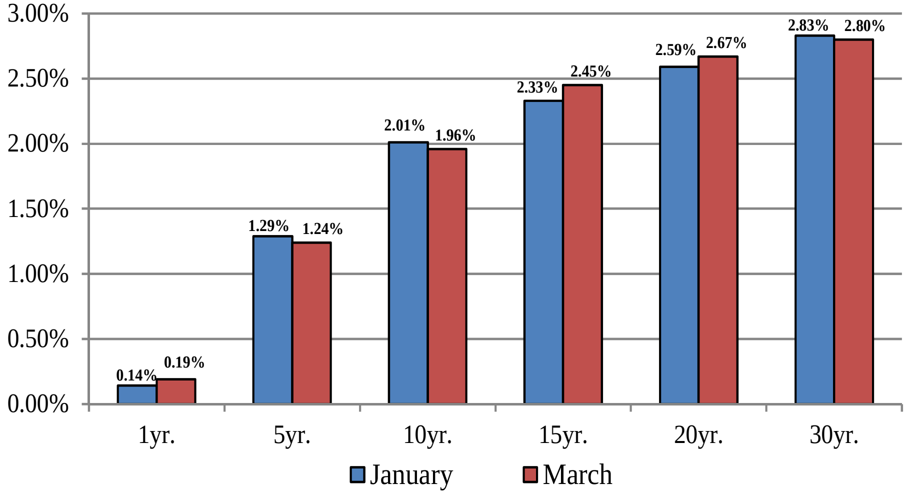
Quarterly Market Review

Spring 2015

Market Update: Municipal bond yields ended the 1st quarter of 2015 relatively unchanged from prior year end. Municipal yields rose in February, partially offsetting the declines across the yield curve that occurred during the month of January. During March, yields on the long end of the curve fell, while short-term yields (5 years and in) continued their rise from February.

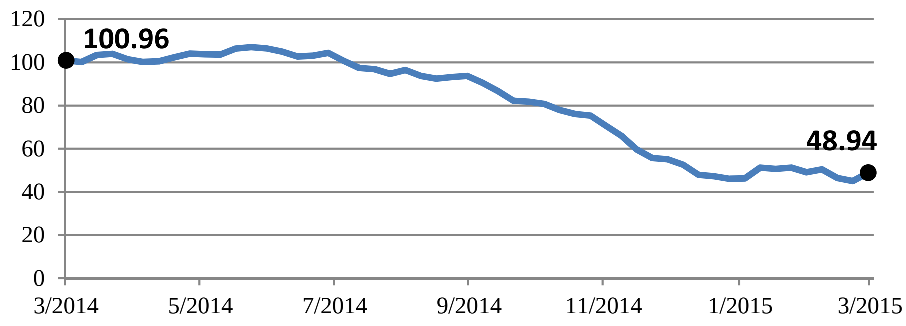
The driving force behind these moves was the Federal Reserve and the market's opinion of subdued long-term growth and inflation. Although the term "patient" was removed from the Fed's March meeting minutes release, the minutes showed that Fed members believed the projected long-term rate would be lower than during their December meeting of last year. This helped drive down yields on the long end of the curve from their February month-end levels.

AAA Muni Bond Yields (%)



Source: Municipal Market Data (MMD).

Crude Oil Prices: West Texas Intermediate (WTI)



Source: FRED Economic Data: Economic Research, Federal Reserve Bank of St. Louis.

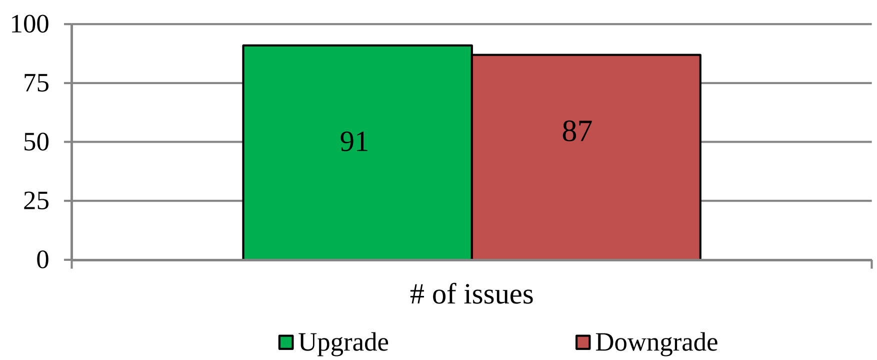
Oil prices continue their fall: Oil prices continued their plunge as high production levels in the U.S. drove prices lower. Prices of West Texas Intermediate (WTI), a popular grade of crude oil that is often used as a domestic benchmark price of the commodity, ended the quarter at roughly $48/barrel, down about 54% from a year ago. The plunge in price has already affected some states whose budgets rely heavily on tax collections from production and activities as it relates to the oil industry. States including Alaska, North Dakota, and Texas, among others have already cut their revenue projections for the year, as they expect lower revenue generated from taxes related to the oil industry. Despite the setback, most have well established reserve funds that will be able to support the lower revenue projections in the short term. If prices remain low for an extended period, more pressure may be put on their budgets.

Our take: We continue to remain vigilant of states that are heavily dependent on oil revenues. A number of these states, Texas for example, have broad diversified economies that serve to blunt the negative oil economy repercussions. We rely on our market expertise and credit research capabilities to find attractive opportunities for our client portfolios…uncovering investment values despite the oil related "headline risk."

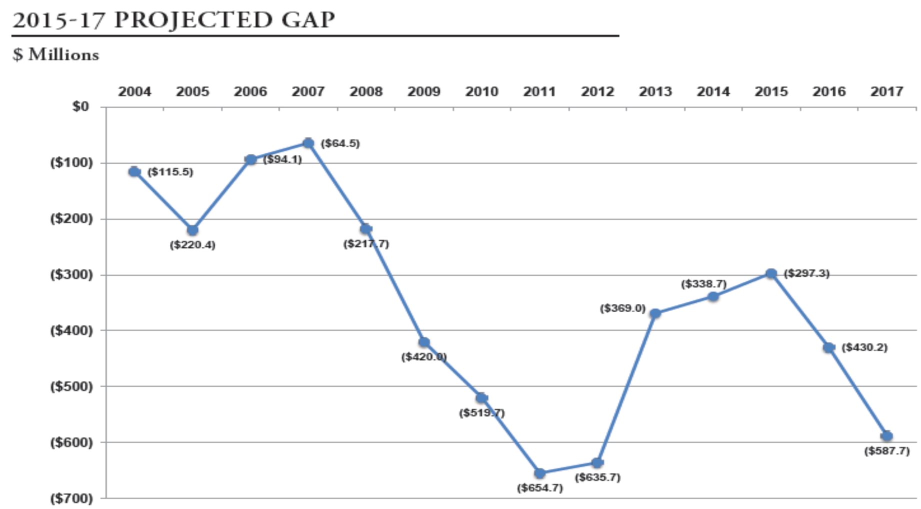
Improving metrics: On average, municipalities nationwide have continued to improve their balance sheets and credit metrics. In a February report, Moody's Investors Services disclosed that during the 4th quarter of 2014 upgrades outpaced downgrades for the first time since 2008. Additionally, Fitch Ratings released a report in early March showing that its ratio for downgrades to upgrades was 0.7 to 1.0. This compares to a ratio a year earlier of 2:1. An improving economy, nationwide changes in municipal leadership, and low borrowing rates have all help in the improvement in overall credit quality of the municipal market.

Our take: Each credit is different from the next. As such, our credit research department continues to evaluate credits on our approved list and those we seek to add to the list. It is this subset of credits that we recommend to our clients. The nationally recognized rating agencies provide one form of measurement and act as a complement to our internal proprietary credit research process. There still are plenty of "problem child" credits in the municipal bond universe that we look to avoid due to their weak structures or below average credit quality…and there are numerous solid quality, undervalued credits. These are the ones we seek.

Moody's Rating Changes 4Q 2014



Source:
Fitch Ratings, "U.S. Public Finance 2014 Transition and Default Study."
Moody's Investor Services, "Public finance upgrades outperform in fourth quarter; downgrades prevail in 2014"



Source: City of Chicago: Annual Financial Analysis 2014.

Chicago Troubles: City of Chicago general-obligation bonds were cut by Moody's to Baa2 at the end of February, with a Negative outlook. Furthermore, the Chicago Public School System (CPS) debt was cut by Fitch Ratings to BBB-, with Fitch citing rising pension costs attributing to the downgrade. Illinois Governor, Bruce Rauner, has not minced his words, either, regarding restructuring particular CPS debt.

Our take: We continue to closely monitor the situation occurring in the City of Chicago. We view certain credit structures of the city's debt more warily than others. As a result, we have avoided certain sectors within Chicago for several years. Given the complicated nature of this discussion and the nuances within the municipal market, we encourage you to reach out to us if you would like to have a more detailed discussion on this topic.

From the Credit Research Desk

Spring 2015

The Relationship between Tax-Exempt Municipals and U.S. Treasury Rates

Most investors with exposure to the bond market are worried about the inevitable rise in interest rates. The graph on the top right shows a strong positive relationship (high R^2) between Treasury and municipal bond yields. Despite the positive relationship, additional analysis reveals that over the most recent full market cycle municipal bond yields are less volatile than their Treasury counterparts. By looking at a regression analysis of the 10 year AAA Municipal Bank-Qualified Index on the 10 year U.S. Treasury Index, our analysis shows that since 2003, for every 100 basis point increase in the 10 year Treasury yield, the mean increase of the 10 year tax-exempt municipal yield was 61 basis points (95% confidence interval 60-62bps).

We are well aware that market conditions today are much different than they were at any time over the period data was collected and the most recent financial crisis needs to be taken into consideration when analyzing the dataset. As a result, we will have more in depth commentary on this topic next quarter.

The analysis above raises a valuable question for all investors: Where do municipal bonds fit into your personal asset allocation? We believe all investors can benefit from exposure to the municipal market for purposes of increased diversification, preservation of principal, and tax-free or taxable income generation. If you have specific questions in regards to the municipal market or investing in municipal bonds, please contact your Investment Specialist.

Thank you for your continued confidence in our team and our credit research and portfolio management process.

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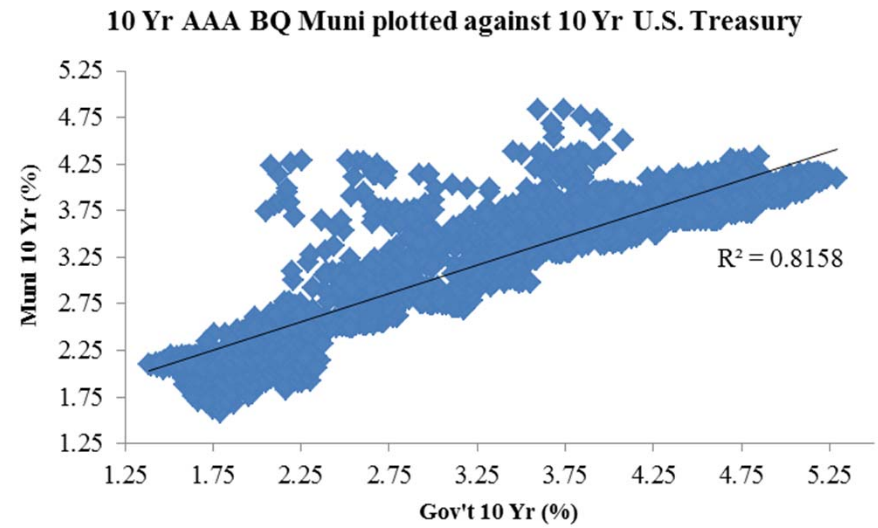
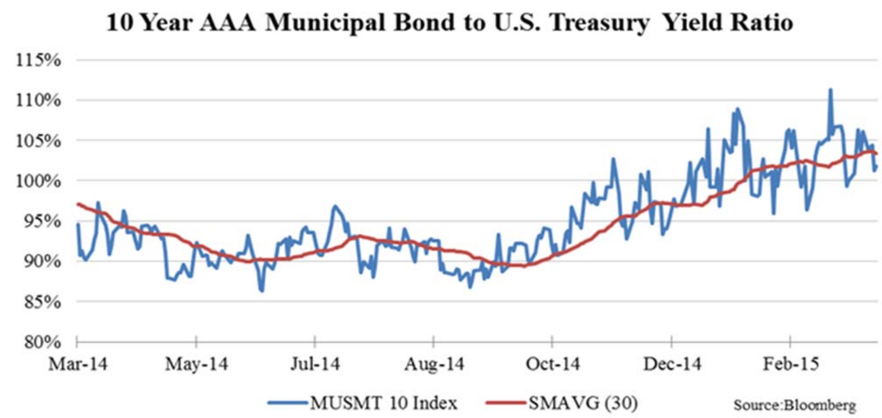


Source: Bloomberg



Source: Bloomberg