APPLETON PARTNERS, INC.

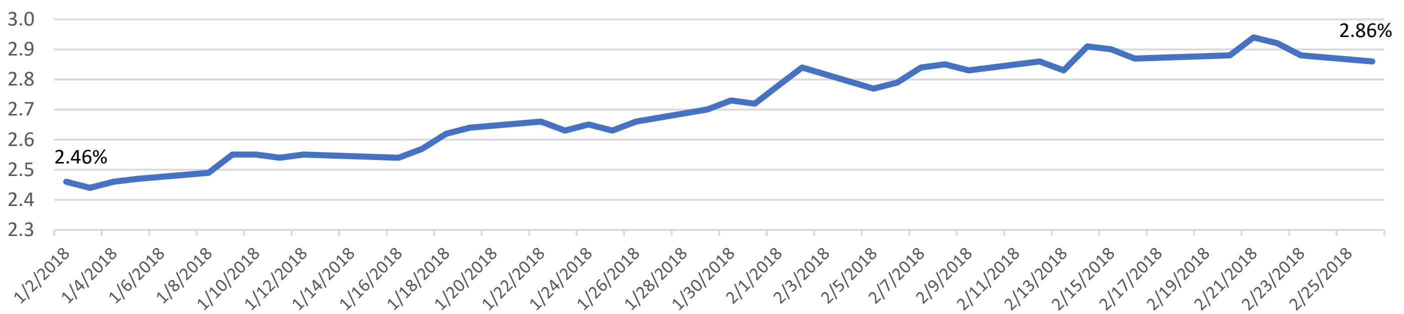
WITH A SPOTLIGHT ON INTEREST RATES AND EQUITIES, WHERE DO MUNIS STAND?

THE END OF AN ERA?

The past few weeks have vividly demonstrated the extent to which placid markets can suddenly turn, prompting a wave of differing interpretations, forecasts, and concerns. While no one can be sure what comes next, let alone the path to get there, we see value in looking at municipal securities in the context of today's environment.

A much anticipated but long delayed spike in Treasury yields jolted financial markets in early February, accelerating a slow, upward trajectory from the lows of early 2016. We see several precipitating factors.

- Global economic growth remains strong, the US is at or very near full employment, and consensus 2018 US GDP expectations fall in a healthy 2.5 – 3.0% range. This will likely provide the Federal Reserve with confidence to proceed with a less accommodative monetary policy after a historic era of quantitative easing.
- February 2nd brought news of 2.9% US wage growth, adding fuel to the fire of inflation hawks. Since the beginning of the year, 10Yr yields have increased from 2.46% to 2.86% as of the 2/26/18 close.
- Recently enacted tax cuts, and a Congressional budget agreement that largely sidelined the voices of fiscal austerity, have also considerably aggravated Federal budget and Treasury supply concerns. The Committee for a Responsible Federal Budget now anticipates that the deficit will exceed $1 trillion by 2019, a record level for a time of low unemployment.
- Nonetheless, fears of excess inflation are tempered by factors such as strong productivity growth, a stabilizing dollar that has eased commodity pressures, and published inflation data that has yet to definitively breach the Fed's 2% target.



Source: Bloomberg

EYES ON THE FED

So, in the face of these uncertainties, how might advisors counsel skittish bond investors? Let's start with where we see Fed policy over the remainder of 2018. ***Our base case calls for two or three 0.25% hikes***. We are not in the camp that anticipates more hawkish Fed action during Chairman Jerome Powell's first year, particularly given unnerving equity market volatility.

In our view, this speaks to a range bound, but modestly rising, 10Yr from this point forward, rather than a surge in inflation and Treasury yields. The greatest risk to this forecast may be the bond market's reaction to federal budget developments and their potential impact on real interest rates.

Of course, ***the Fed's ability to control short term rates does not directly translate to the behavior of intermediate and longer-term rates***. In the face of a rise in Treasury yields, the yield curve has recently steepened, with the spread between the 2Yr and 10Yr increasing from 51 basis points at the beginning of the year to 68 basis points as of February 22nd.

Nonetheless, given our expectation of 2 or 3 well telegraphed 0.25% rate hikes, coupled with already embedded expectations of solid, sustained GDP growth, we anticipate very modest additional Treasury and municipal yield curve steepening in 2018. Given this backdrop, ***we see the greatest value in the 6 to 9Yr portion of the municipal curve***.

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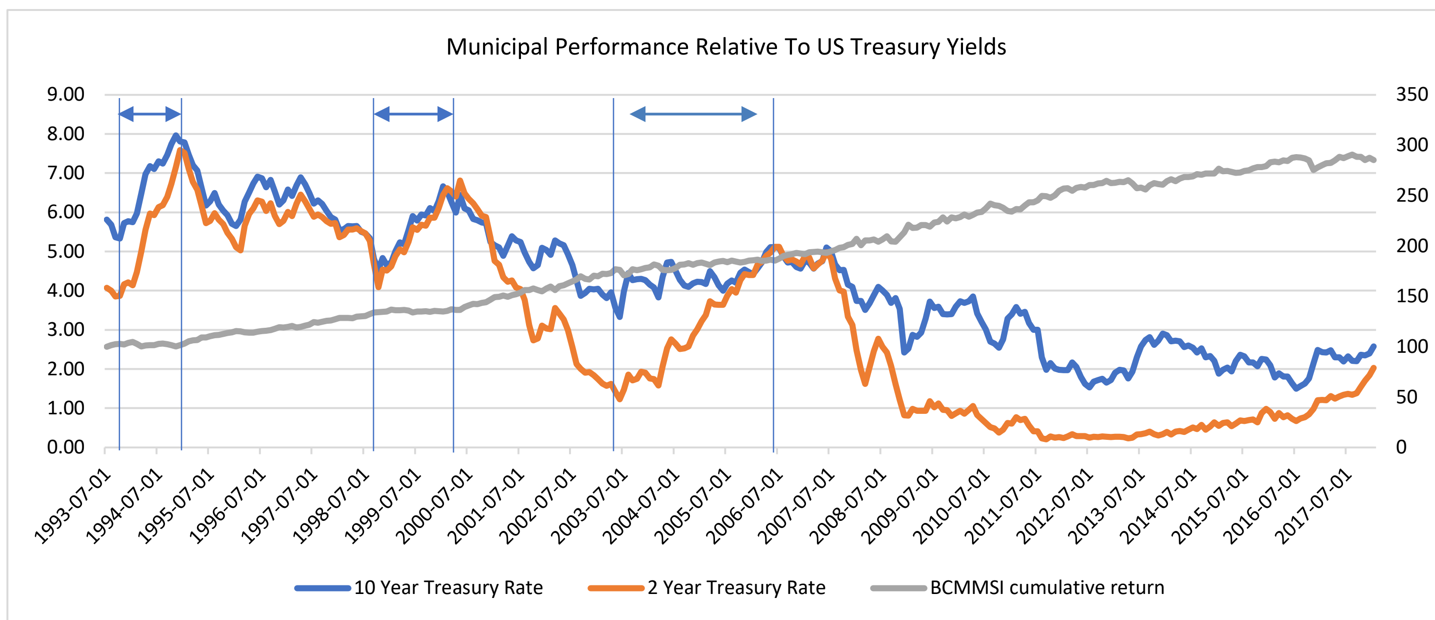
WHAT CAN WE LEARN FROM HISTORY?

Should Treasury yields move higher and/or more quickly than we anticipate, how might municipals respond? Each economic and market cycle is unique, as they are driven by specific economic, fiscal, and monetary factors. Nonetheless, the prospects for high quality intermediate term municipals in an environment of upward rate pressure is promising. As detailed in the accompanying chart, ***municipals have held up well during periods marked by significant increases in Treasury yields***.



Source: Federal Reserve Bank of St. Louis. US Treasury Yields are expressed in % terms as per the scale to the left of the graph. Municipal returns reflect the performance of the Bloomberg Barclays Managed Money Short/Intermediate (1-10 Years) Index and are expressed as cumulative return beginning on 7/31/93.

ROOTS OF INTEREST RATE RESILIENCE

Several attributes of actively managed municipal portfolios can help explain these dynamics, offering investors fearing higher interest rates some comfort.

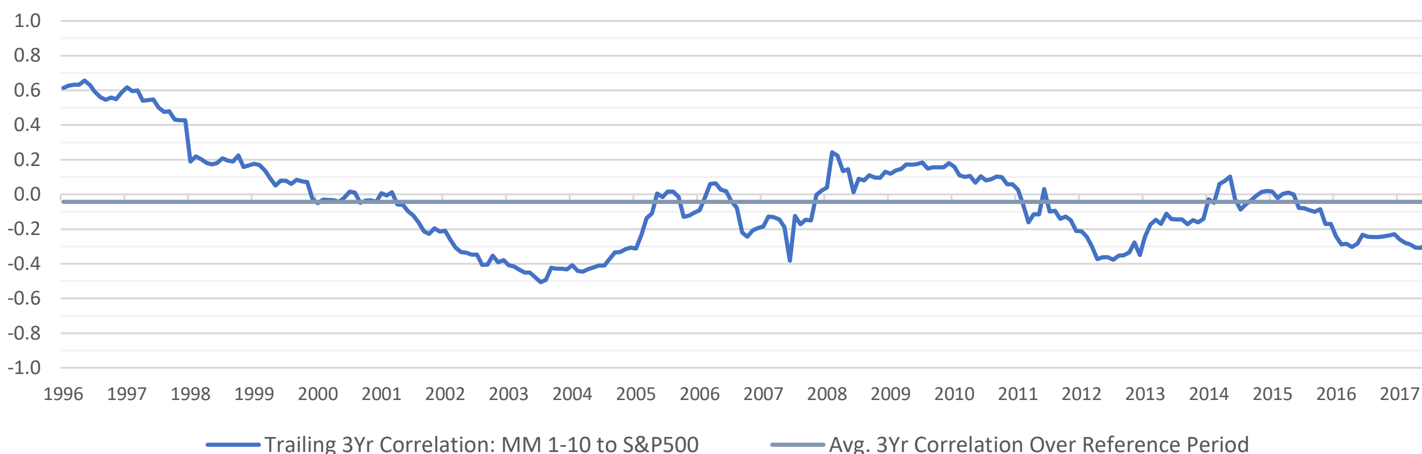
- ***Higher yields provide an ability to reinvest a growing stream of tax-exempt income.*** Despite the likelihood of initial price declines, increased cash flow derived from higher yields can add significant value to investor portfolios over time.
- ***Municipal supply is often constrained in rising rate periods*** given a lack of issuer refinancing, thereby providing a degree of pricing support.
- ***Tactical flexibility in liquid, high grade markets can prove valuable,*** as it enables separate account managers to tailor the maturity of individual bonds and the portfolio at large, while also targeting pockets of value along the yield curve.

With a Spotlight on Interest Rates and Equities, Where Do Munis Stand?

An Asset Allocation Resource

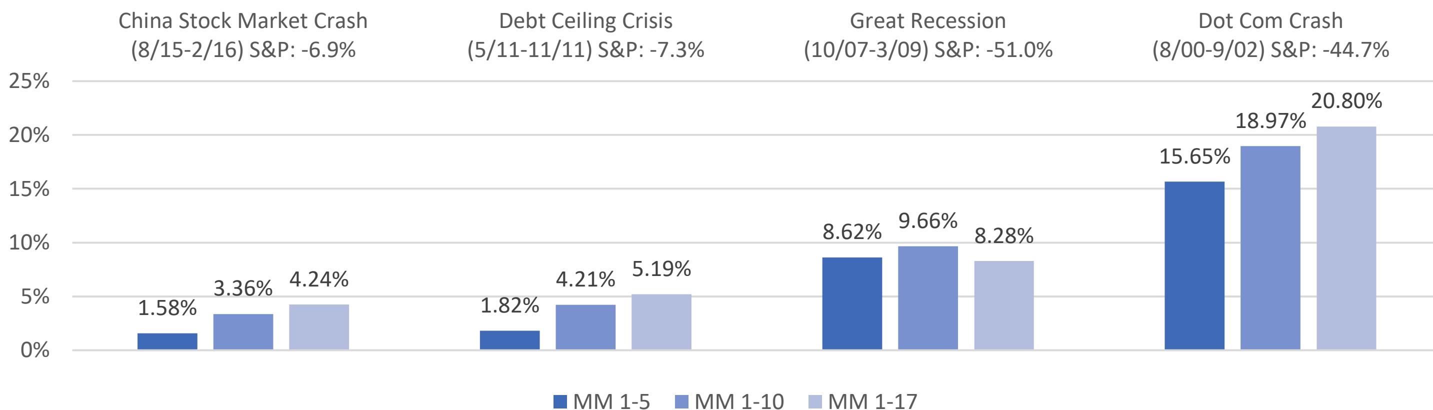
From a diversification perspective, municipal portfolios are often intended to complement riskier asset classes. This suggests taking a closer look at the relationship between municipals and equities.

While the nature of economic cycles and markets differ, thereby potentially altering past patterns, ***municipals have historically demonstrated a low correlation to equities***.



Source: Bloomberg. Municipal returns used in correlation analysis reflect the performance of the Bloomberg Barclays Managed Money Short/Intermediate (1-10 Years) Index from its inception on 7/31/93.

The portfolio efficiency value demonstrated above is reinforced by municipal market performance during periods of equity weakness. Despite a strong overall upward trend, there have been four major equity market corrections over the past 25 years. Although circumstances differ, ***municipals delivered positive performance in each downturn, generating income while hedging equity exposure.***



Source: Bloomberg, API. Indices are the Bloomberg Barclays Managed Money series ordered by average maturity; the Short (1-5 years), the Short/Inter (1-10 years), and the Intermediate (1-17 years).

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GUIDANCE AMID UNCERTAINTY

Headlines introduce risks of their own, as investor reaction may not prove beneficial over the long term. As advisors and their clients weigh investment decisions, several summary points are worth reinforcing:

- the magnitude of further interest rate increases may be somewhat overstated
- we do not anticipate major shifts in the municipal yield curve and feel it is likely to remain moderately upward sloping for an extended period
- municipals may offer investors an ability to diversify equity exposure and mitigate associated volatility given relatively low historical correlation
- municipals have also traditionally held up during rising rate cycles and equity market downturns

Regardless of environment, we will continue to rely on fundamental analysis, macroeconomic research, careful security selection, and tailoring portfolios to specific investor needs. By emphasizing liquidity in high-grade markets, we intend to maintain the flexibility needed to help investors capitalize on credit specific, economic and market developments.

Source: Bloomberg, API. Indices are the Bloomberg Barclays Managed Money series ordered by average maturity; the Short (1-5 years), the Short/Inter (1-10 years), and the Intermediate (1-17 years).