Fresh on the heels of the December rate hike, we entered 2016 with optimism for continued economic growth and the Fed broadcasting expectations for four interest rate hikes in 2016. Over the subsequent months, the Fed has re-considered these expected rate moves due to continued global economic pressures and domestic economic stagnation. The Fed is now looking for only two rate hikes; however, the Treasury Futures Market is barely pricing in one rate increase in 2016, which will likely not happen until after the election. Meanwhile, municipals have benefitted from a larger than expected decrease in supply, strong monthly cash flows into municipal bond mutual funds, and a continued sense that interest rates will remain “low for longer.” Volatility in the capital markets continues to help steer flows into municipals helping the Municipal Market deliver another strong QI for the third year in a row. Furthermore, while March and April tend to be weak performing periods in the municipal market due to selling pressure caused by investors looking to satisfy their tax bills, strong technicals for municipal bonds have thus far muted the typically weak seasonal impact of tax season this year.

Investors have been looking for signs of a turnaround in the economy and were hoping that the recent uptick in jobs was their proof. However, further scrutiny of the recent employment additions shows growth in predominantly low paying, service sector jobs, which is not building any upward pressure on wages. This low wage growth combined with an elevated savings rate does not translate into increased consumer spending and consumption. We have continued to see limited GDP growth, with expectations for QI 2016 at roughly 1%, after QIV 2015 was revised up to 1.4%. First quarter GDP growth in the prior two years was low, but was attributed to bad weather. That excuse is not valid this year and it bodes poorly for any resulting build up in economic activity like we saw in the subsequent quarters in 2015 and 2014, when the weather turned. Meaning: we will likely have limited economic growth in QII GDP as well.

Lower oil prices are creating deflationary pressures throughout the world, and when combined with a slowing Chinese economy, prospects for economic growth remain muted. These issues have the Federal Reserve on hold in terms of rate increases, and were the impetus for Fed Chair Janet Yellen’s recent comments to the Economic Club of New York where she noted, “Reflecting global economic and financial developments since December, however, the pace of rate increases is now expected to be somewhat slower.” She later stated that the Fed will “Proceed with caution in adjusting Policy,” likely pushing off a rate hike into late 2016. We continue to view inflation concerns as minimal, and would be surprised if oil prices were somehow able to increase, the dollar to weaken, or wage growth to pick up, all of which we believe are unlikely.

Over the quarter, Japan joined the “negative interest rate club” when it issued a 10-year bond with a negative 0.024% yield. With Japan’s negative rates and the German 10-year trading below 10 basis points for the first time in 12 months, the US 10-year Treasury at 1.77% at quarter-end remains attractive. A dearth of yield in developed markets makes the US Treasury market attractive on a relative basis, which should support other US fixed income assets, including municipals.

In addition to cues from the Treasury market and the likelihood that rates remain low, the drop in issuance and also the strong YTD inflows experienced by municipal bond mutual funds strengthened the bid side for municipals. March marked the 7th consecutive month of year-over-year issuance declines, and year-to-date issuance is down almost 12% over the same period in 2015. Despite total issuance being off slightly more than expected in 2016, new money issuance is up 27% from QI 2015, and its share of total QI 2016 issuance jumped from 27% in QI 2015 to almost 40%. Sustaining the growth in new money issuance would reflect a pickup in infrastructure investment by municipalities, an economic investment that many believe is long overdue. Also increasing demand for municipals are the continued inflows to municipal bond mutual funds. For the period ending 3/30/2016, the 4-week moving average was $1.1 billion in inflows, while YTD flows are over $14 billion, eclipsing total flows of $13.1 billion for all of 2015.

Municipal credit, which has experienced an extended period of moderate improvement, is also beginning to decelerate as revenue growth over the last 5-7 years is slowing. According to the Rockefeller Institute, state tax revenue growth slowed in QIII 2015 to 3.8% year-over-year vs. 6.9% in the second quarter. Personal Income tax revenue growth slowed to 6.5% in QIII over 2014 after jumping 14.4% in QII. Expectations are that state tax revenues will moderate for the remainder of 2016 and into 2017. Meanwhile, a number of states continue to struggle with the growth of unfunded pension liabilities and the associated cost of supporting those obligations. States, including Kentucky, Connecticut, and New Jersey, are keenly focused on their funding levels and are challenged to find ways to lower the burden that pensions are placing on their fiscal resources.

Tightening municipal credit spreads in QI presented us with an opportunity to improve overall quality and take advantage of relative value trades, when available. As credit spreads tighten, we are looking for opportunities to upgrade in credit with limited give up in yield, thus improving overall credit quality and providing greater protection against potential fundamental pressures. These factors could be the previously mentioned burden from pensions or the growing pressures on energy-reliant regions from the collapse in oil prices and the resulting economic challenges.

Performance in QI 2016 was driven by curve positioning and credit selection, specifically in the AA rated credits. Following the trend from last year, the long-end was the best performing component of the yield curve in QI and lower grade credits out-performed. As expectations for four Fed Funds Rate increases diminished, there was strong support for municipals 3-5 years on out. Although there was a 5 basis point (bp) increase in the 1-year AAA municipal, yields across the rest of the curve were lower over the quarter. The 7-10 year part of the curve saw the biggest drop at 22 bps, with the 10-year AAA dropping from 1.92% at year-end to 1.70% at quarter-end. The 2-year AAA dropped 10 bps from 0.77% to 0.67%. The 2-10 year spread flattened to 103 bps from 115 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 2.24% for the quarter. Conversely, the Barclay's 1Yr Index was the Quarter's worst performing segment of the larger Barclay's Index, returning 0.32% over the quarter. Despite high profile credit concerns (i.e.: Puerto Rico, Illinois, and Chicago among others), the higher yield in lower rated bonds continues to entice buyers, driving lower grade sectors to outperform, with the Industrial Development and Tobacco sectors the best performing sectors for the quarter. Other lower grade sectors, such as Transportation and Housing were also strong performers for the quarter. Credit spreads did not materially change over the quarter with the 10Yr AAA-BBB credit spreads at 92, down 4 bps over the quarter while the AAA-A spread narrowed by 1bp.

Looking to the remainder of the year, our bias continues to be towards "lower for longer." Between the tepid macroeconomic environment and the fast-approaching US elections, we remain convinced the Fed will struggle to hike the overnight rate more than once in 2016, an attitude the rest of the market is gradually embracing. Meanwhile, low domestic inflation and continued weak wage growth, compounded by market volatility that is likely to continue and ongoing net negative Municipal market issuance, should keep pressure on the long end of the curve. As always, we remain diligent in our efforts to uncover pockets of value in a tight market, and will maintain our intermediate curve positioning and our target duration of 4.60 years as we enter the second quarter.

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.