Quarterly Market Review **Spring 2016**

<u>Market Update:</u> Municipal bond yields decreased during the first quarter with AAA 5-year, 10-year, and 20-year yields falling 15, 18, and 8 basis points, respectively. In March, the Federal Reserve announced that their pace of interest rate increases was likely to be slower than initially expected. It anticipates two rate increases this year, down from the initial four predicted. Slower growth abroad and market volatility were reasons for the reduction in rate rising estimates.

As seen from the rate hike probability chart below, the market is predicting about a 55% chance there will be another rate hike by year end. Though rates are low by historic standards, so is inflation and global growth. Until we see a more resilient global economy take-hold or inflation pick up steam, do not expect long term rates to increase. The Fed's continued dovish stance is putting a ceiling on short-term rates as well.

Federal Funds Rate Hike/Cut Probabilities
(as of 04/20/16)

United States | Instrument: Futures: Fed Funds | FED Effective Rate 0.37

1) Overview | 2) Future Implied Probability

Current Implied Probabilities | 3) Add/Rem

Dates: Meeting / Calculation | Calculated 04/20/2016 | Based on rate 0.25-0.50

Meeting	Prob Of Hike	Prob of Cut	0-0.25	0.25-0.5	0.5-0.75	0.75-1	1-1.25	1.25-1.5	1.5-1.75
04/27/2016	0.0%	4.0%	4.0%	96.0%	0.0%	0.0%	0.0%	0.0%	0.0%
06/15/2016	17.3%	3.3%	3.3%	79.4%	17.3%	0.0%	0.0%	0.0%	0.0%
07/27/2016	30.0%	2.8%	2.8%	67.3%	27.2%	2.8%	0.0%	0.0%	0.0%
09/21/2016	40.8%	2.3%	2.3%	56.9%	33.6%	6.7%	0.4%	0.0%	0.0%
11/02/2016	43.2%	2.2%	2.2%	54.6%	34.6%	7.8%	0.7%	0.0%	0.0%
12/14/2016	55.0%	1.7%	1.7%	43.2%	39.0%	13.7%	2.3%	0.2%	0.0%
02/01/2017	58.6%	1.6%	1.6%	39.8%	39.3%	15.8%	3.2%	0.3%	0.0%

Source: Bloomberg. Accessed: 04/20/16.

<u>Regulatory Update:</u> MSRB Rule G-18 went into effect on March, 21, 2016 . The "Best Execution" rule "requires brokers, dealers and municipal securities dealers (dealers) to use reasonable diligence to ascertain the best market for the subject security and buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions."[1] Various factors must be gauged in order to determine best execution, including: price, volatility, relative liquidity, size, terms of the client order, among many other factors.

Our take: The rule is new to the industry and, as with all new regulatory initiatives, we adapt our polices and procedures to conform with the rules.

That said, we have been providing good order execution for our clients since the firm's founding more than 30 years ago. We believe our business succeeds and prosperous because we do our best to align our interests with our clients' interests. We formulate our operating procedures in order to achieve this goal. We understand our clients expect us to provide them with efficient and transparent advice and recommendations.

The advice and value we provide to our clients and their portfolios serves as an excellent example of our commitment to them.

If you have any questions about the rule or the municipal market in general, please feel free to reach out to an Investment Specialist or Portfolio Manager.

Sources:
http://www.msrb.org/~/media/Files/MISC/Best-Ex-Implementation-Guidance.ashx

The State, City, and it's Schools…Oh my!: $143 billion. This is the combined pension liability of the Land of Lincoln, Chicago and Chicago's public schools. Over the past year, these three systems have been the center of much attention. Back in February, the Chicago Board of Education issued $675 million of debt at yields of 7.75% and 8.50%, for 10 and 28 year bonds, with a portion used just to cover operating expenses. The City and School System have seen continuous downgrades in recent years by Moody's, Standard and Poor's, and Fitch. The state holds the lowest rating of any U.S. state.

Unfortunately a combination of political deadlock in Springfield and constitutional constraints are prohibiting any sort of progress to be made.

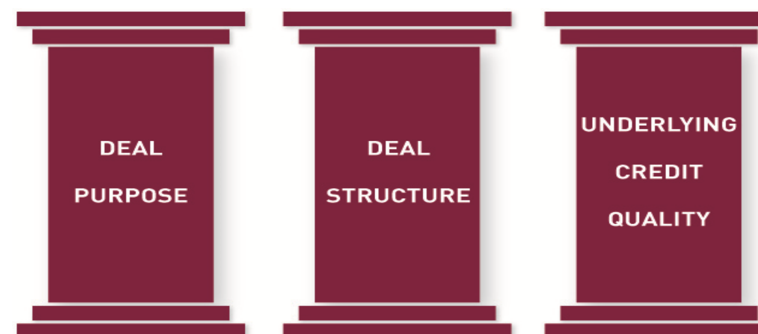
Our take: The financial problems at the state, city, and school system levels are significant. We have been aware and in front of these issues for a long time. Chicago has seen a deterioration in its finances for years. The source of the problem is primarily pensions compared to Detroit's problems centering on economic and population deterioration.

Sources:
http://www.cityofchicago.org/city/en/depts/mayor/iframe/just_the_facts.html

http://www.bondbuyer.com/news/regionalnews/illinois-net-fiscal-position-slides-1100598-1.html

http://www.bondbuyer.com/news/regionalnews/uncertainty-over-chicago-schools-special-revenue-claim-1100037-1.html

Three Pillars of Credit Research



The Three Pillars: A bond **issue's structure** is one of the three pillars of our credit evaluation process – along with **underlying credit** and **deal purpose**. The importance for investors of a solid structure has been amplified in recent distressed credit situations. San Bernardino, CA is the latest example. Moody's estimated the municipality's Pension Obligation Bond (POB) holders will recover less than 30% of their investment. Though this is up from the initial pennies-on-the-dollar proposal, it is much lower than recoveries for particular liens of other distressed municipal bondholders (e.g. Detroit UTGO bonds). This relatively lower recovery primarily rests on the weak structure of the bonds. The POB debt is unsecured and paid from general government revenues - without a general obligation (GO) pledge.

Our take: In our opinion, the purpose (pension funding) of the bonds, exacerbates the recovery potential. The other aspect that comes into play is local politics. It is interesting to note that the sub 30% recovery for San Bernardino POB holders is much less than the 41% average corporate high-yield bond recovery rate since 1988. In our opinion such a difference could only be attributed to the influence of politics – an impossible metric to measure. This is one of the many reasons high-yield municipal bonds are an entirely different animal and should not play a role in your "mattress-money" allocation.

Sources:
https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_188781

https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/guide-to-the-markets/viewer?utm_medium=SocialMedia?utm_source=Twitter&utm_campaign=Guide%20to%20the%20Markets&utm_content=11

Short Duration Strategy: Enhanced Cash Management

Spring 2016

Seven years ago, the Federal Reserve lowered the federal funds rate- an overnight interbank lending rate - to a range of 0.00 – 0.25%. This move, which occurred during the financial crisis, was an effort to boost overall economic growth within the U.S. The lowering of the fed funds rate led to an overall decrease in both taxable and tax-exempt rates across the yield curve.

Many investors were set on the idea of "waiting on the sidelines" to invest until rates started to move up again. Seven years later, many investors are still "waiting" and have paid the cost of sitting in cash or money market funds paying effectively 0.00%. We have referred to this before as "the cost of waiting" (Bernardi "cost of waiting" article here).

We understand investors fears and hesitation with investing in today's rate environment. We believe, however, that history has proven that trying to "time the market" rarely, if ever, works for income oriented bond investors. The past seven years are proof. A traditional laddered bond portfolio is the best way to mitigate interest rate risk, allowing for a steady stream of principal and interest payments to come due each year to reinvest at going market yields.

Despite the evidence and facts supporting our argument, we realize certain investors may still be weary about investing in todays low-rate environment. **We have developed a short-duration portfolio**, for these individuals, to help reduce the lost opportunity costs they would otherwise generate, while allowing them to have short-term liquidity to invest when rates begin to rise.

Utilizing separately managed accounts (SMAs), this strategy can be tailored to each specific client's needs. The short-duration strategy gives the investor a liquid portfolio which will allow them to have an ample amount of principal available to invest when rates eventually do begin to rise. Additionally, it allows them to continue to earn tax-free or taxable income, instead of the 0% they would otherwise be earning in a cash or money-market alternative.

We have provided example metrics of a current portfolio with a two-year maximum maturity. As you can see, this portfolio is extremely liquid, earns a taxable equivalent yield of 1.40% at the highest federal tax bracket (39.6%) and has an average maturity of 1.21 years.

Short Duration Portfolio (as of 04/01/16)	
Overall Yield-To-Maturity (at cost – fixed income portfolio)	0.85%
Taxable Equivalent Yield (@ 39.60% federal tax bracket)	***1.40%***
1-Year Treasury 2-Year Treasury	0.58% 0.78%

Short Duration Portfolio (as of 04/01/16)	
Maximum Maturity	2 years
Average Maturity	1.21 years
Modified Duration Average Duration	1.12 1.18
Average Credit Quality	AAA/AA

Those investors who continue to be worried can utilize a short-duration, laddered portfolio. This will allow them to earn income, be invested, and have ample liquidity for the day when rates begin to rise.

If you or your clients are fearful of investing in today's low-rate environment, consider taking advantage of the short duration portfolio option. It provides liquidity, tax-free (or taxable) income, and a return on your investment. It can be tailor made to you or your clients needs. And it allows for a disciplined investment process where trying to time the market will not hold you back.

If you have any questions or interest, please contact your Investment Specialist or Portfolio Manager.

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Municipal bonds not FDIC insured • May lose principal • Not appropriate for all investors

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