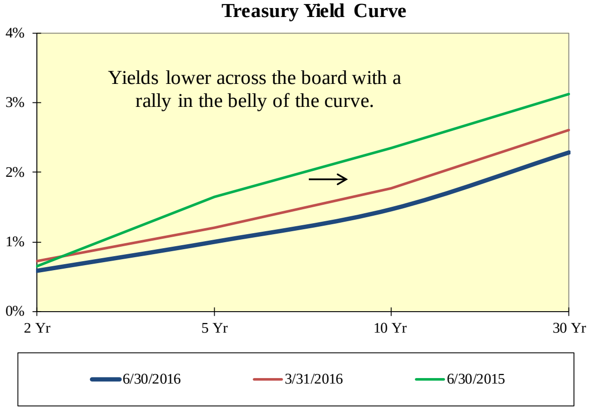
National Investment Services

Second Quarter, 2016
Investment Review

FIXED INCOME OVERVIEW

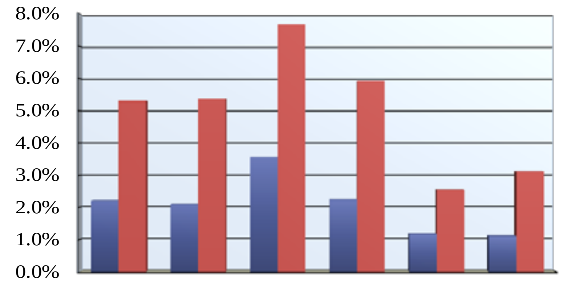
Bonds continued their march higher as Treasury yields gapped lower on European growth concerns, spurred by the surprise Brexit vote for the United Kingdom to leave the E.U. The broad-based bond market ended the quarter on a very strong note as investors flocked to safe-haven assets. The Barclays Aggregate Index finished 2.21% higher for the quarter, driving a 5.31% year-to-date gain. Low and even negative rates abroad have pushed investors head first into the U.S. markets and nowhere is this more apparent than in the Treasury sector. Longer-dated Treasury holdings have done particularly well with the 20+ year component of the index up an astonishing 15.8% for the year. The net result of this action is a yield curve that is both low and flat, not something that signals strong growth or confidence.

Treasury Yield Curve



Digging deeper into quarterly performance, ABS and MBS debt lagged, while corporate debt did relatively well, buoyed in part by strong international demand for U.S. credits and yield.

Index Sector Performance

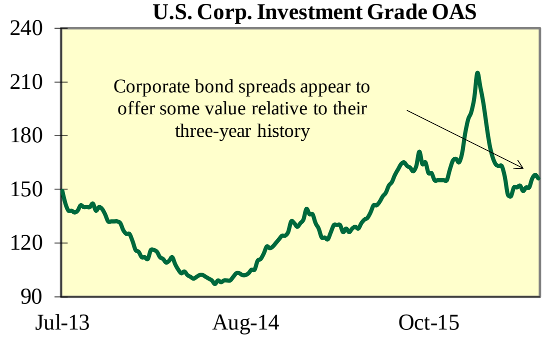


	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q2 2016	2.21%	2.10%	3.57%	2.24%	1.17%	1.11%
Year-to-Date	5.31%	5.37%	7.68%	5.92%	2.54%	3.11%

Source: Barclays, Bloomberg

This action was a continuation of a mid-February corporate rally with only the Brexit scare causing it to pause near the end of the quarter. This weakness has so far been short-lived.

U.S. Corp. Investment Grade OAS

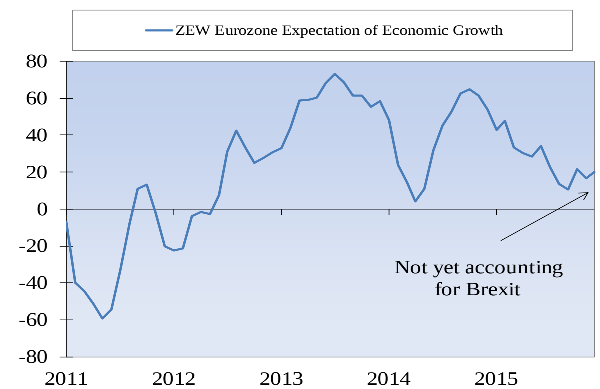


Source: Barclays, Bloomberg

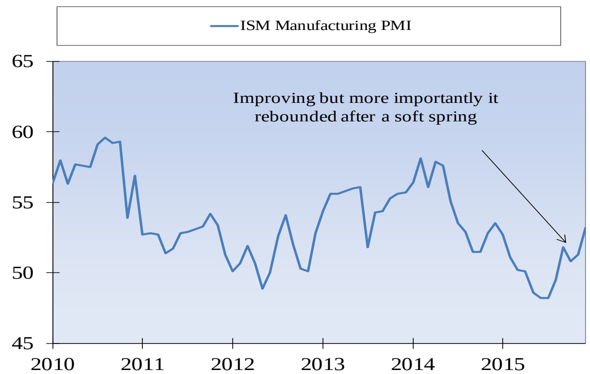
Our portfolio managers noticed that within the Brexit drama, financial names widened more so than their industrial counterparts. One of the early byproducts of Brexit is uncertainty surrounding the health of banks, specifically those doing a lot of business in Europe. Aside from the geographic concern, investors are worried about the banking industry's ability to make a profit in a low rate environment. We share this concern and are monitoring the sector closely.

THE ECONOMY

The Brexit vote has probably left more psychological scars than monetary, but there is no arguing that financial markets have been volatile in the wake of the decision. While there has been much ink spilled regarding politics, policies and more defections, much of that analysis seems to be based on speculation. The referendum's impact on trade, growth and spending does seem a bit more tangible as odds for a slowdown in the U.K. seem inevitable. Consensus GDP estimates for the U.S. and the rest of the world are being scaled back as economists adjust their models for heightened uncertainty. Expectations in Europe had stopped falling heading into the Brexit vote, so it will be very interesting to see what happens next.

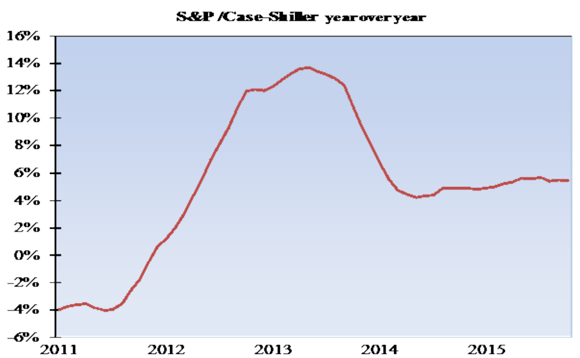


Source: ZEW, Bloomberg



Source: Institute for Supply Management, Bloomberg

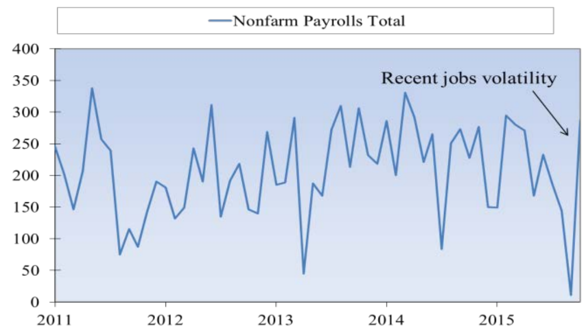
Data in the United States has been a mixed bag with confidence, PMI and inflation data all behaving fairly well with readings in well-defined zones. With interest rates at such low levels, we are not surprised that the domestic housing market seems to have found solid ground, with S&P Case-Shiller Index readings of single-family home prices averaging 5% or so over the last six months. Housing seems to have finally found a balance.



Source: S&P/Case-Shiller, Bloomberg

MONETARY POLICY

Unfortunately, not everything is full steam ahead, as the U.S. industrial complex remains fragile and both business and personal spending cautious. The volatility surrounding the May and June payroll numbers is a stark reminder that things change quickly, which only heightens the uncertainty decision-makers face.



Source: Bureau of Labor Statistics, Bloomberg

Monetary policy makers on both sides of the pond are closely monitoring for signs of any Brexit-related weakness, and the Bank of England has already provided some accommodations. Collectively, the recent moves by dovish central banks around the world are keeping rates at or near historical lows. More and more market participants are accepting this as a new reality and they are scooping up just about anything with yield. This action has us a bit concerned but we are also worried whether the Fed will truly be on hold. It is looking doubtful whether they will do anything before the November election. But if recent history tells us anything, it is that we are sure to hear much jawboning from the Fed governors during their updates.

THIRD QUARTER STRATEGY

We are happy to say that the volatility surrounding the Brexit vote had limited effect on most client portfolios as we sold some riskier assets heading into the vote. Our focus for the second half will be to remain conservative going into August and September and start to leg into a slightly more aggressive stance if the credit fundamentals remain positive and valuations palatable. Meanwhile, the technically-driven demand for yield seems to know no bounds, so we are using this strength to exit names that have reached our sell targets, while paying close attention to the levels at which we place new buy orders.

With regard to interest rates and curve expectations, we would not be shocked by further curve flattening on the longer-end, but we believe the easy money has been made. The 10-Year benchmark note ended the quarter at 1.47% and while it does not seem like rates can go much lower, they just might. Because of this possibility, we are not making any bold calls with regard to overall portfolio durations. We have been, and will continue to be, positioned slightly below our benchmark durations. This is a defensive stance and one that accounts for the heightened interest rate sensitivity that bond portfolios now carry.

Mark R. Anderson, CFA
Chief Strategy Officer

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