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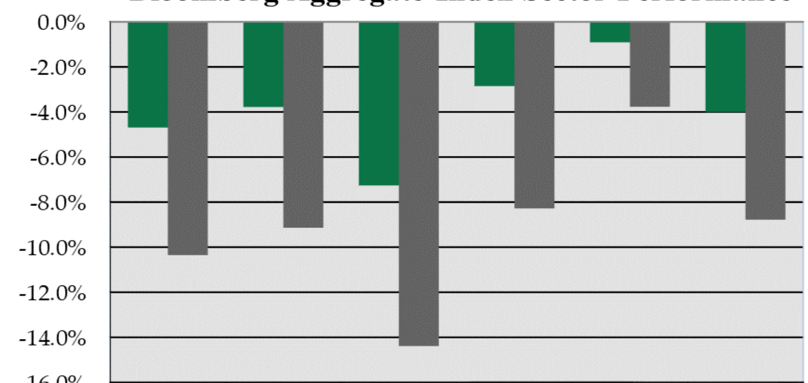
SECOND QUARTER 2022 *INVESTMENT REVIEW*

FIXED INCOME OVERVIEW

"Nowhere to hide" was a phrase that we continued to hear throughout the second quarter as risk markets sold off while inflation surprised to the upside, the Fed leaned hawkish and the war in Ukraine raged on. The Bloomberg Aggregate Index was down about 4.5% bringing the year-to-date performance number down 10%. There really was no place to hide unless you were heavily invested in Asia Pacific debt, as this area of the market was up marginally. The table to the right shows just how difficult it was to find a safe spot within the bond market as rates dominated the market tone.

Bloomberg Aggregate Index Sector Performance



	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q2 '22	-4.69%	-3.78%	-7.26%	-2.85%	-0.91%	-4.01%
YTD	-10.35%	-9.14%	-14.39%	-8.28%	-3.77%	-8.78%

Source: Bloomberg

Bond yields continued their unrelenting climb as inflation hit a multi-decade high during the second quarter of 2022. U.S. Treasury bonds sold off as the Fed moved yields higher. The benchmark 10-yr Treasury began the quarter at 2.34% but moved solidly northward to finish at a yield of 3.01% after making a run at 3.50% in mid-June. Corporate bonds also suffered, losing over 7% as outflows and a general risk-off sentiment dominated the fixed income market. Structured securities within the index finished slightly better but still in the red with ABS bonds down about 1% and CMBS down 3%. The less rate sensitive Bloomberg Intermediate Gov/Credit Index finished down 2.37% on the quarter.

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SCAN IT & GO

777 E Wisconsin Ave
Suite 2350
Milwaukee, WI
53202

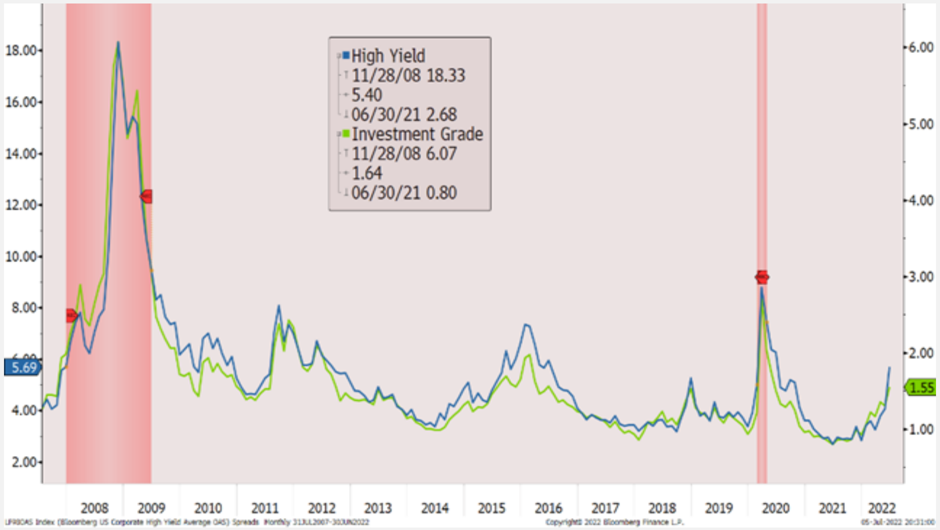
Phone:
414.765.1980

CHICAGO
MILWAUKEE

CREDIT SPREADS

Investment-grade corporate credit spreads (green line) widened about 35bps as fears of a possible Fed led recession and record bond market outflows weakened the sector. IG spreads finished the quarter at 155bps after starting at 116bps. Things were more volatile in the high yield sector (blue line) as spreads widened over 200bps to end the quarter near 570 after trading in the low 300's in early April. While it is tempting to proclaim this an opportunistic entry point, we note that valuations are only a touch wide to long-term averages (540bps, chart to the right). We remain underweight high yield within our DFI and Core Plus accounts, as the path of least resistance seems to be more recessionary pricing. Within our investment-grade portfolios, we continue to pare back our municipal exposure, while carefully trading within the corporate area. We have taken advantage of relatively flat credit curves in the money center banks, moving from ten-year to five- year paper giving 15 basis points or less in spread, while losing only single digits in yield. This spread differential was 25-35 basis points earlier this year. Given the dramatic rate moves, we have seen opportunities to execute trades within similar maturity buckets, picking up yield and taking out significant dollars in the trade. We continue to look for these trading anomalies as we try to increase portfolio quality and liquidity.

Credit Spreads



Source: Bloomberg

THE ECONOMY

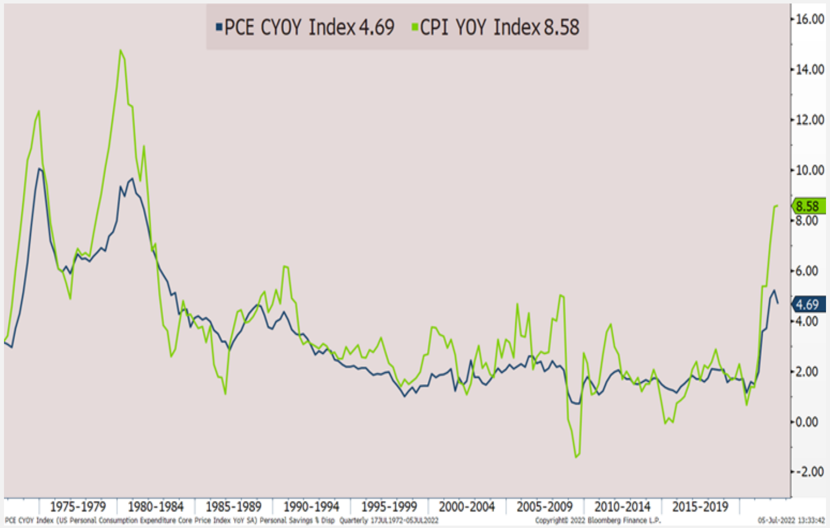
Even though employment remains a bright light and June factory orders surprised to the upside, there is mounting evidence that things may be cooling off. Within retail, company reports suggest moderating foot and website activity. BBBY (Bed Bath and Beyond), TGT (Target) and RH (Restoration Hardware) recently reported weakness during their earnings/investor day presentations. Our analysis of the consumer hints at fatigue building as the University of Michigan's measure of sentiment dropped 8 points in June to a record low of 50, as high prices seem to be hurting those that can least afford it and undoubtedly affecting some spending decisions.

(Cont.)

THE ECONOMY

(Cont.) We are keeping a close eye on services data as the ISM Services PMI has rolled over but remains above recessionary levels. Recent credit card spending data also indicates a slowdown at U.S. restaurants. However, spending is higher than a year ago which makes sense as things simply cost more. Existing Home sales also indicate signs of trouble (down 3.4% in the latest monthly reading), as mortgage rates are approximately 280bps higher than a year ago while home prices are up 20% over the same period, leaving affordability back at 2008 levels. According to JPMorgan, consumers are borrowing more and running down their cash balances to cover expenses as 35% of households are having trouble paying bills, which is up 10% from the same time last year. Everyone is wondering when inflation will roll over from its multi-decade high. The chart on the right shows that we need to dial Doc Brown's DeLorean back to the early 80's to see readings like this. Maybe the best cure for inflation will end up being inflation, but the result could be a mild recession unless the Fed successfully orchestrates a soft landing.

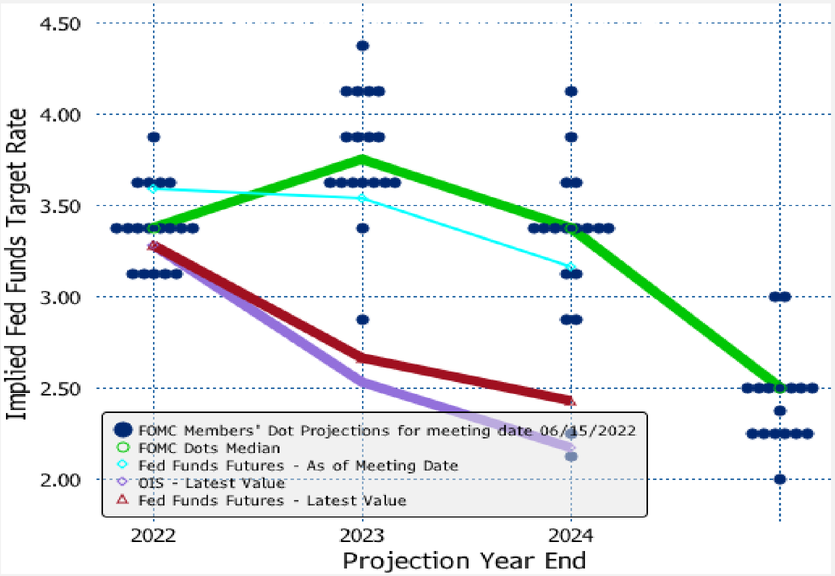
Inflation at Multi-Decade High's



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Bloomberg

THE FED

Not many people were predicting a 125 bps hike in the Fed Funds rate during the second quarter. Yet, the Federal Reserve finally seems serious about fighting inflation. The following chart shows that voting members anticipate another 150bps of increases before year-end and further increases in early 2023. The overnight index swaps market along with the Fed Funds Futures market seem to be in the camp that the Fed might actually end up lowering rates in 2023 as the economy slows. It is truly a matter of whether everything is priced into the rates market and we feel that it is getting close. While we have never envied the job of the Fed, we certainly can appreciate the predicament they are in trying to tame inflation and remove liquidity while not causing a recession. A difficult task indeed!

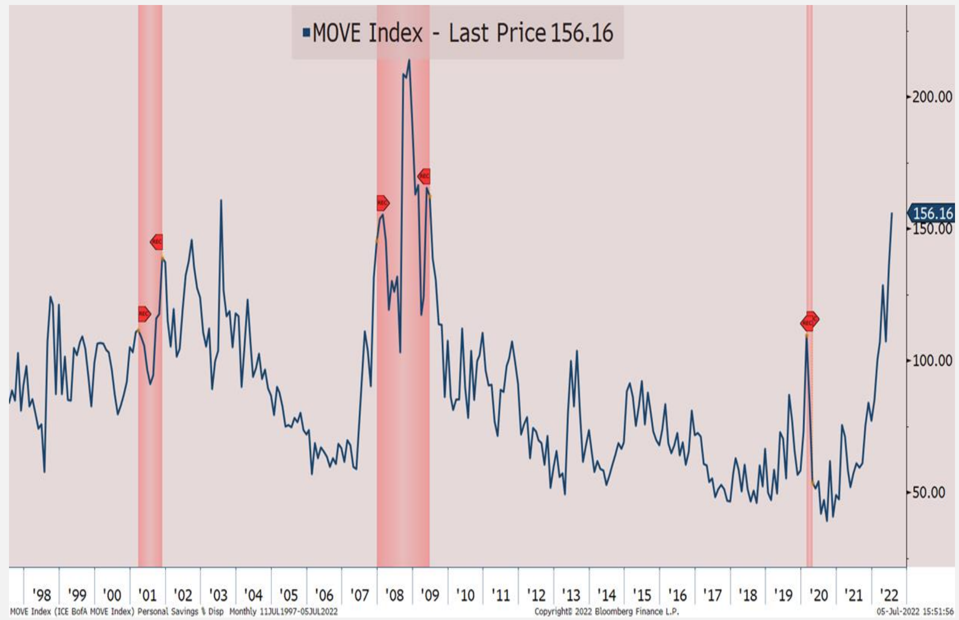


Source: Bloomberg

THIRD QUARTER 2022 STRATEGY

The second half of the year begins with our market in what appears to be an epic three-way battle between "don't fight the Fed", a slowing economy with lower yields and trying to call a bottom for risk assets. The correct course will only be known in time, but it certainly does not seem like a time to take a lot of risk in the near-term. We like to keep a close eye on volatility within the Treasury options market, and unfortunately, there is growing angst among market participants as the recent rise of the MOVE Index is not abating. We would really like to see this barometer drop since the current level is near all-time highs and somewhat indicative of recessionary pressure.

MOVE Index and IG Spreads



Source: BofA, Bloomberg

As painful as this year has been, we would be remiss not to point out that the yield to worst on the Bloomberg Aggregate index sits at its highest level (3.72%) since the end of 2009 and corporate spreads are a touch wide to historical averages so a lot of fear seems priced into the market. Our managers expect periods of heightened market volatility as investors continue to shift asset allocations and the Fed reacts to economic data. We still like the auto ABS market as car values remain relatively high and focusing on prime auto lease deals as there is spread pick-up to prime auto loans. Our managers are also seeing a pick-up in issuance in the credit card space. We like this sector when valuations appear reasonable. Additionally, we have been increasing our U.S. Treasury exposure to maintain liquidity and buying Agency Mortgage pools, which are close to their widest levels in a number of years.

Lastly, we remain underweight duration across portfolio mandates. Yet, we acknowledge the growing concerns that the Fed might be too aggressive, which could leave the broader market range-bound with the curve possibly inverted.

Mark R. Anderson, CFA

Chief Strategy Officer