Municipal performance year-to-date has exceeded our expectations and fundamentals continue to support the market. Demand for municipals over the quarter was strong and pervasive, and we anticipate this trend to continue through the summer. The hope that a consensus would build in the Republican Party ending the gridlock in Washington was short lived, and now lack of progress has led to political disorder and uncertainty; as a result, we believe the bond market remains a safe haven. Inflation remains below expectations, largely driven by prices of petroleum and other commodities, and we remain skeptical of the Fed's continuing focus on raising rates.

While the House seemed to break gridlock with the passage of an Affordable Care Act repeal bill at the start of May, the Senate chose to start fresh rather than debating the House bill; with the vote now postponed until after the Fourth of July recess, the Senate version looks increasingly likely to fail. Meanwhile, Trump's surprise decision to fire FBI Director James Comey in mid-May only briefly rattled the market and led to the appointment of a special counsel to oversee the Russian investigation, almost ensuring that this investigation will continue to absorb policy bandwidth in Washington for many months to come. This will likely sideline much of Trump's legislative agenda; tax reform remains a possibility, but in our reckoning, the odds of meaningful legislation passing before 2018 have dropped significantly since the start of the year.

Political malaise does not seem to have spread to the economy thus far. The Q1 GDP growth rate, initially weak at 0.9%, was subsequently revised up to 1.4%, while earnings growth of S&P 500 companies came in solidly ahead of consensus. The Treasury curve's flattening in the wake of the Fed's well-telegraphed increase of the Fed Funds Rate to 1-1.25% in June suggests uncertainty. While extenuating factors (such as the slide in the price of oil and an escalating mobile carrier price war) likely depressed inflation, they do not seem enough to fully explain the retracement in the 10Yr Treasury yield from 2.40% at the start of the quarter to 2.15% after the release of the Fed statement on the 14th.

While May's 4.3% unemployment rate marks the lowest reading in 16 years, the 138k jobs added were well below expectation, and, with April's downward revision, the three-month average is now an anemic 121k. Durable goods orders dropped as well, sliding nearly double the expected decline of 0.6% to 1.1%. The reasonably solid May Consumer Confidence survey also shows forward-looking concern. While the overall index increased to 118.9 (rather than falling to 116.0, as expected), beneath the headline number is a widening gap between the current conditions' rise to 146.3 and the expectations' decline to 100.6, a reading only a decimal place removed from expectations for economic contraction. All in, companies seem to be deferring business investment due to political uncertainty. The market may not yet be influenced by the events in Washington, but there is growing evidence that it is starting to pay attention. The market has taken notice, reflected by the decline in Treasury yields.

Municipals' out-performance relative to Treasuries has driven the ratio of AAA municipals as a percent of the corresponding Treasury yield to drop. The 10-year AAA municipal had been averaging 93% of the 10-year Treasury over the last 12 months, but the strong buying patterns discussed below have brought the ratio down to 86% at quarter-end after reaching a low of 84% in early June. As long as the municipal fundamentals remain strong, we expect this relationship will persist. One factor that had been keeping the ratio elevated in recent years was concern over the tax exemption of municipals during tax reform discussions. It seems the current administration is doing their best to take this concern out of the market, acknowledging the important role that Municipal bond market plays in financing the infrastructure needs for state and local governments. However, recent legislation was introduced to eliminate tax exemption for professional sports teams to finance stadiums; therefore, it is possible that we could see a change in the scope of sectors benefitting from the tax exemption.

Municipals' strong performance persisted until the final weeks of the quarter. In addition to the already mentioned decreased inflation concerns and uncertainty in Washington, strong demand for municipals was a function of increased cash into mutual funds and a drop off in issuance,. Mutual fund flows have remained strong throughout the quarter, adding almost $5.8 billion, bringing year-to-date flows to $5.3 billion. Investors' quest to find more yield in this low yield environment drove the majority of the flows into High Yield and Long-Term funds. After getting off to a strong start in the first quarter, municipal issuance has slowed in QII. Both new money issuance and refundings have dropped resulting in year-to-date issuance down 14% from the same period last year to $195 billion. We anticipate this trend to continue throughout the remainder of the year. The drop in new issuance, coupled with a large amount of bonds maturing or being called, creates the net negative issuance situation we have experienced during the summer months and will likely experience in November and December. This net negative issuance causes further imbalance in the supply and demand relationship generally leading to tighter credit spreads.

Broadly speaking, states continue to face challenges as constrained resources compete with rising costs, particularly for healthcare and pension benefits. While 2016 was the sixth consecutive year of growth for state tax revenues, that rate slowed, growing only 1.2% in fiscal year 2016, and actually declined 0.1% if adjusted for inflation. This is the weakest tax collection performance since 2010 and is significantly slower than the 4.7% growth in fiscal 2015. All major sources of tax revenues declined including personal income, sales, and corporate income taxes, and severance taxes in oil and mineral producing states. Collections continue to be mixed as preliminary data for the first quarter of 2017 indicate stronger growth in personal income taxes and sales taxes while corporate income tax collections declined. The heavily anticipated April tax collection data for states indicates a number of state governments saw an unexpectedly sharp decline in income tax collections. The disappointing revenue numbers suggest more challenges ahead for states as they finalize their budgets for the new fiscal year and continue to manage constrained revenues against a backdrop of rising spending pressures. We continue to monitor the credit environment with an eye to any developments that could potentially impact our holdings and look for opportunities to add value where appropriate.

Punctuating the credit landscape this quarter was the downgrade of the State of Illinois to the fringe of junk. Both Moody's and S&P downgraded the State to Baa3 and BBB-, respectively. The downgrades primarily reflect the political paralysis that has long afflicted the State, magnifying their challenges and preventing the State from addressing their growing and significant pension liabilities, structural budget imbalance, and large accumulated backlog of unpaid bills. Illinois could be heading into their third fiscal year without a spending plan in place, putting vendors, local governments, state universities, social care providers and others at risk due to perpetual state funding delays and shortfalls.

With yields dropping over the quarter and credit spreads tightening, duration and lower grade credits drove the quarter's performance. The long-end was the best performing component of the yield curve in QII, while "A" rated credits out-performed on the credit spectrum. The curve flattened over the quarter as the front-end sold off a bit due to the Fed hike, while yields were lower 4 years and out. The 2-10 year spread flattened to 93 bps from 123 bps. This market movement is reflected in the Barclay's Municipal Index performance, as the Barclay's Long Bond Index (22 years and out) was the best performing index, returning 2.75% for the quarter. Conversely, the Barclay's 1Yr Index was the Quarter's worst performing segment of the larger Barclay's Index, returning 0.26% over the quarter. With new money going into High Yield Funds, lower grades out-performed, with Hospitals being the best performing sector for the quarter.

Expectations for the second half of 2017 and beyond are for the curve to continue to flatten, as the Fed is focused on a combination of higher Fed Funds rates and slowing reinvestment of maturities from their balance sheet. Both of these actions could cause rates to inch up further in the front end of the yield curve, while lower inflation expectations will likely keep the long end in check. Municipal fundamentals remain favorable through summer's end, although we could see the supply picture change in September and October. Hints of economic strength, albeit with little follow through, heighten our focus on maintaining strong underlying credits, and not extending too far on the yield curve. We are focusing on new issue supply, the net supply position, as well as mutual fund flows ,and feel these three factors will dictate ratios and the shape of the yield curve. If we see a reversal of the Net Negative Supply and positive Fund Flows, that could impact the constructive market fundamentals we have discussed. We will maintain our duration target at 4.60-4.70 years, which remains in line with the benchmark.

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.