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Q4 2015 SHORT MATURITY QUARTERLY COMMENTARY

SHORT MATURITY MUNI COMPOSITE CHARACTERISTICS

AS OF: 12/31/2015

Duration: 1.44 yrs
Yield-to-Worst: 0.89%
Yield-to-Maturity: 0.91%
Maturity: 1.5 yrs

LOW DURATION TAXABLE COMPOSITE CHARACTERISTICS

AS OF: 12/31/2015

Duration: 1.32 yrs
Yield-to-Worst: 1.25%
Yield-to-Maturity: 1.25%
Maturity: 1.35 yrs

Strategic Overview

Macro: The last three months of 2015 will be remembered as the quarter that produced the first interest rate hike from the FOMC in almost a decade. Stronger than expected Nonfarm payroll numbers in October and November provided additional leverage to a Federal Reserve already anxious to raise rates after foregoing their chance in September. Markets largely dismissed the move as U.S. Treasuries rallied post-hike, implying the Fed achieved its goal in telegraphing its intent, perhaps learning from the 2013 “taper tantrum”. The move was well-priced into the market as evidenced by benchmark rates rising across the curve during the quarter. The increases were led by the front-end where 2-yr and 5-yr Treasury rates rose 42 and 40 basis points respectively, while 10-yr and 30-yr Treasury rates rose only 23 and 16 basis points. Looking into 2016, we maintain our view that the front-end of the curve will be driven by Fed policy while the longer-end of the curve should ultimately be supported by 1) lackluster domestic growth and inflation trends, and 2) economic instability abroad. Looking at inflation, the “transitory” headwinds that the Fed has convinced itself will eventually subside, still persist. PCE (Personal Consumption Expenditures) remained depressed at 1.32%, well below the Fed’s 2% target, and the price of oil fell an additional 18% during the quarter, ending the year at $37/barrel (a 7-year low). The Fed has stressed future, “gradual” rate hikes as the economy improves, with their estimates calling for four separate 0.25% increases in the coming year and another four 0.25% increases in 2017. Time will tell, but for a Fed that sat on 0.00% for almost a decade, we wonder if the “gradual” estimates will be difficult to achieve while domestic and global headwinds abound.

Market Dynamics: Front-end and money market yields were finally able to relieve some pent up pressure following December’s FOMC rate increase, the first in over a decade. Treasury and U.S. Dollar Swap rates began drifting wider as a more hawkish tone emerged from the central bank in October. The 2-yr and 3-yr portions of the curve moved higher by approximately 40 basis points with the 2-yr UST breaking a 1.00% yield for the first time since 2010. We expect the front-end of the treasury curve to continue to pitch upward and be the biggest contributor to an overall flatter curve as we head into 2016. A rather high degree of variance exists between FOMC rate projections and the expectation of traders for the upcoming year, as illustrated by the continued divergence of the Fed dot plot and derivative market pricing. As was the story in 2015, the Fed forecasts remain more aggressive than the market on the timing and degree of this fledgling normalization. This will lead to yet another year of data dependent rate volatility as markets can easily get caught in the vicious cycle of attempting to interpret how the Fed views incoming economic indications.

Caprin Performance Notes: As the Federal Reserve now looks to slowly influence front-end yields higher, strategies focused on short-dated instruments demand particular awareness and monitoring. Even with the move higher in rates seen in Q4, the short maturity strategies generally posted flat to slightly positive returns, outperforming respective benchmarks. Our overweight to high-grade spread products and strategically shortened duration profiles has proved a prudent backstop in maintaining yield and performance through this historic reduction in accommodative monetary policy.

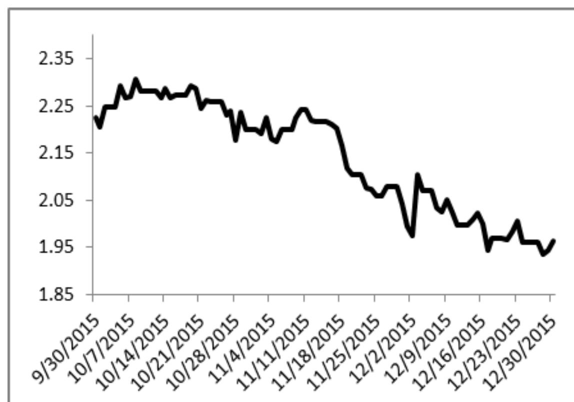

Figure 1: Spread between 2-Yr and 30-Yr US Treasury Yields
Source: Bloomberg

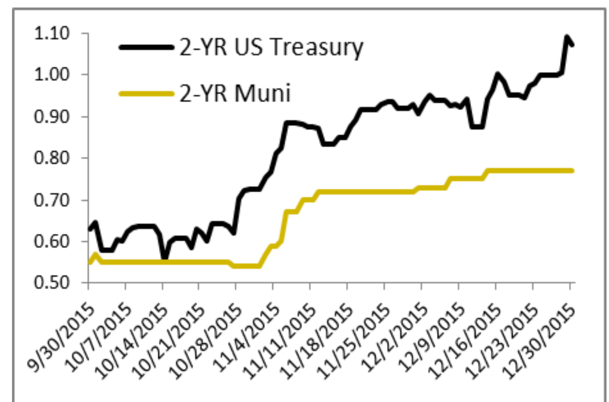

Figure 2: 2-Yr US Treasury Yields vs. 2-Yr Muni Yields
Source: Bloomberg; MMD

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