Harbor Bond Fund

Manager Commentary
As of 06/30/2020

Subadviser: Pacific Investment Management Company, LLC *(Since 12/29/1987)*
Portfolio Managers: Scott A. Mather, Mark R. Kiesel, Mohit Mittal

2nd Quarter, 2020

"Our base case is that the economic recovery will be gradual and uneven, with many economies not returning to their pre-crisis, gross domestic product (GDP) levels until 2022."

Pacific Investment Management Company LLC

Market in Review

Risk appetite improved considerably in the second quarter, following positive developments in the macroeconomic backdrop. Among the developments were the easing of lockdown measures, some improvement in economic data, and continued fiscal and monetary policy support. Credit spreads tightened considerably, and the dollar weakened. While demand concerns briefly spurred U.S. oil prices into uncharted, negative price territory early in the quarter, sentiment stabilized. Sovereign yield moves were broadly mixed, with yield curves steepening in some regions, though central bank activity generally anchored rates at low levels.

After months of lockdowns, several regions around the world began easing restrictions, including those combating the highest infection rates. Economic data indicated that some recovery was underway. Global purchasing managers' indexes (PMIs) improved, following sharp declines, and unemployment measures fell from record peaks. Concerns persisted, however, about the vulnerabilities related to the path of the virus, as cases globally surpassed 10 million. Select regions within the U.S. reported a resurgence in the pace of new infections, and some states even began to slow or reverse reopening efforts.

Global central banks and policymakers reaffirmed commitments to supportive policy and quantitative easing measures. On the fiscal front, the European Commission proposed a €750 billion plan to finance COVID-19 stimulus efforts, and Japan's cabinet approved a total of $1.1 trillion in fiscal stimulus. The U.S. announced a package to expand its Paycheck Protection Program, adding $480 billion in April. Geopolitical tensions also garnered headlines in the quarter. Social unrest spread across the U.S., including waves of protests and riots in major cities. Meanwhile, China announced and imposed a national-security law in Hong Kong, in part to subdue swelling, anti-government and pro-democracy protests—a move that escalated tensions with the U.S.

Portfolio Performance

In the second quarter of 2020, the Harbor Bond Fund (Institutional Class) returned 4.20%, outperforming its benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index, which returned 2.90%.

Performance data shown represents past performance and is no guarantee of future results. Past performance is net of management fees and expenses and reflects reinvested dividends and distributions. Past performance reflects the beneficial effect of any expense waivers or reimbursements, without which returns would have been lower. Investment returns and principal value will fluctuate and when redeemed may be worth more or less than their original cost. Returns for periods less than one year are not annualized. Current performance may be higher or lower and is available through the most recent month end at harborfunds.com or by calling 800-422-1050.

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Performance over the quarter was led by duration and positioning in the U.S., with a focus on the intermediate portion of the yield curve, along with security selection in both investment grade and high yield corporate credit. Out-of-benchmark exposures to non-Agency mortgage-backed securities (MBS) and U.S. Treasury Inflation-Protected Securities (TIPS) also contributed to performance. Non-U.S. interest rate strategies, including Italy and the U.K., and selection within Agency MBS detracted from performance over the quarter.

Portfolio Positioning

The Fund was underweight to headline duration, though we still favor U.S. duration against rate exposure in other developed regions, including the U.K. and Japan. Even though U.S. yields have fallen, we believe U.S. duration continues to remain attractive on a relative basis. We still favor a curve- steepening bias, though we are mindful that the extent of Fed asset purchases could anchor long term yields in the near term. Overall, our duration positioning was positive for performance.

We continue to have a bias towards liquid and high quality corporate credit, while de-emphasizing generic, corporate credit exposure. We are opportunistically seeking to take advantage of dislocations, though we remain patient, given the likelihood of a true credit cycle—with downgrades and defaults—to unfold. Overall, credit-sector positioning was positive for performance.

Out-of-benchmark allocations contributed to performance, including an allocation to U.S. TIPS, as inflation expectations rose over the quarter. We have decreased our TIPS exposure and are currently neutral TIPS in the portfolio, given that TIPS may face some near term volatility with a challenged growth outlook.

We currently have minimal currency positioning, given the uncertain backdrop. We will continue to seek opportunities from overshoots and undershoots that provide attractive risk-reward profiles and the ability to diversify sources of return.

Contributors and Detractors

Over the second quarter, the largest contributors to performance were the Fund’s holdings in non-Agency MBS and other securitized positions. We continue to favor senior positions in mortgage credit, given the inherent fundamental strength and the deleveraging nature of these assets. The prices on these securities also continued to recover, amid broader market stabilization.

Non-U.S. interest rate strategies, overall, detracted from performance. Italian duration positioning was negative for returns, primarily over the month of April, as Italian yields rose. As U.K. yields fell over the quarter, short exposure to U.K. duration also detracted.

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Buys and Sells

We still favor U.S. duration against rate exposure in other developed regions. Even though U.S. yields have fallen, we think U.S. duration remains relatively attractive. This is based on the potential for capital appreciation (i.e., U.S. rates have more room to fall if downside risks materialize), an easing bias from the Federal Reserve (the Fed), and relatively range-bound rates, as it is unlikely the Fed will move off the zero bound on interest rates anytime soon.

We have brought down our TIPS position currently, as TIPS may face some near term volatility, due to oil price declines and a challenged growth outlook. Over the longer term, we still expect inflation to shift back toward the Fed's target. While there is the potential for overshoots on its inflation target, given a supportive Fed, we have adjusted our position lower for now due to near term headwinds.

Outlook

Our base case is that the economic recovery will be gradual and uneven, with many economies not returning to their pre-crisis, gross domestic product (GDP) levels until 2022. We believe social distancing, be it voluntary or mandated, will be necessary and likely until an effective medical treatment for the virus is widely available. This means many sectors will not be able to ramp up to pre-crisis capacity anytime soon. Global and national supply chains will remain impaired for some time because reopening will be uneven across countries, regions, and sectors, in our view.

The reallocation of labor and capital from losing to winning sectors and companies is a process that takes time and may even be hampered by policies that keep "zombie" firms in business. We also believe that a debt overhang in the corporate and household sector, as a consequence of the recession, will likely weigh on consumer and investment spending for the foreseeable future.

Along with the base case, our outlook encompasses other potential paths, good and bad. Under the optimistic scenario, the rapid development of a medical treatment for the virus would enable economies to reopen and normalize more quickly than is currently anticipated. The pessimistic scenario involves a strong and widespread second wave of the virus that forces governments to renew social-distancing policies. This could lead to a double-dip recession and result in permanent business closures and job losses. In aggregate, while our base case assumes a gradual improvement in economic data, the risks appear skewed to the downside. However, we believe it seems fairly clear that policymakers are committed to further easing, even if better-than-expected economic indicators prevail, creating a plausible upside scenario as well.

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Trusted Partnerships › Trusted Solutions

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ECONOMIC SECTORS

	% of Net Assets
Mortgage Pass-Through	42.44
Corporate Bonds & Notes	41.63
U.S. Government Obligations	22.18
Collateralized Mortgage Obligations	10.01
Asset-Backed Securities	7.50
Foreign Government Obligations	2.82
Municipal Bonds	0.33
Bank Loan Obligations	0.27
Escrow	0.00

TOP TEN HOLDINGS

Company Name	% of Net Assets
1. Federal National Mortgage Association	8.55
2. Federal National Mortgage Association	5.57
3. Government National Mortgage Associat	5.13
4. U.S. Treasury Bonds	4.94
5. Federal National Mortgage Association	4.16
6. Federal National Mortgage Association	3.53
7. Federal National Mortgage Association	3.32
8. U.S. Treasury Notes	2.22
9. U.S. Treasury Notes	2.17
10. U.S. Treasury Bonds	2.08

TOTAL RETURNS

	Three Months	1 Yr.	5 Yr.	10 Yr.	Since Incp. (12/29/1987)	Expense Ratios Net	Expense Ratios Gross
Harbor Bond Fund - *INST*	4.20%	8.45%	4.42%	4.06%	6.95%	1.04%	1.15%
Bloomberg Barclays U.S. Aggregate Bond Index	2.90%	8.74%	4.30%	3.82%	6.33%		

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This information should not be considered as a recommendation to purchase or sell a particular security. The holdings or countries mentioned may change at any time and may not represent current or future investments.

Adjusted Expense Ratio: 0.51% The Adjusted Expense Ratio excludes certain investment expenses, such as interest expense from borrowings and repurchase agreements and dividend expense from investments on short sales, incurred directly by the Fund or indirectly through the Fund's investments in underlying Harbor Funds (if applicable), none of which are paid to Harbor. The net expense ratios for this fund are subject to a contractual management fee waiver and/or expense limitation agreement, excluding interest expense and acquired fund fees and expenses (if any), through 02/28/2021. Interest expense for the fiscal year ended October 31, 2019 was 0.53%.

The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index of investment-grade fixed-rate debt issues with maturities of at least one year. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

Fixed income investments are affected by interest rate changes and the creditworthiness of the issues held by the Fund. As interest rates rise, the values of fixed income securities held by the Fund are likely to decrease and reduce the value of the Fund's portfolio. The use of derivative instruments may add additional risk. There may be a greater risk that the Fund could lose money due to prepayment and extension risks because the Fund invests heavily at times in mortgage-related and/or asset backed securities. The Fund may engage in active and frequent trading to achieve its principal investment strategies. Investing in international and emerging markets poses special risks, including potentially greater price volatility due to social, political and economic factors, as well as currency exchange rate fluctuations. These risks are more severe for securities of issuers in emerging market regions.

Views expressed herein are drawn from commentary provided to Harbor by the subadviser, Pacific Investment Management Company LLC, and may not be reflective of their current opinions or future actions, are subject to change without prior notice, and should not be considered investment advice.

Investors should carefully consider the investment objectives, risks, charges and expenses of a Harbor fund before investing. A summary prospectus or prospectus for this and other information is available at harborfunds.com or by calling 800-422-1050. Read it carefully before investing.

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