Quarterly Market Review **Summer 2016**

Market Update: Municipal bond yields decreased during the second quarter with AAA 5-year, 10-year, and 20-year yields falling 21, 37, and 49 basis points, respectively. Yields dropped dramatically after the United Kingdom (U.K.) voted to leave the European Union (EU), in late June. The Prime Minister of the U.K., David Cameron, resigned shortly after the announcement. The process for leaving the EU will take time and involve many discussions with other EU members over various trade agreements. It is too soon to tell who benefits from this decision, but it will create short-term uncertainty which will affect all financial markets.

The market was predicting a roughly 55% chance that the Federal Reserve would raise rates by the end of the year, at the end of last quarter. That has since fallen to 37%. Continued market volatility and uncertainty will only further reduce those expectations.

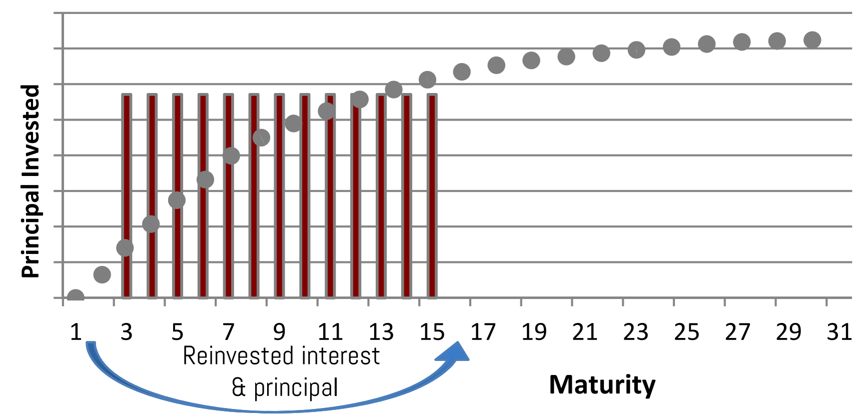
Federal Funds Rate Hike/Cut Probabilities
(as of 07/14/16)

United States | Instrument Futures: Fed Funds | FED Effective Rate 0.40
1) Overview | 2) Future Implied Probability
Current Implied Probabilities | 3) Add/Rem
Dates: Meeting / Calculation | Calculated 07/14/2016 | 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
07/27/2016	6.0%	0.0%	0.0%	94.0%	6.0%	0.0%	0.0%	0.0%	0.0%
09/21/2016	21.0%	0.0%	0.0%	79.0%	20.1%	1.0%	0.0%	0.0%	0.0%
11/02/2016	21.0%	0.0%	0.0%	79.0%	20.1%	1.0%	0.0%	0.0%	0.0%
12/14/2016	36.8%	0.0%	0.0%	63.2%	31.9%	4.8%	0.2%	0.0%	0.0%
02/01/2017	36.8%	0.0%	0.0%	63.2%	31.9%	4.8%	0.2%	0.0%	0.0%
03/15/2017	41.9%	0.0%	0.0%	58.1%	34.4%	6.9%	0.6%	0.0%	0.0%
05/03/2017	43.2%	0.0%	0.0%	56.8%	34.9%	7.6%	0.7%	0.0%	0.0%
06/14/2017	51.5%	0.0%	0.0%	48.5%	38.1%	11.5%	1.7%	0.1%	0.0%
07/26/2017	50.4%	1.4%	1.4%	48.2%	37.3%	11.3%	1.7%	0.1%	0.0%
09/20/2017	57.2%	1.2%	1.2%	41.7%	38.9%	14.9%	3.0%	0.3%	0.0%

Source: Bloomberg.

Traditional Portfolio Structure



Low Yields Beg the Question(s): What do record low yields portend?

1. Are they a harbinger of a worsening economy?
2. Are they a central-bank fueled bubble ready to pop once the economy gains full steam?
3. Are they simply indicating economic stagnation for decades?

Today's low yields put the most weight in the first and third scenario listed above. Investors expect the Fed to remain dovish for an extended period, which is confirmed with the market not ascribing a greater than 50% chance that the Fed hikes rates until late-2017. The market today is telling us that its expectations for growth and inflation in tomorrow's economy remain subdued.

Our take: Municipals are still well situated to serve their purposes of i) tax-exempt income, ii) attractive risk-adjusted returns, and iii) principal preservation. The laddered portfolio structure allows us to generally avoid "timing the market" in the current low yield environment. Clients who seek higher income utilize a target yield portfolio with a higher than average duration. Clients with opposite needs are utilizing a short duration strategy.

Please call your investment specialist or portfolio manager if you have questions.

Puerto Rico and the next shoe to drop: One day after President Obama signed a law shielding Puerto Rico against creditor lawsuits, the Commonwealth defaulted on roughly $1 billion in debt payments, including "constitutionally guaranteed" general obligation bonds. The default was well telegraphed, therefore having minimal impact on the market. The legislation will create a federally appointed financial oversight board, which will oversee the island's financial books, including the budget and any debt reduction measures.

Many investors are now asking themselves, who is next? Perhaps, the Chicago Public School System (CPS)? CPS is effectively banished from borrowing in the public bond market. In the district's last bond issue, investors demanded yields as high as 8.50%.

Our take: The new legislation for Puerto Rico helps ease some of the tension within the market. Both Puerto Rico and CPS are primary examples of financial mismanagement and the effects of "kick the can" type actions that do not solve financial problems. Puerto Rico and CPS's problems remain significant and unresolved.

The municipal market is an idiosyncratic in nature. Puerto Rico and CPS are not representational of the market as a whole, which perhaps explains why there was not a sell-off in the broader municipal market when Puerto Rico defaulted. We look to find value in the market by avoiding these "one-off" weak credits like Puerto Rico and CPS, while investing in solid credits on our approved list especially when market dislocation creates sell-off situations.

Situations such as Puerto Rico and CPS will negatively impact below average quality municipal issuers, making it harder for them to gain market access. This dynamic underscores the importance of our Portfolio Management process, focusing on bottom-up credit analysis.

Source: Bloomberg

IL Budget Band-Aid: Overshadowed by the Brexit vote and Puerto Rico default was the passage of a stopgap budget for the State of Illinois at the end of last month. The plan provides funding through December, easing the current gridlock. It will provide funding to schools, social services, and prisons. Although Governor Rauner stepped back his push for reforms in order to get the budget through, he made it clear that he would continue to push his reform ideas forward calling the budget a "bridge to reform."

Another bill, passed the same day, gives the State authority to provide the Chicago Teachers Pension Fund $215 million on 6/1/17. This bill is contingent upon lawmakers passing pension reforms in January, however. If this occurs, the final bill will be sent to Governor Rauner for signature.

Our take: We have discussed the financial issues with the State of Illinois in prior publications. The stopgap budget provides a bit of relief but the major financial problems still exist. Significant reforms are needed, including pension reform. The provision pertaining to pensions is positive news, assuming the deal is settled. If significant pension reform can be achieved, the state will have a much better grasp on its future.

Our portfolio management process focuses on undervalued, sound credits in out of favor geographies. Municipal bonds issued by governments located in Illinois is a current example. There are still many attractive, well-managed municipalities throughout the state that pay higher yields to borrow because they are located in the State of Illinois. Solid credits in this group provide our clients with good investment opportunities.

Source: Chicago Sun Times ("Rauner signs stopgap budget-but he and Madigan still at odds." 06/30/16).
Bloomberg Municipal Market Brief (7/1/16).
Tristatehomepage ("Gov. Rauner Talks Budget, Upcoming Priorities in Exclusive Interview." 07/07/16)

Should Investors Fear Rising Rates?

Summer 2016

There is a lot of anxiety on the part of bond investors concerned as to when the Federal Reserve ("Fed") will raise interest rates and the result of such action on their fixed income portfolios. A common theme for many is to invest in the short end of the curve or sit in cash and wait for higher rates. But is this the right approach? If we look back at the last two Fed tightening cycles (i.e. raising rates) the answer is…no.

From June of 2004 through June of 2006 the Fed raised the federal funds rate from 1.00% to 5.25%. As the graph below shows (10-year yield minus 2-year yield) the Treasury yield curve actually inverted during this time (short term yields were higher than long term yields).

While the muni curve didn't invert during this time, the return distribution across the curve is similar in that the long end outperformed the short end.

05/31/2004-06/30/2006	Returns during tightening cycle
Barclays Cap 3yr	3.64%
Barclays Cap 5yr	5.15%
Barclays Cap 7yr	6.44%
Barclays Cap 10yr	8.17%
Barclays Cap 15yr	10.56%
Barclays Cap 20yr	13.04%

The Fed also raised rates from July 1999 through May 2000. Rates rose from 4.75% to 6.50% during this time. The chart below shows, the yield curve again inverted, only this time the 2-year surpassed the 10-year by 20 bps.

Performance in the municipal market once again held up well, only this time the front end of the curve outperformed the long end. Positive returns were still earned in the 10-15 year part of the curve.

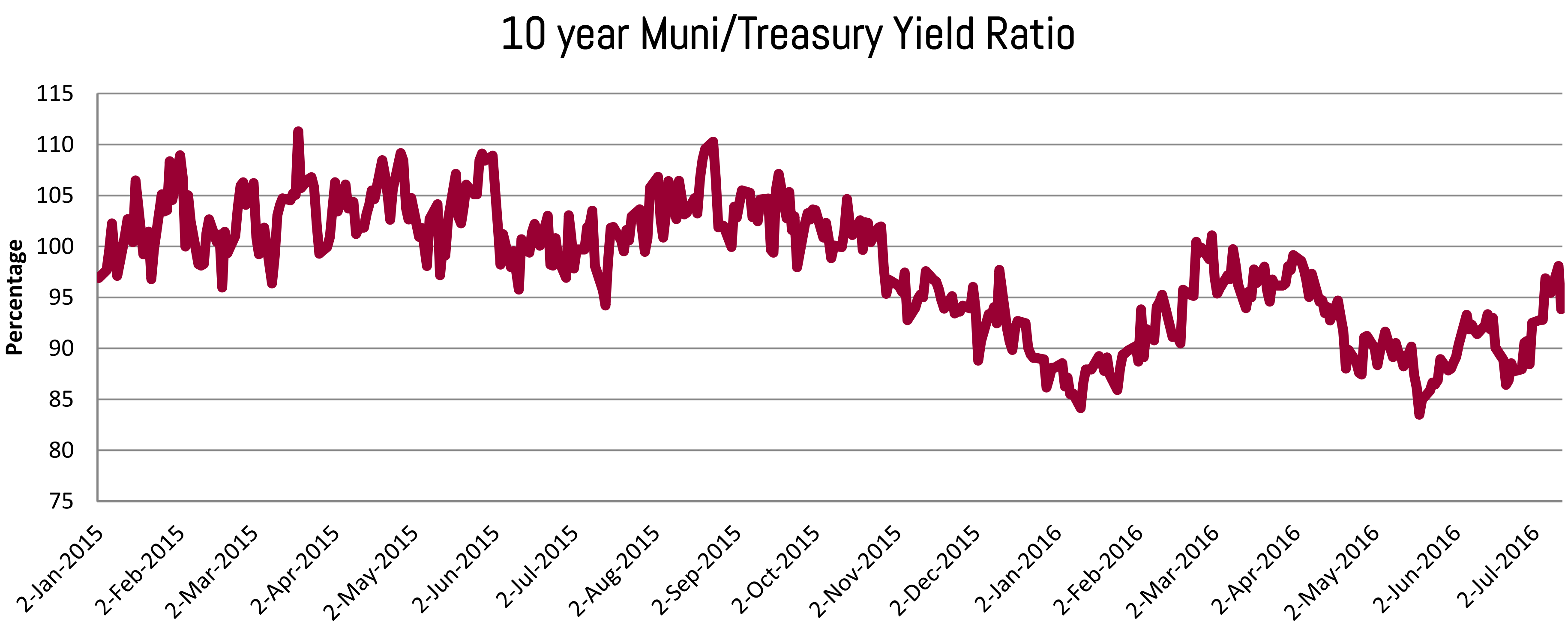
06/30/1999-05/31/2000	Returns during tightening cycle
Barclays Cap 3yr	2.44%
Barclays Cap 5yr	1.91%
Barclays Cap 7yr	1.75%
Barclays Cap 10yr	1.72%
Barclays Cap 15yr	1.73%
Barclays Cap 20yr	-1.04%

As income seeking bond investors we need to be cognizant of what the Fed is doing with interest rates, but we do not necessarily fear a rising rate environment. Historically, a properly structured laddered portfolio has been able to weather a rising interest rate environment. We look forward to seeing what the future brings.

Source: Bloomberg

Quarterly Chart Book

Summer 2016

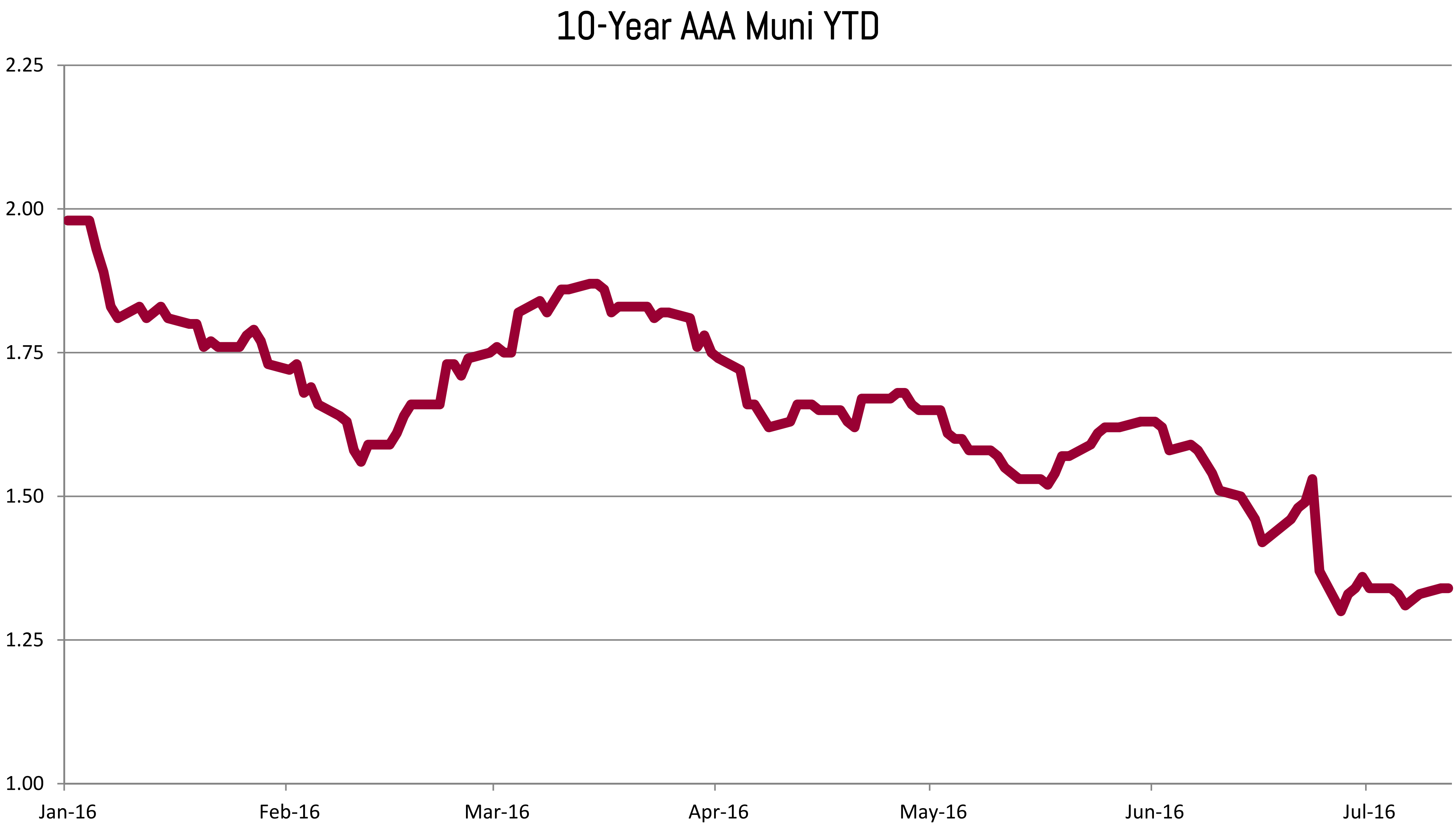


Source: Bloomberg

Today	93.85	**10-year average:**	97.94
High:	111.30	**5-year average:**	100.87
Low:	83.50		
Average:	97.75		

Quarterly Chart Book

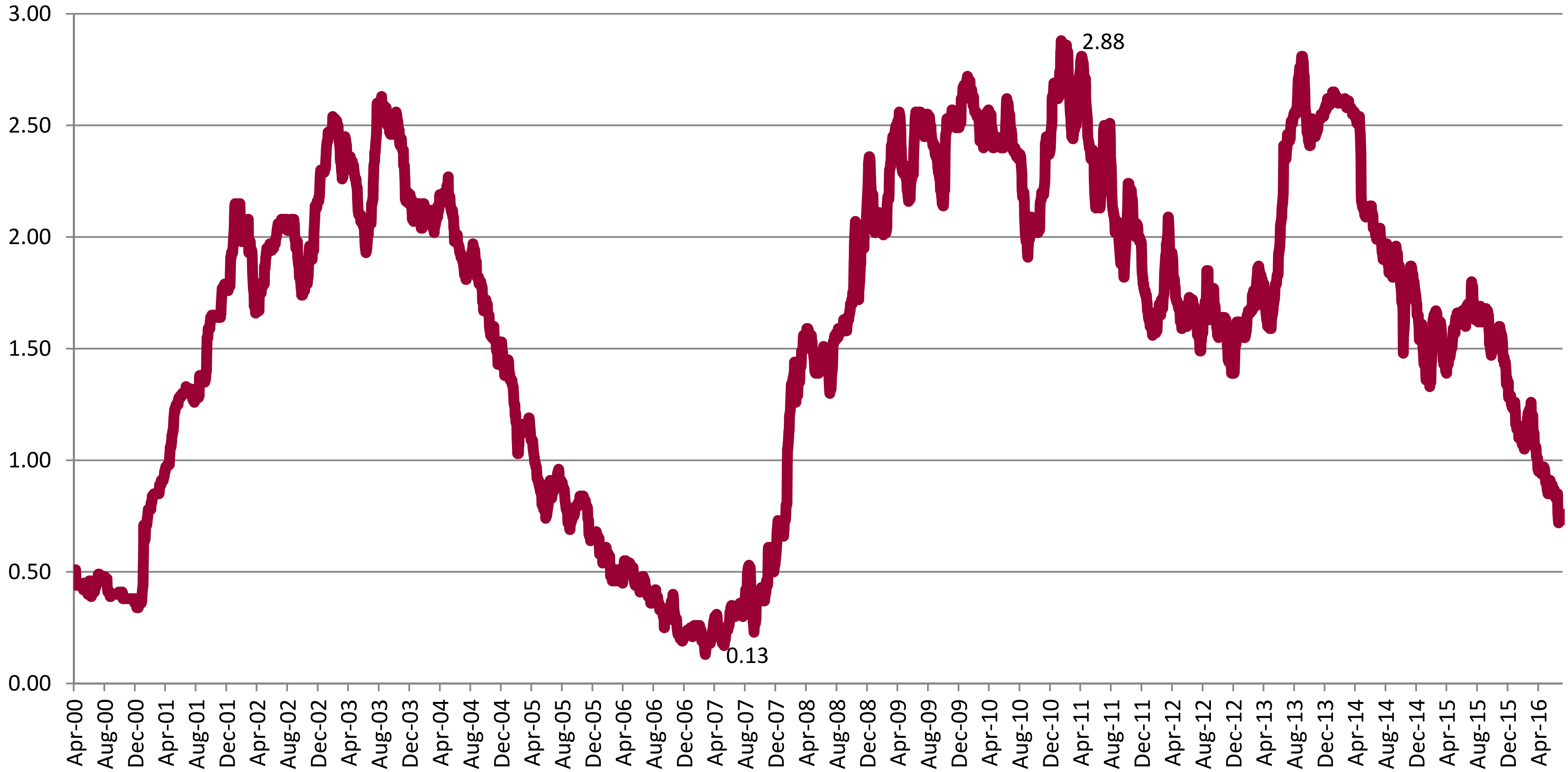
Summer 2016



Source: Bloomberg

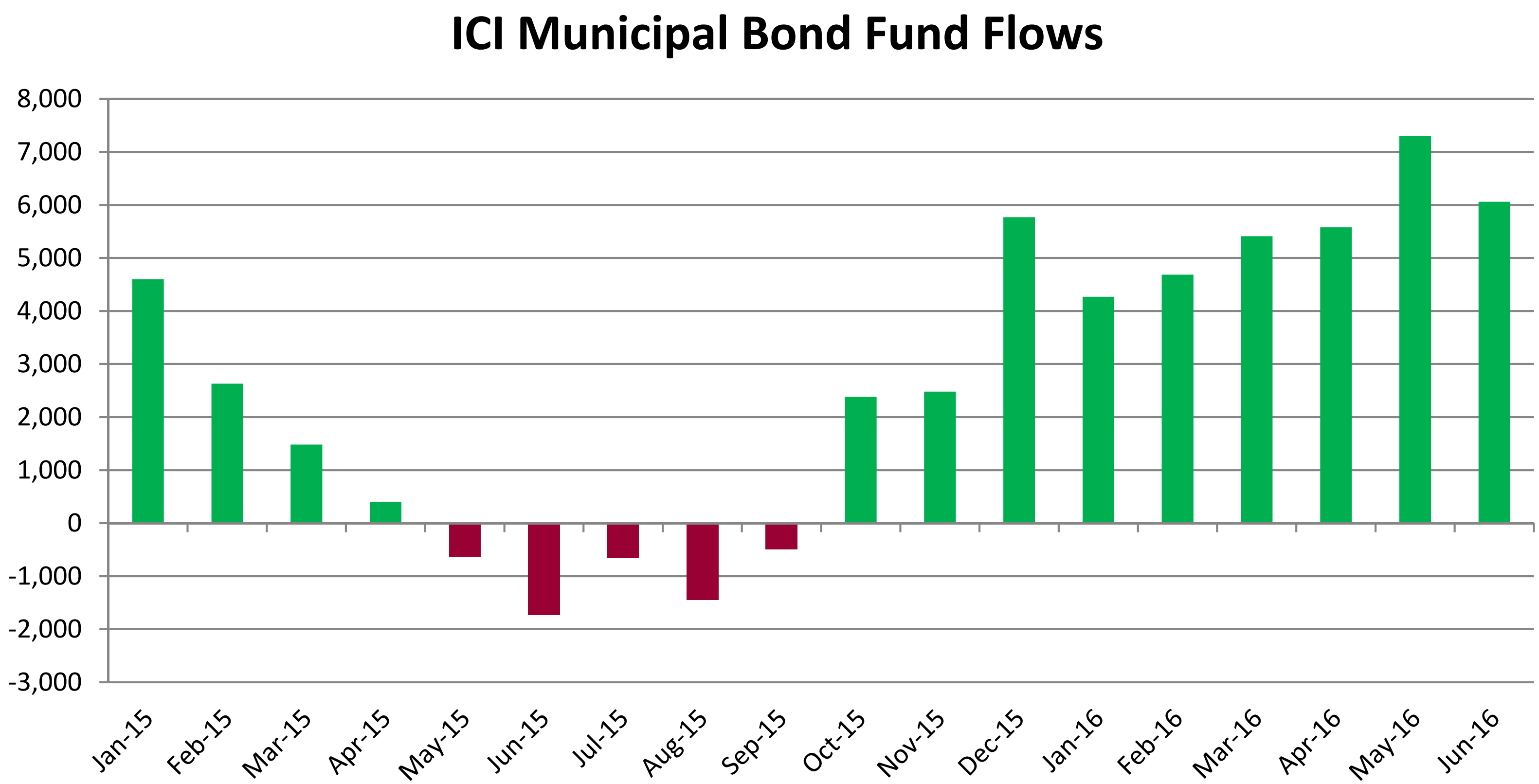
Quarterly Chart Book **Summer 2016**

2s10s AAA Muni (Spread between 2-year and 10-year)

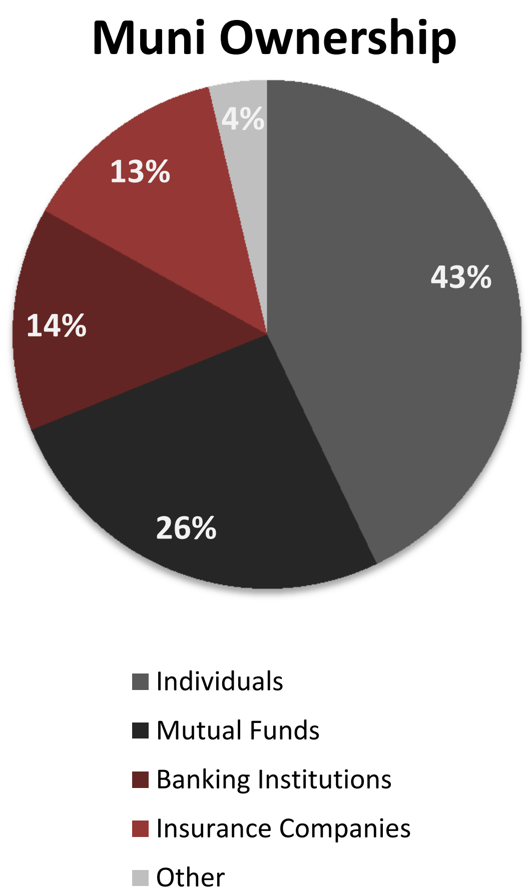


Source: Bloomberg

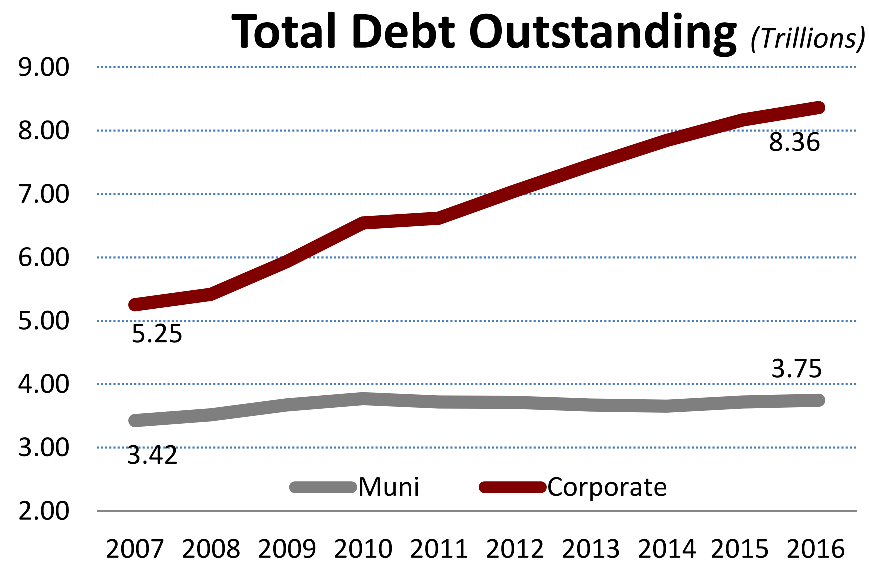
Today	0.76
High:	2.88
Low:	0.13
Average:	1.60



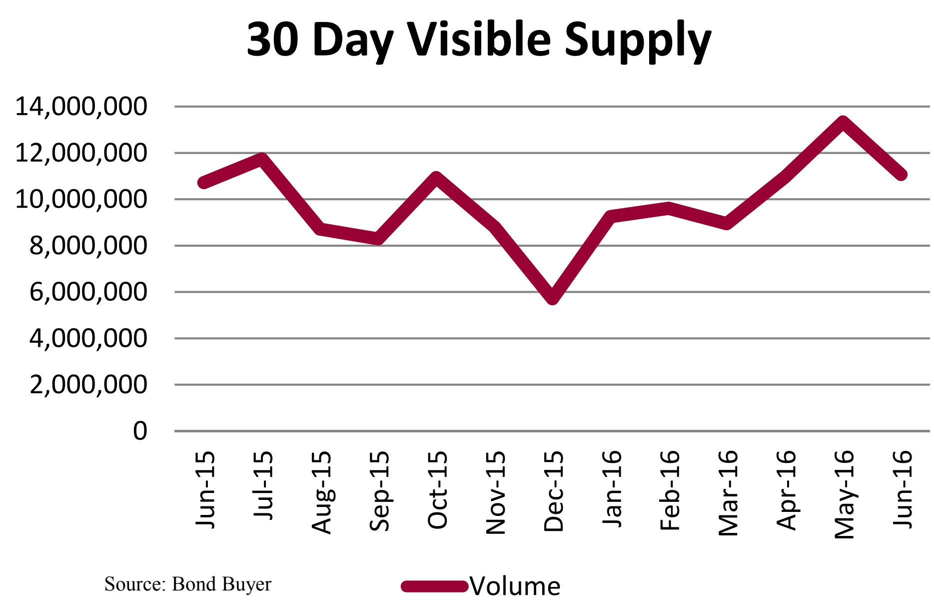
Source: Investment Company Institute



Source: SIFMA



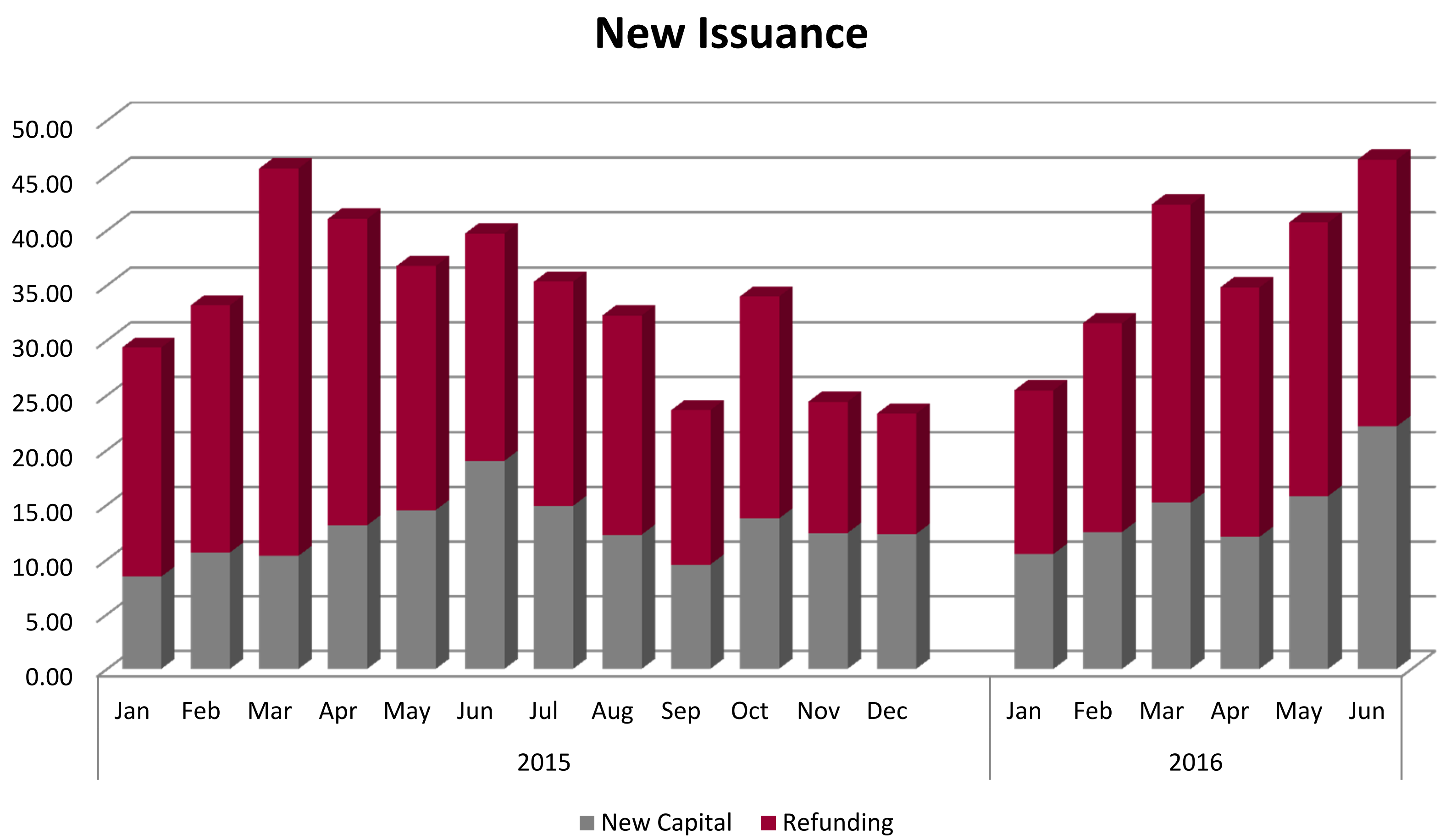
Source: SIFMA



Source: Bond Buyer

Quarterly Chart Book

Summer 2016



Source: SIFMA