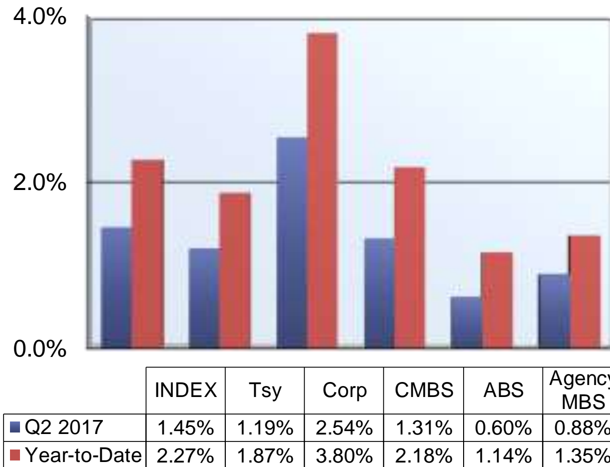
National Investment Services

Second Quarter, 2017
Investment Review

FIXED INCOME OVERVIEW

Bonds rallied sharply this quarter as investors continue to place yield into their portfolios. While this unrelenting buying made for a rather uneventful quarter from a spread volatility standpoint, it certainly bolstered fixed income returns. The Bloomberg Barclays Aggregate Index gained 1.45% despite another Federal Reserve interest rate hike and record equity prices.

Index Sector Performance



	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q2 2017	1.45%	1.19%	2.54%	1.31%	0.60%	0.88%
Year-to-Date	2.27%	1.87%	3.80%	2.18%	1.14%	1.35%

Source: Bloomberg

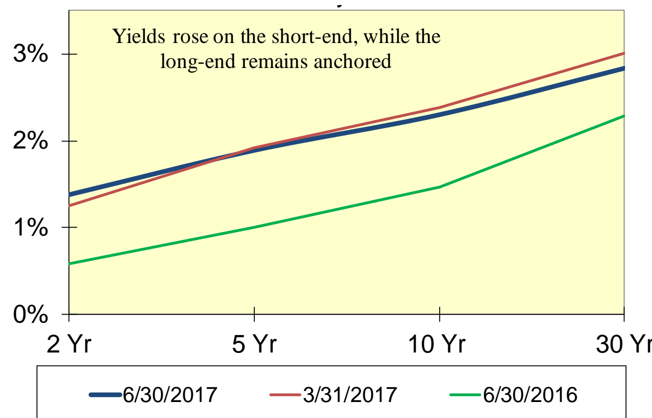
Digging deeper into index performance, corporate and commercial mortgage-backed debt remained solid performers. Treasuries also did well with longer-dated bonds offering the best performance on additional curve flattening. Interest rate carry proved beneficial within the corporate sector as spreads traded in a relatively narrow range in what can best be described as a grind. For the quarter, this barometer finished seven basis points lower.

Source: Bloomberg

MONETARY POLICY

Interest rates on the short-end of the curve increased as the Federal Reserve delivered its second rate increase of the year, but yields on the long-end of the curve missed the message, flattening an already flat U.S. Treasury curve benefiting longer-duration assets.

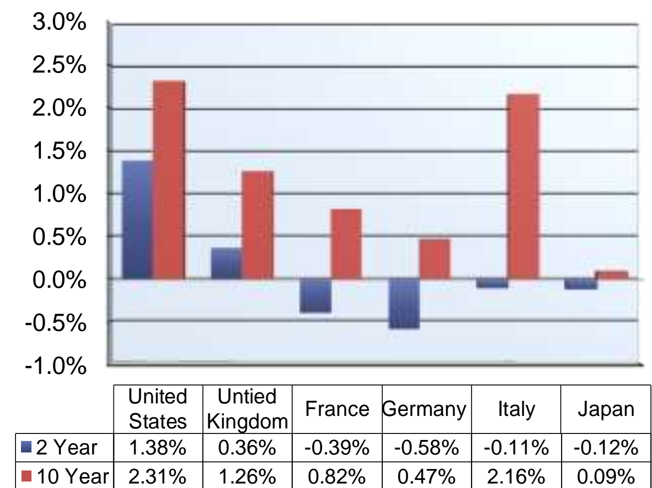
Treasury Yield Curve



Source: Bloomberg

Yields are also starting to move higher overseas as economies continue to grow and in some cases exceed expectations. It is hard to believe that one year ago Brexit was at the forefront of many conversations with some dire predictions of what might unfold a year out. The U.K. and Europe in general appear to have weathered the latest election-based drama very well. Recently, European Central Bank president Mario Draghi sent shockwaves across fixed income markets with a simple phrase, "Deflationary forces have been replaced by reflationary ones." The Euro moved higher vs. the Dollar and yields on the German ten-year moved almost 20 basis points in short order, pushing Deutschland government yields to yearly highs. Bond yields in other developed economies remain similar to last quarter after falling in May.

Debt Yields of Developed Nations



	United States	Untied Kingdom	France	Germany	Italy	Japan
2 Year	1.38%	0.36%	-0.39%	-0.58%	-0.11%	-0.12%
10 Year	2.31%	1.26%	0.82%	0.47%	2.16%	0.09%

Source: Bloomberg

If it seems like markets are overly sensitive to the nuances emanating from our central bankers, they are, because so much is riding on a smooth transition from excessive stimulus. Policy makers and investors really have to consider whether the markets and the economy can handle even a telegraphed wind down.

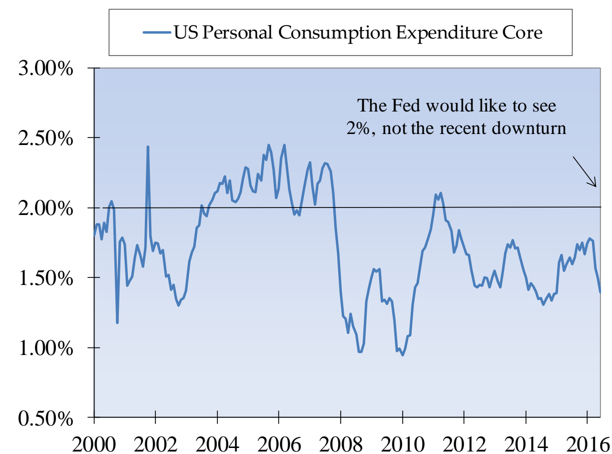
THE ECONOMY

With U.S. unemployment at 4.3%, it is hard to argue that the Fed has not delivered on the employment portion of their dual mandate. The following graphic indicates just how far the labor market has come with the number of people per job opening below 2006-07 levels.

Less slack in the labor market

Source: BLS. JOLTS, Haver Analytics, DB Global Markets Research

Labor costs and average hourly earnings are also worth keeping an eye on, as these metrics should theoretically start to increase, provided the economy stays on track; so far they have not. Oil is another potential factor that could drive costs higher but has remained in the mid-$40's. One need not look any further than the Federal Reserve's preferred inflation gauge, Personal Consumption Expenditure Core Price Index (PCE), which excludes food and energy, to see how difficult it has been to achieve their 2% target.



Source: Bureau of Economic Analysis, Bloomberg

The question for market participants then becomes whether the recent dip in PCE to 1.4% is temporary, or a sign of larger structural problems in the economy. Likewise, investors must also account for a painfully slow political system that has yet to restructure healthcare, let alone implement tax cuts and fiscal spending in a timely fashion. Above trend economic growth remains elusive.

THIRD QUARTER STRATEGY

The summer months generally bring lower trading volumes and occasionally heightened volatility. It is with this backdrop that we have positioned our portfolios in a relatively conservative manner from both a credit and duration standpoint, as there appears little room for error with yields so low and spreads commensurately tight. The market has looked like this for a while, but the rate-driven sell-off in November 2016 is fresh in our minds and the downside risks seem to outweigh the positive right now, but if there is one thing we have learned it is that yields can remain low longer than people think. With this in mind, we will manage traditional portfolios near a 95% index duration and look for opportunities to move within a narrow window. We believe the ten-year will trade between 2.25%-2.75% in the back half of the year on continued economic strength and another central bank rate hike. Additionally, we still favor the financials, as bonds in this sector trade cheap to their industrial counterparts. Higher interest rates should also benefit the banks while their balance sheets remain in very good shape. We are, however, being patient in this area, as a number of large issuers recently warned that Q2 trading revenues are down 10% year-over-year. We also see pockets of opportunity in the ABS sector with auto bonds from 2013-2015 that have been upgraded. Our managers also want to stay on the short-end of the curve in the taxable muni sector and we are focusing on higher coupon callable issues. Conversely, recent supply in longer-dated university debt has created valuation opportunities and we still favor legacy non-agency RMBS debt.

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