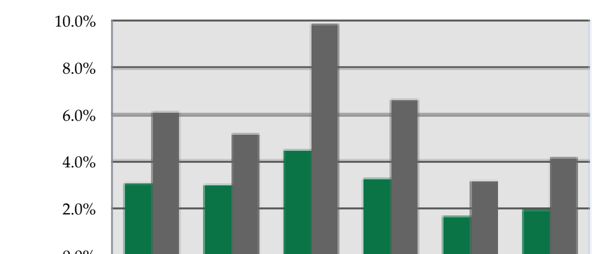
National Investment Services

Second Quarter, 2019 Investment Review

FIXED INCOME OVERVIEW

A dovish-leaning Federal Reserve supported risk markets during the second quarter as investors largely shrugged off the ongoing trade war and heightened tensions in the Middle East. Bond investors enjoyed favorable returns across most sectors as the Bloomberg Barclays Aggregate index gained 3.08% on the quarter, led by a strong performance in the corporate sector. Spread overweights in Bank and Finance and good security selection within Industrials proved beneficial for our portfolios, while our overweighting in the ABS sector detracted a bit from our performance. We do believe, however, that the market for risk-taking may have gotten a little ahead of itself and we are looking to trim some corporate exposure as we enter the third quarter.

Index Sector Performance

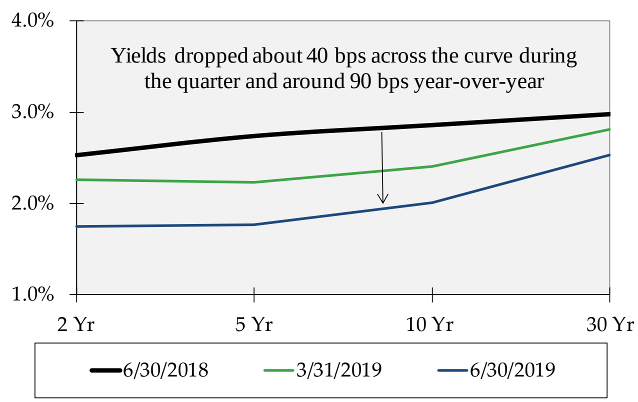


	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q2 '19	3.08%	3.01%	4.48%	3.28%	1.67%	1.96%
Year to Date	6.11%	5.18%	9.85%	6.62%	3.17%	4.17%

Source: Bloomberg

Treasury bond yields continued their rally, pushing the ten-year yield below 2% for the first time since November of 2016. The 10-year benchmark treasury yield fell almost 40 basis points to 2.01%, while the 2-year note dropped 50 bps in yield to finish the quarter at 1.76%. There remains a slight inversion in the 3-year part of the curve, which we are now underweight across portfolios. We feel the bond market has done some of the easing for the Fed, as U.S. Treasury yields are almost 90 bps lower than a year ago.

Treasury Yield Curve

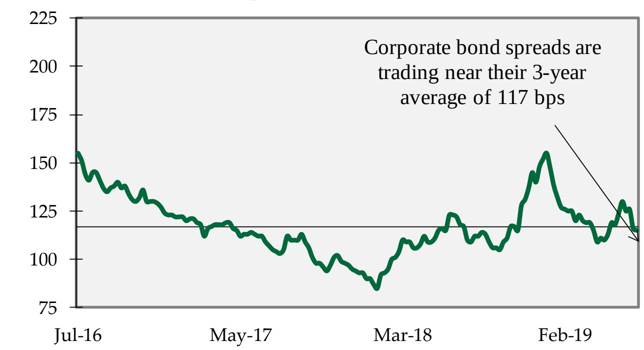


Source: Bloomberg

CREDIT SPREADS

Corporate bonds traded in a rather tight range during the second quarter as mixed economic data and lingering trade concerns pushed spreads wider in May, only to see the market rally on dovish central bank leanings in June. Corporate bond spreads are back in line with their 3-year average, which seems about right given the manufacturing slowdown concerns with offsetting Fed policy. Bond spreads are 26 bps tighter since year-end, and coupled with a 70 bp move in Treasury yields, conditions have eased almost 100 bps for many businesses. Our managers are taking a patient but optimistic approach to spread risk as we recognize the strong move. We have been selling into this strength and have increased our cash and treasury levels as we anticipate somewhat lower trading volumes and better entry point in the coming summer months.

U.S. Corp. Investment Grade OAS



Source: Bloomberg

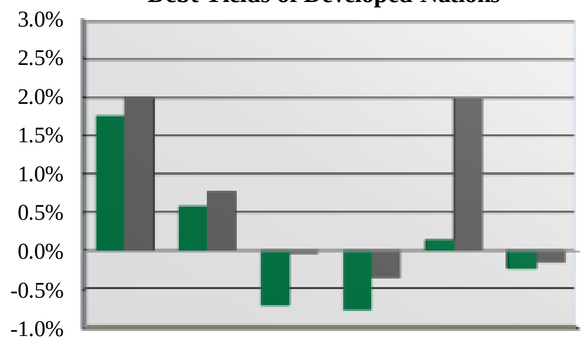
THE ECONOMY

Although economic data in the U.S. remains mixed, the latest Nonfarm Payrolls reading of 224K net new jobs in June boosted the animal spirits after registering a weak 72K number the month before. A strong labor market, decent income growth of around 3% and lower borrowing costs, are all supporting the U.S. consumer. Retail sales slowed a bit in May but are above year-end levels, while consumer sentiment and confidence data remain at high levels. Additionally, inflation readings are tame thanks in part to productivity gains. Core PCE recently registered a paltry 1.6% (the Fed has targeted 2%) despite tariffs starting to flow through the supply chain.

We are keeping an eye on the industrial complex to help judge the effects of the tariff battle. U.S. Manufacturing PMI (Markit) posted a 50.6 reading after falling from 53.8 earlier this year. The ISM numbers echo a similar pattern, so it is no surprise that business managers are becoming hesitant when making capital-spending decisions.

The global slowdown is certainly being felt in Europe, as manufacturing readings there are in contraction territory. Central bankers around the world remain accommodative as yields in many industrialized nations remain low.

Debt Yields of Developed Nations



	United States	United Kingdom	France	Germany	Italy	Japan
2 Year	1.76%	0.58%	-0.71%	-0.77%	0.14%	-0.24%
10 Year	2.01%	0.78%	-0.04%	-0.36%	1.99%	-0.16%

Source: Bloomberg

China is also in on the stimulus game, having implemented 87 different easing moves over the last year (according to Cornerstone Macro Economic Research), with plans for more as their PMI readings ticked down in June. We are watching the China story closely, as they tend to lead global recoveries and are front and center of the administration's trade agenda.

THE FED

All eyes will again be on the U.S. Fed when they release the July rate decision on the 31st. Market expectations call for a 25 basis point cut at the next meeting, as Reserve Chair Powell appeared more dovish after the June meeting. It seems our policymakers are walking a tightrope, as equities are at or near all-time highs, financial conditions are positive and jobs plentiful. Lower energy prices may help keep a lid on headline inflation and that might provide enough wiggle room for the Fed to deliver a cut. The chart below highlights this dynamic as it correlates PCE inflation and Interest on Excess Reserves.

Source: Bloomberg, Bureau of Economic Analysis

THIRD QUARTER STRATEGY

As we look to the back half of 2019, we cannot help but reflect on current trading levels and wonder if some of the good news is priced in. So what can go wrong? Here are a few: Tariff negotiations with China take a turn for the worse, tensions continue to rise in the Middle East as Iran breaches their nuclear deal and what if the Fed doesn't cut? A dose of caution seems warranted right now.

Our call is for Treasury yields to remain range-bound with a slight upward bias as the rates market may have priced in a recession that appears far on the horizon. We are slightly underweight duration across most mandates, primarily the 3-5 year area of the curve. Our investment grade portfolio managers are finding value in certain segments of the auto ABS markets, non-agency MBS and CMBS markets. We will maintain an overweight in Bank and Finance as supply within this sector remains subdued and the fundamentals sound.

Enjoy your summer!

Mark R. Anderson, CFA
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