Tax Efficient Fixed Income Market Commentary
July 2016

Overview
- Fed says they still plan to tighten, but bond markets are skeptical
- “Brexit” shocks markets, driving fixed income rally
- Corporate crossover position exited at a profit
- Puerto Rico federal oversight legislation (PROMESA) signed into law
- Significant budget developments in New Jersey and Illinois

Second Quarter Highlights
The second quarter started off with far more optimism and stability than the first. This normalization, in combination with a Fed indicating that it still expected to tighten, pushed rates modestly higher. This increase proved short-lived, however, as weaker economic indicators (particularly payrolls) and the surprising British vote to leave the European Union, drove yields toward the lows of this cycle during the quarter’s closing days. Market stability in much of the quarter enabled us to systematically take profits in our corporate crossover position and rotate back into municipal bonds at more attractive levels. By the end of the quarter our crossover position was substantially eliminated.

Interest Rates
Despite fluctuations throughout the quarter, interest rates ultimately fell significantly by the end of June. Yield curves flattened dramatically as bond investors appeared far from optimistic. Strong demand for tax-exempt bonds enabled the municipal market to keep pace with, and in some cases outperform, Treasuries. Ten year municipal bonds performed particularly well, with their yields falling 40 basis points (bps) in comparison with Treasury bonds which only fell 34 bps.

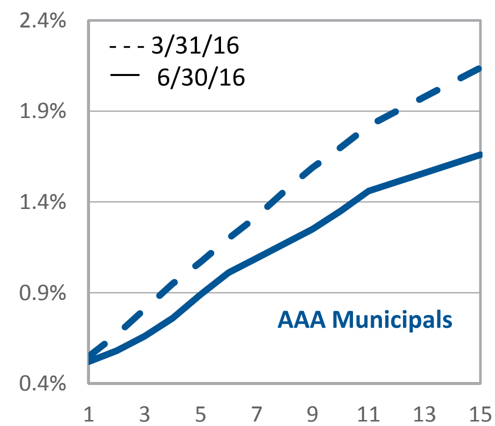
LOOKING AHEAD
A continuation of strong inflows into municipal funds combined with light seasonal issuance could prove to be supportive of municipal relative valuations in the next quarter. Key themes we will be watching in the third quarter include:
- Developments in the shape of the yield curve after a substantial curve flattening in Q2
- Uncertainty in Europe, which will likely remain an important driver of market sentiment
- Progress in the formation of the federal oversight board for Puerto Rico

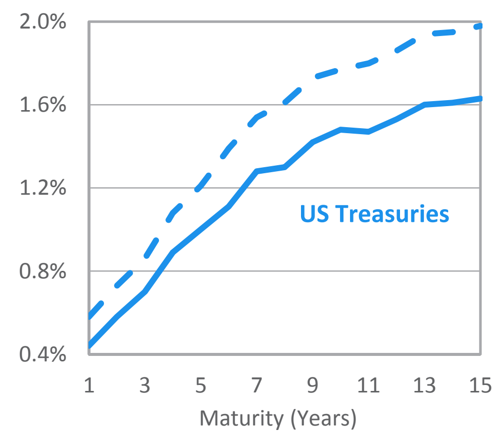
Market Returns

	2Q16	YTD
BC Muni Index	2.61%	**4.33%**
1 Year	0.34%	**0.66%**
3 Year	0.68%	**1.46%**
5 Year	1.16%	**2.32%**
7 Year	1.70%	**3.22%**
10 Year	2.53%	**4.47%**
20 Year	3.59%	**5.61%**
1-10 Year	1.44%	**2.70%**
Prerefunded	0.65%	**1.28%**
AAA	2.20%	**3.74%**
AA	2.40%	**4.00%**
A	3.14%	**5.12%**
BBB	3.21%	**5.30%**
Muni High Yield	5.10%	**7.98%**
S&P 500	2.46%	**3.84%**

Source: Barclays Capital

Yield Curves





Source: Thomson Reuters, Bloomberg

Muni Market Factors

Mutual fund flows were positive in each week during the second quarter. There have now been 40 consecutive weeks of inflows into municipal funds. At nearly $1 billion, the average weekly flows during the month of June were particularly robust. Strong inflows were met with new issue supply of $119 billion, up from $99 billion in the first quarter. Although overall supply through the first half of 2016 is down 3.6% year over year, new money supply in the first half of 2016 is actually up 13% in comparison to the same period last year.

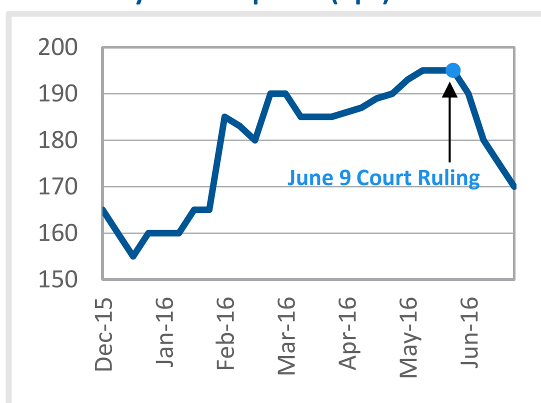
Credit Insight

When the quarter ended, Illinois became the first state in decades to go an entire fiscal year without enacting a budget. A last-minute deal was reached on a short-term spending plan for the fiscal year that began on July 1st. While this budget provides the necessary spending guidelines through the State's critical November elections, it does not include any new revenues. In the time since a temporary income tax expired in 2015, imbalanced operations have caused the substantial backlog of unpaid bills to grow. While the mechanics for debt service repayment remain strong, all three ratings agencies took negative action on Illinois during the second quarter.

There were several developments in New Jersey during the second quarter as well. Late year budget adjustments were required as April tax collections fell short of expectations. Additionally, a last-minute agreement to replenish the State's Transportation Trust Fund did not pass. The deal would have coupled a 23 cent per gallon gas tax increase with a reduction in the statewide sales tax. While this would have directed much-needed revenue towards infrastructure projects, the sales tax reduction could have proven burdensome to New Jersey's already tight budget. New Jersey has since suspended $2.7 billion in transportation projects while a funding agreement is negotiated.

On the positive side, New Jersey won a critical court decision when the State Supreme Court ruled that annual cost of living increases ("COLAs") for pensioners were not protected by the constitution. COLAs were reduced as part of pension reform in 2010. If the Court had ruled that the COLAs were protected, New Jersey would have faced a substantial increase in its already outsized unfunded pension liability. Spreads on New Jersey's appropriation debt tightened subsequent to the court ruling, after rising throughout much of the quarter.

New Jersey 5-Year Spread (bps)



Sources: Fiera Capital, Barclays

On June 30th, President Obama signed legislation into law that creates a federal oversight board for Puerto Rico. The law, known as PROMESA, establishes a seven member board with broad powers over the Commonwealth's fiscal health. In addition, the board will oversee the complicated process of restructuring the Commonwealth's debt obligations. PROMESA included a stay on bondholder lawsuits with the intent of establishing an orderly restructuring process. Subsequently, Puerto Rico's Governor declared a debt moratorium and numerous issuers defaulted on July 1. While Puerto Rico's troubles have largely been isolated to the island, we will be closely watching events unfold over the next several years to see if there is any broader market impact.

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Index Definitions:

- The 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 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 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 Barclays Municipal High Yield 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 non investment-grade (below BBB-) 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.
- The Barclays US Corporate Bond 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 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.