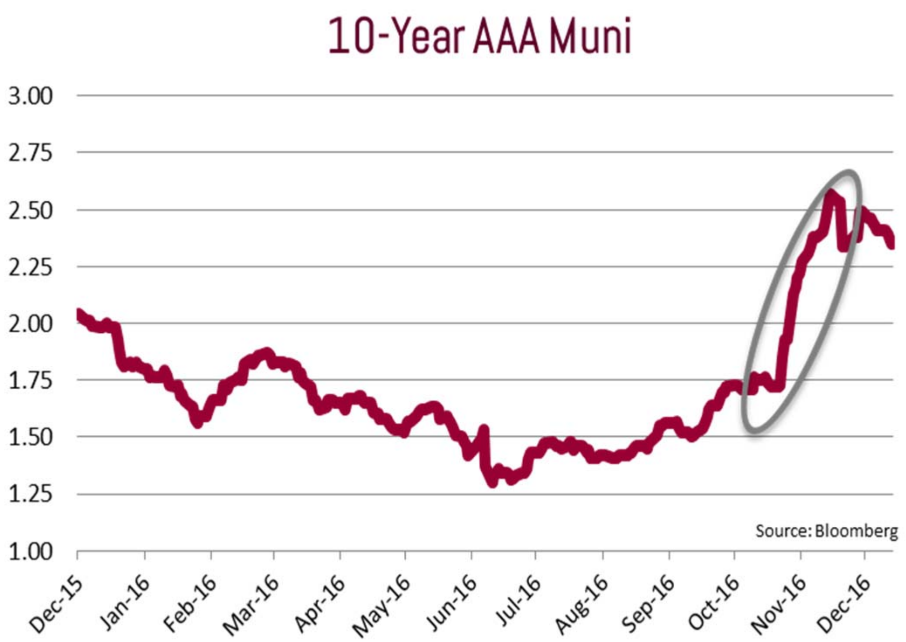
Quarterly Market Review

Winter 2016

Market Update:

The election of Donald Trump surprised many and sent bond markets into a market frenzy. On the day before the election, the 10-year AAA rated average municipal yield was 1.73%. By the end of November, the yield jumped to 2.51%. This 78 basis points jump in yield was more than the jump in the 10-year Treasury (+53 basis points) over the same timeframe.

Historically, municipal yields tend to be less volatile than their Treasury counterparts. This dynamic did not occur in November. Factors contributing to the sell-off in municipals ranged from uncertainty of tax reform to forced selling by municipal mutual funds due to client redemption requests. The sell-off provided attractive investment opportunities to our clients as the Muni/Treasury ratio spiked to over 105% providing extremely attractive taxable-equivalent yields for investors.



Jump on the Rate Train:

The Federal Reserve unanimously raised their target for the federal funds rate from 0.25%-0.50% to 0.50%-0.75%, as expected in mid-December. It also raised the forecast for rate hikes in 2017 from two to three.

The "Trump Tantrum", following the U.S. Presidential election, gave the Fed the room it needed to hike. The 10-year Treasury sold off 53 basis points (rising from 1.85% to 2.38%), from November 6th through November 30th . Additionally, inflation, which is one of the main drivers of yields on the long end of the yield curve, crept closer to the Fed's 2% target. Core PCE, the Fed's preferred inflation gauge, read 1.6% year-over-year (expectation was for 1.7%) during the last reading, with the prior month revised up to 1.8% from 1.7%. If inflation continues to climb, the Fed's chances of meeting their rate hike projections in 2017 will increase.

Low inflation and/or foreign capital flows into the U.S., however, have the potential to keep a lid on Treasury yields and could alter the Fed's plans. Zero and negative interest rate policy in other parts of the developed world are causing foreign flows into the U.S. in search of yield. For example, the last 5-year Treasury auction was very strong, stopping over one basis point through with a bid to cover of 2.72 (metrics used to analyze demand) and 71.4% of the awards going to indirect bidders (often used as a rough proxy for foreign investors).

If short term rates rise (due to Fed hikes) and long end rates do not increase at the same pace (due to lower projected inflation/growth), the yield curve will flatten. The Fed wants to avoid a flat curve, as it signals low growth and a potential recession. It also reduces credit availability as bank's net interest margins are compressed. That said, if growth and inflation expectations are met, the yield curve will continue to steepen, leading to higher rates and therefore more income for our clients and their municipal bond portfolios.

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Plumbing the Pension Liability Backlog:

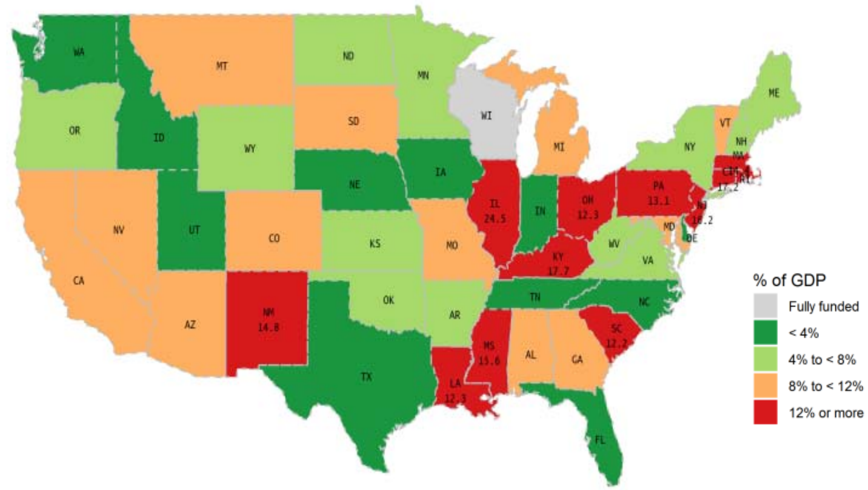
State and local pension liabilities are a prominent area of focus for our research team. Some publications would cause you to believe there is unbridled pressure on municipal coffers caused by pensions. This is true for many issuers, but not all. Additionally, the impact pension liabilities can and will have on budgets varies greatly, state by state, locality by locality. Many governments have high levels of political and judicial adaptability in adjusting to these burdens. Many have already reformed and realigned their taxpayers' and pensioners' interests and are projected to see funding levels increase in the coming decades. According to a study by the Center for State and Local Government Excellence, the majority of U.S. public pension systems reduced benefits from 2009 to 2014 to cope with rising costs. 74 percent of state plans and 57 percent of large local systems cut benefits and/or increased worker contributions.

Recently implemented pension reforms and varying annual portfolio returns make it very difficult to accurately predict future pension funding requirements. They are ever changing.

The next momentous headline regarding pension reform may come from the Supreme Court of California. It is currently reviewing a recent appellate court ruling. That ruling declared that public retirement plans were not "immutable" and could be reduced. This has been viewed as a major change in California pension law and stemmed from pension reform law passed in 2012. We expect a final decision from the court in the coming months.

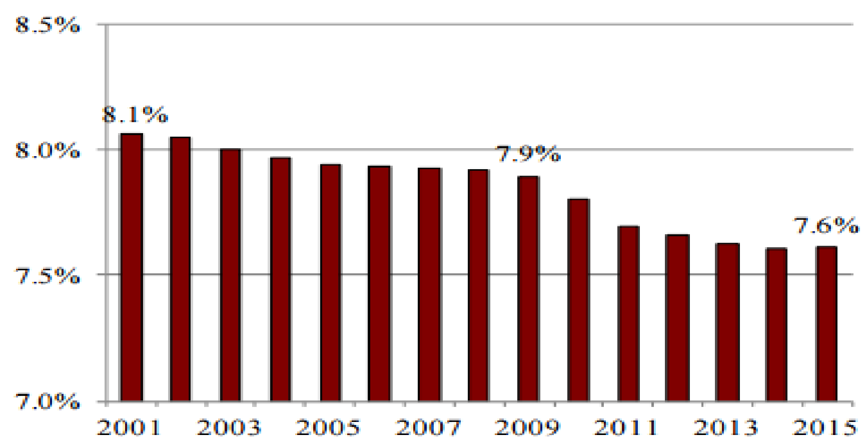
Should the Supreme Court of California uphold the appellate court ruling, we would view this as a positive credit development for certain California credits. If the opinion is overturned, we will continue to target credits whose revenues are relatively immune from capture for pension funding, as we do in other geographies faced with low pension funding levels.

Unfunded liability as % of state GDP, 2013



Source: Federal Reserve Board Enhanced Financial Accounts.
https://www.federalreserve.gov/apps/fof/efa/efa-project-state-local-government-defined-benefit-pension-plans.htm

Average Discount Rates



Source: Center for Retirement Research at Boston College. "The Funding of State and Local Pensions: 2015-2020. Published June 2016

Reduce Your Taxes with Your Bond Portfolio

Winter 2016

We often conduct bond "swaps" to improve the structure of our clients' portfolios. Simply put, a "swap" means selling one bond and purchasing another bond within the portfolio. What are the benefits to this? We're glad you asked!

A bond swap may improve a portfolio in one of many ways:

- Increase the annual income in the portfolio
  - i.e. selling lower yielding issues and purchasing higher yielding issues
- Increase the credit quality of the portfolio
  - i.e. selling a deteriorating credit and purchasing a credit on the Bernardi approved list
- Reducing a certain allocation (state, sector, maturity year, etc.…)
  - i.e. Decrease an overconcentration in a particular state, sector or maturity
  - i.e. Add exposure to a state, sector, or maturity rung that currently does not exist or has a low allocation
- Increase/reduce the duration of the portfolio based on our targets.

We often utilize bond "swaps" to not only enhance the structure of our client portfolios, but also to help them reduce their taxes.
The traditional tax-loss swap involves two steps: (1) selling a bond at a loss and (2) simultaneously purchasing a different bond issue. This converts a "paper" loss into a realized loss that can be used to offset a taxable gain or a portion of our clients annual income tax bill (up to $3,000).

In the example to the right you see the effects of a tax-loss swap. The Kitsap, WA issue is sold at a loss, with the proceeds reinvested in a Milwaukee, WI issue. This particular swap not only results in a tax-loss, but also benefits the portfolio by increasing annual income without taking on additional duration risk. Our clients can use this loss to offset a capital gain in their equity portfolio or against their annual income.

Sell the following bonds:

Amount	Description	Coupon	Maturity	Bid Yield (%)	YTM (at cost)	Principal	Annual Income	Gain (Loss)
50,000	KITSAP CNTY WA REF	4.000	12/1/2019	1.911%	1.200%	52,974.00	648.55	($1,072.19)
	REF-LIMITED TAX							
	NON-CALLABLE			Bid Price				
	Aa3/AA+. Stable Outlook.			105.948				
	CUSIP: 498035Z56							
50,000	Weighted Avg. Maty (Yrs)	119.92				$52,974.00	$648.55	(1,072.19)

Buy the following bonds:

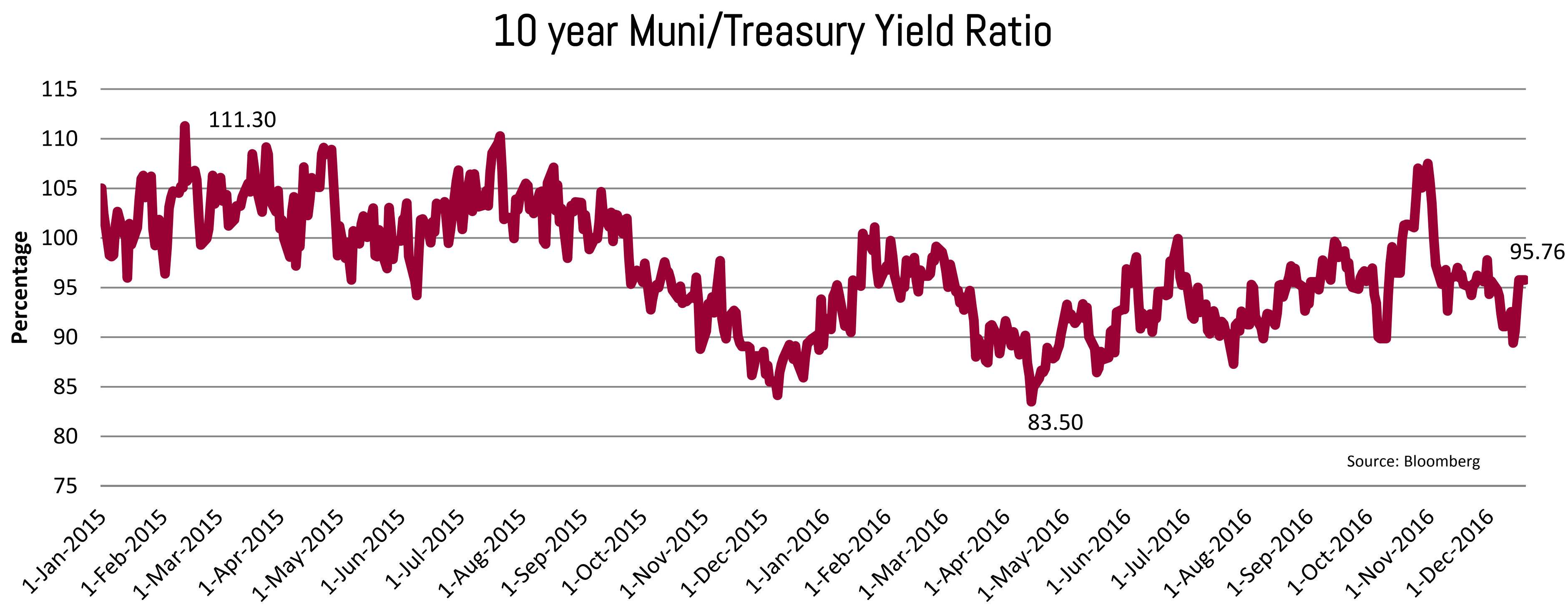
Amount	Description	Coupon	Maturity	Yield (%)	Principal	Annual Income
50,000	MILWAUKEE WI UTGO	2.000	6/1/2020	1.850%	50,246.00	929.55
	AREA TECH CLG DIST					
	SER 2016-17G					
	NON-CALLABLE			Price		
	Aa2/Non-Rated Underlying Rating.			100.492		
	CUSIP: 6023684Y5					
50,000	Weighted Avg. Maturity (Yrs)		3.45		50,246.00	929.55

Results of swap

After Tax Income Gain (Loss)	$281.00	
Tax Gain/(Loss)	($1,072.19)	
Cash result	Principal received back or (contributed)	$2,728.00
Maturity	Extended by	0.50

During the past three years, it has been difficult to find opportunities for tax-loss swaps as the bond market rallied. Following the November market sell-off, however, we have been able to execute many tax-loss swaps for our clients. These losses will help them offset gains elsewhere in the portfolio or reduce their income tax bill in April. Please keep this in mind as the year progresses. And remember, capital losses can be carried forward even if you cannot use them this year. This is just another example of how an allocation to municipal bonds can be used to benefit your overall asset allocation and tax planning decisions.

Quarterly Chart Book **As of 1/24/17**

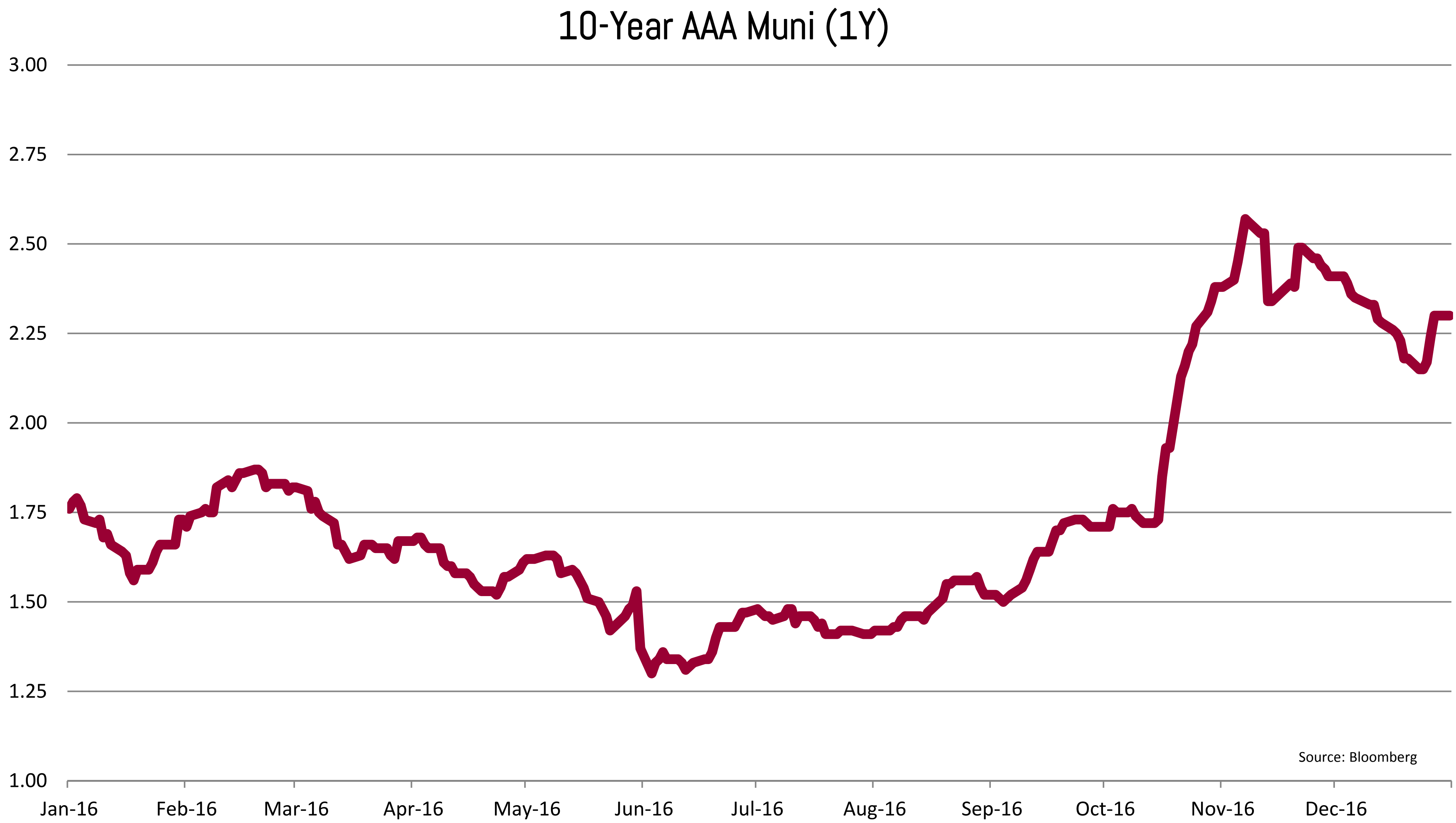


Source: Bloomberg

Today	95.76	**10-year average:**	97.16
High:	111.30	**5-year average:**	99.60
Low:	83.50		
Average:	97.10		

Quarterly Chart Book

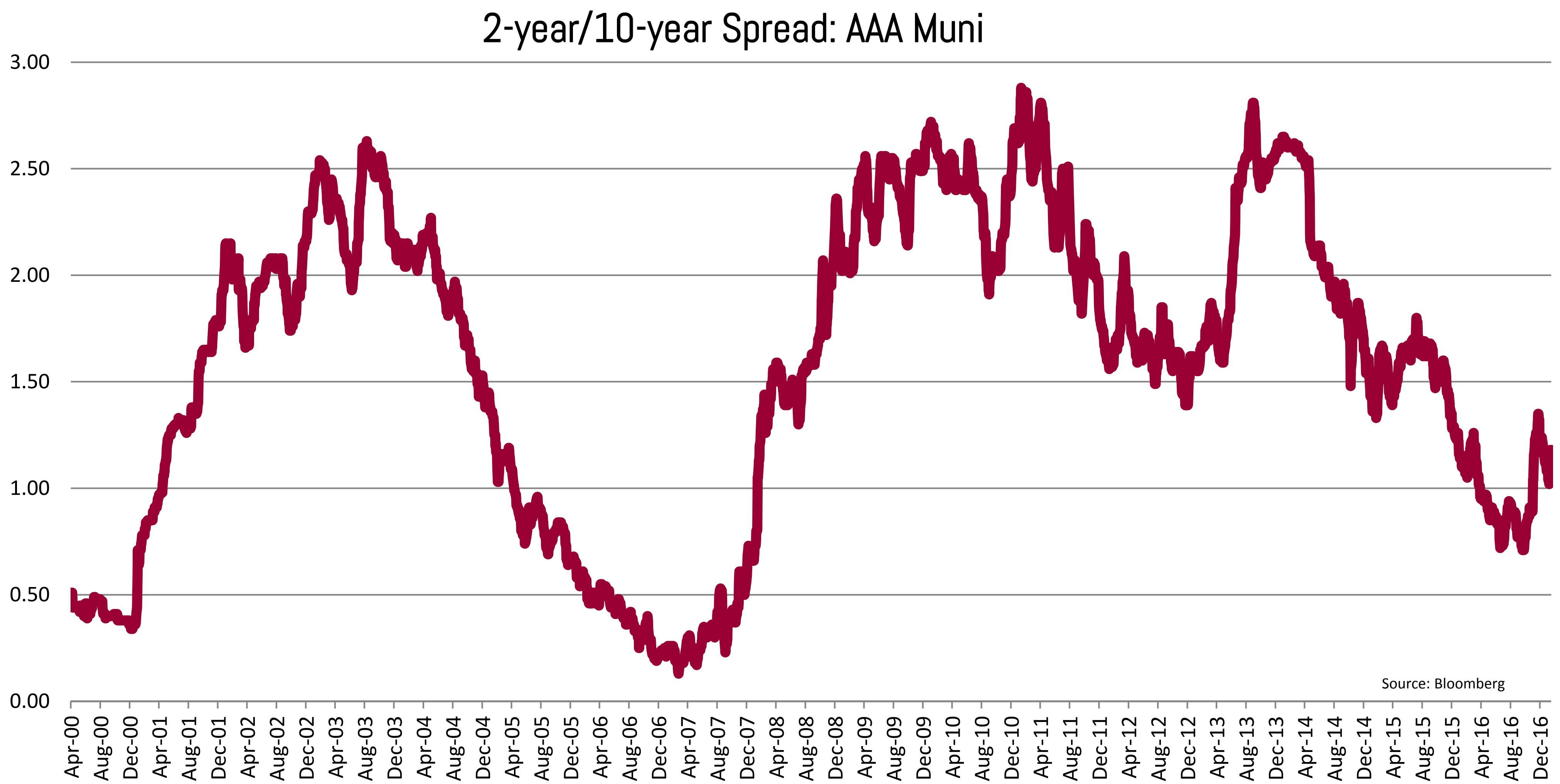
As of 1/24/17



Source: Bloomberg

Quarterly Chart Book

As of 1/24/17

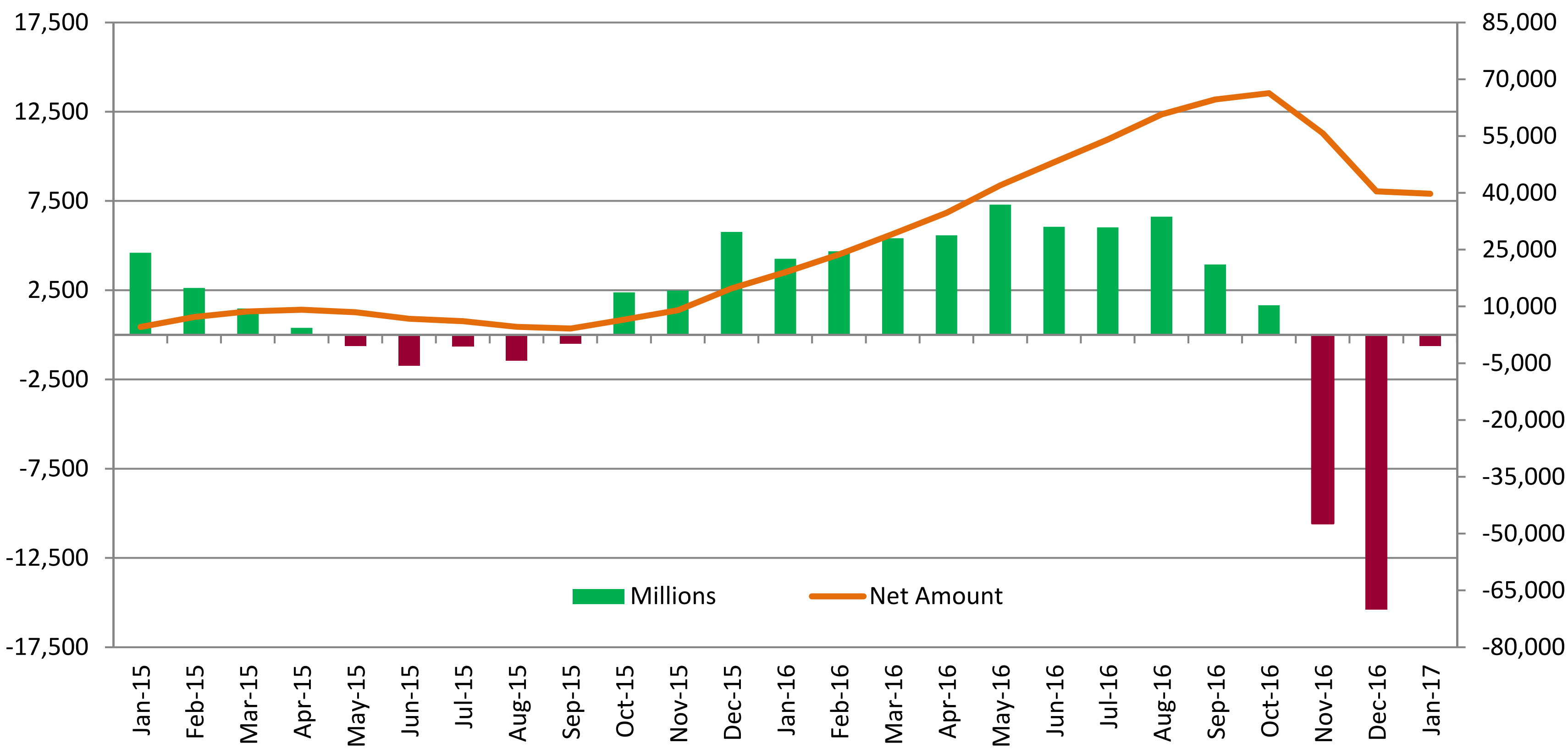


Source: Bloomberg

Today	1.18
High:	2.88
Low:	0.13
Average:	1.58

Quarterly Chart Book As of 1/24/17

ICI Municipal Bond Fund Flows

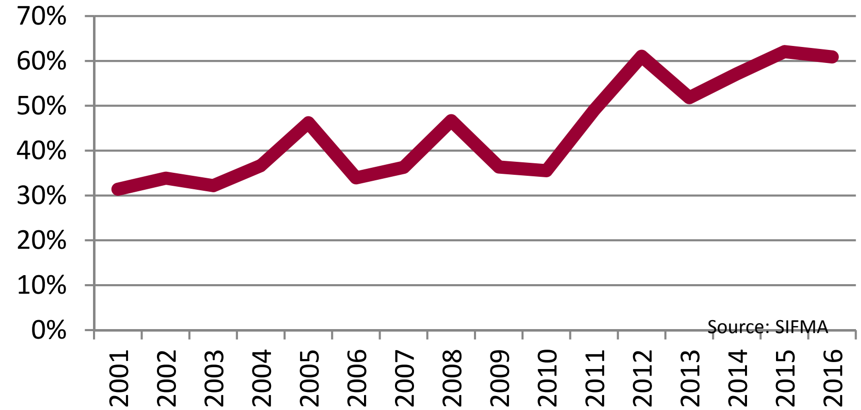


Source: Investment Company Institute

Quarterly Chart Book

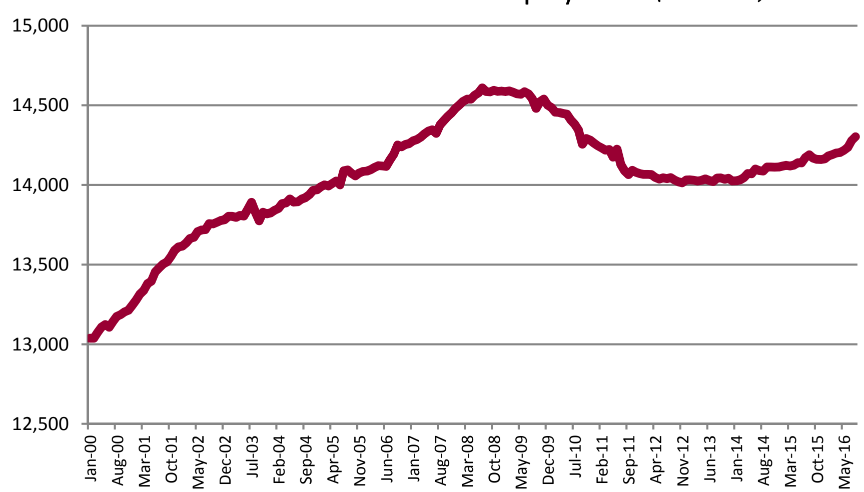
As of 1/24/17

Refunding Pct. of New Issuance



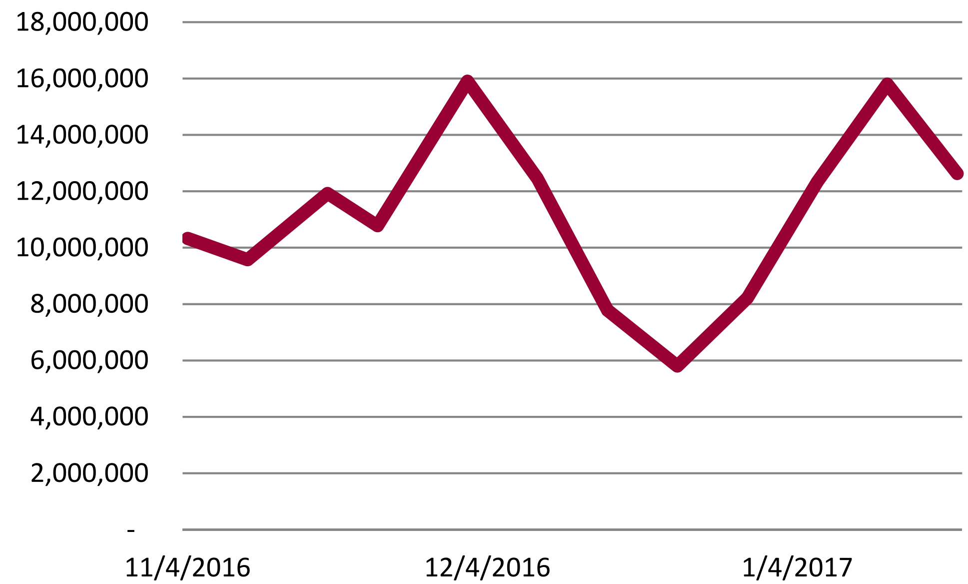
Source: SIFMA

State and Local Employment *(Thousands)*



Source: U.S. Census Bureau

30 Day Visible Supply



Source: Bond Buyer