Intermediate Maturity Muni

Commentary – Fourth Quarter 2018

Macro Overview

Volatility across risk markets in December served as the defining chapter of the quarter and the year. Equities posted their worst December since the Great Depression (1931), with the S&P falling approximately 10%, and 14% for the quarter. US Treasuries were the primary beneficiary of this rout as investors sought a safe haven. The 10yr UST rallied 55bps from 3.23% in early November to end the year at 2.68%. Despite this backdrop, the Federal Reserve increased rates by 25bps at their December meeting, the fourth rate hike of 2018. While that move was largely anticipated, markets were expecting a pause in future hikes, but the FOMC reiterated its gradual increase approach. As trade disputes and the government shutdown linger, we believe volatility will be front and center until some tensions subside.

- US growth, aided by fiscal policy, meaningfully improved in 2018 but will likely moderate in 2019 as tariffs and tighter financials conditions weigh on output. Recession does not seem likely.
- Based on Fed Funds futures, 2018 ended with no rate hikes priced in for calendar year 2019. The Fed dot plots still suggest 2 hikes for the year.
- Further curve flattening and inversion possible with front-end rates higher via Fed policy and intermediate to longer-term yields anchored by risk market volatility and trade concerns.

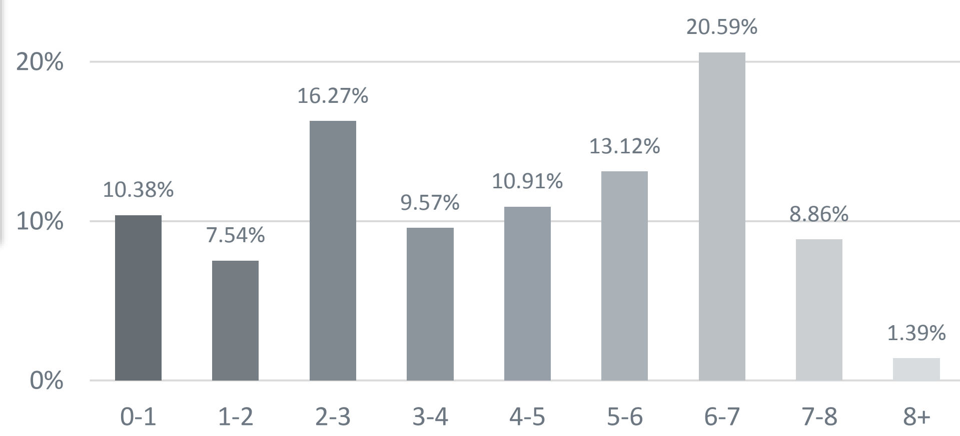
Market Dynamics

Municipals ended the year in strong fashion. For Q4, yields on the benchmark AAA MMD Index were lower by 19bps, 26bps, 30bps and 17bps in the 2yr, 5yr, 10yr and 30yr portions of the curve, respectively. Issuance for the year was down approximately 25% while net issuance ended in negative territory by approximately $45Bln, marking the first contraction in three years. One interesting market development in Q4 was that municipal fund outflows did not reverse as the market began to rally in November and December. We believe these outflows were related to year-end tax selling and do not think it is the beginning of a longer-term trend. Looking forward, munis should be well positioned to perform over the near-term as January redemption and reinvestment dollars chase limited supply to begin 2019.

Composite Characteristics

Duration: 4.26 yrs
Yield-to-Worst: 2.49 %
Yield-to-Maturity: 2.56 %
Maturity: 6.25 yrs

Duration Profile



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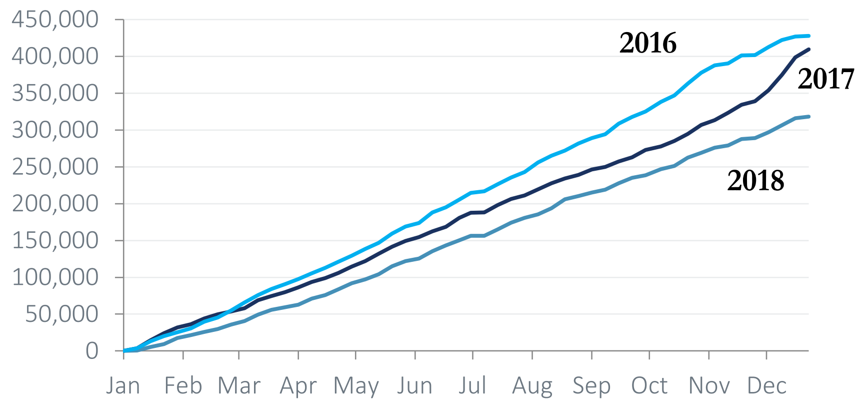
Performance Notes

Strategy performance was in-line to slightly below benchmarks for the quarter. Modest underperformance was mainly attributable to the rally in November and December where the longer duration benchmarks benefitted. However, our more defensive yield curve positioning was additive in October as municipals were weaker during the month. After withstanding yield pressure most of the calendar year, 2018 returns finished positive following the rally into year-end. Investment grade municipals ended the year as one of the best performing asset classes with most other fixed income and equity indices flat to negative.

Total Municipal Issuance YoY ($Bln)

Source: Bloomberg



"Municipals lagged during the first half of 2018 as economic and inflation expectations propelled rates higher.

Late 2018 equity volatility and ongoing trade concerns produced a flight to quality

… that helped munis end on a strong note."

10 YR MMD

Source: Bloomberg

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