Tax Efficient Fixed Income Market Commentary

July 2017

Overview

- Reduced new issue supply meets strong demand for municipals
- State budget negotiations head into overtime across the nation
- Fed offers initial guidance on balance sheet

Second Quarter Highlights

Yields on most high quality bonds fell during the quarter, generating positive performance across the yield curve.[1] While many economic indicators showed signs of strength, disappointing payroll numbers and few signs of price pressures helped to support the bond market.[2] Despite low inflation, the Fed increased their target for Fed Funds by an additional 25 bps in June. While this increase was broadly expected, the statement did contain a surprise which was an indication that they expect to begin to reduce the size of their balance sheet or "taper" in the near future.

The municipal market continued to outperform Treasuries over the quarter, supported by strong supply-demand technicals. The second quarter new issue calendar declined 17% year over year, driven by reduced refunding activity. Amid a reduced primary market, mutual fund flows showed strong demand. Flows were positive for 10 of 13 weeks during the quarter, averaging a healthy inflow of $332 million per week.[3]

We believe that this supply-demand imbalance could remain in place for the near term. This has the potential to create opportunities for a "crossover" trade (selling municipals and buying Treasuries) if we expect the imbalance to normalize. For portfolios holding excess cash, we did begin to use Treasuries as, by some measures, they are attractive versus municipals.

LOOKING AHEAD

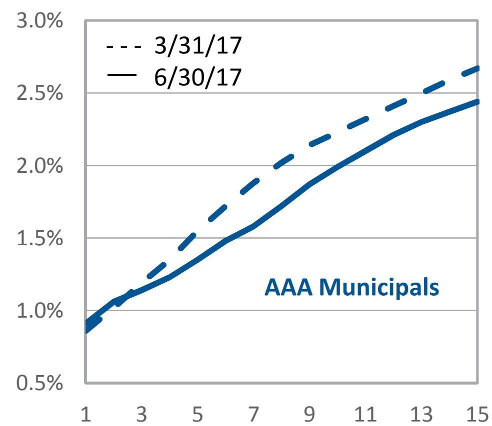
- **Federal Reserve:** In June, the Federal Reserve released its first insight into plans to gradually reduce their $4.5 trillion balance sheet. The plan did not anticipate asset sales, but rather the gradual roll off of limited amounts of Treasury and mortgage securities as they mature. We will look for further guidance, particularly on timing, during the third quarter. Furthermore, market attention may increasingly center on the expiration of Janet Yellen's term in early 2018.
- **Washington:** Following passage of a healthcare bill in the House, focus will remain on the Senate heading into the third quarter. Progress on healthcare reform or a shift toward tax reform efforts will be important developments to monitor.

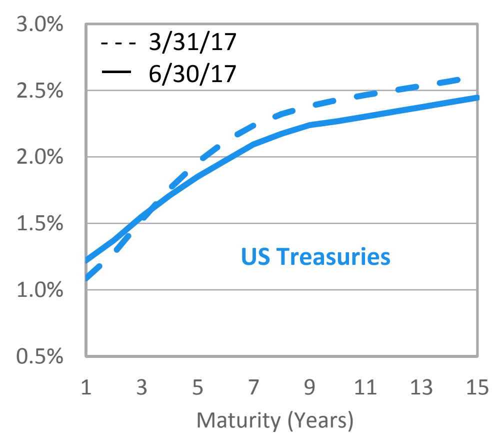
Market Returns

	2Q17	YTD
Muni Index	1.96%	3.57%
1 Year	0.26%	0.96%
3 Year	0.54%	1.81%
5 Year	1.25%	3.17%
7 Year	1.93%	3.92%
10 Year	2.35%	4.18%
20 Year	2.49%	4.02%
1-10 Year	1.39%	2.96%
Prerefunded	0.54%	1.54%
AAA	1.73%	3.19%
AA	1.89%	3.41%
A	2.19%	3.94%
US Corp 5-7 Year	1.96%	3.47%
US Treasury 5 Year	0.66%	1.12%
S&P 500	3.09%	9.34%

Source: Barclays Capital 6/30/17

Yield Curves





Source: Thomson Reuters, Merrill Lynch 6/30/17

Past performance is not indicative of future results. Inherent in any investment is the potential for loss.

MONEY MARKET REFORM IMPACTS INVESTOR OPTIONS FOR CASH MANAGEMENT

Short term yields have risen enough that more investors are interested in keeping a portion of their investments liquid. However, recent changes to money market funds have made them a less desirable investment. Prompted by problems in money market funds during the financial crisis, the SEC made significant changes to Rule 2a-7 which became effective in October 2016. The new rule distinguishes funds as Governmental or non-Governmental funds. Governmental funds generally act like money funds of old. Non-Governmental funds have to impose gates and redemption fees should fund liquidity fall below certain thresholds and the board determines that it is in the fund's best interest. While Governmental funds help investors avoid these detrimental terms, they often aren't optimal for a tax paying investor.

Another important distinction created by the rule classifies investors as either institutional or retail. This is important, as institutional funds are required to have floating NAVs, while retail can continue to use a stable $1.00 NAV. In order to be qualified as a retail investor, and remain eligible for a stable NAV, investors must be a "natural person," which excludes investment vehicles popular with our clients such as partnerships and trusts.

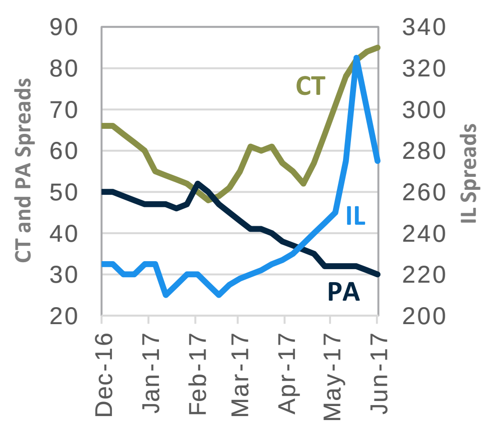
We have designed a spectrum of options for investors who don't want to be exposed to the new terms, but want a more tax efficient investment than the government funds. One such option is a liquidity portfolio in a separate account which can be customized to the clients' risk, tax and liquidity needs. Another strategy that has been of interest is our Short Term Deployment Capital strategy, which aims to optimize a portfolio return for investors who have known cash needs in the future, such as large tax payments or investment commitments.

Credit Insight

The second quarter brings about state budget season, with most beginning their new fiscal year on July 1st. Budget debates went into overtime in several states. We note some of the most important developments below.

Illinois: The first quarter brought the long-running budget impasse in Illinois to a critical level. Pressure had been building on lawmakers to end the dispute, which had resulted in credit rating downgrades and severe financial stress for state service providers. Public universities had been hit particularly hard and several lost their investment grade bond ratings. In addition, the State's payment backlog reached approximately $15 billion and a Federal judge ruled that the State must provide significant additional monies for Medicaid. On July 6th, the building pressures ultimately pushed lawmakers to pass a budget for the first time in two years. The budget included a meaningful increase in the State's income tax rates. While the revenue increase was a significant positive development, long term challenges persist and it remains to be seen if Illinois will avoid further downgrades.[4]

5 Yr State General Obligation Spreads



Source: Fiera Capital 6/30/17

Connecticut and Pennsylvania: Faced with meaningful revenue shortfalls and rising fixed costs, both Pennsylvania and Connecticut failed to pass budgets for the fiscal year that begins July 1st. Negotiations will continue into the third quarter, though difficult decisions lie ahead in order for either state to adopt a balanced spending plan for fiscal 2018. Connecticut lawmakers continue a contentious debate surrounding raising the State's already high tax rates and how much of the budget pressures will fall on its local governments. One local government in particular, Hartford, will continue to face significant fiscal stress without additional state monies.[5] Pennsylvania managed to agree on a spending bill, but did not agree on the associated revenue bill required to close the sizable spending gap. The Commonwealth hopes to avoid a scenario similar to the 9 month budget impasse that started fiscal year 2016.[6]

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ENDNOTES - SOURCES

1. Bloomberg as of 6/30/17
2. Bureau of Labor Statistics, 4/7/17, 5/5/17, 6/2/17
3. The Bond Buyer as of 7/1/17
4. Bloomberg, *In America's Richest State, the Capital Flirts With Bankruptcy*, 7/7/17
5. Reuters, *Big financial woes linger in Illinois' new budget*, 7/10/17
6. Reuters, *Pennsylvania governor to let state budget become law*, 7/10/17

Index Definitions:

- The Bloomberg Barclays Municipal Bond Index is a rules-based and market value weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a double-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.
  - Subindices include: 1 Year (1-2 year maturities), 3 Year (2-4 year maturities), 5 Year (4-6 year maturities), 7 Year (6-8 year maturities), 10 Year (8-12 year maturities), 15 Year (12-17 year maturities), 20 Year (17-22 year maturities), 1-10 Year (1-12 year maturities).
- The Bloomberg Barclays US Corporate Index is composed of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.
  - The Bloomberg Barclays US Corporate Index 5-7 Year Index represents 5-7 year maturities.
- The Bloomberg Barclays US Treasury Index is composed of public obligations of the U.S. Treasury with a remaining maturity of one year or more.
  - The Bloomberg Barclays US Treasury 5 Year Index represents 5 year maturities.
- The S&P 500, or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.
- **It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns and will bear the cost of fees and expenses that will reduce returns.**