Intermediate Maturity Muni

Commentary – Second Quarter 2018

Macro Overview

Short rates continued to drift higher over the quarter as the FOMC hiked in June for the second time this year. Record low unemployment and moderately stronger inflation readings in early May pushed yields on the 10YR UST to 3.12%, a seven year high, while the 30YR UST touched 3.24%, an approximate four year high. However, a nationalist's party election threat in Italy reminded investors of just how fragile the EU remains and a modest flight to quality ensued. Economic data in June did little to push rates out of the new lower range with intermediate yields finishing a bit more than 10 basis points higher on the quarter. Even with the second rate hike this year and a seemingly more hawkish outlook on the economy and inflation from the Fed, a flatter yield curve remains the norm for now.

- The spread between the 2YR UST and 30YR UST is currently 39bps, tightest since the summer of 2007. The front-end of the curve will continue to react to Fed policy while the long-end is currently contained by trade tensions and subdued inflation.
- The likelihood of gradual and deliberate rate normalization is apparent with the probability of a September Fed rate hike at approximately 70%, with an additional hike in December at nearly 50%.
- Increasing trade disputes could threaten global economic growth and could offset the economic gains derived from tax cuts here in the U.S.
- Low unemployment (4.00%) has yet to lead to meaningful wage pressures.

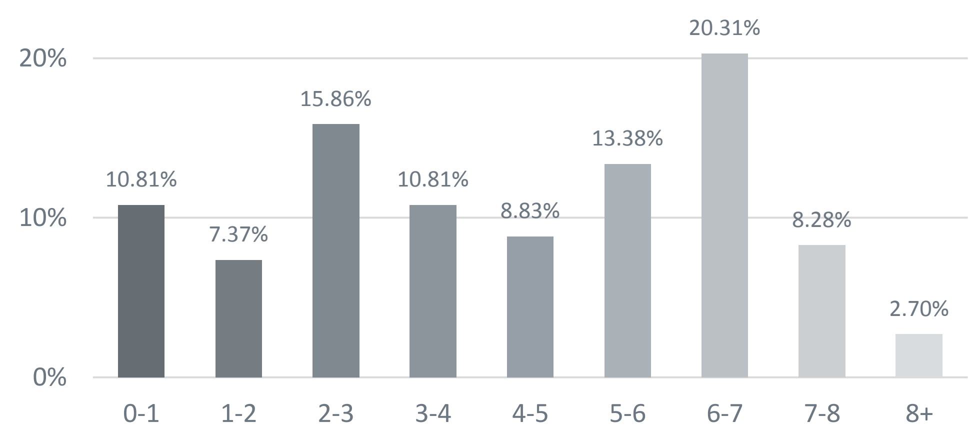
Market Dynamics

A general lack of supply during the quarter continued to be the primary theme in the municipal market. Although not as drastic as Q1 (down ~30%) issuance in Q2 fell approximately 20% quarter-over-quarter. Performance across the curve was positive, helping to offset some of the negative returns the market realized in Q1. Bank selling began to subside during the period while inflows, especially from the retail space, remained steady. Front-end Muni-to-UST ratios closed out Q2 at still extremely rich levels, while the 10YR and 30YR ratios finished around near-term averages. We continue to believe that tepid summer supply will be met with robust coupon and maturity reinvestment dollars, thus munis, from a technical standpoint continue to look attractive. Any widening of Muni-to-UST ratios, especially on the long-end of the curve could also spark interest from non-traditional and cross over buyers.

Composite Characteristics

Duration: 4.27 yrs
Yield-to-Worst: 2.32 %
Yield-to-Maturity: 2.50 %
Maturity: 6.13 yrs

Duration Profile



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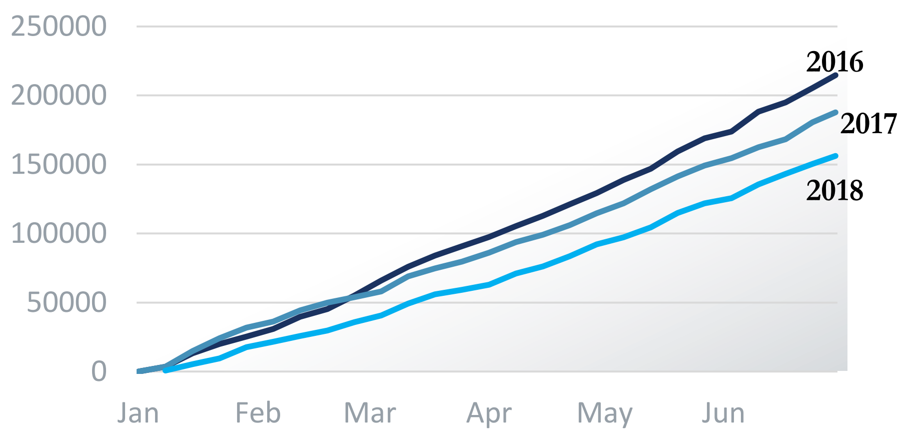
Performance Notes

Strategy performance was in-line to slightly below benchmarks for the quarter. Mild underperformance was mainly attributed to the rally in May which the slightly longer benchmarks benefitted from. However, YTD performance is now only off approximately -0.40% after withstanding a meaningful selloff in both January and February. The muni curve was essentially flat for the quarter with the 5YR portion of the curve performing best. For the quarter, the 2YR maturity was lower by 1bp, the 5YR lower by 5bps while the 10YR was higher by 4bps and the 30YR was flat. Munis largely outperformed their Treasury counterparts during the quarter most notably in the short-end of the curve where yields on the AAA index have held firm despite the Fed pushing short taxable rates higher.

Total Municipal Issuance YoY ($Bln)
Source: Bloomberg



10 YR MMD
Source: Bloomberg

"From a technical standpoint Munis continue to look attractive over the near-term.

The supply-demand component looks encouraging, specifically over the next several months

... as large coupon and maturity redemptions will be chasing light primary supply."

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