Short Maturity Muni and Low Duration Taxable

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 further increase to the Federal Funds rate was all but guaranteed going into the June FOMC meeting, but the more hawkish sentiment from committee members was not widely expected by market participants. While no one adjustment in statement language or forecasts was monumental, the overall tone certainly portrayed increasing confidence in both the state of the economy and the need to continue down a deliberate path of rate increases. Of particular importance to front-end investors were the upgraded forecasts now showing four 25 basis point increases in '18, and at least three increases in '19 as near-term growth and inflation rise a bit more quickly than previously estimated. While we continue to respect the central bank's forecasted path to higher rates within strategy positioning we are still cautious as inflation gauges have failed to sustain significant momentum, and more recently as global trade tensions have escalated.

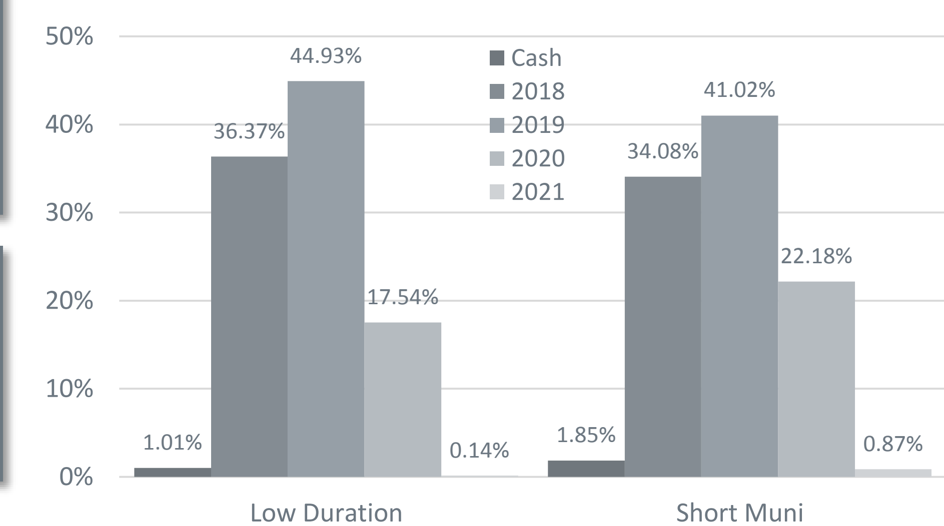
Low Duration

Duration: 1.26 yrs
Yield-to-Worst: 2.67 %
Yield-to-Maturity: 2.67 %
Maturity: 1.31 yrs

Short Muni

Duration: 1.34 yrs
Yield-to-Worst: 1.80 %
Yield-to-Maturity: 1.82 %
Maturity: 1.41 yrs

Maturity Profile



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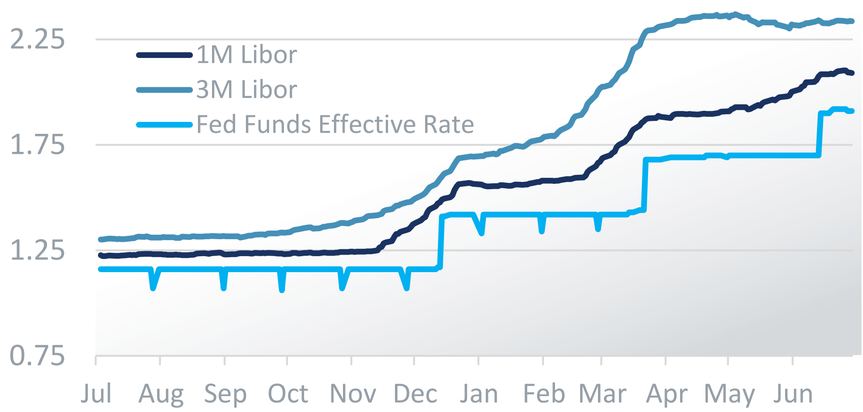
Performance Notes

Short maturity yields again rose gradually over the period as the FOMC continued down its deliberate path of rate increases. The 2YR UST ended June at approximately 2.52%, a level not seen in nearly a decade. Although rising short term yields have been a headwind for the strategies from a price return standpoint, steadily increasing portfolio yield levels have been able to overcome this and still produce positive total returns through the first half of the year. Corporate credit continued to provide incremental income despite spreads widening further on persistent supply and equity volatility. Our near-to-medium term view still sees corporates supported by strong economic growth, and healthy earnings. We continue to favor a shorter position on the yield curve within low duration taxable portfolios and see the more laddered structure of the short maturity municipal strategy continuing to benefit from a consistent stream of reinvestable cash flow.

1M, 3M LIBOR Rates

Source: Bloomberg



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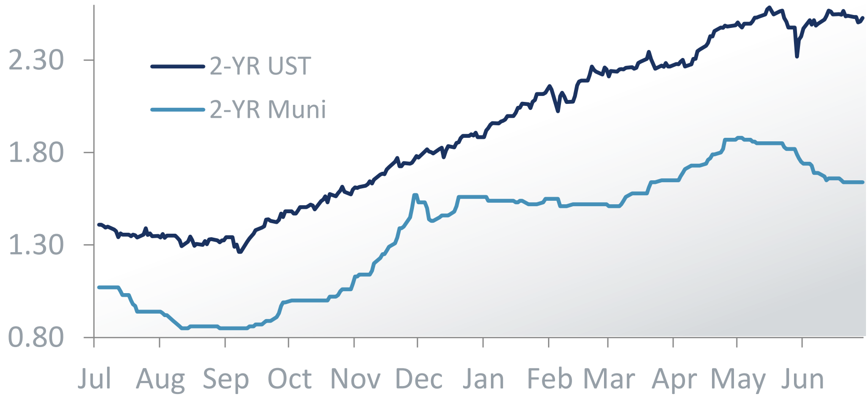
2 YR UST vs 2 YR MUNI

Source: Bloomberg



Contact Us

804.648.3333

WWW.CAPRINBONDS.COM

Media Contact:
aplotkin@caprinbonds.com