APPLETON PARTNERS, INC.

This Week in the Bond Market
12/19/16

Headline News

Federal Reserve Increases Funds Rate

- The Federal Reserve hiked the Fed Funds Rate to a target of 0.50-0.75% on Wednesday. This move was widely expected by the market, with Fed Funds Futures implying a nearly 100% probability of a hike in advance of the meeting.
- The bigger news was the “dots” indicating the Fed expects to hike rates three times, rather than two previously anticipated in 2017; although forecasts for the pace of increases in 2018 and beyond were unchanged. Chairwoman Janet Yellen downplayed the significance of this change in the accompanying press conference. On the news, the 10Yr Treasury rose 10bps to 2.57%.
- While the economy and labor market are unquestionably strengthening, we continue to caution that the Fed has failed to meet its rate hike forecasts for the past two years, and their current forecast needs to be taken in perspective.

Trump pledges to support tax exemption

- In a meeting with the U.S. Conference of Mayors on Thursday, President-Elect Donald Trump indicated he plans to maintain the tax-exempt status of municipal bonds, easing market participant concerns that the tax exemption might have been under discussion as part of proposed tax reform. Uncertainty in the details of Trump’s proposed tax plans previously left the future of the tax exemption in question.
- While Congress could still move to reduce or eliminate the exemption, the Trump presidency seemingly posed the greater risk, as less was known about the specific tax policies he might advocate. With this news, we believe the odds of any change to existing treatment have dropped substantially.

Connecticut Restructures Pension Payments

- Connecticut Governor Dannel Malloy announced that after months of negotiations the State and public sector union leaders reached an agreement to restructure the funding of outstanding pension liabilities. Changes will extend payments into future years, but are meant to avoid an anticipated spike in contribution levels. Connecticut will contribute $1.6 billion into its State Employees Retirement System this year, with annual costs expected to increase as high as $6.6 billion in 2032 under the prior schedule. New projected payments are more modest and range from $1.7 billion to $2.2 billion annually.
- The agreement, which now goes to the General Assembly for approval, will reduce the assumed investment return to a more conservative 6.9% from 8.0%, but will extend the amortization of the unfunded liabilities from 2032 to 2046. The lower investment assumption will require larger annual contributions, but lowers the plan’s investment risk. And while extending the amortization schedule may seem to be “kicking the can down the road,” we note that Connecticut did ascribe to a much shorter payment schedule than most states.
- The pension plan is expected to release an updated actuarial report later this month which will provide a more accurate framework of how plan liabilities will be affected. Connecticut’s pension funding has been a focus of investors and rating agencies for the last few years. While approval of the changes are not a foregone conclusion, the agreement shows some progress in tackling one of the State’s primary challenges.

Market Update

Muni Market Overview

- Despite speculation that recent market volatility might have deferred some early December issuance to the coming week, the projected weekly issuance of $490 million is in line with typical volume for the week before Christmas and well below the weekly average of about $8.8 billion for 2016.
- While YTD issuance through 12/6 of $441 billion is already in excess of the previous calendar year issuance record of $433 billion set in 2010, the final weeks of December are traditionally a quiet period for the municipal markets. Historically, the lack of supply in late December followed by traditionally strong retail demand in January has provided technical support for the municipal market.

Corporate Market Overview

- With the continuation of rate volatility and the Fed’s decision to raise short term interest rates, it was no surprise that last week’s $4.25 billion of Investment Grade corporate issuance was the lowest weekly volume so far this year. With year-to-date volume reaching $1.61 trillion, issuance is up 7% over last year. It may be safe to say that issuance could be done as we approach the holidays and year-end. With that said, there is still demand for IG credit with spreads tighter on the week.

FIXED INCOME INDEX RETURNS AS OF 12/16/2016

	MTD	YTD
Barclays 3Yr	0.03	-0.18
Barclays 5Yr	0.05	-0.84
Barclays 7Yr	0.16	-1.11
Barclays MM Short 1-5Yr	0.08	-0.50
Barclays MM 1-10Yr	0.24	-1.15
ML US Gov/Corp 1-10 Yr	-0.64	0.85

Source: Interactive Data

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