National Investment Services

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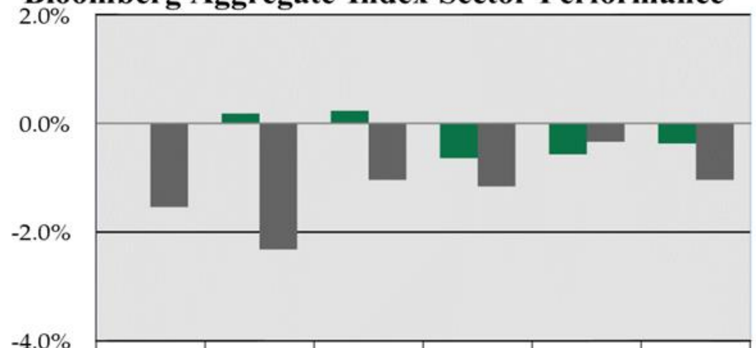
FOURTH QUARTER 2021 *INVESTMENT REVIEW*

FIXED INCOME OVERVIEW

Once again, the overall fixed income market as measured by the Bloomberg Aggregate Index was essentially flat during the quarter at 0.01% vs. the third quarter at 0.05%. Just as the market was digesting the uptick in Delta variant cases, as well as a Federal Reserve that was sounding a bit hawkish, another letter of the Greek alphabet, Omicron, became a part of our collective vocabulary. Uncertainty surrounding its quick spread and the possibility of its severity gave investors pause just in time for the holidays. The table to the right shows that U.S. Treasuries and corporate bonds were up slightly on the quarter, while segments of the structured sector finished lower. This general weakness was reflected through the year as the index finished down about 1.5% for the year as inflation and rising yields pressured values. Meanwhile, rising yields on the short-end and in the belly of the Treasury curve pushed the Bloomberg Intermediate Govt. /Credit Index 57bps lower on the quarter, while the short duration Bloomberg 1-3yr. Govt./Credit Index finished -0.56%.

Bloomberg Aggregate Index Sector Performance



	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q4 '21	0.01%	0.18%	0.23%	-0.64%	-0.57%	-0.37%
Year-to-Date	-1.54%	-2.32%	-1.04%	-1.16%	-0.34%	-1.04%

Source: Bloomberg

CREDIT SPREADS

Investment-grade corporate credit spreads (green line) also widened as Omicron variant fears coupled with year-end balance sheet positioning kept many buyers on the sidelines. IG spreads finished the quarter at 92bps after starting at 84bps. (Cont.)

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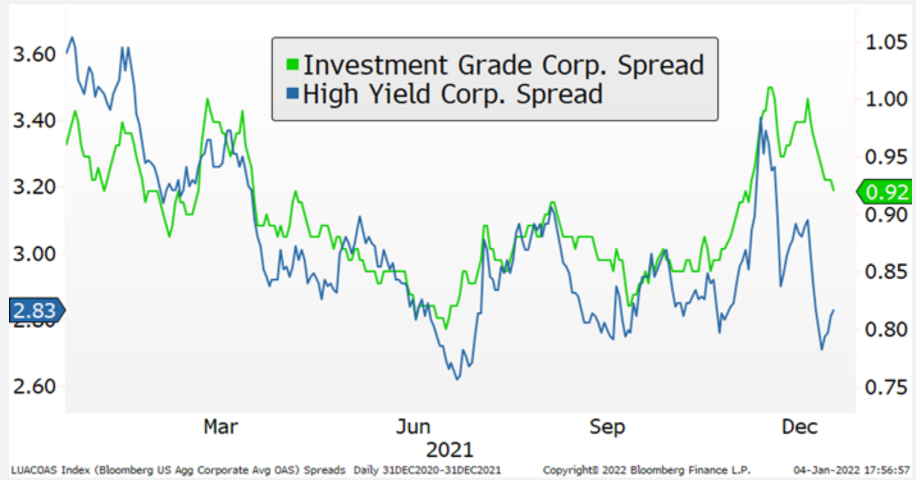
CREDIT SPREADS

(Cont.) Things became a bit more volatile in the high yield sector (blue line) as spreads widened 50bps by the end of November, only to rally and finish tighter on the quarter. The chart to the right highlights this action and we are happy to report that our managers were able to capture some of these moves by increasing client exposures to high yield in accounts for which it is a part of their mandate. We want to point out how quickly the high yield market rallied in December +1.8%, and we are already considering trimming some holdings here. Within our investment-grade portfolios we look to pare back some of our municipal exposure as this sector posted strong gains in 2021. We feel there could be improved risk-adjusted returns in other sectors such as corporate bonds.

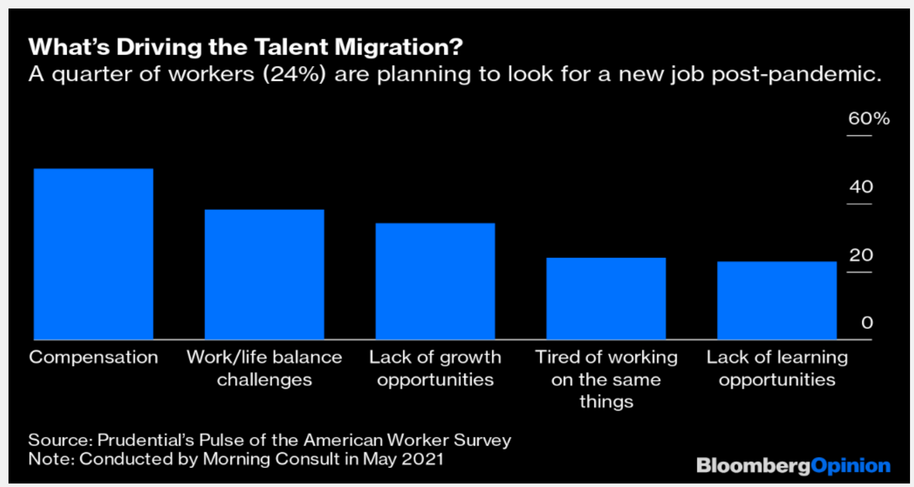
Bond Market Spreads



Source: Bloomberg

THE ECONOMY

If the financial, academic and media industries are good at one thing, it might just be coining new terminologies in a world hungry for something different. While the Great Recession that began in 2008 seems a distant memory, Anthony Klotz, a professor of management at Mays Business School at Texas A&M University coined the uptrend of recent voluntary resignations, The Great Resignation. According to a survey conducted by Morning Consult, 24% of workers are planning to look for a new job post-pandemic and the reasons are not just compensation-related (although it was the #1 answer). We bring this up now as the Department of Labor just announced that 4.5 million people quit their jobs in November, the highest rate ever, and eclipsing 4.3 million in September. One million were in the leisure and hospitality sector, followed by retail, manufacturing and healthcare. It is sometimes unclear where all of these workers end up, as each of these sectors now appears to need workers, but we ponder the longer-term effect of this churn, and whether it will affect overall inflation. A question to which we, along with many others, will be paying close attention in the coming months.



THE ECONOMY

We feel the Federal Reserve will also be paying attention to labor imbalances and within a backdrop of seemingly full employment rising wages play into the inflation scenario. Elsewhere, the latest ISM Services PMI reading came in a bit shy of expectations, as the Omicron outbreak appears quite widespread. What was interesting within the numbers, however, was a smaller decline in the employment component, which is indicative of companies wanting to hold on to workers due to the labor shortage. Durable goods orders came in a touch better than expectations on a rebound in civilian aircraft orders and an increase in the autos and parts component. The report signals general continued strength with perhaps the one weak spot being a 0.1% dip in orders for "core" capital equipment, which is a proxy for business spending on equipment. We speculate, however, that this dip represents money being spent on retaining labor talent. Therefore, looking forward, the new orders component for capital goods is still sending a positive signal.

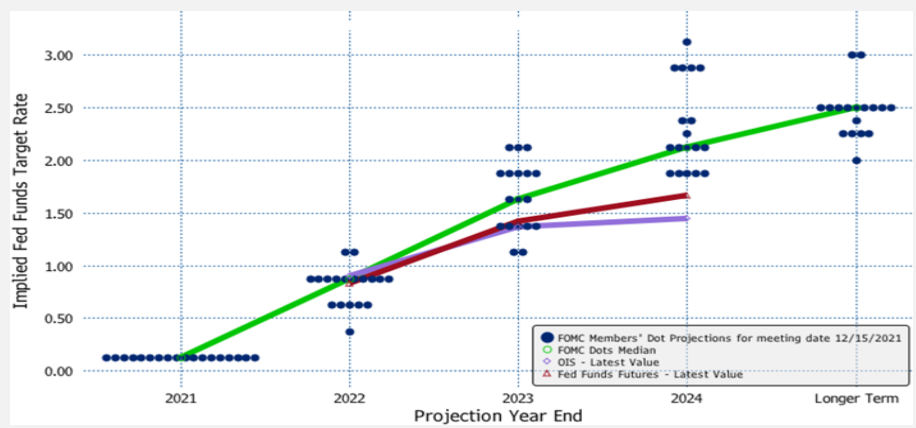
New Orders for Capital Goods year-over-year % change

Source: U.S. Census Bureau, Pantheon Macro, Bloomberg

FISCAL AND MONETARY POLICY

We are also keeping a watchful eye on the housing and auto markets as they can play important roles in the inflationary backdrop. While supply chain disruptions and shortages have affected each sector, we know that prices of homes and autos have been strong, to say the least. The most recent S&P CoreLogic Case-Shiller Home Price Index shows home values up over 18% year-over-year, while the Bureau of Labor Statistics reports a 30+% gain in used car and truck values. It's no wonder headline inflation came in at 6.8%. Core inflation, which backs out all the gasoline and food we don't consume, came in a shade under 5%. Inflation is definitely running hot, and while nobody is calling for these very high numbers to persist, we continue to believe that **inflation runs higher in '22 than the Fed's prediction of between 2.2%-3.0% for PCE.**

We must admit our surprise at seeing the Fed and others in Washington do an about-face on their "transitory" rhetoric regarding inflation, although, in actuality, they had little choice given the inflation and labor data referenced above. Furthermore, the Fed brought clarity to their tapering of asset purchases, and even more significantly, their projections for rate increases have recently taken on a more serious tone, which is highlighted in their projections to the right:



Source: Federal Reserve Open Market Committee, Bloomberg

FIRST QUARTER 2022 STRATEGY

The New Year begins with the U.S. experiencing record virus caseloads, a more hawkish central bank and financial market valuations that are not exactly cheap by historical standards. Our managers expect some periods of heightened market volatility as investors adjust to rising rates. Fortunately, our assessment of the overall economic backdrop is one of continued general strength while the Covid-driven pandemic shifts to an endemic reality and society transitions to a more normal way of functioning. Although there will no doubt be unforeseen setbacks in this scenario, many of the hybrid and work from home models have been tested and our ability to be productive and move forward will prevail. Business "as usual" should benefit businesses and consumers, while steady cash flows should support bond fundamentals within many of the sectors that we manage.

Our managers recognize that valuations in some sectors are still a bit stretched and therefore recently reduced exposure to some of our hospital and muni bonds. We still prefer money center banks to regionals, find the 7-10 year part of the curve attractive, and have been adding here. Additionally, our corporate team likes fundamentals within the utility sector where we have added as valuations pulled back in the last month. Fundamentals remain constructive within the auto ABS sector, where we find value in both prime and subprime deals, being selective among issuers and tranches. Lastly, we remain of the mindset that the rates market does not yet reflect the reality of Fed increases and an economy that can grow in spite of higher yields, and are therefore keeping client portfolios on the lower side of their respective duration bands across mandates. We all wish you good health and success in the New Year!

NIS

Mark R. Anderson, CFA

Chief Strategy Officer