

Overview

- Heavy new issue calendar and strong municipal fund inflows
- Money market reforms spike yields on variable rate demand notes
- Barclays indices transition to Bloomberg for pricing
- Pennsylvania narrowly avoids a downgrade

Third Quarter Highlights

The continued strong performance of fixed income markets during early July appeared in conflict with our expectation for modest but positive economic growth. This contributed to our decision early in the quarter to reduce our average duration targets to a neutral position from being moderately long. Reducing duration proved to be the correct course of action as interest rates moved higher during the quarter and record municipal supply caused municipal underperformance despite continued strong demand from a broad range of buyers. Many economic statistics exceeded expectations, increasing the prospect of a near term Fed tightening. Although the Fed Funds rate remains unchanged, a growing number of dissenting board members suggests that the threshold for a decision to tighten is quite low.

Interest Rates

Interest rates trended higher throughout much of the quarter with unusual volatility. Municipal bonds saw their yields rise significantly more than Treasury bonds. This underperformance was driven not only by the unexpected supply increases in municipals but also by changes to a money market fund rule that makes these funds a far less attractive place for institutions to park their cash.

*Please see page 3 for additional information.

LOOKING AHEAD

Pressure continues to build within the Fed to raise rates in the coming months. With Fed meetings scheduled in November and December, the shape of the yield curve is likely to be Fed dependent. Other key themes we will be watching in the fourth quarter include:

- **Election day:** In addition to the Presidential election, there are many key ballot initiatives like the extension of Proposition 30 income tax hikes in California
- **New Issue Calendar:** The municipal calendar appears poised for another substantial flow of deals in the fourth quarter

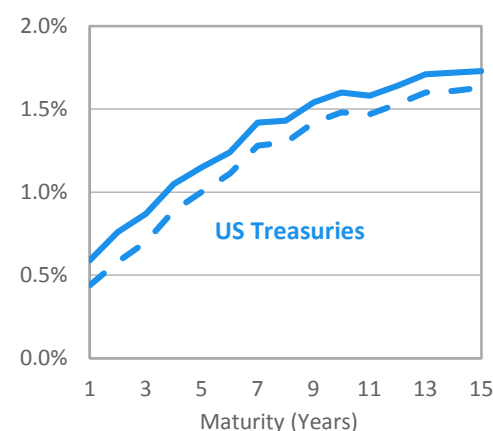
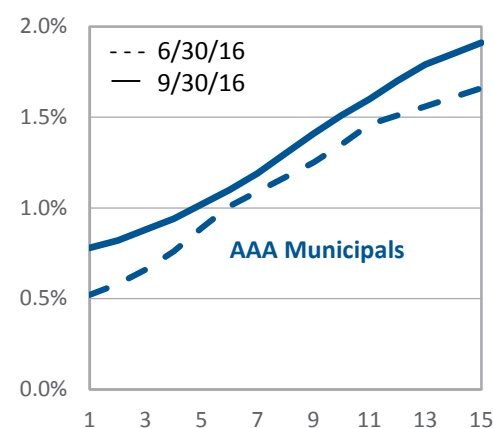
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Market Returns

	3Q16	YTD
BC Muni Index	-0.30%	4.01%
1 Year	-0.19%	0.47%
3 Year	-0.25%	1.20%
5 Year	-0.02%	2.30%
7 Year	0.07%	3.29%
10 Year	-0.12%	4.35%
20 Year	-0.34%	5.25%
1-10 Year	-0.11%	2.58%
Prerefunded	-0.31%	0.96%
AAA	-0.47%	3.26%
AA	-0.37%	3.61%
A	-0.10%	5.01%
BBB	-0.27%	5.02%
Muni High Yield	1.29%	9.37%
S&P 500	3.85%	7.84%

Source: Barclays Capital.

Yield Curves



Source: Bloomberg.

Muni Market Technical Factors

On September 30th, mutual fund flows were reported positive for the 52nd consecutive week. Inflows averaged \$846 million per week in the third quarter. Robust flows helped provide some support for municipals during a quarter in which the market absorbed a heavy new issue calendar. The quarter's \$110 billion calendar contributed to underperformance relative to other high quality fixed income sectors. 2016 remains on pace to exceed \$400 billion in new issue supply, a level not surpassed since 2010, which saw elevated issuance due to the Build America Bond Program. Volume is being driven by refunding from continued low rates as well as a long awaited increase in new money/infrastructure investment.

IN DEPTH: Bloomberg BVAL Takes Over Pricing Barclays Indices

In August the Barclays fixed income indexes were sold to Bloomberg and Bloomberg's pricing service (BVAL) replaced IDC as the pricing source of the indexes. Why would anyone care? This is material for two reasons. First, when the change occurred in mid-August this caused as much as 18bps of deviation in some indexes due to differences in prices between the two. Fortunately, the impact on most of the indexes that we use appeared to be less than 5 bps. Second, most managers and custodians do not currently use BVAL to value portfolios so going forward there is likely to be additional tracking error between the indexes and individual portfolios. We have been studying the BVAL service for some time in an effort to understand the strengths and weaknesses of their methodology. Overall, we have been impressed by their offering. The market will continue to scrutinize BVAL going forward and a larger migration towards Bloomberg's pricing for municipals remains a possibility.

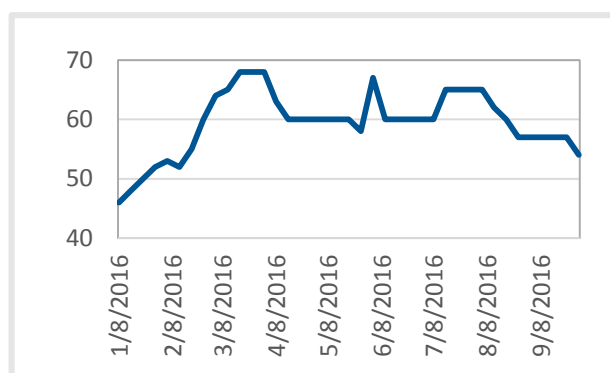
Credit Insight

The U.S. Census Bureau released preliminary estimates that showed state and local tax collections declined to \$338.2 billion the second quarter, down slightly from \$340.4 billion in the same quarter in 2015. The modest decline was caused by drops in both corporate and individual income tax receipts. Property tax collections did not decline, once again demonstrating the stability that underpins local government credit quality. State and local tax collections have largely been increasing since the recession, making the second quarter report notable. While one preliminary data point does not make a trend, we will continue to closely watch collections going forward.

Softness in revenue growth would be an unwelcome development for those governments facing steadily increasing fixed costs. One such government, the Commonwealth of Pennsylvania, made some progress in addressing its own challenges in the third quarter. After operating without a budget for much of fiscal year 2016, the Commonwealth began its fiscal year 2017 in July, with a budget that contained an approximate \$1.2 billion shortfall.

Days after the imbalanced budget was enacted, a compromise was reached that included meaningful new revenues. Importantly, the spending plan includes another increase in pension contributions. This follows consistent underfunding over the last decade. With its elevated pension liability and limited revenue growth, Pennsylvania has lagged the recovery seen in many other states. However, the budget agreement was enough to avoid an immediate downgrade from Standard and Poor's, which had briefly placed the Commonwealth on negative watch in July.

Pennsylvania 10-Year Spread (bps)



Sources: Reuters.

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*As of 10/16/16 institutional municipal money market funds will need to post a floating share price rather than a stable \$1.00 price per share via the amortized cost method of accounting. Additionally the funds will be required to charge liquidity fees of 1-2% should their assets drop below thresholds in short amounts of time and the funds may “gate” redemptions for up to 10 business days if the fund’s board believes it to be in the best interest of the fund. Because Retail funds and Institutional Government funds are still permitted to maintain a \$1.00 NAV many assets have shifted over to these portfolios rather than be subject to these potentially onerous restrictions.

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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 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 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.