MUNICIPAL PERFORMANCE HIGHLIGHTS

- 2016 started off strong as municipals delivered positive performance across the entire tax exempt yield curve in the first quarter.

- December 2015 brought the much anticipated initial rate hike from the FOMC. With inflation expectations remaining tame, we saw the yield curve flatten as the 2–to 10-year spread tightened 25 bps and the 2 – to 30-year spread tightened 13 bps.

- During the quarter municipals lagged U.S. Treasuries across the curve leading to higher Muni/Treasury ratios.
MUNICIPAL PERFORMANCE HIGHLIGHTS (CONT.)

- Continuing the trend that we witnessed in 2015, lower quality issuers significantly outperformed higher quality issuers during the quarter. The continued strong performance of the Intermediate and Long Credit Strategies was a result of our overweight positioning in ‘A’ and ‘BBB’ rated issuers during the quarter.

- Revenue bonds significantly outperformed general obligation bonds during the quarter. The outperformance of revenue bonds benefited the Credit Strategies as they were significantly overweight and also the High Grade Strategies which were slightly overweight.

- IDR/PCR issuers were the top performing sector during the quarter which significantly benefitted the Credit Strategies. While housing was the 2nd best performing sector which benefitted the High Grade Strategies. Resource Recovery issuers were the laggard which is a sector that all of our strategies are significantly underweight.

BARCLAYS CAPITAL YTD MUNICIPAL RETURNS
Source: Barclays; As of 3/31/2016

BARCLAYS CAPITAL YTD RETURNS BY QUALITY
Source: Barclays; As of 3/31/2016
MUNICIPAL CREDIT TRENDS

CREDIT QUALITY

- Municipal credit quality continues to strengthen, but the exceptions continue to garner the headlines. Illinois continues to operate without a budget, New Jersey continues to have budget deficits that are closed with lower pension payments, and Puerto Rico is Puerto Rico.

- While municipal finances have significantly improved since the economic downturn, rainy day balances remain below pre-recession levels. This metric continues to be closely monitored by WSC.

STATE OF THE STATES

- Pennsylvania finally released a state budget, but Illinois continues to operate without a budget due to political wrangling. The rating agencies have taken note and downgraded periphery credits that rely on state funds in both states.

- Understanding the reliance on state funding at the local level is extremely important in the current environment due to less financial flexibility.

- Lower oil prices continue to put pressure on certain state budgets. Louisiana was the latest state to be cast into the spotlight.

KEY TRENDS

- Direct bank loans – 15% of 2015 issuance ($60 billion)

- GASB pension rates begin to come into effect.

- Puerto Rico default battle continues.
MUNICIPAL TECHNICALS/SUPPLY & DEMAND

- Municipal issuance was $89 billion in 1Q 2016 which was a decrease of approximately 16% on a year-over-year basis.
- Issuers continued to capitalize on low interest rates as refunding issuance accounted for 53% of the quarter’s issuance.
- With municipals lagging U.S. Treasuries during the quarter, municipals appear slightly cheap to fairly valued vs. Treasuries from a historical basis.

MUNI TO TREASURY
Source: Bloomberg; 12/31/2015 - 3/31/2016
SUPPLY/DEMAND DYNAMICS

- Municipal Fund flows started the New Year on a very strong note with positive inflows of $14.97 billion during 1Q 2016. That represented a 72% year-over-year increase.
INTRODUCING THE CREDIT STRATEGIES

- Three major changes within the “credit sensitive” space have allowed for the development of prudent SMA strategies
  - The amount of ‘BBB’ rated, speculative grade, and non-rated outstanding issuance now accounts for 15% of the municipal market or $570 billion.
  - Greater pricing and trading transparency through electronic trading platforms and ongoing enhancements to EMMA.
  - Forward looking technology investment by WSC, which allows for surveillance of issuers in real time.

- Two different strategies allow investors the ability to choose their yield curve exposure based on their view of interest rates within the credit space/
  - The Intermediate version, ITEC, utilizes the same yield curve exposure as ITTE, but as of 3/31/2016 yields roughly 110 bps more than ITTE as measured by YTW.
  - The Long version, LTEC, utilizes the same yield curve exposure as STEFI, but as of 3/31/2016 yields roughly 71 bps more than STEFI as measured by YTW.
  - The strategies DO NOT invest in “traditional” high yield sectors such as tobacco bonds and uninsured Puerto Rico. While the Credit Strategies invest in credit sensitive ratings and sectors, our credit methodology continues to manage to a zero default expectation within these strategies.

- The strategies carry a $1 million minimum to ensure prudent portfolio construction and diversity.
STRATEGY UPDATES

- **STTE**
  - Low duration, currently around 1.25 years.
  - With the Fed officially in play, YTW may begin to rise slowly as bonds rollover.

- **ITTE**
  - No changes to duration or curve placement, extending maturities in accounts that have drifted lower in duration.
  - Increasing credit quality due to low relative value in credit trades.

- **STEFI**
  - Strong performance due to duration.
  - Continue to reduce allocation to ARS as prices have rallied and increase fixed rate exposure to the initial 5 years of the yield curve.

- **VISTA**
  - Minimum account size currently stands at $1 million.
  - Strategy continues to mitigate risk for clients if the Fed tightens quicker or more than anticipated in the structure of rates.

- **ITEC**
  - Minimum account size is $1 million, to ensure prudent diversification and liquidity.
  - Intermediate duration, curve placement similar to ITTE.
  - Low investment grade average credit rating.

- **LTEC**
  - Minimum account size is $1 million, to ensure prudent diversification and liquidity.
  - Long duration, curve placement similar to STEFI.
  - Low investment grade average credit rating.
LOOKING AHEAD

- At the end of 2015 the markets saw the Fed officially in play and factored in 3-4 rate hikes during 2016. At the end of 1Q the market viewed 1-2 hikes more likely. Global headwinds continue to make that projection a moving target.

- A Presidential election, an engaged Fed, and slowing global growth continue to be three factors that bear watching in 2016.

- With inflation expectations well tamed, the curve can continue to flatten.

- The municipal market should continue to perform relatively well through year end and provide stability in client portfolios.
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