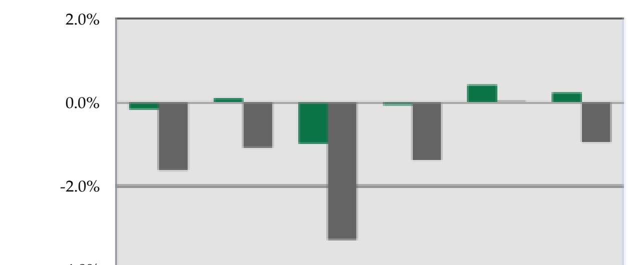
National Investment Services

Second Quarter, 2018 Investment Review

FIXED INCOME OVERVIEW

Bonds finished the quarter a bit lower as the market continues to wrestle with higher interest rates and uncertainty surrounding trade. The Bloomberg Barclays Aggregate Index lost almost 0.16% to start the year as the FED increased their benchmark yield range by another 25 basis points. Diversification was a key driver to our outperformance, as our mortgage, ABS and CMBS sectors led the way, while corporate bonds performed poorly from an absolute return perspective.

Index Sector Performance

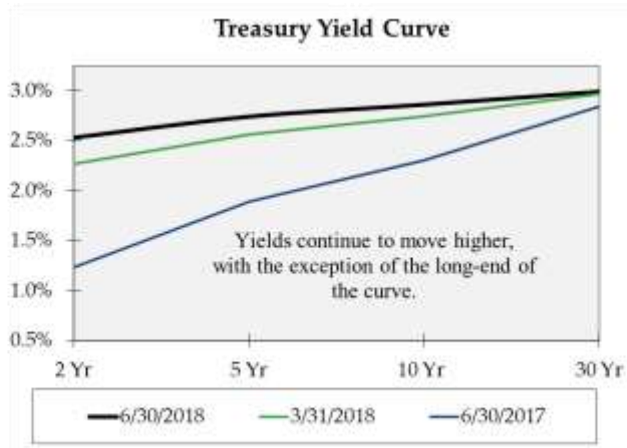


	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q2 '18	-0.16%	0.10%	-0.98%	-0.06%	0.42%	0.24%
Year-to-Date	-1.62%	-1.08%	-3.27%	-1.38%	0.03%	-0.95%

Source: Bloomberg

Treasury bond yields continued their general trend higher as the domestic economy continues to grow. The ten-year benchmark yield rose about 10 basis points to 2.83% and the two-year note finished the quarter at 2.55%, making for an even flatter curve.

We also find it interesting that the thirty-year benchmark yield now stands inside of 3%, making this the flattest interest rate curve since just before the "Great Recession."



Source: Bloomberg

CREDIT SPREADS

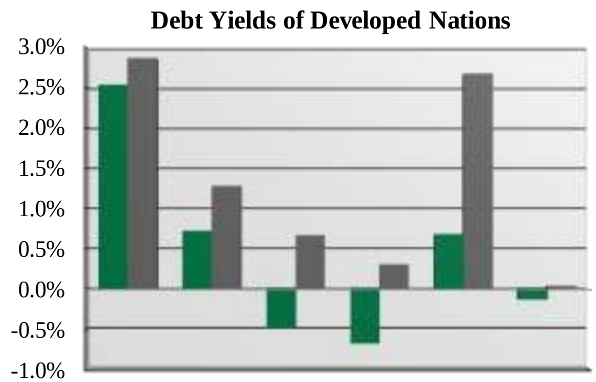
Corporate bonds struggled to find their footing as selling pressure moved spreads 14 basis points wider. Investment grade bond spreads are now 30 basis points wider than year-end levels. Our general observation is that this weakness is more the result of supply/demand issues than actual business fundamentals. Few sectors were spared, but we know that telecommunications and media names suffered the most, as supply, mega-mergers and legal matters directly influenced this area of the market.

Our corporate bond managers are finding value in many areas of their sectors and we as a firm have been shifting sector allocations to better focus our efforts.

Source: Bloomberg

THE ECONOMY

The U.S. economy continues to motor along seemingly unfazed by the reality that we might be at the beginning of a trade war with the world's second largest economy, China. We note, however, that the Shanghai stock index was down almost 10% in the second quarter, as the U.S. dollar strengthened, potentially signaling that U.S. exporters may face a bit of a headwind in the coming months. Another area that appears to be noticing the new reality of harsher trade conditions is that of the European bond yields.



	United States	United Kingdom	France	Germany	Italy	Japan
2 Year	2.53%	0.72%	-0.48%	-0.67%	0.68%	-0.13%
10 Year	2.86%	1.28%	0.66%	0.30%	2.67%	0.03%

Source: Bloomberg

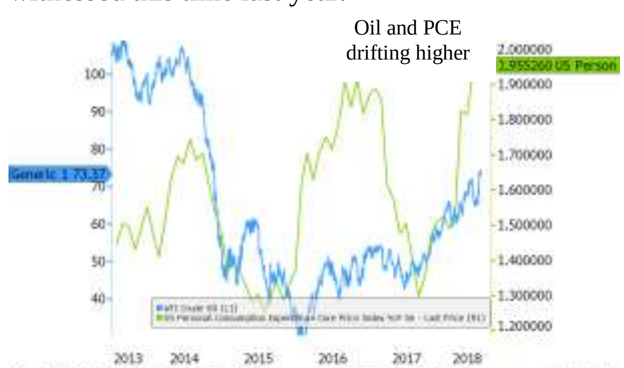
Yields in the UK, France, Germany and Italy are all lower than the previous quarter, while Japanese bond yields remain about the same. The current difference between the U.S. and German 10 yr. bonds has probably kept a lid on our rates but we wonder how long this dichotomy can last?

Source: Bloomberg

Employment growth in the U.S. remains solid and the labor force participation rate for working-age people has actually increased, offsetting some of the decline from retiring "baby boomers." Wage growth remains elusive, which should extend the current economic expansion while keeping inflation relatively in check. We are, however, keeping our eye on the core PCE and other inflationary gauges for signs of an overheating economy.

Source: Bureau of Economic Analysis, Bloomberg

Oil is another factor that could drive inflation higher and it recently made a run into the $70's, which is a big jump from the mid-$40's we witnessed this time last year.



Source: NY Mercantile Exchange, Bloomberg

THIRD QUARTER STRATEGY

As we look forward to the back half of 2018, our managers are concerned with how the market will handle an approximate $600 billion increase in U.S. Treasury supply over the next year or so. We wonder specifically, who is the net buyer and at what price? We therefore believe that caution is warranted, especially with regard to rate exposure, and we are managing portfolio durations in a general range of 95% of index levels. We have also shifted our closing 2018 10-year UST forecast to 3.20%. Accounts with DFI mandates will remain lower in relative duration and in the coming months should look for a slight shift away from their core and high yield allocations into the NIS Absolute Return Strategy, as the risk/return profile of Absolute Return continues to look favorable given the aforementioned spread widening within investment grade corporate bonds. Our managers continue to seek out investments in the non-agency mortgage and CMBS sectors when presented, as we like their diversifying properties. We also plan to reduce some of our taxable muni and ABS holdings, as these areas have approached their fair value.

Mark R. Anderson, CFA
Chief Strategy Officer

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