The only thing that we know for certain about the markets is that the volatility is here to stay, and 2015 has provided plenty of volatility. We are operating in an increasingly global market place, and despite signs that the domestic economy is on firmer ground, global influences have brought on increased uncertainty and lowered inflation expectations. China's economy continues to weaken, commodities remain under deflationary pressures, and Europe continues to work through its challenges. All of these factors are driving uncertainty into our market place, challenging the Fed on when it will throw caution to the wind and start raising rates. This uncertainty has been driving recent rate volatility as markets try to anticipate when the Fed will move. With no rate move in September, we are now eyeing the potential for a December Fed Fund increase. While recent economic releases have been supporting the notion that the economy may not yet be ready for a rate increase, market participants would surely benefit from a clearer picture and sense of direction.

Market Overview: Rates Range-bound, Net Negative Issuance a Persistent Trend

Since 2014, we have held that late 2015 would be the earliest we could see the Fed move to increase the Fed Funds Rate. Despite the recent weak September employment report, the labor picture has firmed. With unemployment well below the Fed's initial 6% target, the Fed appears well on its way to meeting the full employment part of its dual mandate. Price stability, however, remains elusive, with inflation still trending well below the 2% target. The Fed acknowledges positive developments at home, including increased household spending and business investment, but remains worried that conditions overseas could restrain US Growth and put further downward pressure on near-term inflation. As Fed Chairwoman Yellen indicated in her press conference following September's rate decision, the Fed has been focusing heavily on the situation in China and other emerging markets and how these negative elements could "spill over" into the US given "the significant economic and financial interconnections between the US and the rest of the world." In light of these global issues, along with the recent weak labor report and persistently low inflation, we believe that the odds of a December hike are dropping below even.

Issuance continues to be a big story in the Municipal market. Increased refundings in 2015 are pushing overall numbers significantly ahead of 2014 levels, and the market is poised for its first year of over $400 billion in issuance since 2010. Issuance had been more than 40% ahead of last year until a large year-over-year drop-off in September, when issuance was down 27% over the same month last year. This drop in issuance last month was a function of shortened holiday weeks and more importantly, the built up anticipation of the Fed's rate increase. Despite this recent drop, year-to-date issuance remains 32% ahead of 2014 levels.

Even with the strong issuance we have experienced in 2015, due to the large amount of bonds that are either being called or maturing, we still will likely finish the year with net negative issuance approaching $72 billion, according to JP Morgan. This net negative issuance continued in QIII and contributed to deals being significantly over-subscribed. In acknowledgment that the Fed will likely not increase rates until December, or even QI 2016 necessarily, demand from professional investors for Municipals remained strong in the 1-15 year part of the yield curve, even as Municipal Mutual Funds experienced significant outflows. QIII outflows, combined with only three weeks of inflows posted by Funds over the quarter, brought total year-to-date inflows from $9.8 billion at the beginning of QIII down to $5.1 billion by quarter end.

Muni Credit Fundamentals Strong, Focus Remains on a Few Stressed Credits

Barring a few pockets of stress, specifically in Puerto Rico, Illinois and New Jersey, credit fundamentals continue to improve at the State level as tax revenue growth is strong and outperforming expectations. These excess revenues provide states with greater budgetary flexibility, allowing them to either revive programs that were cut during the recession or rebuild reserves. We have also seen a trend where more budgets are passed on time, with the exception of Pennsylvania and Illinois. Pension issues persist and continue to hamper the lower funded states like Illinois, New Jersey, and Connecticut, among others. Puerto Rico remains in the news, as Governor Padilla appointed a Working Group which has offered an economic recovery and debt adjustment plan. We believe the plan to be the first step in a most likely long and arduous process, and we will continue to closely monitor any developments. With $72 billion of debt outstanding, among a number of issuers, we believe negotiations with creditors and stakeholders will be difficult.

Potential Tax Implications of the Presidential Election

The 2016 Presidential election may prove to be a growing distraction in the market. The candidate field is large and even though we are finally beginning to see some platforms emerge, we have not heard any of the candidates specifically targeting tax treatment of the Municipal bond market. A few candidates have joined the current administration in calling for capping deductions at the 28% bracket, which includes a cap on Municipal interest deductions. We expect to hear a variety of proposals over the next year that will try to simplify a tax code in a revenue neutral manner and we will focus on any proposals and their potential impact on the Municipal market.

Performance Recap

After trading off in the second quarter of 2015, the Municipal yield curve reached a near-term peak in rates at the start of QIII, only to see rates grind lower through the summer. However, the discussion of a potential rate hike at the Fed's meeting in September caused yields to turn the corner. Combined with a disappointing September labor report, the Fed's decision not to raise the Funds Rate caused interest rates to rally into October thereby leading to strong performance across the curve in late QIII 2015. Prior quarters' credit spread widening in specific lease-backed debt in New Jersey and Kentucky continued into the first two months of QIII, only to see a reversal in September. Overall for the quarter, 10Yr AAA Municipal yields rallied lower by 25bps to finish at 2.03%, while 30Yr AAA Municipal yields were down 24bps and 5Yr yields were down only 11bps. This bull flattening of the yield curve is reflected in the Barclay's Municipal Index performance, as the Barclay's 15-year Index was the best performing index, returning 2.12%, and the Long Bond index was a close 2nd with a 2.07% return. The Barclay's 1-year Index was the worst performing segment of the larger Barclay's Index, returning 0.44% over the quarter. Within the Index, lower quality sectors detracted from performance, with Leasing, Industrial Development, and Housing being the three worst performing sectors. Conversely, high quality sectors, such as Local GOs, Water and Sewer, and Education outperformed over the quarter. We saw minimal movement in credit spreads over the quarter according to MMD, which does not reflect the widening of specific names.

Global & Fed Uncertainties Linger into Year End

The markets continue to remain focused on the Fed and the timing of a rate increase. While there is no consensus on the timing of the actual increase, there is consensus that the move higher in rates will be small and incremental due to the fragile global economy. In light of the many economic and global factors persistent in the markets, it has proven important for Appleton to stay the course with our Municipal portfolios and continue to rely on them as part of a broader asset allocation model. We continue to hold an intermediate positioning on the yield curve, targeting a strategy duration of 4.60-4.65 years. We believe that once the market has fully digested any potential Fed Fund Rate increase, a further flattening of the yield curve, with the very short end of the curve trading up, shall follow. We continue to look for opportunities in the intermediate and longer end of our maturity range (6-12 years), while not extending overall duration and would view any sudden spikes in the yield curve as buying opportunities for our clients.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives. Appleton is also now active on Twitter: follow us on Twitter at @AppletonPtnrs.