Short Maturity Muni and Low Duration Taxable 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.

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.

Composite Characteristics

SHORT MATURITY MUNI

AS OF: 12/31/2016

Duration: 1.34 yrs

Yield-to-Worst: 1.28%

Yield-to-Maturity: 1.30%

Maturity: 1.40 yrs

LOW DURATION TAXABLE

AS OF: 12/31/2016

Duration: 1.65 yrs

Yield-to-Worst: 1.45%

Yield-to-Maturity: 1.45%

Maturity: 1.72 yrs

Market Dynamics

With the rather orderly execution of money market reform behind us in 2016, shorter maturity bonds faced two significant events in the quarter, which ultimately left 2-yr and 3-yr Treasury notes 47 and 58 basis points higher than where they began the year. Post-election, the market immediately and unexpectedly assumed without much doubt that President-elect Trump's administration will be the growth and inflation driver of the US economy. Optimism coupled with further monetary policy tightening (.25% hike at December FOMC meeting) pushed short taxable and tax-exempt yields to levels not seen since 2009/2010. Furthermore, projections from Federal Reserve governors showed increased support for an additional rate hike beyond the two already anticipated for 2017. The rapid ascent seen in yields did stabilize into year-end as stronger bidding resurfaced for front-end US Treasury auctions. Despite this rate volatility, short credit spreads held firm and in many cases tightened as expectations of a more pro-business administration furthered the corporate bond buying trend witnessed through much of the year.

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Performance Notes

Returns in the short fixed income markets were negative for the quarter in light of the rapid ascent in yields mentioned above. Short dated municipal bonds lagged their taxable counterparts as heightened supply and mutual fund outflows weighed on the sector. Using similar duration ETFs as a proxy for performance, SHY (short government), CSJ (short credit) and SHM (short muni) posted quarterly returns of -0.45%, -0.28% and -1.50%, respectively. The Low Duration Taxable strategy had a shorter-than-benchmark duration all year, and this positioning contributed to positive relative performance in this quarter. The continued credit overweight and disciplined name selection within the corporate sector was also additive to returns as it was the best performing of the aforementioned components. The incremental yield of essential revenue issuers helped offset November price pressure in the short maturity municipal strategy.

FIGURE 1: 1M, 3M LIBOR RATES
Source: Bloomberg

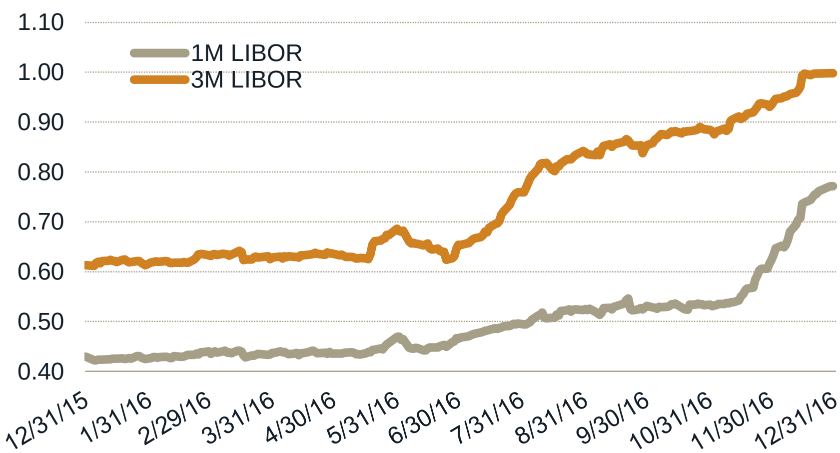
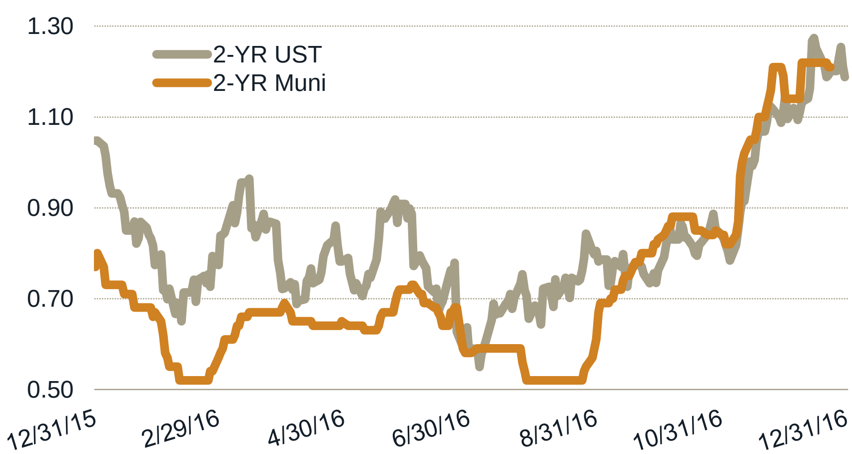


FIGURE 2: 2-YR US TREASURY YIELDS VS. 2-YR MUNI YIELDS
Source: Bloomberg; MMD



"The Low Duration Taxable strategy had a shorter-than-benchmark duration all year, and this positioning contributed to

positive relative performance

in this quarter."

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