Short Maturity Muni and Low Duration Taxable Quarterly Commentary

SECOND QUARTER 2017

Macro Overview

Much of the global tension that grabbed headlines in the first part of the quarter eased following Emmanuel Macron's decisive victory over his anti-establishment counterpart Marine LePen in the French Presidential election. Here in the US, President Trump's policy initiatives, most notably tax and healthcare reform, remained deadlocked in Washington while the administration faces an investigation surrounding its ties to Russia. In the markets, stocks continued to push higher as both the Dow and S&P were up over 3% in the quarter and continued to break record levels. Corporate earnings showed strength in Q1, and many estimates for Q2 look even better. However, the mature bull market in equities has made many pundits highlight just how expensive stocks have become with the S&P 500 P/E ratio hovering around 25. Unlike earnings, hard economic data did not prove as resilient. Q1 GDP, although stronger than first reported (1.4% vs. 0.7%), did little to improve on the longer term trend of growth malaise. An unexpected slowdown in retail sales throughout the quarter along with softer jobs numbers has now dampened forecasts for a robust Q2 rebound. The Federal Reserve raised rates as advertised in June and their updated interest rate forecasts were little changed, leading the yield curve to flatten further as the long-end remained anchored by weaker inflation expectations. Core CPI softened to 1.9% in April and again in May pushing the yr/yr number to 1.7%, down from 2.3% in January. The Fed has taken notice of slowing inflation but continues to voice that one more rate hike (most likely December) is warranted. Also contributing to a lack of inflation during Q2 was the price of oil which fell 8% during the quarter and is down 17% from the start of the year. Looking ahead, we are closely monitoring whether hard economic data will support the need for an additional rate hike later this year, about the same time the Fed wishes to start reducing its balance sheet.

Composite Characteristics

SHORT MATURITY MUNI

AS OF: 6/30/2017

Duration: 1.41 yrs

Yield-to-Worst: 1.25%

Yield-to-Maturity: 1.27%

Maturity: 1.50 yrs

LOW DURATION TAXABLE

AS OF: 6/30/2017

Duration: 1.60 yrs

Yield-to-Worst: 1.52%

Yield-to-Maturity: 1.52%

Maturity: 1.60 yrs

Market Dynamics

After a brief trip near year-to-date lows early in the quarter, front-end yields resumed their deliberate, albeit modest, climb higher. Benchmark 2Y and 3Y US Treasury rates traded in ranges of 22bps and 20bps respectively over the period, ultimately ending the quarter higher by 13bps and 6bps. Driving most of the movement in shorter maturities was an additional Federal Reserve rate increase and speculation over future policy, including the timing and scope of the much anticipated balance sheet reduction. Despite considerable conjecture among market participants, the Fed did not veer from the course they laid out late last year. A single 25bps rate increase in the quarter and further details about a slow reduction of reinvestments allowed Chair Yellen to again navigate away from the zero bound with virtually no market discourse. Looking into the second half of the year we see a more stark divergence of opinions. Current market probabilities show less than a 50% chance of a third rate increase at the December meeting versus Fed governor forecasts that have remained steady at 1.4% on Fed Funds. From our standpoint, a third rate hike along with a balance sheet reduction program would need the support of growth and inflation results markedly better than the first half of the year. However, we respect the possibility given how muted the reactions have been from risk markets following recent increases.

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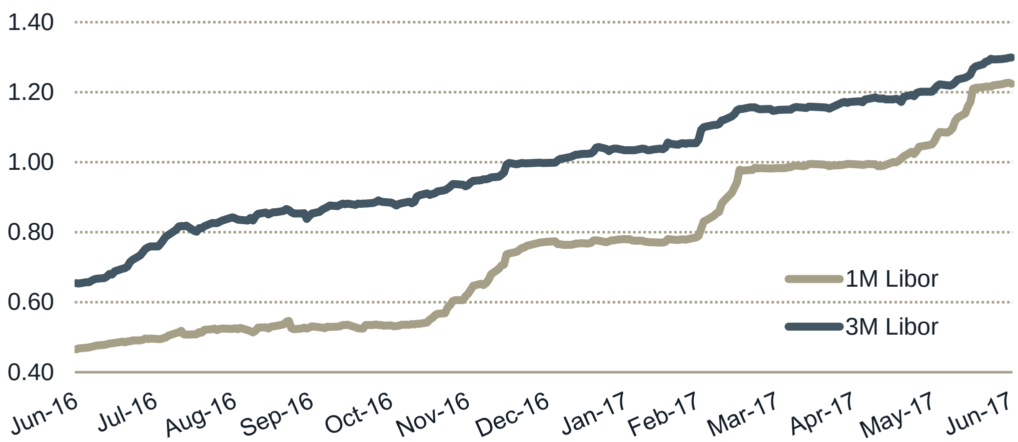
Performance Notes

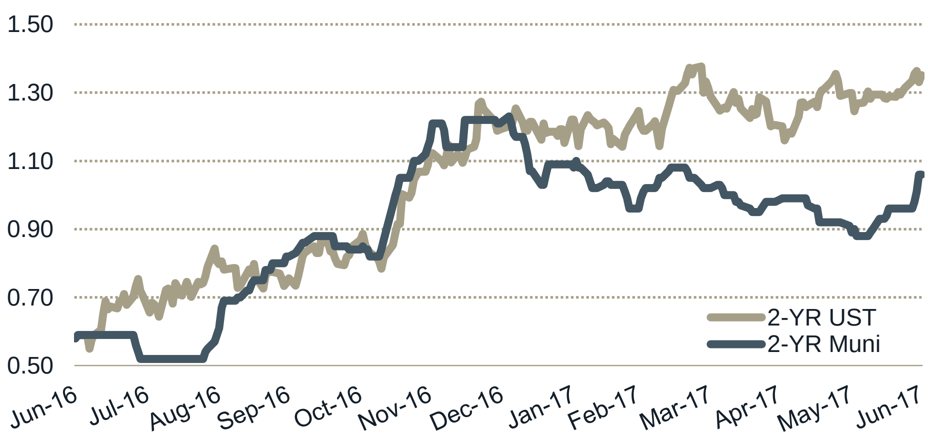
Despite an additional 25 basis point increase from the Federal Reserve, shorter maturity taxable and municipal bonds still posted modest positive performance for the quarter. In the low duration taxable strategy the continued emphasis on quality corporate credits has remained a positive contributor to performance through much of 2016 and into 2017 as spreads have tightened back to near pre-crisis levels, and incremental yield versus USTs and GSEs has been additive. Within the short maturity municipal portfolios a strategic overweight to higher yielding revenue sectors continues to provide added income versus general obligations without sacrificing credit worthiness.

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



"… a strategic overweight to higher yielding revenue sectors continues **provide added income** versus general obligations without sacrificing credit worthiness."

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