JUST HANGING AROUND

It wasn’t supposed to be this way. To hear most pundits and, for that matter, many of our clients over the course of the first quarter, higher interest rates here in the U.S. were a foregone conclusion. After all, the U.S. and, to a lesser but noticeable extent, Europe were already seeing increased economic activity, and the newly elected administration here was sure to add fiscal fuel to the fire already lit by aggressive monetary policy. Consumers, more confident than they have been in over a decade, would spend aggressively and U.S. workers would surely garner increased wages as the labor market became ever tighter. Further, the Fed would have to be more aggressive in their removal of policy accommodation as the economy accelerated, which would surely lead to even higher rates, especially in the short end of the maturity spectrum.

This is not to say that this scenario may not play out in the coming quarters, but it certainly did not in the first quarter. To be sure, the inability of the House to pass the first piece of President Trump’s agenda regarding Obamacare called into question the ultimate extent of fiscal stimulus the Republicans will be able to enact in the near term. Consumers are feeling good by most measures, but their spending continues to be lackluster; this in turn has led to first quarter GDP estimates of a meager 1.5% despite a relatively mild winter in most of the country. The Fed did, as expected, raise rates at their March meeting and stands ready to raise rates again later in the year. Though they remain data dependent, at this point in time two more hikes in the Fed Funds rate are anticipated by the market before year-end.

The bond market’s reaction to this: not much. Despite what seemed like several whipsaw moves and a strong rally in equity prices and risk spreads to start the year, the U.S. Treasury curve was virtually unchanged over the course of the last three months.
The benchmark 10-year note fell from 2.45% to 2.39%, and traded in a relatively tight 2.31% to 2.63% range. As expected, the 2-year rose in yield slightly, from 1.19% to 1.26%, but even this flattening move was, obviously, quite muted. Spreads did finish the quarter generally tighter than where they began the year but off their best levels, following the pattern seen in stock prices. Surprisingly, despite a robust news (and tweet) flow, most measures of volatility remained stubbornly low.

The global economy is in decent shape and growth should rebound in the coming quarters. Here at WSC we believe that rates will probably rise slightly through the remainder of the year, and the curve will continue to slowly flatten as the Fed continues its work. This increase may be as much a technical trade as a fundamental shift to a higher inflationary environment. However, as we have said for some time, there are secular forces, including demand for safe yield from a large global pool of savings, aging demographics, and ever improving technologies that we believe will continue to ultimately keep a lid on inflation and yields around the globe, especially here at home.

**Tax Exempt Market**

**Duration/Structure**

Tax exempt returns were positive during the quarter, and were especially strong in the 5- to 7-year portion of the yield curve. Since the beginning of the year, yields in 5-year municipals fell by approximately 22 basis points and the 5-year muni-to-Treasury ratio tightened from around 93% to 82%. In contrast, tax exempt 10-year yields were lower by 9 basis points and 30-year yields ended the quarter essentially unchanged. Additionally, 10-year and 30-year ratios ended the quarter pretty much in line with where they began at approximately 95% and 102%, respectively. Although the 5-year portion of the curve performed the best during the first two months of the year, we saw this trend reverse during March as longer maturities (10 years and longer) outperformed significantly and returns in the 0- to 5-year portion of the yield curve lagged.

We believe the outperformance of shorter maturities that occurred during the beginning of the year had to do with a combination of the following:

1. Elevated ratios to begin the year.
2. Individual investors’ concerns surrounding Federal Reserve rate hikes.
3. Increased uncertainty regarding tax reform.

It appears this year that tax exempt investors have been faced with the conundrum of possessing a strong desire to own munis (evidenced by continued fund inflows) while harboring apprehension over rising interest rates. Although we know that when the Fed embarks on an interest rate hiking regime it doesn’t always mean longer interest rates will rise, we believe that many muni investors are still hesitant to own longer duration bonds.

Additionally, we believe investors remain concerned that potential changes to the tax code, especially a lower corporate tax rate, may decrease demand for munis, especially those with maturities greater than 10 years. This uncertainty will most likely cause intermediate and longer ratios to remain elevated vs. historical levels until tax reform has been finalized. As we have mentioned in past commentaries, we believe steady demand for munis will persist even if individual tax rates fall. Lower corporate tax rates could reduce demand for tax exempt munis, however, the corporate tax rate would be have to be lowered significantly for a drastic impact to be felt. We believe this is unlikely. We believe comprehensive tax reform will be extremely complicated and large scale changes to the tax code appear unlikely, even more so following...
the inability of Congress to pass the American Health Care Act bill. Regardless, it is clear that tax reform continues to be a significant concern for tax exempt investors and we would not be surprised to see periods of intermittent volatility dominating the headlines. In the end, we anticipate eventual changes will likely be smaller than originally anticipated and may take much longer to materialize.

**SUPPLY/Demand**

Although January supply started out at an above average pace, year to date issuance is down approximately 12% vs. the same period last year. Typically the market sees an uptick in supply during March, however, this year March issuance disappointed with just under $30 Billion coming to market, a 30% decline vs. March of last year [1]. Refunding volume in particular has been lower as higher Treasury rates have made some refinancing less attractive. Additionally, many deals were accelerated into the fourth quarter of 2016 and early 2017 as municipalities sought to secure financing ahead of the anticipated Fed rate hike, and uncertainty surrounding policy changes with the new administration. We anticipate supply will begin to increase once some of the uncertainty surrounding potential policy changes is addressed, especially in regards to healthcare, tax reform, and infrastructure spending.

**MONTHLY MUNICIPAL ISSUANCE**

*Source: The Bond Buyer, 12/31/2014 - 3/31/2017*

Demand has remained steady this year as we have seen tax exempt muni fund inflows in 10 out of 13 weeks. Additionally, the seasonal weakness which typically accompanies late March as investors raise funds to cover upcoming tax payments, has thus far failed to materialize. Going forward, we expect demand to remain steady and to potentially increase as investors become more comfortable with the notion that interest rates may not rise by as much in the near term as previously feared, and fiscal policy changes may be less impactful and take longer to materialize.

**CREDIT QUALITY**

During the first quarter lower quality bonds outperformed higher quality bonds. Investors continue to remain comfortable taking on additional credit risk in the current environment.

**1Q 2017 RETURNS BY CREDIT QUALITY**

*Source: Barclays; 12/31/2016 - 3/31/2017*

Looking ahead we believe overall credit trends continue to look positive. As we illustrated in our recent white paper entitled, “Trump Credit Effect on Municipal Bonds”, steady U.S. employment and housing conditions, along with a generally strong consumer, will continue to support a constructive environment for municipal credit overall. Because state and local credit quality is positively correlated to the health of the national economy, the eight years of slow and steady U.S. economic recovery we have seen post-recession have corresponded with steady tax revenue growth at the state level. While some areas of the country continue to experience pockets of weakness, especially those states with heavy dependence on oil prices, most areas of the country continue to experience solid growth. Additionally, local property tax revenue growth, which is a major driver of muni credit quality, has been robust. That said, we continue to believe credit selection remains more important than ever as pockets of weakness do exist and many issuers continue to struggle with outsized pension obligations.
Taxable Market

CREDIT QUALITY

By the numbers, it is difficult to argue that credit quality is improving markedly across a number of asset classes. While municipal credit continues to improve, somewhat offset by rising pension and post retirement obligations, other markets have not fared as well. For example, auto and commercial mortgage-backed issues have shown recent and concerning weakness. Defaults are up significantly for private Chinese companies. When we look specifically at investment grade, developed world corporations, net leverage is at the highest level since the financial crisis. However, this observation needs to be tempered by the fact that economies are growing positively. While top line growth in the S&P is concentrated in relatively few companies, many more still have significant cost levers to pull. In the bank and finance arena, balance sheets continue their improvement based, among other factors, on continued strong domestic employment numbers and better net interest margins as a result of higher short-term interest rates. We continue to look for negative trends, but do not see anything that gives us immediate pause. Spreads on investment grade credit continues to do better, and while outright we believe that they are expensive, the positive direction makes sense to us. In all markets, it is likely that we are moving into a period of real delineation, issuer by issuer, so that individual security selection will have more of an impact than pure sector allocation, at least in the near future.

SECTOR FOCUS

Corporate bonds continue to be the star performer in the investment grade bond world. In addition, the trend of the weaker credits performing the best is still intact. There are a number of reasons for this, both technical and fundamental. While supply continues to come at record levels, demand has no problem keeping up. Appetite by pension funds and long duration players seems insatiable. Shorter on the curve, total return managers and corporate cash exhibit like demand. On the taxable municipal side, similar dynamics are at work. While we saw good supply in January that kept spreads at reasonable levels, lower issuance in February and March brought spreads in. While the fundamental framework in the market is constructive, shorter maturities appear fully valued. We are contemplating lowering the allocation to taxable munipicals slightly in the near term, especially in the short end where valuations are full, and redeploying into ‘A’ rated corporate bonds where we have identified credits we like. At present, we are not contemplating a change in allocation percentage in our government related allocation for strategies that include them.

DURATION/STRUCTURE

By now, most of you know that we do not speculate on the direction of interest rates or curve placement in our strategies, but instead seek to add alpha through our active share and qualitative differences from our benchmarks, especially with our emphasis on the taxable municipal market. That said, we continue to focus on longer duration taxable munipicals as opposed to shorter ones as credit curves are particularly steep in that market. A similar dynamic is at work in our corporate bond allocation, but to a lesser extent. For strategies that contain government related allocations, clearly we focus on shorter bonds as credit curves there are very flat.
The Bond Buyer, *March Muni Volume Plunges Amid Political Turmoil*, April 3, 2017

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