We entered QIII in the aftermath of the BREXIT vote, which drove the 10-year Treasury to its low for the year and brought the rest of the markets along for the ride. Up until the surprising vote result, the year had been marked by a significant amount of market volatility, but was about to enter a period of relative calm, despite incessant FOMC rate hike discussion. In fact, rates remained steady through most of the summer, only to begin trading higher after Labor Day. A large turnaround in Municipal supply began to flood the market in August and September, pushing yields higher as Mutual Fund inflows were not enough to absorb the increased issuance. We also began to see pressure on the front-end (0-2Yr) of the Municipal yield curve, as new Money Market regulation caused massive outflows. Meanwhile, Fed chatter continued to hang on every economic data release, fueling a "*will they or won't they*" discussion that ended the quarter with, yet again, no rate moves and expectations that the Fed will wait at least until after November's presidential election.

### MACRO VIEW

The surprise Brexit vote was viewed as a threat to global economic output, causing the 10Yr Treasury to reach a low of 1.36% in early July. However, better than expected retail sales in June and strong July payroll numbers led the 10Yr Treasury to recover to a range of 1.50 – 1.60%, where it traded for much of July and August. The 10Yr traded higher in September, after Chairman Yellen stated in her Jackson Hole Summit speech that she believes "the case for an increase in the Federal Funds rate has strengthened in recent months." Despite her comments, the Fed did not hike rates at the September meeting, and in all likelihood will hold off until after the election. At the start of QIV (10/3/16), the Fed Funds futures market was implying only a 17% probability of a hike at the November meeting, and 61% in December.

### MUNICIPAL MARKET TECHNICALS

In addition to the global and domestic market factors, the Municipal market continues to have specific drivers. Issuance and Mutual Fund flows continue to gather headlines, with issuance taking a positive turn in August and September and Mutual Fund flows remaining strong. After breaking a record for Municipal issuance in the month of August, the trend continued into September, setting the all-time issuance level for the month and driving year-to-date issuance to $334 billion. Municipal issuance is on track to exceed $400 billion for the year, exceeding 2015 issuance totals. As we have discussed, austerity measures in the post-2008 economic collapse era had caused new-money issuance to decline to a low of 37% of total issuance. Yet, we have begun to see a rebound recently; year-to-date new-money issuance has accounted for 39% of issuance, and for the month of September, new money issuance provided 47% of the month's total. This is a trend we could see continue as, according to the Bond Buyer, voters in November are facing over 30 different local referendums for Transportation related bonds totaling $200 billion.

Fortunately, cash flows into Municipal bond mutual funds continue to help absorb the increased issuance, with 52 consecutive weeks of inflows and a year-to-date total of $50.4 billion. As the "lower for longer" mantra continues, the majority of this cash, approximately $28.7 billion, went into Long Municipal Funds, followed by $16 billion to Intermediate Funds. Tax-exempt money funds have not been participating in these inflows; rather, they have experienced $107 billion in outflows. These outflows are driven by a market dislocation in the front-end of the Municipal yield curve, a result of changes in SEC Rule 2A-7, which regulates money market funds. Under these new rules that went into effect October 14, 2016, the vast majority of current money market funds will no longer be allowed to maintain a constant $1.00 Net Asset Value (NAV) and will now have a floating NAV. The only exceptions to this rule are retail money funds (limited to individual investors) and Government funds (holding only Treasury and Agency Securities). Most market participants do not want exposure to a floating NAV product, and, as a result, they are selling their current money market funds and purchasing either Government Money Market Funds or individual securities. With this large dislocation, short-term securities, Variable Rate Demand Notes (VRDN) and Commercial Paper (CP), are trading at yields that are 40 to 60 basis points higher than they were six months ago. The length of this dislocation will be a factor of either rates continuing to increase, attracting non-traditional buyers, or product inventories shrinking through issuers restructuring their funding profiles. Most likely, it will be a combination of the two. We are currently looking to capitalize on this market opportunity with clients that have a significant amount of cash on the sidelines.

### ELECTION OUTLOOK

The overhang of November's Presidential election is nearing the end, but the capital markets remain uncertain to the implications of either candidate. This political ambiguity will certainly be a risk to 4th quarter growth, given that the US Presidential election remains closely contested. As we stated last quarter, the reality is that until either party controls the White House and both Houses of Congress, substantive tax reform is very unlikely; thus, we anticipate the status quo will remain.

### CREDIT UPDATE

Broad credit conditions remain solid within the Municipal Market, but the growth we have experienced over the last few years may be approaching a plateau. This past quarter, we received contrasting data from state and local governments indicating that credit improvement may be slowing down. The U.S. Census Bureau reported that state tax revenues declined in the second quarter by 2.5% compared to the same period a year earlier, which marks the first decline since the second quarter of 2014 and only the second down quarter since late 2009. This phenomenon appears to be widespread, as stagnant equity markets and modest wage growth led to weaker personal income tax collections. Local governments, on the other hand, posted a 2.4% increase in tax revenues for the second quarter, marking the fourth consecutive quarter of growth and the 12th in the last 14 quarters. While this currently bodes well for municipalities and their fiscal profiles, property taxes, which account for 80% of local government revenue on average, typically lag real economic activity by 12 to 18 months due to assessment practices. We continue to monitor developing credit trends and incorporate material findings, when appropriate, into our investment decision making process.

### PERFORMANCE RECAP

After posting strong returns through the first half of 2016, the market was fairly flat for QIII. The initial rally into the beginning of July quickly retraced with rates remaining steady through August, only to trend higher in September. With the front-end selling off in light of the money funds situation, the middle of the Intermediate range was the best performing component of the yield curve. The Intermediate curve flattened over the quarter, with the 2-10 year spread declining to 69 bps from 77 bps. This market movement is reflected in the Barclay's Municipal Index performance, as the Barclay's 7-yr Index was the best performing index, returning 0.07% for the quarter and up 3.29% year-to-date. Conversely, the Barclay's Long Index (22+ years) was the quarter's worst performing segment of the larger Barclay's Index, returning -0.67% over the quarter, but still leads the charge for the year at 6.13%. With limited market movement, albeit higher in yield, the excess yield in low grades drove performance, as lower rated sectors like, Leasing, Resource Recovery, and Hospitals outperformed.

Municipal performance year-to-date has exceeded expectations, as rates over the year have largely fallen along the intermediate to long-end of the yield curve. However, with the election in November and a lack of clarity on when the Fed will move, expectations are for rates to remain stable in QIV. The outcome of the election, economic changes in Europe and Asia, and 4th quarter issuance remain wildcards. The amount of uncertainty drives us to continue managing the Intermediate portfolios to a market neutral duration of 4.7 years. We are finding the steepness in the 7-12 year part of the Municipal curve attractive, and credit selection remains an important component of managing portfolios in an increasingly complex political and economic environment.

***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 on Twitter: follow us at @AppletonPtnrs.***