Quarterly Commentary: Unwelcome Mat

Exuberance from the tax cuts remained high during quarter, but inflationary concerns heightened talk the Fed may raise rates faster than anticipated. Not unexpectedly, the Fed increased rates at their March meeting citing continued steady growth and inflation nearing their two percent target. Expectations that two to three more hikes this year will continue to place upward pressure on short term rates. Further disrupting the markets have been the steel and aluminum tariffs, along with the retaliatory tariffs promised by impacted countries, placed on imports. Increasingly, economic hostile rhetoric between the US and China continues to heighten concerns that a trade war may become a reality. Higher rates, which could be the end result of the uncertainty, may serve to stymie economic growth.

Overseas, the European economy continues to expand. The ripe economic forecast for further growth has led to a surge in EU merger and acquisitions in the first quarter of the year. Excess corporate cash, along with improving macro-economic metrics, has spurred on deals that were waiting for the right financial climate. Feeding into the solid news, Brexit negotiations have begun to show forward momentum as the EU agreed to a 21 month transitionary period, once the two year exit window concludes, while also approving guidelines for the next phase of talks.

Historically, municipals benefits from a supply/demand imbalance early in a calendar year, which helps boost returns. The first three months of 2018 proved to be atypical. While the lack of supply was present, Fed concerns and a lessening corporate presence placed upward pressure on municipal rates. A steady retail presence, thanks in part to the cap on state and local deductions, was not enough to offset the challenges.

Macro concerns led to continued increases in interest rates during the first quarter. Short term rates continued their climb, thanks in part, to the Fed's first increase of 2018. Trade and inflationary concerns contributed to some interest rate volatility as well. After the dust settled, interest rates increased all along the yield curve with municipals outperforming in shorter dated maturities, while US Treasuries performed better in intermediate and longer dated issues. With the outperformance, the short end of the municipal curve is exhibiting historical relative value ratios. Municipals five years or longer, however, continue to maintain excess spread.

US Treasury Yields			
	12/31/2017	3/31/2018	Change
1 Year	1.72	2.07	35 bps
3 Year	2.01	2.42	41 bps
5 Year	2.20	2.56	36 bps
10 Year	2.42	2.75	33 bps
20 Year	2.60	2.86	26 bps
AAA Municipal Yields			
	12/31/2017	3/31/2018	Change
1 Year	1.44	1.55	11 bps
3 Year	1.59	1.81	22 bps
5 Year	1.70	2.07	37 bps
10 Year	2.01	2.48	47 bps
20 Year	2.51	2.89	38 bps

With economies, both domestically and abroad, continuing to show signs of strength, the unwelcome mat was rolled out to both inflationary and trade concerns. While volatility made its presence known to both, continued uncertainty may be the relative we don't want to see at the front door.

All the best,

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