Intermediate Maturity Muni

Commentary – First Quarter 2018

Macro Overview

The first quarter of 2018 began with a bond selloff finding yields on benchmark 2YR, 10YR and 30YR US Treasuries up 38, 33, and 23 basis points, respectively. The front-end move was fueled by the FOMC rate hike in March and by more interest rate increases forecast for 2019 and 2020 (up to three and two hikes, respectively). This was the first meeting with Jerome Powell as Chairman and financial markets generally believe his policy guidance will remain in-line with his predecessor. Equity volatility also roared back during Q1 after what can be described as a complacent 2017. The VIX index reached a high in February last seen during the summer 2015 flash crash fueled by Chinese growth and credit concerns. Both the DJIA and SPX finished the quarter off approximately 1–2%.

- The Fed will likely pursue two (possibly three) more interest rate increases this year. This will continue to pressure the front-end of the yield curve but a lack of inflation should help contain intermediate and longer-term interest rates.
- Increased US Treasury issuance to accommodate the Fed balance sheet unwind and address the growing deficit may pressure intermediate and longer maturities.
- Bouts of equity volatility are likely to persist as the market dodges global trade tensions and a disruptive DC landscape. Sustained volatility could trigger a broader risk-off trade and support re-allocations to fixed income.

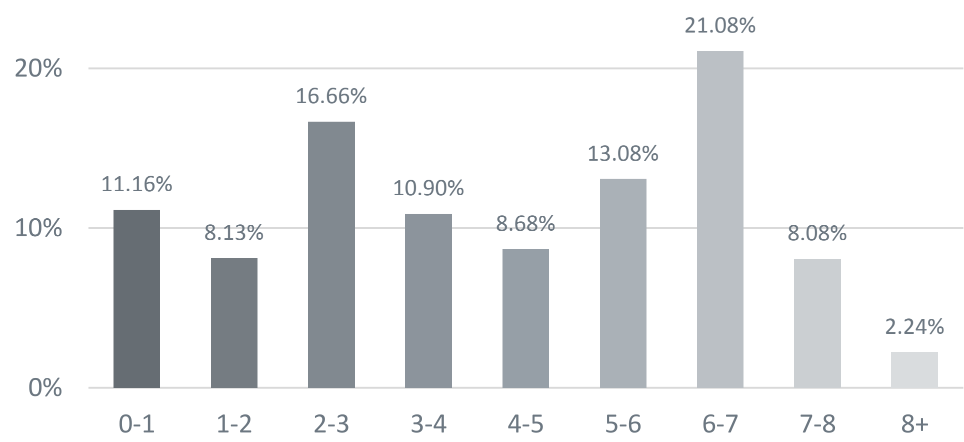
Market Dynamics

Technically municipals were well positioned for the first quarter of 2018. Issuers rushed to the market in December prior to tax reform, so supply was largely expected to be scarce thereafter, setting up a sweeping supply/demand imbalance as Q1 reinvestment dollars chased drastically fewer bonds. Although both sides of the equation proved correct (issuance down ~30% yoy and Q1 muni inflows +$10B), performance was negative to start the year and largely attributable to the sector following the broader US Treasury market selloff. Weak January and February performance is atypical for the start of the calendar year but March performance rebounded as some of the tax reform driven bank and insurance selling dissipated and dealer inventories thinned out. Looking forward, we expect a constructive tax-exempt landscape over the near to medium-term as supply remains subdued.

Composite Characteristics

Duration: 4.25 yrs
Yield-to-Worst: 2.31 %
Yield-to-Maturity: 2.49 %
Maturity: 6.08 yrs

Duration Profile



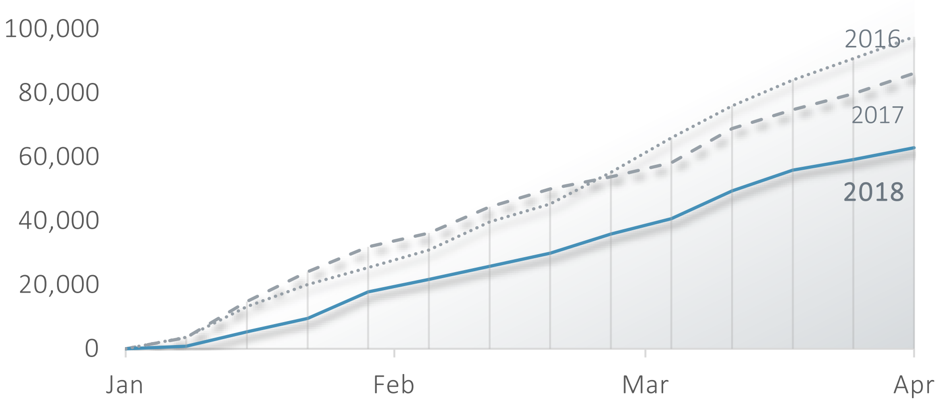
Intermediate Maturity Muni

Commentary – First Quarter 2018

Performance Notes

Strategy performance was generally in-line with benchmarks for the quarter. The muni curve steepened throughout the period with shorter maturities significantly outperforming intermediate and longer-dated bonds. Our move to shorten duration in early February proved additive as muni yields followed US Treasuries higher, especially on the longer-end. For the quarter, the 2YR portion of the curve was higher by only 9 basis points while the 10YR and 30YR portions of the curve were higher by approximately 40 basis points. Shorter maturity outperformance thus far has compressed front-end muni/treasury ratios to historically low levels, and we believe the main driver of this, which may persist, is investor desire to remain in the asset class while dodging duration for fear of further rate pressure.

Total Municipal Issuance YoY ($Bln)
Source: Bloomberg

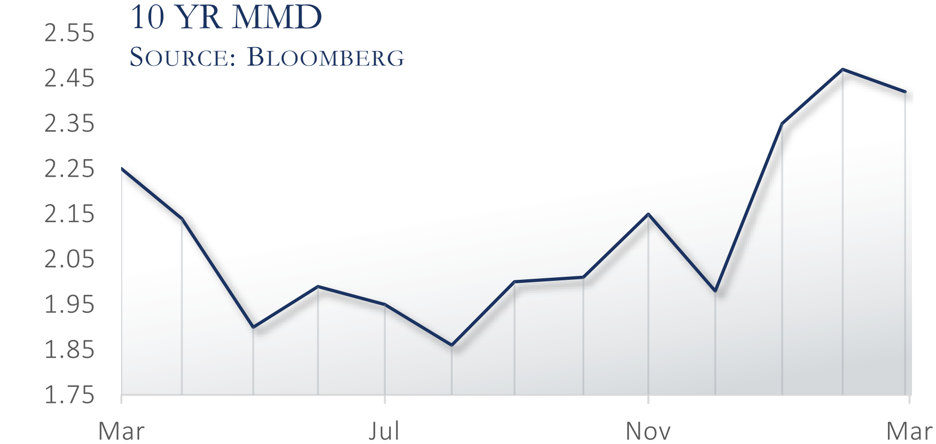


We predicted primary issuance to be lower by approximately 30% this year after the passage of tax reform and that has proven correct thus far. This leads us to believe it's …

a matter of time before the supply/demand imbalance creates a noticeable tailwind

… for munis heading into the heavy reinvestment months of May and June."

10 YR MMD
Source: Bloomberg



Contact Us

804.648.3333

WWW.CAPRINBONDS.COM

Media Contact:
aplotkin@caprinbonds.com