After a very choppy first quarter, QII began with relatively stable rates and a growing perception that, while the Fed would still make a rate move in 2016, they would likely be on hold until after the election. Some Fed officials tried to shake the market out of its complacency, only to have extremely weak May employment figures end any doubt that rates were on hold for the summer. The change in rhetoric on the economy, the dimming US employment outlook, and the recent surprise Brexit vote all led to a downward shift in rates. Risk assets came under pressure, and we saw the resurgence of the "lower for longer" interest rate mantra cause demand for municipals to strengthen and drive returns in QII. Meanwhile, municipal fundamentals were fueled by strong Mutual Fund inflows and non-traditional buying interest from global investors.

Even before Britain's surprise decision to exit the European Union (EU) on June 24th, the second quarter's recalibration of interest rate expectations was remarkable. While a rocky first quarter had made Janet Yellen's stated objective of four Fed Funds Rate hikes in 2016 unlikely, the futures market was still pricing in the possibility of one to two increases before year end, with better than 50-50 odds of at least one occurring by December. By the end of May, the implied probability of a Fed Funds hike at or before July's meeting had exceeded 52%, and by the end of June it was down to 0%.

We have long held that the Fed's outlook was overly ambitious, and that future rate hikes would be hampered because of market weakness, stagnant wage inflation, and depressed global rates. These beliefs were supported by May's abysmal employment report, where Nonfarm Payrolls expanded by a mere 38,000 versus projections for 162,000. While the headline numbers may have been unduly bleak thanks to a Verizon strike's temporary impact on Telecommunications employment, there was little in the way of silver linings.

The UK then confounded both the financial and betting markets by voting to leave the EU, 52% to 48%. Global risk asset markets responded by falling into a tailspin, with the British pound plummeting to levels not seen since the early 80s. As money fled from risk assets and into traditional safe havens, sovereign yields came screaming in; the 10Yr US Treasury flirted with all-time lows before closing the quarter at 1.46%, while the 10Yr German bund, briefly negative before the Brexit vote, fell sharply to -0.13% at quarter end. After a quarter where both foreign and domestic central bankers seemed united in avoiding further strengthening of the dollar, it too surged on the news. In the quarter's final trading days, cooler heads prevailed and US and European stock markets recovered much of their Brexit-related losses. However, looking forward, we see a market that no longer expects the Federal Reserve to raise rates before 2017 (and no longer rules out a rate cut), and believes the Fed is still a long way from achieving it's 2% inflation mandate. If market fundamentals showed a "lower for longer" interest rate environment at the start of the quarter, we believe that picture is even clearer today.

MUNI MARKET FUNDAMENTALS

While the Municipal market continues to take its cue from the Treasury market, Municipal fundamentals continue to bolster demand. Municipal mutual fund flows have experienced 39 consecutive weeks of inflows, bringing the total year-to-date inflows to $33 billion, with Intermediate ($11.7 billion) and Long-Term ($19.9 billion) funds drawing the most interest. Partially countering this strong demand was an increase in Municipal issuance. In fact, June issuance was the highest issuance for that month in the last 8 years, and the highest single month since March 2015. New money issuance continues to increase, accounting for 40% of issuance year-to-date. Typically, the summer months have lower new issuance, which is exacerbated by calls, maturities and coupon payments, leading to a strong period of "net negative" issuance, further driving demand for municipals.

A newer source of demand for Municipals comes from international investors in search of yield. With over $10 Trillion of Sovereign debt trading at negative yields, according to Fitch, Municipals are attractive even to investors not paying US income taxes. In fact, Fed flow of funds data show that in the 12 months ending QI2016, foreign investors added $6.7 billion to their Municipal holdings, with $2.0 billion of that coming in the last quarter alone.

CREDIT UPDATE

Just prior to quarter-end, Puerto Rico was once again in the headlines. On June 30th, Congress approved the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) which will most likely lead to a restructuring of the Commonwealth's $70 billion in debt. PROMESA establishes a seven-member oversight board with substantial fiscal authority and includes a stay on creditor litigation. Subsequently, on July 1st, the island defaulted on $780 million of general obligation bond principal and interest payments. This was Puerto Rico's first GO default, though one that was widely expected by the market. Overall, we believe impacts on the broader municipal market will be muted as the Commonwealth's credit struggles are largely idiosyncratic, and aggregate credit conditions outside of Puerto Rico remain relatively stable. We believe outside of these pockets of stress, municipal credit momentum to be stable.

Aside from Puerto Rico, Municipal credit has been improving for the first half of the year, with only a handful of troubled names capturing the spotlight. The State of Illinois suffered downgrades, landing its credit ratings firmly in the BBB space, reflecting the lack of political will and the ongoing pension funding challenges that have yet to be addressed. As a result, credit spreads have widened 14 bps to 187bps over the AAA curve at 10 years.

Meanwhile, elected officials in Pennsylvania are divided on how to tackle a growing operating deficit and burdensome pension liabilities. While PA managed to pass a budget 9 months into this fiscal year, it was amidst ongoing political friction and the ripple effects spreading down to local municipalities, specifically school districts that rely on the state for funding. Local entities in both states, as well as Michigan, are suffering due to state level challenges. Bond issuers across Illinois, Pennsylvania, and Michigan combined accounted for about 30% of the downgrades year-to-date.

PERFORMANCE

Yields across the whole curve were lower over the quarter, led by the 30-year dropping 67 bps, the 10-year AAA dropping 35 bps from 1.70% to 1.35%, and the 2-year AAA dropping 9 bps from 0.67% to 0.58%. Relatively steady performance across the Municipal yield curve continued, although moves were more dramatic further out the curve, with the long end of the AAA yield curve significantly outperforming 10 years and shorter. Strong demand for yield from mutual funds and non-traditional buyers drove credit spreads tighter for low grades, thus long, lower grade credits outperformed.

Despite the recent decline in rates, the Municipal yield curve remains poised for stable to lower rates, with continued flattening in the second half of 2016. Further stagnant global economic pressures and a strengthening US dollar could ultimately trickle back to the US keeping rates lower. Meanwhile, ongoing positive fund flows and international buyers will keep the supply/demand imbalances in the municipal market a positive influence. As the presidential election approaches and the presumptive nominees further develop their platforms, we are increasingly focused on the potential economic impact from both candidates and whether or not we could see tax reform that could alter the municipal market. However, the reality is that until either Party controls the White House and both Houses of the Legislature, substantive tax reform remains unlikely.

With this as a backdrop, we continue to find the 6-9 year part of the AAA Municipal yield curve attractive and have lengthened our target Intermediate Duration to 4.65 - 4.70 years. We have also recently seen value in certain Municipal structures, such as lower coupon issues and callable bonds and as the market adjusts to the new environment, we will continue to seek out defensive value opportunities.

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.