CAPRIN

Intermediate Muni Quarterly Commentary

FOURTH QUARTER 2016

Macro Overview

The fourth quarter of 2016 will forever be remembered and defined by Donald Trump's implausible U.S. Presidential election upset of Hillary Clinton. The immediate market reaction saw stocks lower and bond prices higher, but that lasted only a few hours overnight and reversed once markets measured what President-elect Trump's mandates might do to future growth, inflation, and interest rates. Fundamentally little changed in the days and weeks that followed, however, money began to pour out of bonds and into stocks, igniting a euphoric equity rally heading into year-end. The world appeared to price in every positive outcome from Trump's proposals while ignoring the significant hurdles or unintended consequences stemming from his policies. We continue to view trading in the fixed income markets based largely on near-term sentiment. As history has shown, there will likely be lengthy and substantial legislative hurdles to clear even with Republican control of Capitol Hill. The Republican Party has arguably never been more divisive than it is currently, not to mention that power shifts in Washington are seldom without unanticipated incidents.

Composite Characteristics

INTERMEDIATE MUNI –
STATE SPECIFIC

AS OF: 12/31/2016

Duration: 4.07 yrs

Yield-to-Worst: 2.09%

Yield-to-Maturity: 2.25%

Maturity: 6.33 yrs

Outside of politics, the Federal Reserve as predicted raised the benchmark lending rate 0.25% in December and updated their projections to show a slightly more accelerated pace of rate hikes in 2017. We expect the overall path still to be gradual and cautious but can appreciate the Fed's desire for a greater rate cushion for whatever the next economic cycle may hold. Another topic capable of rattling markets is the size and potential shrinking of the Federal Reserve's balance sheet and any hints from the new administration about getting that underway. While we expect a gradual reduction of assets, more aggressive rhetoric on the possible sale of securities will be significant for all financial markets.

Market Dynamics

Municipals entered the fourth quarter prepared to close out another year of solid returns in the face of record supply. However, the sector could not avoid the broad post-election bond sell-off that ensued. Munis, which typically lag treasuries during periods of rising rates, actually underperformed in the weeks immediately following the election. Investors quickly and, in our opinion prematurely, priced in the impact of proposed tax cuts and a potential reduction to the current tax-exempt status without full consideration of the likelihood and/or consequences to this vitally important sector. Regarding a reduction or elimination of tax-exemption, we view the probability of change to the current status as low. It would likely prove counterproductive to raise the cost of financing on the municipal sector as the Trump administration seeks to execute on its rather large ($1 trillion) infrastructure commitment. After the election, municipal mutual fund outflows became substantial, and these exerted additional pressure on performance in the quarter. Heading into the final weeks of 2016 however, firmer footing was found as the primary market slowed. Looking ahead we anticipate more moderate new issuance after a record 2016, and although the demand base may shift as a result of changes in incremental tax rates, we do not expect it to diminish substantially.

Performance Notes

Interest rate driven price declines in November were the largest detractors to quarterly performance, pushing total returns negative for the period. While we view the post-election weakness as largely sentiment driven, we have found it prudent to adjust strategies to a more defensive position given recent volatility and expectations for moderately tighter monetary policy going forward. In our bond-only strategies, portfolio roll has and will continue to aid in reducing interest rate sensitivity, and, in our ETF-overlaid strategies, we adjusted allocations to include shorter and, in some cases, inverse vehicles. We would expect munis to find firmer footing heading into early '17 as primary issuance should be well received by investors looking to put December's nearly $27 billion in maturities and coupon payments to work.

FIGURE 1: TOTAL MUNICIPAL ISSUANCE 3rd QUARTER YOY ($Bln)
Source: Bloomberg

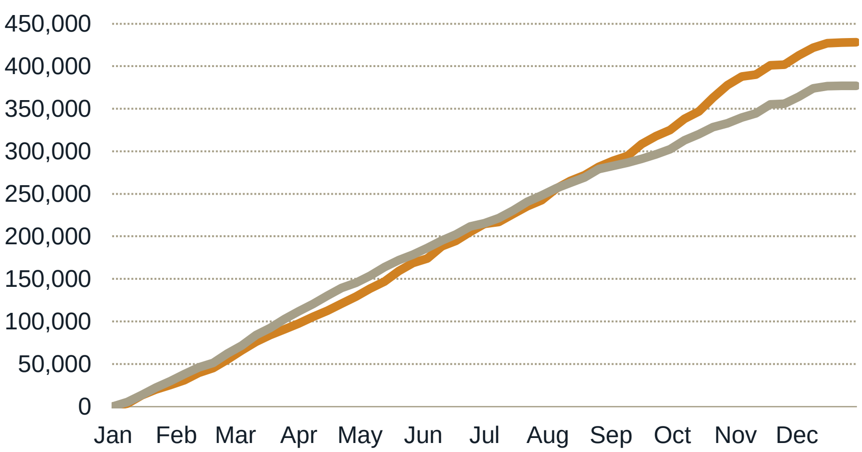
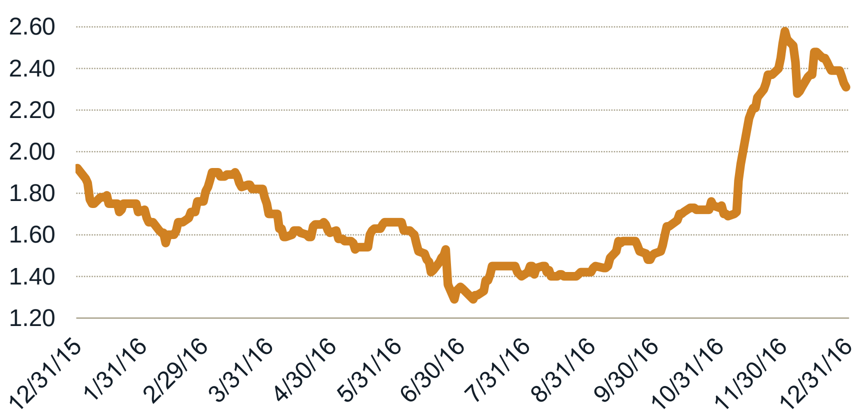


FIGURE 2: 10-YEAR MMD AAA MUNI YIELD
Source: MMD



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