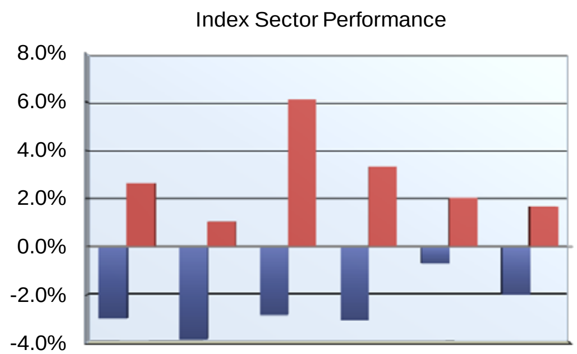
National Investment Services

Fourth Quarter, 2016
Investment Review

FIXED INCOME OVERVIEW

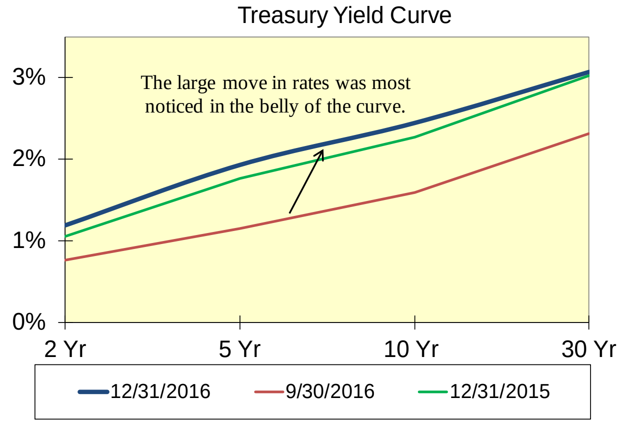
Well it finally happened, and we are not talking about the Federal Reserve making a move or the reality TV star in the White House, but rather the fact that interest rates gapped higher. Unfortunately for bond investors, this was not a normal drift upward but something that the market has not witnessed in about twenty years. The severity of the move caught many by surprise and there were few places within the investment-grade bond market to hide as the participants were reacquainted with the term duration as the Barclays Aggregate Index lost about 3% over the quarter.



	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q4 2016	-2.98%	-3.84%	-2.83%	-3.03%	-0.70%	-1.98%
Year-to-Date	2.65%	1.04%	6.11%	3.32%	2.03%	1.67%

Source: Bloomberg

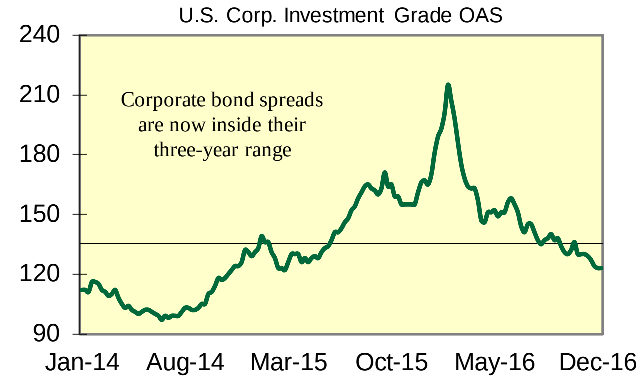
Digging deeper into index performance, mortgage-backed and ABS debt once again reminded us that diversification belongs in both equity and fixed income portfolios. It should also come as no surprise that Treasuries within the index lagged, as these securities offer little in protection from rising interest rates. During the most recent quarter, the yield on the 10 yr. bond rose 84 basis points and its price went down almost 7%. Ironically, interest rates and the shape of the U.S. Treasury curve have not moved much over the course of a year as evidenced by the green and blue lines below.



Source: Bloomberg

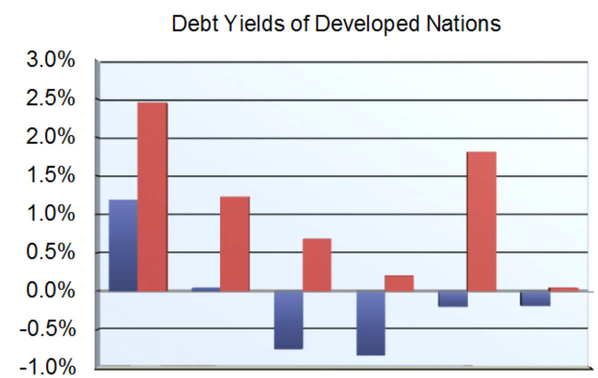
It is only by focusing on the latest (red to blue) quarterly move that we can see how this volatility looked. We note that the longer-end of the curve experienced a bit less movement on both a quarterly and year-over-year basis, casting some doubts on the potential strength of the overall rate move.

Our portfolios benefited as investment grade corporate bonds performed relatively well in 2017. This strength was due in part to an improving economy, robust demand for yield and improving fundaments within the industrial and financial sectors. The following chart depicts a very sharp move tighter in corporate OAS from the February levels.



Source: Bloomberg

Meanwhile, technical demand for U.S. debt should remain strong, fueled in part by foreign buyers. Bloomberg estimates there is still a total of $8 trillion in face value of negative-yielding corporate and sovereign debt within the Global Aggregate Index, so this market reality will be with us for a while.



	United States	Untied Kingdom	France	Germany	Italy	Japan
2 Year	1.19%	0.04%	-0.75%	-0.83%	-0.20%	-0.19%
10 Year	2.45%	1.23%	0.68%	0.20%	1.81%	0.04%

Source: Bloomberg

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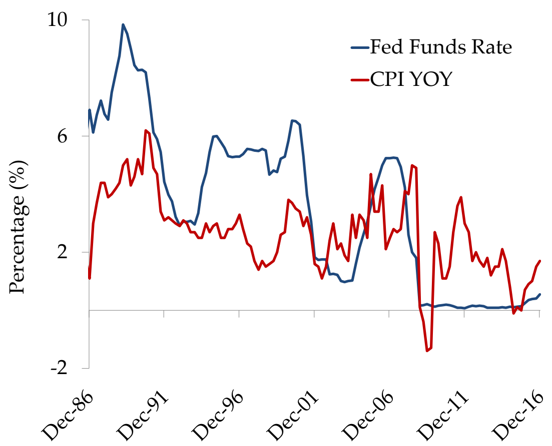
MONETARY POLICY

With U.S. rates selling off, equities moving higher and the election out of the way, The Federal Reserve finally decided they could move the Fed Funds rate higher. This comes just one quarter after they lowered their future GDP growth and interest rate projections, but that is ancient history. Committee members have recently discussed the possibility of expansionary fiscal policy warranting a faster pace of hikes, and Fed voters now appear to be more in line with what the markets are expecting. Year-end 2017 rate projections reside in the 1.35% area, equating to three increases this year. According to the chart below, it appears as though the Fed may have some catching up to do as we monitor a number of inflationary gauges, including CPI.

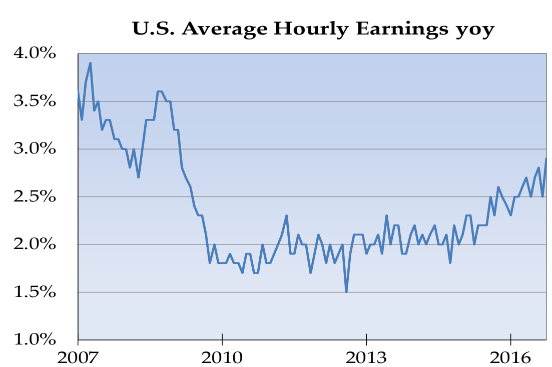


Source: Bureau of Labor Statistics, Bloomberg

Another factor that could weigh on future readings is the recent OPEC production cut agreement. \$50/barrel oil seems to be the new range, and while it has not yet manifested in sharp increases in Producer Prices or Personal Consumption Expenditures, we look to have broken away from the deflationary spiral.

THE ECONOMY

A New Year always seems to usher in both questions and optimism regarding the economy. Much of the current debate centers on policy uncertainty. Will the rally in the U.S. dollar ultimately hurt exports and could we face a trade war with a protectionist tilt? Can fiscal spending from the federal government be the magic pill to replace an easy monetary backdrop? Knowing these are difficult questions to answer, we will focus on more tangible data starting with the labor market. We are pleased to report that wage growth looks very healthy at just under 3% year-over-year while unemployment readings have steadied in the 4.7% range.



Source: Bureau of Labor Statistics, Bloomberg

It will be interesting to see to what extent rising wages pressure inflation and corporate profit margins, but for now, better wages seem to be pushing consumer sentiment northward. A handful of metrics are giving us some concern about growth later in the year. We note weakness in heavy truck sales, tighter lending standards for commercial real estate, and of course, the possibility of higher interest rates slowing the housing market as items to keep a close eye on.

FIRST QUARTER STRATEGY

Interest rates and the underlying health of credits are the two main factors affecting bond portfolio returns. Last quarter reminded investors how quickly rates and expectations can move within our market. Our forecast is for continued growth in the U.S. (a touch above consensus) and a resurgent Eurozone, so we remain slightly underweight duration relative to our respective benchmarks. We acknowledge the possibility of lower yields in the near-term but believe higher rates are in the long-term outlook.

Our managers are growing a bit concerned with overall valuations in the corporate bond space and we will look to opportunistically sell into the strong demand. We see pockets of value in the CMBS market as well as the new issue taxable municipal arena, and focus on relative value, diversification, and small sector shifts in portfolios. Additionally, we favor legacy non-agency RMBS debt.

Mark R. Anderson, CFA
Chief Strategy Officer

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