The dominant theme for much of 2017 has been the disconnect between heightened political gridlock and the remarkably calm markets. Additional stresses in the third quarter were caused by building tensions between the US and North Korea and a devastating storm season that battered the Caribbean islands and Gulf Coast states. These factors led to a flight to quality that brought Treasuries lower over the first two months of the quarter; though, yields did subsequently turn higher when Fed Governors began opining about the need for an additional rate move. The "net" moves in rates left overall yields relatively unchanged over the quarter. Meanwhile, the municipal market was supported, as Fund Flows strengthened and issuance came in below expectations. Demand remains robust and, with preliminary indications for lighter fourth quarter issuance, we anticipate continued supply and demand imbalances.

Outside of the brief flight-to-quality trade mentioned above, the 10Yr Treasury stayed roughly within a 20bps range all quarter, closing the quarter virtually unchanged at 2.33%. The Fed's decision in October to begin a slow and measured balance sheet normalization was widely telegraphed, as was their decision to maintain the Fed Funds Rate at 1.0-1.25% and the accompanying slightly lower forward guidance. The latter was predicated on an unexpected slowdown in inflation (Core PCE fell to 1.29% in August, below the Fed's inflation target of 2%), which Chairperson Yellen strongly believes is transitory in nature.

Heading into the fourth quarter, we believe there are three key themes that will set the stage for the rest of the year and into 2018: (1) a labor market approaching full employment and the Fed's inclination to raise rates, despite stubbornly low inflation; (2) the steady escalation of rhetoric between the US and North Korea and the possibility of open military engagement; and (3) the Republican tax plan. In the wake of the Republican health-care plan collapse, the market remained reassured by the belief that this would allow the party to move forward to tax reform. While a plan was introduced, details need to materialize, and further delay may begin to jeopardize any type of agreement. As new events continue to unfold, seemingly daily, additional themes may also emerge. Overall, we see an economy little changed from the start of the year, with low unemployment, low inflation, and decent underlying growth.

Even though the pillars of the Trump tax plan have been announced, the specifics remain unknown, which casts uncertainty on ultimate costs and potential impact on the municipal market. Increased discussions surrounding the potential elimination of the state and local tax deduction could influence investment decisions for both municipal investors and investors in high-tax states. We will continue to monitor how the tax plan unfolds in order to determine any potential impacts on, or opportunities in, our market.

Demand for municipals remains strong, largely driven by the positive fundamentals in the market place. Municipal bond mutual fund cash inflows added just under $8 billion in the third quarter, bringing total inflows for the year to $13.1 billion. Cash additions have mainly been split between Intermediate and Long Term Funds, with High Yield also gathering a portion of the inflows. The drop off in new issuance from last year further magnifies the potency of strong fund flows in to the market. After nearly a 20% drop in issuance during the first two months of the quarter, September issuance fell further, declining 34% from 2016 and bringing year-to-date totals through September 30th down 17%. The decline in refundings, which dropped 47% in September alone, drove this issuance decline; year-to-date, as a percent of total issuance, refundings are down over 11%, dropping from 41.4% to 30%. Refundings, which are similar to refinancing a mortgage, are becoming less attractive as many issuers have already refinanced expensive bonds throughout this extended low-rate environment. We continue to anticipate lower issuance in the fourth quarter and into 2018; however, one wild card for 2018 issuance could be infrastructure stimulus. At this juncture, though, it is hard to imagine a broad infrastructure plan materializing. Historically, September and October have delivered positive issuance; however, net issuance finished flat for September and does not appear to be picking up in October, thereby contributing to buyers facing a supply-demand imbalance in the market.

The credit picture remains stable at the state and local level, although there are a handful of issuers that are grabbing headlines. Two states, Pennsylvania and Connecticut, remain without a full budget in place, four months into their fiscal year. Pennsylvania is currently working to plug a $2.2 billion shortfall, triggering a one-notch S&P downgrade to A+, and while Connecticut works towards a spending plan, the City of Hartford's woes raised contagion concerns throughout the state. Illinois finally broke a two-year budget log-jam, with legislators pushing through a $36 billion spending package that includes a $5 billion tax hike. While this plan removes some immediate pressures for the state, Illinois sits on the cusp of junk and continues to face significant long-term challenges.

Three powerful hurricanes, Harvey, Irma, and Maria, struck the US within a short period of time, causing destruction across the southeast coast of Texas and Puerto Rico, as well as parts of Louisiana, Florida, and the U.S. Virgin Islands. The storms have led to widespread humanitarian challenges, and recovery and rebuilding efforts for these regions will take time. The full extent of damages currently remains unknown; however, there is historical precedent that the municipal bond market experiences

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minimal credit deterioration or payment defaults due to natural disasters. Short term challenges could materialize for state and local governments in the affected areas, but we anticipate that local, state and federal dollars, as well as insurance proceeds and charitable contributions, should provide the necessary support. In fact, as these affected areas move forward, rebuilding efforts often provide a boost to local and regional economies.

With yields relatively unchanged over the quarter and credit spreads continuing to tighten, duration and lower grade credits outperformed. The longer-end was the best performing component of the yield curve in the third quarter, while “BBB” rated credits out-performed on the credit spectrum. The 2-10 year spread steepened from 93 bps to 100 bps, as the front-end dipped and fears of a third Fed hike were pushed into the fourth quarter or beyond.

As we look ahead, the Fed will begin to pare down its massive balance sheet and expectations for a December rate hike persist. Market participants will continue to debate if inflation will ever rebound and whether the quality of job growth will actually translate into wage growth. We continue to believe the bond market is taking this in stride and will look to remain within a yield range centered on 2.50%. With credit spreads remaining tight, we have made an effort to increase credit quality, which should allow for reduced spread volatility and provide additional liquidity for future opportunities. We believe municipal fundamentals are positive and we are maintaining our duration target at 4.65 years on the Intermediate portfolio. We remain focused on the rhetoric coming out of DC on tax reform, and will assess market moving policy changes as they formulate.

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.

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