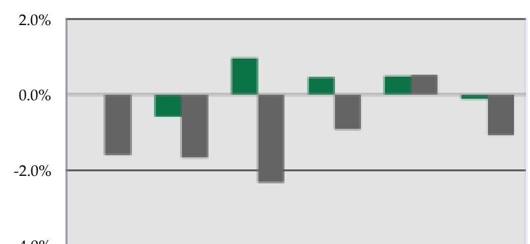
Third Quarter, 2018 Investment Review

National Investment Services

FIXED INCOME OVERVIEW

Bonds finished the quarter essentially flat as interest rates drifted higher in September on a steady U.S. economy and another bump in the Fed Funds rate. The Bloomberg Barclays Aggregate Index gained just 0.02%, with corporate bonds leading the way. Diversification was once again a driver to our index outperformance, as corporates, munis, ABS and CMBS sectors led the way, while treasury bonds lost value.

Index Sector Performance



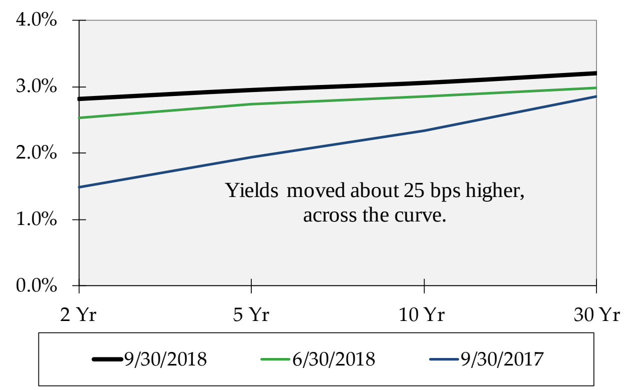
	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q3 '18	0.02%	-0.59%	0.97%	0.46%	0.49%	-0.12%
Year-to-Date	-1.60%	-1.67%	-2.33%	-0.93%	0.52%	-1.07%

Source: Bloomberg

Treasury bond yields marched higher as the Federal Reserve delivered a well-telegraphed rate hike near the end of the quarter. Recent market activity indicates there may be fewer investor concerns around growth as long duration buyers are demanding more of a premium than in recent quarters. The ten-year benchmark treasury yield rose 20 basis points to 3.06%, while the two-year note finished the quarter at 2.82%.

The market has not seen these levels in over a decade. This higher rate trend is important as investors weigh asset allocation and risk decisions.

Treasury Yield Curve

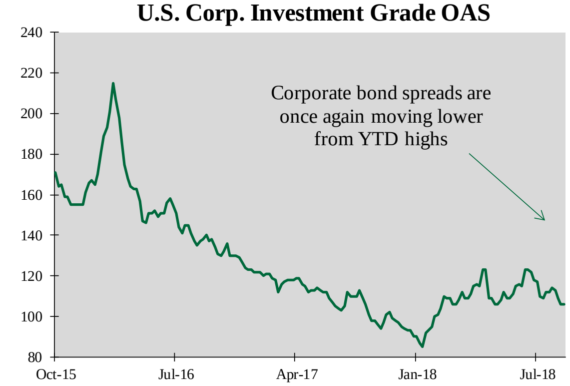


Source: Bloomberg

CREDIT SPREADS

Corporate bonds enjoyed a solid quarter, led by strength across the industrial sector as a cooling of trade war rhetoric focused buyer attention to the positive fundamentals of many U.S. companies. Investment grade corporate bond spreads within the Bloomberg Barclays Aggregate Composite tightened 17 basis points, erasing what they gave back in the previous quarter. Our portfolios benefitted from this move as we recently allocated additional dollars to industrial and communications names while trimming some financial positions, as valuations are quite tight.

U.S. Corp. Investment Grade OAS



Source: Bloomberg

THE ECONOMY

Our view on the U.S. economy continues to be quite favorable from both a fundamental and policy state. Trade tensions have cooled a bit as Canada recently joined the U.S. and Mexico in a revised NAFTA agreement that literally puts the U.S. first (USMCA). Domestic auto manufacturers are spared from tariffs on cars imported from Canada and Mexico, with requirements to build a greater portion of the car in North America with higher wage earners. Manufacturing data remains strong, with the September ISM PMI coming in at a still strong 59.8 reading, while non-manufacturing PMI data suggests synergies forming between manufacturing and the services sector. The unemployment rate in the U.S. stands at 50 year lows. Couple these realities with favorable tax and regulatory policies and it becomes a bit easier to make the case for higher levels of GDP growth in the coming quarters. Market participants will decide whether current prices reflect potential growth, but something has investors spooked, and it is not even Halloween.

THE FED

Much like the U.S. economy, the path of Fed Funds increases has been trending higher as the Open Markets Committee once again raised the overnight benchmark-borrowing rate by 25 basis points to approximately 2.15% at its September meeting.

Source: Bloomberg

The dovish days of easy U.S. central bank policy appear over as the median forecast of voting member projections call for another five to six increases over the next twelve to twenty-four months. This is a daunting outcome for many investors and our rates market is not the only one moving higher. Foreign markets are also taking notice as yields in many developed markets have moved up between 10 and 30 basis points since our last writing and even more so if you take into account the first few trading days of October.

The rates market certainly appears in transition as it seeks higher ground, so the question now becomes, will rates overshoot and when could they peak? It is worth noting that the Federal Reserve committee members have consistently overestimated the rise in Fed Funds since 2010 and we believe they may be doing it again. Therefore, we think rates could peak by the middle of next year, as they have historically peaked three months before the last tightening in prior cycles. This is also in harmony with a normal seasonal pattern of rates being at the highest point of the year on average during the March - June timeframe.

Higher interest rates may already be having an impact on housing. We note a recent pick up in home inventories, a slowdown in refi's and reports of new home price cuts in suburban California and Texas regions as signals of a potential housing slowdown. The chart below highlights a correlation between the 10-Year benchmark yield (green) and new home inventories (blue).

Source: Bloomberg

Additionally, interest rates on auto and credit card debt have jumped considerably, providing a possible headwind to the consumer, all things worth keeping an eye on.

FOURTH QUARTER STRATEGY

We envision some near term volatility as trade talks with China continue and the populist government in Italy frustrates EU leaders with a deficit budget. Interest rates in the U.S. could continue to drift higher as our economic engine is running strong and the FED appears resolute on maintaining their current path of rate hikes. We continue to be cautious with regard to rate exposure, and are managing portfolio durations in a general range of 95% of index levels. Accounts with DFI mandates will remain lower in relative duration, but might look for a small shift into either the NIS Absolute Return Strategy or the Preferred Stock Strategy as opportunities and valuations are looking more compelling. Across the spectrum, our managers continue to seek out investments in the non-agency mortgage and CMBS sectors when presented and we are seeing opportunities in international markets via dollar-denominated sovereign and corporate debt. We also plan to reduce some of our taxable muni and ABS holdings.

Mark R. Anderson, CFA
Chief Strategy Officer

NIS