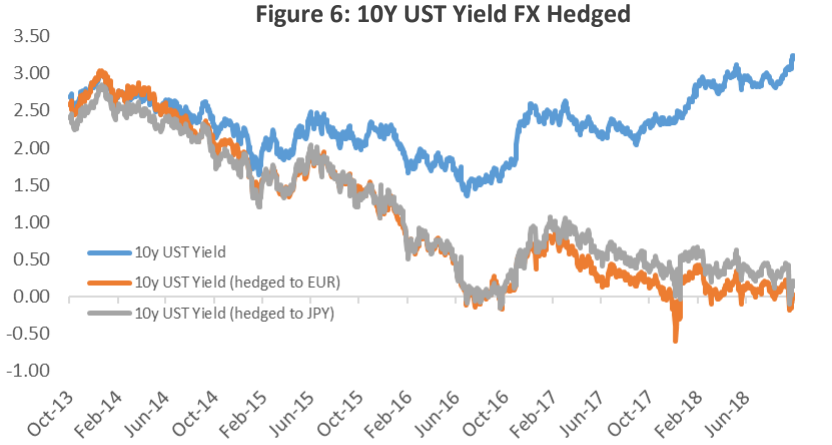
An acceleration higher in yields may also be a headwind for global equities. With 3-month LIBOR at 2.40% cash is starting to look like a viable alternative for investors. Fed rate hikes and quantitative tightening will be a headwind to U.S. equities. U.S. equities have benefitted from fiscal stimulus, with tax reform driving up corporate earnings growth; however, this tailwind may subside as the fiscal effects abate in the coming quarters. The divergence of U.S. equities and

Figure 5: 10Y UST vs. Fed Holdings of U.S. Treasuries (inverted)



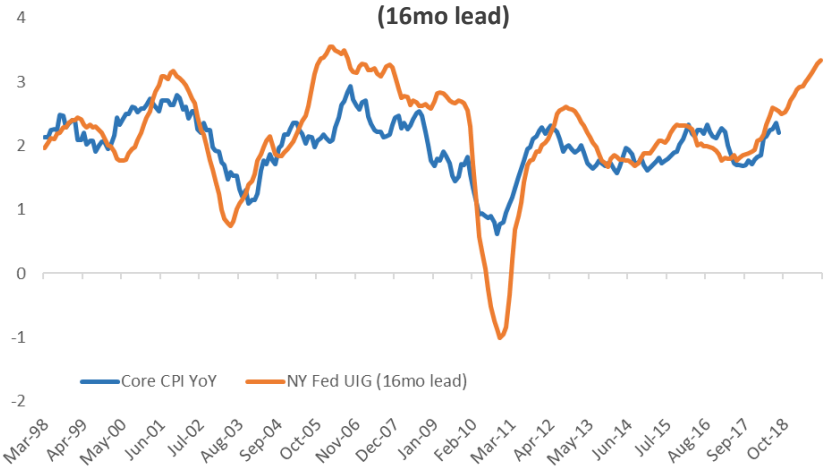
Source: Bloomberg, DoubleLine

Figure 6: 10Y UST Yield FX Hedged



Source: Bloomberg, DoubleLine

Figure 7: Core CPI vs. Underlying Inflation Gauge (16mo lead)



Source: Bloomberg, DoubleLine

1 Estimates from the Federal Reserve Bank of New York. https://www.federalreserve.gov/econres/notes/feds-notes/projected-evolution-of-the-soma-portfolio-and-the-10-year-treasury-term-premium-effect-accessible-20170922.htm#fig1

Outlook (cont'd)

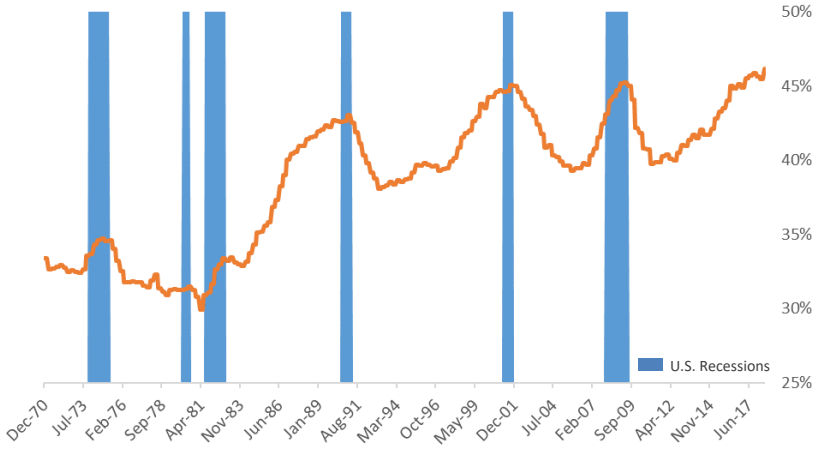
international equities this year is truly staggering, particularly since global equities peaked on January 26 (see Figure 9). We do not think the U.S. outperformance will last. In fact, we are already seeing problems in a number of sectors including homebuilders, auto-makers, and banks. We may have seen the peak in global equities.

Over the long-term, we believe the USD will depreciate. The USD has enjoyed a premium given its reserve currency status, allowing the U.S. to comfortably run both current account and budget deficits. But as the budget deficit grows and the U.S. becomes less involved in global trade, foreigners will start to diversify away from dollars. Jean-Claude Junker, the European Commission president, vowed in September to "turn the euro into a global reserve currency that could rival the dollar."[2] We have already seen a challenge to the Petro dollar with the launch of Chinese Yuan-denominated crude oil futures. These non-dollar instruments already comprise 14% of total crude futures trading volume since they launched a few months ago (see Figure 10).

During the final stretch of 2018, UST yields will likely be a key market driver. An acceleration higher in yields could weigh on both corporate credit and global equities. Whether it will lead to a sustained downtrend in risk assets or an incoming bear market remains to be seen. Keep in mind most economic indicators we monitor continue to signal expansion with low probability of recession over the next six to nine months. Absent a recession, a sustained bear market in both equities and credit is unlikely. The Fed is expected to continue to hike policy rates and reduce its balance sheet as long as financial conditions don't tighten dramatically. However, if inflation continues to edge higher, as some of our indicators are projecting, then the Fed may have to keep tightening even if financial conditions tighten. It is less clear how the dollar will react over the near term as both real and nominal yields rise in the U.S. However, over the long-term it seems likely that the premium afforded to the USD will come into question. We could be at very important inflection points in a number of assets classes. Good luck in the final quarter of 2018. ■

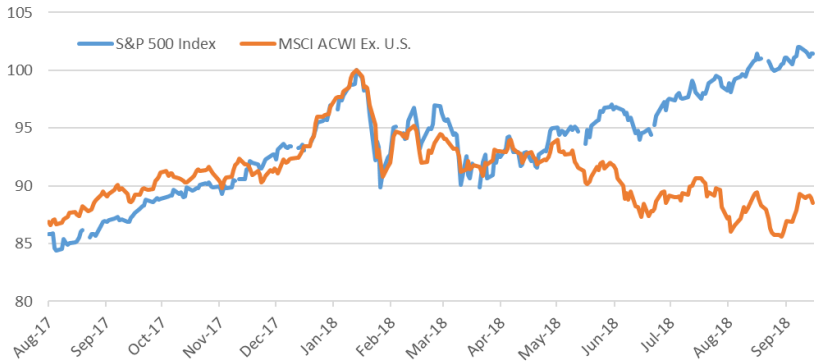
2 Financial Times, *Juncker vows to turn euro into reserve currency to rival US dollar.* September 12, 2018

Figure 8: U.S. Corporate Debt to GDP



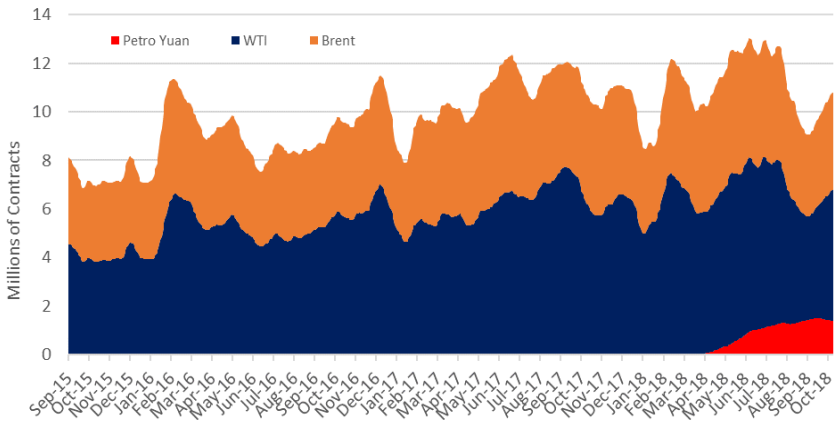
Source: Bloomberg, DoubleLine

Figure 9: S&P 500 vs. MSCI ACWI ex-U.S. Performance Normalized to 1/26/2018



Source: Bloomberg, DoubleLine. 1/26/2018 = 100

Figure 10: Crude Oil: Rolling 5-Day Trading Volume



Source: Bloomberg, DoubleLine

Definitions of Terms Used

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

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. You cannot invest directly in an index.

Consumer Price Index— Measure of prices paid by consumers for a market basket of consumer goods and services. Core CPI excludes food and energy components.

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.

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).

London Interbank Offered Rate - (LIBOR) - An indicative average interest rate at which a selection of banks known as the panel banks are prepared to lend one another unsecured funds on the London money market.

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.

NFIB Small Business Sentiment Index - An economic indicator that measures the amount of optimism or pessimism that business managers feel about the prospects of their companies/organizations. It also provides an overview of the state of the economy.

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.

S&P 500 Index - Standard & Poor's US 500 Index, a capitalized-weighted index of 500 stocks.

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.

Underlying Inflation Gauge – A measure introduced by the NY Federal Reserve Bank that captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data.

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

U.S. Corp HY - The Bloomberg Barclays US 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.

EUR/USD: Price of 1 EUR in USD.

JPY/USD: Price of 1 JPY in USD.

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