At the start of October, the looming presidential election provided an overhang of uncertainty that would ultimately result in the surprise election of Donald Trump as the 45th President of the United States. The markets digested the outcome and the potential impact of Trump's wide-ranging agenda to tackle tax reform, overhaul regulatory and trade policies, and infrastructure investment. The stock market coasted higher, while the bond market suffered one of the worst quarters in recent memory. Rising consumer confidence and the potential for economic growth stemming from tax reform and infrastructure spending stoked increased inflation expectations. These factors, combined with the Federal Reserve rate hike in December, contributed to the bond market sell off. While markets do tend to overreact, and where some were concerned that rates were headed to the moon, taking into consideration the thin margin of control that President-Elect Trump and the Republicans in Congress hold and that sheer will does not guarantee full or timely implementation of their ambitious agenda, we believe the Treasury market sell-off provided an attractive opportunity to invest.

The equity market "Trump rally" and the strengthening dollar in the wake of his upset victory has garnered much attention, but the reaction in the bond markets was, if anything, more notable. The US Treasury 10Yr rose 19bps in a single day from the close on November 8th (when Clinton was still widely expected to win) until the close on November 9th, and by the end of the month had risen to 2.37%, a full 53bps from October's close of 1.84%. Moves of this magnitude are exceedingly rare; in nominal terms, this was the largest month-over-month increase since December 2009, and, relative to the starting yield, the 53 bps move was the largest percentage move in a month since the St. Louis Fed records began in 1962.

With this in mind, the much anticipated Federal Reserve's decision to raise the Fed Funds Rate on December 14th was met with little surprise or reaction by the market, which had been pricing a near 100% certainty of a hike before the meeting. The labor market had shown solid improvement in the third quarter, adding a three month average of just shy of 180,000 jobs a month, while the unemployment rate fell to 4.6% in November. Inflation also firmed moderately, with Core PCE Inflation rising from 1% to 1.6% in advance of the meeting, a modest increase but still up substantially from the 0.6% at the start of the year and approaching the Fed's stated 2% inflation target.

The Municipal market traded in line with Treasuries during much of QIII, but Municipals were contending with some of its own market nuances as we moved further into QIV, including increased issuance, a reversal of mutual fund flows and new concerns on where municipals stood in terms of Trump's tax reform plans. The combination of these factors drove valuations in municipals relative to Treasuries to some of the cheapest levels seen all year, as the 10-year AAA municipal yield as a percent of the 10-year Treasury exceeded 105% coming into December. These levels attracted cross-over buyers to municipals based on their relative attractiveness to Treasuries, thereby increasing demand and eventually helping to normalize the municipal market heading into January.

The year-over-year increase in issuance in the final two months of QIII continued into October and November, only to fall in the aftermath of the election. Despite the December issuance decline, Municipal issuance still finished the year in record territory at $444.8 billion, up 10% from 2015 and over $11 billion higher than the record reached in 2010. A 12% increase in new-money issuance in 2016 as well as increased refundings both contributed to the year's record issuance. Recent voter bond authorizations to finance infrastructure projects have helped drive this issuance and the trend is likely to continue, as voters most recently approved approximately $70 billion in state and local bond measures in November. This marks the largest amount since $82 billion was approved in 2006 and are in addition to any infrastructure projects targeted by the Trump Administration. There are a range of strategist expectations for Municipal issuance in 2017, largely due to differing rate outlooks and subsequent impact on refunding issuance. However, estimates for steady to increased new money issuance have broad support. Interestingly, due to bullish expectations, Merrill Lynch's experts anticipate rates to drop to 1.50% on the 10-year AAA Municipal from 2.31% at year end, driving their 2017 issuance forecast for $470 billion and setting them apart from others.

The increased issuance through much of 2016 was met with 13 straight months of cash flowing into municipal bond mutual funds through the 1st week of November, when total inflows peaked at $54.4 billion YTD. Post-election, investors' anticipation of the inflationary impact of the incoming administration's agenda resulted in both a sharp increase in rates and over $19 billion in outflows, reducing the total 2016 inflows to $35.3 billion. While the forced selling has pressured the market, we anticipate negative outflows to subside in January.

Despite a few ongoing credit concerns, Municipal credit fundamentals remain on solid ground. Economic, demographic, and financial problems continue to plague Puerto Rico, and a contentious political environment, including severe pension challenges, continue to impact the State of Illinois, the City of Chicago and related credits. These continue to be the primary credit outliers, as the most recent data available for the second quarter of 2016 shows forty-one states and Washington DC all reporting their economies grew quarter-over-quarter.

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With a broadly stable credit environment, the greater focus right now is on the potential impact that President-Elect Trump's policies may have on municipal credit, most notably, the repeal of the Affordable Care Act (ACA) and significant infrastructure spending. While no definitive plans have been developed for either the ACA or for infrastructure spending, it appears that the repeal of the ACA could occur quickly and potentially without a full replacement plan in place. This repeal of the ACA and the potential impact on operating costs would drive a growing divide between those large healthcare systems with deep balance sheet resources, large revenue bases, broad diversification and provide services to dynamic, and growing population bases versus those smaller operators with much fewer resources and limited service offerings in smaller, less robust population areas. We believe this will potentially lead to credit downgrades and consolidation in the healthcare sector, with smaller, lower-rated entities looking to align themselves with larger systems.

We entered QIV with strong performance YTD, which dissipated in the aftermath of the Presidential election. The market's sell off in November was dramatic and the retracement in late December was not enough to erase the November losses. The municipal curve steepened in QIV, with rates in the 1-4 year range up 20 – 70 basis points and rates 5 years on out up 75 – 80 bps. The 2-10 year AAA municipal spread increased from 69 bps to 110 bps. The dramatic sell-off across the curve in the quarter led longer bonds to underperform the front end of yield curve. This market movement is reflected in the Barclay's Municipal Index performance, as the Barclay's 1-yr Index was the best performing index, returning -0.17% for the quarter but only up .30% 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 -4.95% over the quarter, though still up for the year at +0.88%. Excess credit spread in low grades assisted performance, as lower rated sectors like Housing, Resource Recovery, and Tobacco outperformed.

We believe the lack of certainty surrounding Trump's initiatives should prevent yields from advancing significantly higher or lower. We will learn more during the initial days of the his administration and will parlay that into our outlook; however, the uncertainty and the various scenarios which could drive market performance in 2017 and beyond have us staying the course in terms of yield curve exposure and maintaining our duration target on the Intermediate portfolio in the 4.65 – 4.75 year range. Despite the perennial concerns in Puerto Rico and Illinois, we believe that the overall municipal credit picture remains stable, while relative steepness in the 5-10 year part of the yield curve is attractive. Keeping in mind that Municipal investors have a long time horizon, we believe taking advantage of the recent back up in rates is prudent and will continue to look to take advantage of these market 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.