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Q1 2016 Intermediate Muni Quarterly Commentary

MACRO

At the end of 2015 we concluded our macro overview by saying “we wonder if the ‘gradual’ estimates will be difficult to achieve while domestic and global headwinds abound.” Our reflections were directed at the then just-released projection of a 1.4% year-end 2016 Fed Funds Rate driven by estimates of approximately four, 25 basis point (.25%) rate hikes. This view of an overly optimistic central bank was certainly not unique, but what caught many off-guard was the significant volatility and weaker tone that washed over markets to begin the New Year. Equity and other risk assets were quickly plagued by renewed concerns over “true” Chinese growth prospects and that government’s ability to continue its deliberate support of an already over-leveraged and inflated system. The rout, already well established, in commodities made new bottoms with crude oil prices declining nearly 30% by late January, and touching a 12 year low of approximately $26 per barrel. Yields on the 10-yr US Treasury, in concert with the aggressive risk-off move, declined nearly 60 bps from its 2015 close, to a level (1.65%) not seen since the same time a year prior, and credit spreads generically moved to their widest level in four years. As the quarter drew on though, markets did eventually find footing with the slowing of negative headlines from Asia and crude oil prices that stabilized on rumors of OPEC production cuts. Federal Reserve members unsurprisingly erred on the side of caution when they met in March, choosing not to pursue a rate increase while also making significant downward revisions to their short and intermediate-term rate outlooks. Now just two, 25 basis point (.25%) hikes are implied for 2016. We certainly see this as a more realistic expectation given the uninspired growth prospects both domestically and abroad but continue to question if even this may be hard to achieve.

MARKET DYNAMICS

After experiencing a significant slowdown in new issue volume to end 2015, municipal issuers began the year with a heightened sense of urgency. Through the first quarter, approximately $97 billion ($80 billion Q4 ‘15) of supply came to market as borrowers again looked to take advantage of historically low funding levels. State and local finance heads saw a closing window of opportunity as the Federal Reserve seemed comfortable with a path to higher rates that few agreed was “gradual” and as uncertainly surrounding the 2016 election intensified. This jump in supply, coupled with relatively lower Muni-to-Treasury ratios to start the year was enough to bring pause to investors looking to deploy cash. Subsequently, municipals lagged their taxable counterparts over the period as yield levels remained relatively sticky compared to the notable declines across the US Treasury curve. Of particular note were the 5-yr and 10-yr portions of the curve, where AAA MMD yields declined by 19 and 22 bps respectively, compared to a decline of 55 and 49 bps in Treasuries. Looking ahead we see the supply pressures easing as we move into the second half of the year and an opportunity emerging for municipals to outperform.

PERFORMANCE NOTES

Maturity and duration positioning across the yield curve remained the largest contributor to performance over the quarter. Our generally neutral duration targeting and slight overweight to maturities in the 10 to 15 year portion of the curve led to composite performance slightly above benchmark for the quarter. At this point we continue to see limited pressure to intermediate and longer term yields as prospects for global growth and inflation remain muted. However, we also view that the limited incremental yield in longer dated municipals, past 15 years, does not adequately compensate for the added interest rate risk as it relates to the strategy’s emphasis on capital preservation.

INTERMEDIATE MUNI STATE SPECIFIC COMPOSITE CHARACTERISTICS

AS OF: 03/31/2016

Duration: 4.52 yrs

Yield-to-Worst: 1.48%

Yield-to-Maturity: 1.75%

Maturity: 6.86 yrs

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

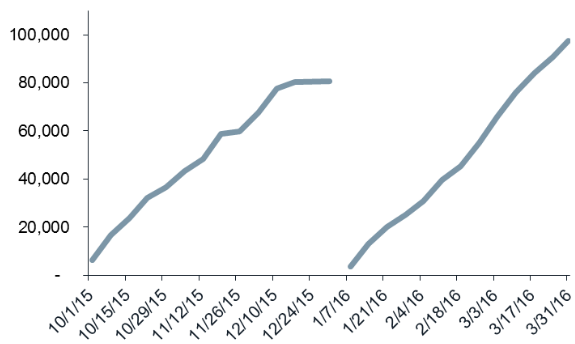
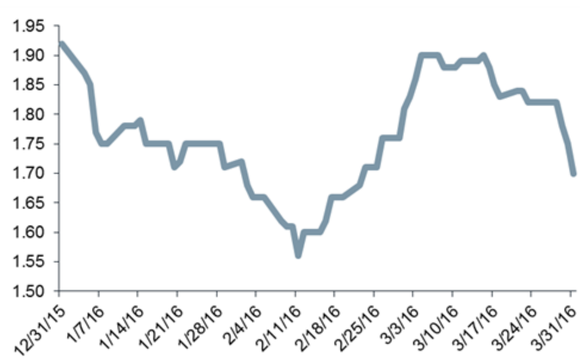


FIGURE 2: 10-YEAR MMD AAA Muni Yield
Source: MMD



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