The widely hyped "liftoff" began in December, as the Federal Reserve finally raised the Fed Funds Rate 25 basis points. However, this rising rate environment will not resemble a rocket ship to the moon, but hopefully more of a well provisioned, trans-Atlantic cruise. The gradual nature of the Fed's potential future movement is a function of a global economy marked by pockets of weakness in Europe and Asia, with specific weakness in China and a domestic economy that has shown signs of employment strength, but is still facing challenges. Meanwhile, the municipal market is faced with strong demand due to the prospect of a further flattening yield curve resulting from inflationary pressures that remain benign, net negative issuance, and positive mutual fund inflows. All of these factors could contribute to 2016 being a similar year to 2015 in municipals. In addition, the overhang of policy and regulation out of Washington seems to be stifling corporate growth, and the 2016 Presidential election will only add to the uncertainty.

When everything was said and done, 2015 ended much the way it began. The big news of the 4th quarter was that the Federal Reserve finally raised the overnight Federal Funds Rate from a range of 0-0.25% to 0.25-0.50%. While the Fed's move had been widely anticipated, the market's reaction was mixed. Short-term rates increased dramatically in the quarter, with the 2-year Treasury climbing 43 basis points to 1.10%, while longer bonds increased more modestly, with the 10-year Treasury increasing 24 basis points to 2.34% and the 30-year increasing 14 basis points to 3.04%. This curve flattening reduced the spread between 2-year and 10-year Treasuries from the start of the year at 149 basis points to a year-end 124 basis points, mere basis points off the low for 2015 of 119bps in February.

Market Overview: Low Inflation, Net Negative Issuance Continue

While the Federal Reserve had been grabbing headlines all year with the 'will they or won't they' question, the real story for Fixed Income investors has been the general lack of inflation. The most recent year-over-year reading of 0.5% hardly provides a strong reason to raise short-term rates. Much of the Consumer Price Index's (CPI) lack of growth can be attributed to the decline of commodities, most notably oil. Historically, falling oil and gas prices have provided a lift to the economy, as consumers have spent savings at the gas pump elsewhere. Unfortunately, it appears that consumers are using the savings to pay down debts or to save for a rainy day, as there has been no meaningful increase in economic activity. A rare exception was auto sales, where we saw sales of over 17 million units this past year. Encouragingly, even with last year's impressive sales, the average age of a car on the road is still close to 12 years old, suggesting there may be room for further growth. Looking to 2016, commodity prices, and especially oil are expected to remain low due to global oversupply and weak industrial demand, and many experts predict that it may be a number of years before oil reaches $50 a barrel again. In spite of all this doom and gloom, the US economy remains the shining star of global economies, admittedly brightened by the comparison to a dark global backdrop. The Federal Reserve will once again have to balance its twin mandates of inflation stabilization and full employment; as a result they will be walking a fine line with regard to further rate increases. We continue to believe four rate hikes in 2016 to be a very optimistic projection if the Fed does not see further progress towards meeting the price stability side of its mandate.

Specifically for the municipal market, supply was the story of the year in 2015, as the strong pace of refundings drove issuance, only to eventually slow down in QIV. We entered QIV with YTD issuance 32% ahead of YTD 2014, but finished the year 17% higher than 2014. Issuance in December experienced the largest Y-O-Y drop at 43%, as issuers were anticipating a Fed Rate hike, and caused the market to fall short of $400 billion in total issuance, a level not seen since the days of Build America Bonds in 2010.

The large amount of cash on the sidelines, as well as the $13.1 billion of inflows that Municipal Mutual Funds experienced in 2015, balanced this large pickup in issuance and drove the tremendous demand. It is interesting to point out the fact that flows were pretty evenly split between long-term and intermediate funds. Another important note is that the municipal market witnessed among the largest weeks of inflows post-Fed Rate hike, with the 4 week average at year-end totaling $924 million per week. Heightening the supply/demand imbalance is the large amount of bonds either being called or maturing. Thus, despite the strong issuance in 2015, we finished the year with net negative issuance of $73 billion, according to JP Morgan. And based upon JPM's issuance expectation in 2016 of $375 billion, they anticipate net negative issuance of $58 billion for this year.

The supply/demand imbalance has translated into elevated prices in the market, as evidenced by the current relationship of Municipals to Treasuries. At year end, the 10-year AAA municipal yield was 85.6% of the 10-year Treasury, down from almost 100% on October 1st and below the 5 year average of 94.9%. The current level is consistent with the average over the last 25 years and could establish a new near-term relationship for Municipals and Treasuries.

Stressed Credits, Upcoming Election Add Level of Uncertainty

Municipal credit conditions continued to grab headlines throughout the year as low-funded pension levels and Puerto Rico's fiscal and economic woes were heightened. The State of Illinois, which has the lowest funded pension system in the country, as well as political gridlock and lack of a 2016 budget six months into the fiscal year, suffered one notch downgrades from both Moody's and Fitch in the fourth quarter. Chicago, its largest city, has fared even worse than the State throughout 2015, as low pension funding levels, large operating deficits, political unwillingness, and lack of flexibility overhang the City and its related credits. The City and the Chicago School District, in particular, suffered multi-notch downgrades with Moody's leading the way and taking a much harsher stance, finally dropping them into junk category. Illinois has been penalized in the market all year with widening credit spreads due to their fiscal and political situation. Chicago experienced a much more significant market penalty because of the greater rating deterioration and the move into junk. The City and some of its related credits now trade at distressed levels.

Puerto Rico captured the majority of the credit headlines this year as the island continued to suffer from economic and demographic deterioration, as well as revenue and liquidity erosion. At this time it is uncertain to know what the outcomes for bondholders will ultimately be, although trading levels make it clear that an impairment in recovery of principal is inevitable for most, if not all bondholders. Appleton does not own Illinois GO, Chicago GO, or Puerto Rico bonds. For further details on these individual situations, please see our recent analysis of stressed credits.

An additional overhang in 2016 will be the presidential election. Despite the current cacophony of rhetoric coming out of both parties, when we enter primary season and the candidate field narrows, actual policy discussion will pick up. Tax reform remains popular, but any meaningful change will not happen without either party gaining control of the White House and both houses of Congress, an event we cannot predict with any likelihood at this point in the election. Both parties have been discussing limiting tax deductions, and while we believe it is unlikely in 2016, we will continue to focus on any potential impact to the municipal market.

Performance Recap

Performance in 2015 was ultimately driven by curve and credit selection, as the long-end was the best performing component of the yield curve and lower grade credits out-performed. Expectations for a Fed Funds rate increase led selling pressure on the front end of the yield curve with 1-4 year municipal yields rising on average 20 basis points (bps) over the quarter, while the longer end of the curve continued the years flattening trend and yields were lower by 23 bps on average 15-30 year range. While the 2-year AAA municipal yield was up 22 bps over the quarter, finishing the year at 0.77%, the 10-Yr AAA municipal yield was down 11 bps to 1.92%. This is consistent with the year's flattening move in which the 2-year was up 29 bps and the 10Yr yield was down 12 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 2.44% for the quarter, and up 4.52% for 2015. Conversely, the Barclay's 1Yr Index was the Quarter's worst performing segment of the larger Barclay's Index, returning -0.04% over the quarter, and only up 0.61% for the year. Despite specific ongoing credit concerns, the higher yield in lower rated bonds continued to entice buyers driving lower grade sectors to outperform, with Industrial Development and Leasing the best performing sectors for the quarter. Other lower grade sectors, such as Transportation, Hospital, and Tobacco were also strong performers for the year. Credit spreads did not materially change over the quarter or the year, with both the 10Yr AAA-BBB credit spread and AAA-A spread down by 1bp over the year, to 96 and 53 bps, respectively.

Fed Closely Monitoring Weakening Domestic & Global Data to Start 2016

Despite significant flattening in the 4th quarter, the municipal yield curve remains poised to flatten further in 2016. The front-end will remain pressured by potential Fed Fund rate increases, while the long-end remains stable with minimal threats of inflation and the potential for further stagnant global economic pressures and upward pressure on the US dollar. We will continue to take our cue from the Treasury Market in this low rate environment, while supply/demand imbalances in the municipal market remain a positive factor. Specifically, we are finding value in the 7-11 year part of the AAA Municipal yield curve. Despite market expectations for at least two increases in the Fed Funds rate in 2016, benign inflation and lackluster global economic output drive our expectations for continued flattening of the yield curve. Therefore, we are maintaining our intermediate duration target of 4.65 years. Potential risks to our expectations will be driven by unforeseen inflationary pressures, and, as we discussed, we strive to remain focused on individual credit selection and look to take advantage of value opportunities as the economic recovery persists.

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.