CAPRIN

Short Maturity Muni and Low Duration Taxable Quarterly Commentary

FIRST QUARTER 2017

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.

Composite Characteristics

SHORT MATURITY MUNI

AS OF: 3/31/2017

Duration: 1.42 yrs

Yield-to-Worst: 1.14%

Yield-to-Maturity: 1.16%

Maturity: 1.49 yrs

LOW DURATION TAXABLE

AS OF: 3/31/2017

Duration: 1.61 yrs

Yield-to-Worst: 1.52%

Yield-to-Maturity: 1.52%

Maturity: 1.67 yrs

Market Dynamics

After closing the books on a tumultuous fourth quarter, the front-end of the yield curve continued to be shaped by speculation surrounding the timing and magnitude of future FOMC rate hikes. Benchmark US 2 year and 3 year rates traded in ranges of 24bps and 30bps respectively with implied volatility in those short tenors returning to mid-2016 levels. Our focus in the low duration strategies remains on the FOMC during this significant transition period in central bank policy, as both changes to the Fed Funds rate and balance sheet size will likely have the most direct effect on performance in the near to medium term. The futures market now sees a 25bp increase in June 2017 as the highest probability, with no further increases during the year. However, several Fed governors and some street strategists are still pounding the table for four hikes in total for 2017. We currently view four hikes this year as unlikely given the lackluster growth and inflation backdrop, but a three hike scenario emerges if growth numbers improve markedly and/or a significant tax reform proposal is released in the second half of the year. The credit landscape remained on firm footing during the quarter, as investment grade spreads continued to move modestly lower and remain near historically tight levels.

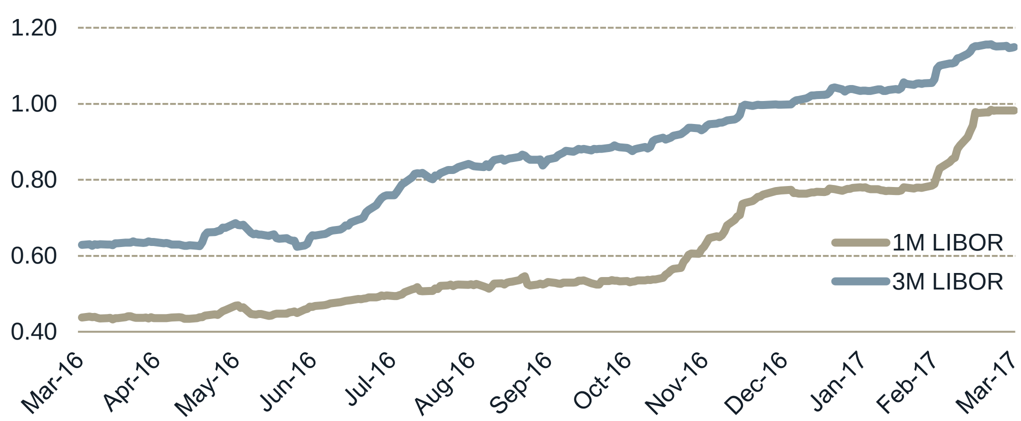
Short Maturity Muni and Low Duration Taxable Quarterly Commentary Continued

FIRST QUARTER 2017

Performance Notes

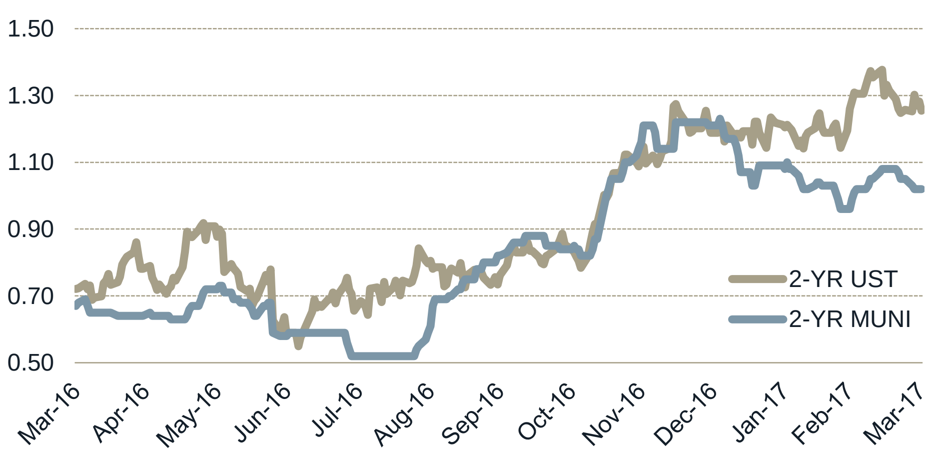
Short high grade bonds, although still positive for the quarter, posted more subdued performance compared to longer maturities. While much of this is attributable to yield curve movements over the period, historically tight front-end credit spreads have also made it more challenging to find incremental yield opportunities. The case for meaningful credit spread tightening from here appears to be weak unless significant fiscal policy changes create another sharp rally in risk assets. Steep credit curves are noticeable throughout the investment grade universe as participants continue to seek shelter in shorter maturities in anticipation of possible monetary and/or fiscal policy driven volatility later in the year. After coming off a tough fourth quarter, short dated municipals fared well and posted very strong performance, as muni-to-treasury ratios moved to historically low levels. We continue to favor lower duration weighted cash flow in order to reinvest at forecasted higher short term rates. This leaves us modestly short of benchmark duration with a continued overweight to strategic yield sectors in both taxable and tax-exempt sectors.

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



"… short dated municipals fared well and posted very strong performance, as muni-to-treasury ratios moved to historically low levels."

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



Contact Information

1802 Bayberry Court, Suite 202
Richmond, Virginia 23226
804] 648-3333
CAPRINBONDS.COM
Media Contact:
aplotkin@caprinbonds.com