Intermediate Muni Quarterly Commentary

SECOND QUARTER 2017

Macro Overview

Much of the global tension that grabbed headlines in the first part of the quarter eased following Emmanuel Macron's decisive victory over his anti-establishment counterpart Marine LePen in the French Presidential election. Here in the US, President Trump's policy initiatives, most notably tax and healthcare reform, remained deadlocked in Washington while the administration faces an investigation surrounding its ties to Russia. In the markets, stocks continued to push higher as both the Dow and S&P were up over 3% in the quarter and continued to break record levels. Corporate earnings showed strength in Q1, and many estimates for Q2 look even better. However, the mature bull market in equities has made many pundits highlight just how expensive stocks have become with the S&P 500 P/E ratio hovering around 25. Unlike earnings, hard economic data did not prove as resilient. Q1 GDP, although stronger than first reported (1.4% vs. 0.7%), did little to improve on the longer term trend of growth malaise. An unexpected slowdown in retail sales throughout the quarter along with softer jobs numbers has now dampened forecasts for a robust Q2 rebound. The Federal Reserve raised rates as advertised in June and their updated interest rate forecasts were little changed, leading the yield curve to flatten further as the long-end remained anchored by weaker inflation expectations. Core CPI softened to 1.9% in April and again in May pushing the yr/yr number to 1.7%, down from 2.3% in January. The Fed has taken notice of slowing inflation but continues to voice that one more rate hike (most likely December) is warranted. Also contributing to a lack of inflation during Q2 was the price of oil which fell 8% during the quarter and is down 17% from the start of the year. Looking ahead, we are closely monitoring whether hard economic data will support the need for an additional rate hike later this year, about the same time the Fed wishes to start reducing its balance sheet.

Composite Characteristics

INTERMEDIATE MUNI – STATE SPECIFIC

AS OF: 6/30/2017

Duration: 4.43 yrs

Yield-to-Worst: 1.75%

Yield-to-Maturity: 1.96%

Maturity: 6.41 yrs

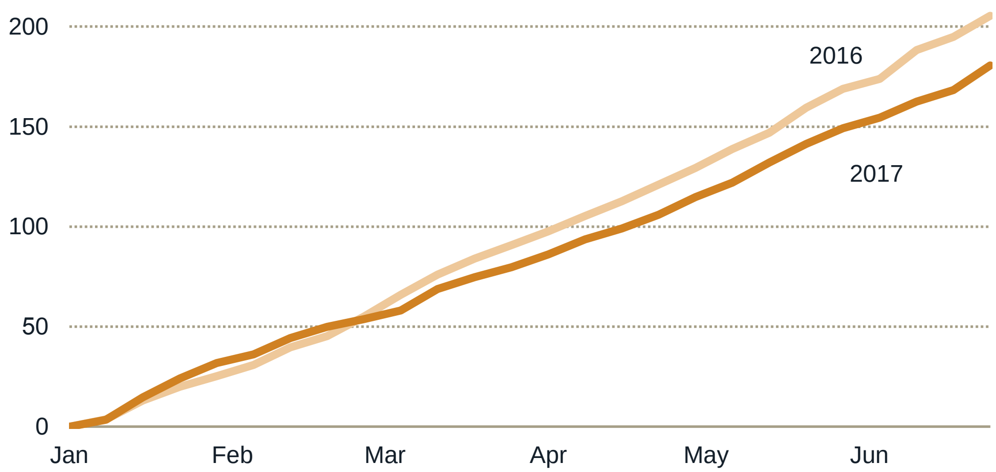
Market Dynamics

Questions that surrounded the muni market in Q1 are still largely unanswered at the end of Q2. President Trump has yet to pass any of his policy initiatives that would potentially impact municipal investors, most noticeably ACA repeal/replace, tax reform, and infrastructure investment. We don't believe that answers are right around the corner either, as the administration remains pre-occupied with the special investigation, and Congress remains divided. For the quarter, municipals outperformed Treasuries again. Front-end tax-exempts outperformed by 10 bps while intermediate and long-end maturities outperformed by 18 and 9 bps, respectively. Total issuance was down 6% quarter-over-quarter and is down 10% from this point last year. The noticeable lack of supply in 2017 can be attributed to the frontloading of refundings ahead of the Fed late last year and general uncertainty surrounding tax reform and infrastructure investment this year. At this point we do not anticipate any near-term resurgence of issuance. On the credit front, Puerto Rico filed for Title III bankruptcy and officially defaulted on billions in bond payments while unfunded pension liabilities and budget stalemates are taking their toll on state-level credit ratings. Illinois, Connecticut, and Massachusetts all received downgrades this quarter while Alaska and Mississippi were put on negative credit watch. As always, Caprin's disciplined and conservative approach to credit selection and monitoring aims to avoid these potential pitfalls.

Performance Notes

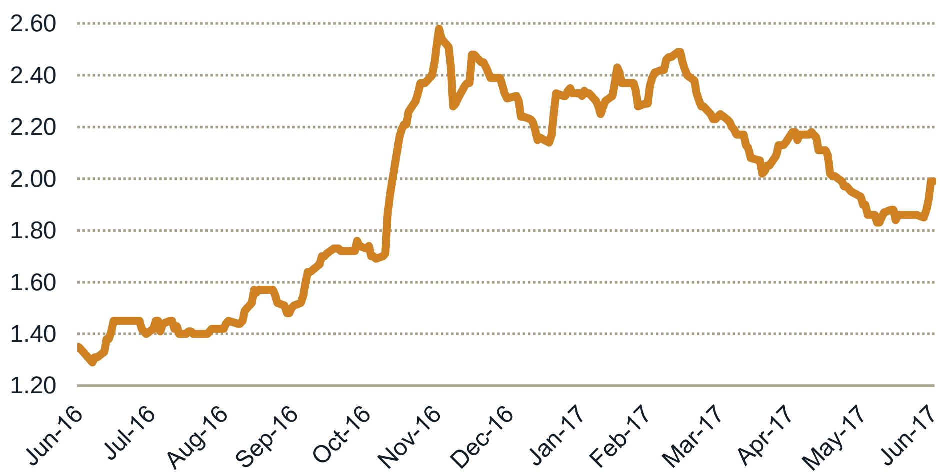
Quarterly performance was slightly below benchmark as our modestly shorter duration targeting was a detractor during the April/May rally, however, it proved beneficial during the back up in rates heading into quarter-end. For the quarter, the intermediate and long portions of the curve performed best, yields were lower by 26 bps at both the 10Y and 30Y spots. We expect supply to remain muted for the balance of the summer and believe munis should perform well as the low supply will be met with plenty of reinvestment dollars. However, since many of the potential market-moving initiatives (tax reform, ACA repeal) are tied up in DC gridlock, we believe munis will likely follow the direction of the Treasury market over the near-term.

FIGURE 1: TOTAL MUNICIPAL ISSUANCE YOY ($Bln)
Source: Bloomberg



"…we believe **munis should perform well** as the low supply will be met with plenty of reinvestment dollars."

FIGURE 2: 10-YEAR MMD AAA MUNI YIELD
Source: MMD



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