After a strong finish to 2017, expectations for a slow start to 2018 were quickly thrown out the window. A combination of embedded market expectations and newfound political risk brought volatility roaring back in the first quarter. Concerns about a potential intentional devaluation of the US Dollar pushed the stock market higher in January, but also caused the bond market to trade off sharply, with the 10Yr treasury climbing 32bps over the course of the month. Meanwhile, the combination of lower municipal issuance and positive mutual fund flows have provided support for a market whose participants have been expecting rates to go higher for over a decade now and are looking for any hint of a sustained sell-off. Economic activity has been strong, but not enough to drive the yield curve materially higher. Light issuance, municipal market inflows, and reduced inflation expectations provide a backstop for a stable environment in the municipal market's intermediate curve, while expectations for more Fed Fund rate increases are driving short rates higher and supporting additional curve flattening.

Economically, we still see cause for optimism, albeit subdued. Consumer confidence remains high, unemployment low, workforce participation continues to rise, and companies continue to hire. And, while the stock and bond markets falling in sync spooked market participants in February, the market began behaving more normally in March, with the 10Yr Treasury yield dropping and bond prices rising as the stock market fell. The irony of the first quarter's volatility may be that it happened in spite of, and not because of, underlying market fundamentals.

Amid all the economic debate, Jerome Powell's first Humphrey-Hawkins testimony on February 27th went largely without event. Powell's commitment to a gradual increase in short term rates is essentially unchanged from Chairperson Yellen's, and a short-term rate hike at the March 21st Fed meeting was all but certain. The futures market implied likelihood of a Fed Funds rate hike in June increased from 61.1% at the end of January to 69.1%, before hitting 60.9% as the quarter ended. The March Fed meeting bumped up the Fed Funds target rate to 1.50 – 1.75%, with an accelerated pace of increases anticipated. Fed policy will ultimately react to economic developments and forward expectations, both of which are increasingly being influenced by an uncertain public policy environment. We expect 1 to 2 more short-term rate increases this year and are not in the camp that foresees more hawkish Fed action.

After a near record year of issuance in 2017, a drop off was certainly anticipated coming into 2018, as issuers had pulled approximately $35 billion of issuance into Q42017 with the Tax Reform bill signed into law in Q4. Eliminating advanced refundings eligibility for tax exempt issuance and the threat of limiting Private Activity issuance caused an acceleration of these deals. The expected drop off materialized, with issuance of $62.8 billion in Q12018 down 32% over Q12017. Without a subsequent pick up in issuance, the market may have a hard time breaking $300 billion, let alone reaching an expected level of $330 billion.

The drop in issuance has also heightened the Net Negative Issuance (NNI) the market has experienced in recent years. According to JP Morgan, the 5-year average of NNI is roughly -$50 billion, while expectations for 2018 are for NNI to reach -$119 billion. With close to $120 billion more estimated in bond maturities, calls, and coupon payments than the expected issuance in 2018, strong fundamental support will likely add to the demand for municipals. Also adding to favorable fundamentals has been positive municipal bond mutual fund flows, which saw over $6 billion of inflows in the 1st quarter, with Intermediate and Long-Term funds being the principal benefactors.

A conundrum municipals face is that despite strong market fundamentals, the ratios of municipals to Treasuries traded higher this quarter. However, we did see a drop-off in corporate purchasing of municipals as the Tax Bill decreased the value of municipals for banks and insurance companies, buyers that represent over 25% of the municipal market. Lower issuance was offset by lack of corporate buying and concerns brought on by market volatility, resulting in municipals underperforming relative to Treasuries. The 10Yr AAA Municipal as a percent of the 10Yr Treasury started the year at 81.4% and finished the quarter at 88.3%. We believe these current levels and relative value in municipals should be a positive technical for municipals and may drive ratios back down to the low 80% range, especially with primary issuance languishing where it is.

The credit landscape continues to exhibit broad stability. State and local tax revenues are growing, albeit at a slower pace, while balance sheets have been rebuilt in many instances. Sustained growth in the national economy should support ongoing stability of revenues that secure the debt of state and local governments, as well as essential service revenue bonds. The credit picture in Illinois and Puerto Rico continues to unfold and we remain focused on how both entities work themselves out of their respective predicaments. While we have no exposure to either, we are closely monitoring developments given their potential to disrupt the broader municipal market.

Of surprise in the credit market this quarter, was the lifeline that Connecticut threw Hartford, its capital city. The state will take over the city's annual GO debt service payments on about $500 million of debt to avoid a threatened payment default and/or bankruptcy filing. As part of the bailout plan, the city will also be placed under state fiscal oversight, which will include state approval of a 3-year financial plan, oversight of all labor agreements, and the requirement to provide monthly financial reports to the state. The oversight is likely the best scenario for CT, as a default or bankruptcy by its capital city could impact market access for other strained CT local governments. However, it will be a balancing act as the State works on its own fiscal position while seeking to avoid encouraging other fiscally challenged local governments to seek similar bailouts.

The selloff across the AAA Yield Curve in January and into February drove performance for the quarter and caused a flat yield curve to steepen, with the 2-10 AAA yield curve steepening from 42 basis points at year-end to a wide of 94 bps, only to finish the quarter at 77 bps. The initial inflation concerns which caused the intermediate to long end of the AAA curve to sell off in early 2018 abated and 10-30Yr yields retraced some of the sell-off. The front-end of the curve as measured by 2-7Yrs traded higher over the quarter due to expectations for more moves by the Fed. Credit and the carry on the extra credit spread led lower grade credits to outperform. The housing, industrial development and resource recovery sectors outperformed high grades sectors such as Education, Transportation, and Water and Sewer.

Although fundamentals in the market are supportive of municipals, areas of concern remain. There has been significant turnover in the Trump Administration, and the new administration may be more likely to pursue a hawkish foreign policy abroad and more deficit-financed tax cuts at home. While we do not see significant inflation in the market today, we remain vigilant to the risk of it picking up later in the year, a development that could force the Fed to hike short term rates faster than the one or two additional increases we - and the market - expect before year-end. And while the bull case is that Trump's trade rhetoric is merely staking out an extreme position before negotiating towards the center, there's a real risk that he means what he says on trade, and we are drawn into a trade war in coming months. However, at present, we see an economy that looks stronger than it has in some time, and one that could continue to grow for an extended period absent any external shocks. Therefore, with market fundamentals positive for municipals, we are looking to maintain our Intermediate duration at 4.6 years.