National Investment Services

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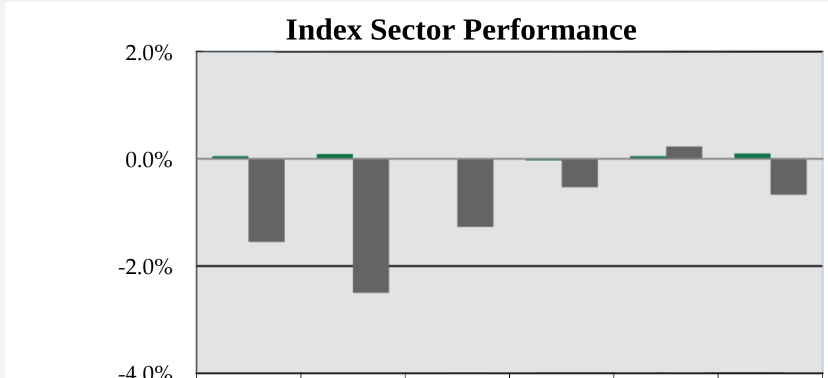
THIRD QUARTER 2021 — *INVESTMENT REVIEW*

FIXED INCOME OVERVIEW

Although the performance numbers don't necessarily reflect it, the bond market experienced a dose of turbulence during the third quarter as an uptick in Delta variant cases and subsequent growth concerns brought out some sellers. The Treasury bond market was not immune from worries as inflationary concerns remain high and the debt ceiling timeline draws close. U.S. Treasuries were down 1.2% in September, but large gains in July helped propel this index component to a quarterly gain of 9 bps. The benchmark 10-yr Treasury started the quarter at 1.47% and finished September at 1.49%. The index returns to the right reflect some of the larger components of the Bloomberg Aggregate index, which finished 0.05% higher for the quarter without any significant contributors or detractors. Meanwhile, the Bloomberg Intermediate Govt. /Credit Index finished up at 0.02% and shorter duration indices up about 0.10%. Many market participants take long vacations in the summer and those appear well timed this year, as they did not miss much.



	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q3 '21	0.05%	0.09%	0.00%	-0.03%	0.05%	0.10%
Year-to-Date	-1.55%	-2.50%	-1.27%	-0.53%	0.23%	-0.67%

Source: Bloomberg

CREDIT SPREADS

Investment grade corporate credit spreads (green line) widened a touch on the quarter to close at 84bps after getting as wide as 91bps. There was a little more action in high yield spreads (blue line) as they traded in a 45bps bandwidth between 268 and 314, only to close at 289. (Cont.)

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CREDIT SPREADS

(Cont.) The corresponding chart highlights how far the market has come versus a year ago and looking back a bit further, the bond market is now trading at normalized, if not, tighter spread levels. Our portfolio managers were able to use some of the small volatility to incorporate some small sector shifts and to raise our Treasury exposure for what we believe will be future opportunities. Although markets are trading at relatively tight levels, we are still finding a few reasonable values and are looking to trade up in quality and liquidity when possible. Thankfully, the market has remained conducive to this objective.

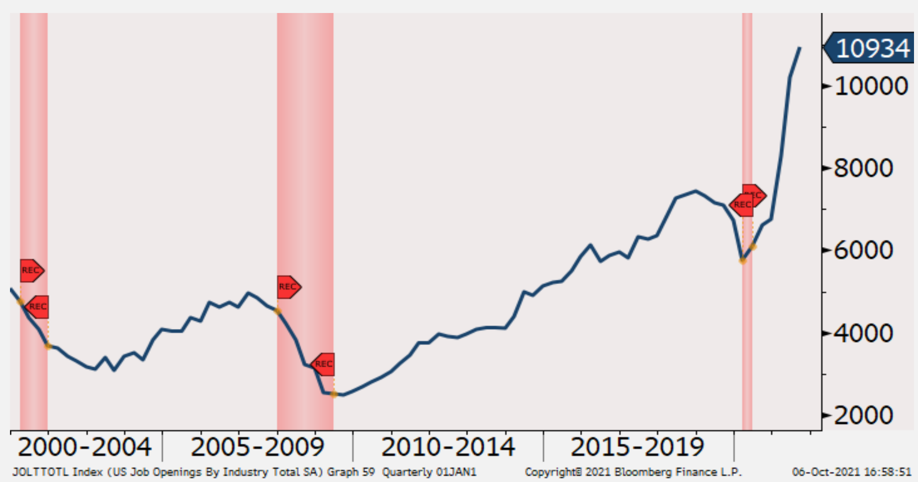
THE ECONOMY

The COVID-19 hit to the employment market remains as total U.S. employment appears 6 million jobs short of pre-pandemic levels. At times, it is difficult to comprehend that we just went through the largest (albeit short) bout of total job displacement since the depression with many still seeking work as some industries have been slow to recover. In an ironic twist, the level of job openings is unprecedented as the chart to the right highlights. Many industries face a shortage of workers due to difficulty in finding workers in some geographic locations, skills and training mismatch, or in some cases, general worker burnout. We mention all of this because investors should be concerned whether business' attempt to lure new workers with higher wages, (which are generally passed down to consumers) or if lack of workers result in continued long lead times, supply shortages and pre-buying, (which all seem to push prices higher). The Atlanta Fed Wage Growth Tracker stands at 3.9%, which is back to its highs of the last 10 years and Average Hourly Earnings are up 4.3% year-over-year and easily past pre-pandemic levels by 75bps.

Bond Spreads (100bps) – Investment Grade(R), High Yield (L)

Source: Bloomberg

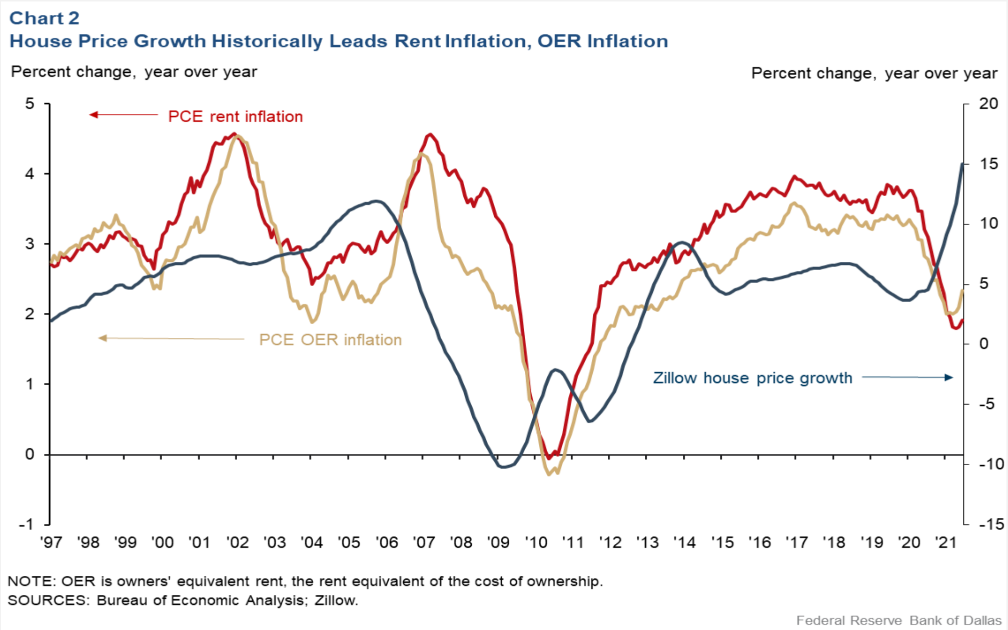
U.S. Job Vacancies (in 1,000's)



Source: Bureau of Labor Statistics, Bloomberg

THE ECONOMY

We are also keeping a keen eye on the housing market and its potential impact on the inflation picture. Analysts at the Federal Reserve Bank of Dallas recently published a chart that correlated home price growth to rent inflation. Home price growth leads to rent increases and the current disconnect seems noteworthy. Builders still point to high material prices, supply shortages and lack of workers so these higher prices may be here a while.



The real estate market is not the only sector seeing price gains as September saw an impressive rise in energy prices. WTI oil prices surged almost 10% during the month, with Brent crude not far behind with a gain of 7%. Natural gas has been making headlines across the pond with prices up over 90%, yes 90% and well over 150% in the past three months alone. It hasn't been quite that bad in the U.S. but the Jan. 22' futures contract was up about 33% in September and therefore it doesn't seem like energy prices will be going down anytime soon, although I am thinking of writing "transitory" on the memo line of the check to the gas company this winter.

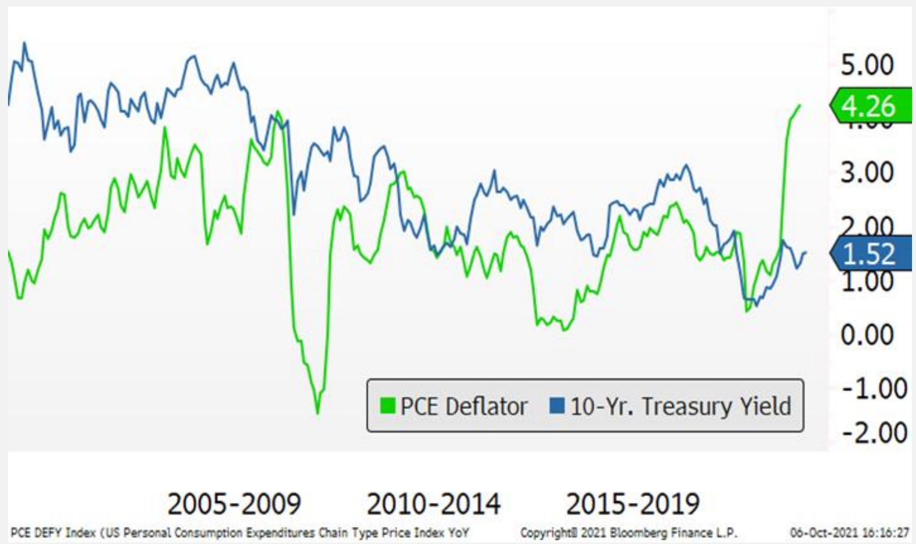
FISCAL AND MONETARY POLICY

Speaking of transitory, Fed chair Powell is probably feeling like his role as Fed chair is becoming a bit more transitory as a few politicians have recently been taking their shots. Regardless, a reappointment is the expectation. The FOMC met in September and echoed its normal employment concerns while stating their inflationary projections have been met at the current 4.2%, with 2.2% projected a year out. We believe their expectations might be a bit low. Nonetheless, if inflation runs higher than expected they hint at using their tools to cool it. In discussing asset purchases and progress toward their economic goals, they determined that moderation of purchases seems warranted and broadly supported via unanimous vote. The timing and pace are still up in the air but there was mention of a mid-22' ending of purchases which gives some runway to a possible lift-off of rates in 2023.

FOURTH QUARTER 2021 STRATEGY

The final quarter of 2021 began with the usual partisan politics in D.C. affecting risk markets as the debt ceiling increase and the $3.5 trillion spending package appear in limbo. Recent negotiations have odds on the debt ceiling being pushed out until December and talks of a reduced spending package in the $2 trillion range. Therefore, it's business as usual in Washington, while it's business in China that has us a bit worried as real estate developer Evergrande, home to 200,000 employees and $300 billion of debt, teeters on collapse. China flagged them a risk in 2018 and it doesn't sound like the Chinese government has much of an appetite for rescuing a company run by one of the wealthiest (at least he was) people in China. The investment community is most worried about the possible spillover effect similar to Lehman in 2008, although at least there does not appear to be the massive derivatives exposure in this case. What it might mean, however, is another slowing of global growth expectations and its potential impact on the risk and rates markets. Our interest rates team feels strongly that the path of rates remains higher as we still believe the market has not fully digested the possibility of higher inflation. We have, started to trim our relative duration underweighting across mandates as some areas of the Treasury curve are gaining appeal.

Within the corporate arena, we have reduced some non-profit hospital exposure and trimmed within our bank and finance sector while remaining overweight this area. Our structured team is finding value in select subordinated tranches of sub-prime auto loans, which tend to delever and upgrade quickly, as well as prime auto lease deals. Once recent example is the Tesla Auto Lease Trust, Aa2-rated, 2.6yr. Avg. life yielding approximately 1%, and a weighted average 788 FICO of the borrowers.



Source: Bureau of Economic Analysis, Bloomberg

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