Tax Efficient Fixed Income Market Commentary

April 2017

Overview

- Normalization in municipals following post-election volatility
- Improved supply and demand dynamics have driven strong performance
- Fed raises short term rates; hints at balance sheet reduction
- Updates on health care reform and nuclear power construction

First Quarter Highlights

Some feared that the difficult market seen in fixed income, and particularly municipals, would continue into 2017. However, as we indicated in our final commentary of 2016, we believed the municipal market was well positioned for a strong start to the new year. This proved to be the case as most fixed income began the year with strength and municipal bonds outperformed the broader fixed income market (as indicated in the table on the right). The supply-demand picture which pressured the market during the fourth quarter reversed, further bolstering performance.

Because we viewed the market as attractive and the technical picture as supportive of municipals, we entered the quarter targeting portfolio durations slightly longer than the benchmark, but, as the bond market achieved our expectations, we moved back to a neutral target mid-quarter. Additionally, outperformance of bonds with maturities around 5 years provided an opportunity to begin moving towards a slightly barbelled maturity structure.

Muni Market Factors

Following 2016's record level of supply, 2017 began with a notable decline in issuance. At $88 billion, first issuance was 12% below the same period last year. The decline was attributable to a sharp drop in bonds issued for refunding. At the same time, mutual fund flows turned positive for much of January and February, which represented a reversal of the sizable fund outflows that followed the November election. While flows were mixed in March, overall they were positive for the quarter, contributing to municipal outperformance.

LOOKING AHEAD

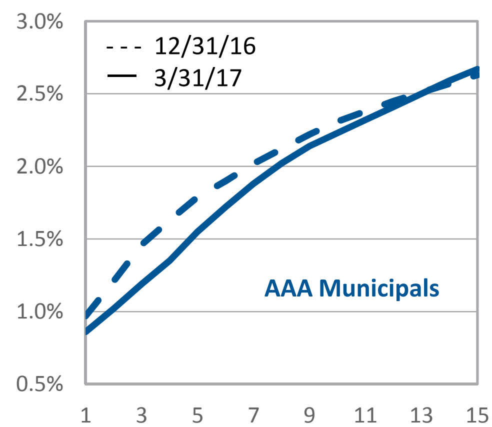
- **Federal Reserve:** The Fed's recent indication that it intends to begin reducing securities held on its balance sheet could have a meaningful impact on fixed income markets. While they are expected to proceed cautiously with any reduction, we will be watching closely as they communicate their intentions.
- **Washington**: While initial efforts to repeal and replace The Affordable Care Act (ACA) have faltered, we will be on the lookout for a renewed effort or a shift towards tax reform.

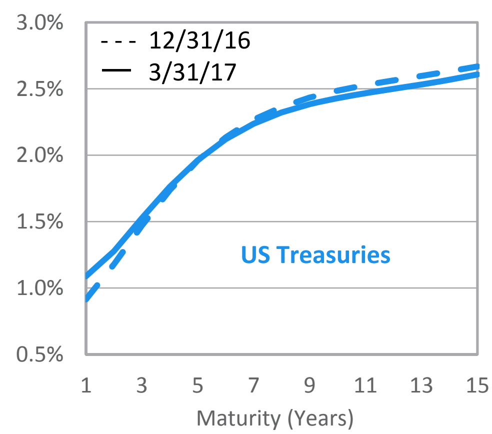
Market Returns as of March 31, 2017

	1Q17
BC Municipal Bond Index	1.58%
1 Year	0.69%
3 Year	1.27%
5 Year	1.90%
7 Year	1.95%
10 Year	1.78%
20 Year	1.50%
1-10 Year	1.55%
Prerefunded	1.00%
AAA	1.43%
AA	1.49%
A	1.71%
BC US Corporate 5-7 Year Index	1.48%
BC US Treasury 5 Year Index	0.46%
S&P 500	6.07%

Source: Bloomberg Barclays Capital (BC).

Yield Curves





Source: Thompson Reuters, Merrill Lynch as of March 31, 2017.

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

EYE ON WASHINGTON: FIRST QUARTER OF THE NEW ADMINISTRATION

While there is much uncertainty as to the new administration's legislative priorities, we believe that there are two which could have an outsized impact on the municipal market: **health care reform** and **tax reform**.

Health care reform efforts appeared to stall in Washington during the first quarter. Whether or when health care reform efforts are taken up again remains to be seen. Changes to the health care law would likely have ushered in a period of transition for the not-for-profit hospital systems that issue in the municipal market. The 2010 health care law resulted in a large number of Americans obtaining insurance, many through Medicaid. This had the effect of reducing the amount of uncompensated care provided by the hospitals, particularly in states that expanded Medicaid.

Part of the Republican plan would have shifted costs of the Medicaid program to states in the coming years. If a similar plan is passed into law in the future, these additional Medicaid costs will compete for state tax dollars, particularly for those states facing escalating pension liabilities. If funding is reduced, this could create financial strains for hospitals that are overly reliant on revenue from Medicaid. Within Fiera Capital portfolios, we try to avoid investing in systems which are too reliant on any single revenue source, particularly Medicaid. This strategy is designed to offer protection should reform again gather steam.

The tax advantaged nature of municipal bonds makes **tax reform** one of the most important issues for investors in these securities. Tax reform is an idea that everyone seems to agree is necessary in concept but there is significant disagreement as to how to achieve it, even from members of the same political party. Based on the difficulty the Republicans had finding common ground on replacing the ACA, it currently appears that any tax reform legislation passed into law may be less far-reaching and take longer than originally envisioned. Additionally, if the bitter fight over the confirmation of Judge Gorsuch is any indication, finding agreement across party lines may prove to be very difficult. This further reduces the likelihood of a significant legislative victory and suggests less potential for disruption of the status quo in the municipal market.

Credit Insight

Nuclear power moved to the forefront of the municipal credit conversation during the quarter when cost overruns related to nuclear projects in Georgia and South Carolina began to threaten the fiscal stability of Toshiba Corp. The nuclear units are being constructed for a group of utilities that includes investor owned utilities, as well as municipal issuers Santee Cooper, the Municipal Electric Authority of Georgia (MEAG) and JEA. Toshiba's Westinghouse subsidiary entered into a contract to complete the projects for a fixed price.

Due to significant cost overruns, Toshiba has been forced to recognize a sizable loss from the projects. Toshiba has placed its core chip business for sale to cover these losses and its Westinghouse unit has filed for bankruptcy protection in the United States. It appears that many parties are interested in completing the projects, however, we await further clarity in the coming weeks and months, particularly relating to the fixed price contract and its associated Toshiba guarantee.

We have long avoided bonds backed specifically by contracts relating to the construction of the nuclear plants, providing insulation from the direct project pressures. Importantly, Santee Cooper, MEAG and JEA each have a relatively large and stable base of customers and currently serve those customers with power resources outside of the new nuclear projects. Each utility possesses the power to raise revenues should additional project costs be passed on to ratepayers. Nonetheless, spreads have widened as the market looks to discern the future of the projects.

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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 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.**