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Q4 2015 INTERMEDIATE MUNI QUARTERLY COMMENTARY

Strategic Overview

STATE SPECIFIC COMPOSITE CHARACTERISTICS

AS OF: 12/31/2015

Duration: 4.40 yrs
Yield-to-Worst: 1.65%
Yield-to-Maturity: 1.89%
Maturity: 6.68 yrs

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. Municipal volume slowed dramatically toward year-end after a robust first three quarters, primarily driven by heightened refunding activity. Volume fell compared to Q4 2014 bringing total muni issuance for the year to $377 billion, slightly below our prediction of $400 billion, but still the highest level since 2010. As Treasury yields rose in anticipation of a Fed hike, Muni’s outperformed. The 2-yr AAA MMD rate followed the Treasury trend and increased 22 basis points (2-yr Treasury rose 42 bps); however the 5-yr, 10-yr and 30-yr AAA MMD rates actually decreased 1, 11, and 22 basis points, respectively. The demand for municipals was strong as retail investors looking for year-end tax shelters and investors exiting high-yield investments were forced to chase thin supply. Dealers who shored up balance sheets early, thus limiting available capital, exacerbated the issue. On the credit front, familiar names stole the headlines. Puerto Rico intercepted revenues budgeted for the debt service of several issuing Authorities to meet its General Obligation payments. Negotiations are ongoing for a full restructuring of the territory’s debt. Illinois was downgraded to Baa1, the lowest of any state, as it continues to battle a budget stalemate and structural imbalances, and we continue to monitor the impact that declining oil prices may have on the revenues of energy producing states. Within our core footprint, we view higher-rated general obligation bonds, strong state housing authorities, select hospital credits, and bonds secured by dedicated revenue streams to be most attractive and the best fit for our lower volatility objectives.

Caprin Performance Notes: Yield curve positioning was the key performance driver over the quarter as our neutral targeting generally returned results in-line with benchmarks. Given our near-term outlook for limited upside pressure in intermediate to longer-term rates, we remain comfortable with this positioning and exposure to the upper bands of our maturity ranges. Longer-term yields may again rise and test near term trading ranges, but we do not see the foundation for a significant move given the lackluster global growth picture and absence of inflation. Municipal credit spreads have compressed to multi-year lows making the risks associated with moving down the credit spectrum imprudent in our opinion. We will continue to approach both our yield curve positioning and credit selection with an emphasis on capital preservation as we prepare for what will surely be an interesting 2016.

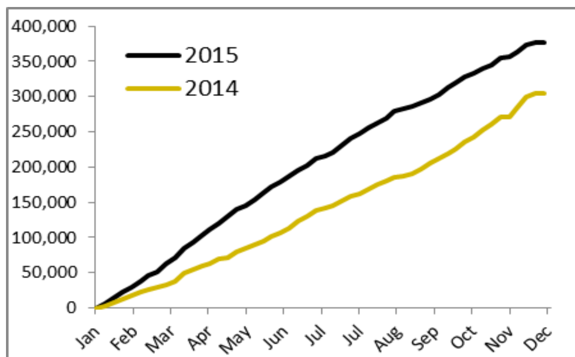

Figure 1: Total US Muni Issuance 2014 vs. 2015 ($mlns)
Source: Bloomberg

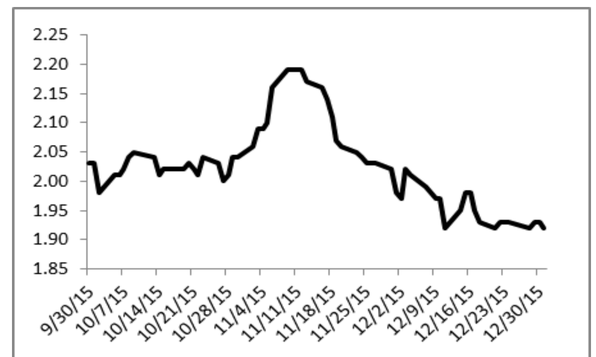

Figure 2: 10-Year MMD AAA Muni Yield
Source: MMD

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