The world within Washington, DC, was once again a driving force in the fixed income markets; although, it was not President Trump's tweets, but the workings of the Federal Reserve, that set the tone. Persistently low unemployment rates increased the Fed's concerns that inflation, especially wage inflation, might reappear after years of dormancy; this resulted in the Fed preemptively raising rates for the third time in 2017, bringing the overnight rate range to 1.25% - 1.50%. The Fed also continued to shrink its massive $4.5 trillion balance sheet, although the scope of this plan was initially rather modest. As these events unfolded, inflation remained benign with CPI falling over the year down to 1.7% as of the latest release in December. With inflation seemingly contained and the long end relatively stable, the yield curve flattened dramatically as the Fed raised short-term rates.

While political news drowned out most other economic news, the fourth quarter of 2017 brought some surprisingly strong economic releases. Though September job's report missed expectations, it proved to be a blip, as strong October and November reports showed that the US workforce continues to expand. The unemployment rate now stands at 4.1%, a new cyclical low. Business sentiment indices continued to show strong investment and confidence, and consumer sentiment seems to be finally catching up. Retailers posted a banner holiday shopping season, and consumers also appeared to be spending on bigger-ticket items. December auto sales proved better than expected, and existing home sales surged for the third straight month in November to 5.6%, the fastest pace in a decade. With third quarter growth revised to 3.2%, the second and third quarters of 2017 now represent the strongest six-month stretch of growth since 2014. Yet, with all this positive economic news, wage growth remained sluggish at 2.5%, and inflation, as mentioned above, remains muted.

Against this backdrop, the Republican-controlled Congress passed the largest reduction in US taxes since the Reagan era at the end of December. While much has been written about the minutia, these various changes in the tax code could impact the economy significantly: this bill represents fiscal stimulus of nearly a trillion dollars over a ten-year period. With consumer and business spending already strong, the tax cuts could provide a helpful boost to wage growth and broaden an economic recovery that, thus far, has favored capital over labor. However, with some evidence that consumer spending may already be rising, there is a risk that the numbers have not yet caught up with the reality, and stimulus on an already hot economy could lead to overheating. With Jerome Powell assuming the Federal Reserve Chair and with five openings for President Trump to fill on the 9-person FOMC in 2018, a largely new Federal Reserve will need to manage the balance between growth and inflation. How, and to what extent, the Fed maneuvers these decisions could become a dominant theme in 2018.

Tax reform was the focus of the fourth quarter, and it led to an onslaught of municipal debt as issuers rushed to market in anticipation of looming tax bill limitations. In fact, municipal issuance set a new all-time monthly high in December, and 2017 was the second highest year of issuance ever, at $436 billion, just under 2016's record year. It is estimated that $30-40 billion of issuance was pulled forward from first quarter 2018 projections. This development increased 2017 totals, but lowers expectations for 2018 down to a range of $285-$330 billion.

Lower issuance for 2018 will likely heighten the Net Negative Issuance (NNI) we have experienced in recent years. JP Morgan estimates total 2018 NNI at more than $120 billion, with estimates for the first quarter rising potentially as high as $42 billion. These projections rise even further up to $60 billion over the summer months. Municipal Fund Flows proved strong throughout 2017, and we expect this trend to continue. Mutual funds took in $18.1 billion in 2017, split roughly evenly between Intermediate, Long, and High Yield strategies. The shrinking market, along with continued steady demand, further supports market fundamentals.

How well the market digested the increased fourth quarter issuance evidenced the strong demand for municipals in the market, thereby driving valuations higher on a ratio basis. The 10Yr Municipal to Treasury ratio finished year-end at 82.5%, down from 86% in the third quarter and 95% at the end of 2016. We anticipate that, although ratios are currently below long-term averages of 86%, demand for municipals will support valuations and could potentially drive ratios lower.

As the Fed raised rates throughout 2017, the 2-10Yr AAA Municipal curve flattened from 110 basis points on December 31, 2016 to 42 basis points by year end 2017. Looking ahead, we anticipate a relatively flat yield curve, as the front end reacts to expectations for three to four Fed Fund increases in 2018 and intermediate to longer rates remain focused on low inflation expectations. While the curve seems flat, there have been periods of more pronounced flattening, such as 2006 and 2007 when the 2-10Yr was 35 bps and flattened to 11 bps. We see changing inflation expectations as the wild card, and if inflation were to increase, the intermediate to longer-end of the market could come under pressure and steepen.

After prices sold off in November, investor demand drove yields lower in December, gaining back some of the prior month's negative returns. The flattening of the curve, with long rates dropping and short rates increasing, led to longer duration outperformance for both the quarter and year. Demand for yield also drove credit spreads tighter, with Hospital and Industrial Development bonds being the best performing sectors and BBB rated paper outperforming higher quality for the quarter and year.

We see general municipal credit stability carrying on through the first part of 2018. The economy should continue to grow thereby strengthening the labor and housing markets, household incomes and consumer spending, and supporting growth in various state and local government tax revenues. This momentum, in addition to tempered debt issuance and larger reserve balances, has many states in good fiscal position. While we see broad stability, several long-term challenges remain for state and local governments, specifically increasing fixed costs and expenditures (e.g., pensions), a decrease in federal support, and shifting demographics, all of which we are monitoring and incorporate into our credit decisions.

We will continue to evaluate the impact of legislative changes out of Washington, DC, including the recent tax reform package and the ensuing potential impact on state and local governments. The limitation on state and local tax deductions is grabbing headlines and could inhibit the flexibility of state and local governments to increase taxes, particularly those with high current tax structures. If so, this would chip away at future revenue bases. In addition, the mortgage interest limitation, combined with the reduced property tax deduction, could limit growth in property values and corresponding tax collections. The new restrictions could begin to erode credit quality over time and bears watching as the consequences of this legislation become clearer.

As we previously stated, new Chairman Jerome Powell is set to take over for Janet Yellen in February, and the team at Appleton will be monitoring the new leadership at the Federal Reserve. While Powell is perceived to lean dovish, investor consensus is for the Fed to raise interest rates anywhere from two to four times in 2018. We will be watching for any changes to the yield curve, inflation, productivity, and fiscal policy that could cause the Fed to diverge from their current path. We expect continued flattening of the yield curve, and trading for our Intermediate Strategy will likely focus on the 3-5Yr and 8-12Yr ranges. Overall, the combination of improving economic conditions and a historically accommodative Fed should provide a stable backdrop for fixed income as we move forward into 2018.

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.