Intermediate Muni Quarterly Commentary

FIRST QUARTER 2017

Composite Characteristics

INTERMEDIATE MUNI –
STATE SPECIFIC

AS OF: 3/31/2017

Duration: 4.43 yrs

Yield-to-Worst: 1.91%

Yield-to-Maturity: 2.09%

Maturity: 6.43 yrs

Macro Overview

The optimism emanating from President Trump's November election spilled into the first quarter, although momentum eventually stalled as Republicans were unable to pass a replacement of the Affordable Care Act. This inability to push through his first major piece of legislation cast doubt on the President's chances to deliver on other campaign promises and served as a stern reminder that D.C. political gridlock is alive and well. Still, the S&P and Dow did reach record highs during the quarter before retreating late in the period, while bond yields followed a similar trend. To begin the quarter, markets were comfortably anticipating multiple Fed rate increases in 2017, but they were priced later in the year. On January 1, Fed Funds Futures assigned only a 31% probability for a hike at the Committee's March meeting. However, as positive economic data filtered out in February, the probability of a move in March began to increase. Then, after testimony from Fed Chair Yellen to the Senate Banking Committee was perceived hawkish, markets quickly adjusted even further to a near certain 25bps increase. The subsequent hike at the Committee's meeting a few days later sent front-end Treasury yields higher but saw intermediate and longer dated yields remain anchored, signifying near-term inflation concerns were softening. As equities cooled, bonds rallied to close out the quarter: the 10-yr ended at 2.38% after hitting a high of 2.62% (March 13th). The focus now turns to tax reform. The Trump administration has promised major change to both individual and corporate taxes but has provided little in the way of details. Should reform not live up to market expectations or delays push meaningful legislation well into 2018, the Trump reflation trade could be sidelined for the time being.

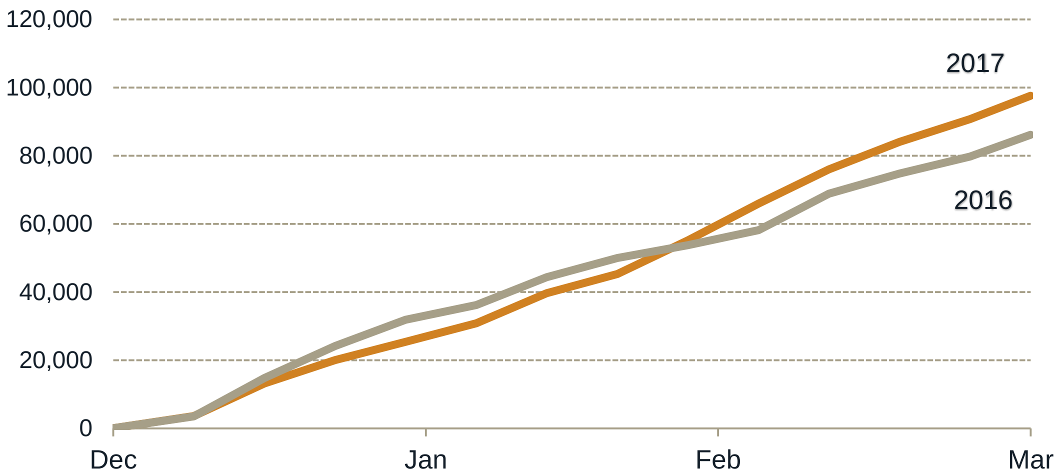
Market Dynamics

The major question for the muni market entering the New Year, was how (and to what extent) President Trump's policy initiatives, most notably ACA repeal, tax reform, and infrastructure investment, would impact the market. As previously discussed, tax reform details impacting municipals are scarce, and proposals range from no change to the unlikely capping of tax-exempt interest income. After the healthcare legislature was defeated, tax reform consumed the muni market's attention, pushing any type of infrastructure initiative, in our view, until much further into 2017 and potentially 2018. Muni's significantly outperformed Treasuries on the front-end of the curve and performed in-line with Treasuries at intermediate and longer dated maturities. The front-end out-performance can largely be attributed to investors' desire to stay defensive and not add incremental duration in the face of potentially higher rates and uncertainty around tax reform's impact on municipals. Primary supply for the quarter was approximately 13% lower than Q1 2016, but net issuance was still positive by approximately $10 billion as more new money deals were brought to market. Demand remained steady through the quarter with total fund inflows reported to be nearly $4.5 billion. We expect supply for the remainder of 2017 to be manageable and believe that significant change to municipal taxation is unlikely.

Performance Notes

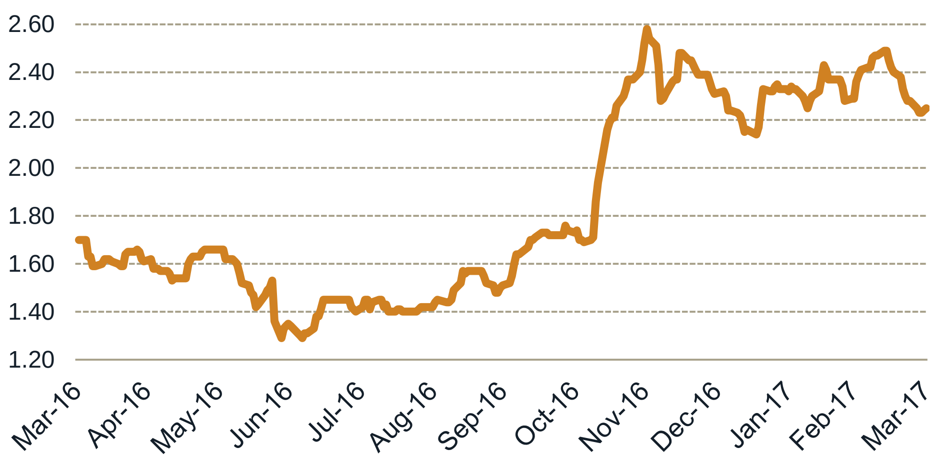
Quarterly performance was below benchmark as our modestly shorter duration targeting and greater exposure to high quality (via state specific strategies) were detractors. In the near-term, we believe our more conservative duration position to be prudent as there is still significant uncertainty surrounding the timing and scale of both a Trump tax reform plan and further action, including possible balance sheet reduction on the part of the Fed. Primary muni market supply should remain somewhat muted, and we believe demand will remain steady, creating a generally constructive tone for the asset class. Until more clarity can be seen on several fronts, we anticipate munis will likely take their cues from Treasury market movement.

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



"…we believe **demand will remain steady,** creating a generally constructive tone for the asset class."

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



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