Quarterly Commentary Q2 2016: An "Eagles" Eye View

While you would be seemingly hard pressed to find people who aren't familiar with a song by the legendary band The Eagles, it is harder to comprehend how fitting their lyrics are to macro-economic analysis. Alas, in our research, we have dusted off some vinyl and come to the realization that perhaps the band members may have spent some time as analysts prior to making it big.

"Every form of refuge has its price" The Eagles, Lyin' Eyes

In the municipal market, the big news was the default of $2 billion in payments of principal and interest owed by Puerto Rico to its bondholders. The Governor of Puerto Rico, Alejandro Garcia Padilla, stated that the Commonwealth would not be able to meet this obligation and, as the calendar hit July, the default was realized. Prior to the default, the Federal government adopted PROMESA- The Puerto Rico Oversight, Management, and Economic Stability Act. While this temporary refuge will outline a path for restructuring more than $70 billion of outstanding debt, an additional question regarding the treatment of more than $40 billion of outstanding pension obligations owed to public employees remains. The federally appointed board will also be faced with the task of confronting a shrinking population and declining business sector. Any restructuring process will come with a fair amount of austerity; and both bondholders and pensioners stand to pay a price for the fiscal challenges facing the Commonwealth.

"You can check out any time you like, but you can never leave" The Eagles, Hotel California

The BREXIT vote, which resulted in the United Kingdom's decision to leave the European Union, has been met with a fair amount of fall-out. Firstly, David Cameron, the Prime Minister, announced his resignation. Not to be outdone, the leaders of the leave movement, Boris Johnson of the Conservative Party and Nigel Farage of the UK Independence Party, both resigned their positions as well. A proverbial hangover continues to linger as a fair amount of uncertainty surrounding the renegotiation of trade deals and future interactions with other EU member nations are considered. Even though the execution of the vote will take place over a two year period- which has yet to begin, foreign firms with operations in the UK are watching developments closely and considering their options. It should be noted that, even though the UK was an EU member nation, exemptions granted the United Kingdom their own currency and visa regulations prior to the vote. While these exemptions will not lessen the challenges of the separation process, it removes a level of complexity. Trading relations, in contrast, will need to be handled with more caution. The UK, being a main importer from most EU nations, displays the dependency of the UK and EU member nations on each other. As such, it makes economic sense for future trade deals to be reconstructed in a similar fashion to existing agreements. The UK's dependency on EU member nations will make a clean break and an ultimate "nationalization" realization a bit more difficult to obtain.

"Half the distance takes you twice as long…after the thrill is gone" The Eagles, After the Thrill is Gone

The Federal Reserve has remained cautious amid an anemic domestic job growth report in May, global uncertainty and continued deflationary pressures. In December of 2015, the Fed raised interest rates for the first time since 2006, leading to expectations of three to four additional hikes in 2016. Fallout from the BREXIT vote, among other macro concerns, has nearly removed the probability of a rate hike this year with a meager 50% chance of a hike in 2017. The insatiable demand for US Treasury securities has only grown as foreign investors, fleeing negative yields in their own countries, have opted to buy obligations backed by the US Government. This has helped to drive down long term interest rates to new all-time lows and further flatten the yield curve, which impacts the economic health for financial institutions. An overreaction to global events may cause another delayed response from the Fed which could serve as a buoy to continued domestic growth.

"In the master's chamber, they gather for feast. They stab it with their steely knives, but they just can't kill the beast." The Eagles, Hotel California

After being the best performing asset class of 2015, municipals continued their bull run well into the new year. In spite of 39 consecutive weeks of positive flows into municipal funds, and in the face of global uncertainties, municipals outperformed US Treasury bonds maturing ten years or longer. Investors clamoring for additional yield went further down on the credit scale pushing single A rated municipal bonds to outperform their AAA rated counterparts. US Treasures, in contrast, outperformed in bonds maturing two to four years. Even though municipals outperformed during the quarter, the yield ratio of municipal to US Treasury debt continues to trend above historical norms.

US Treasury Yields			
	3/31/2016	6/30/2016	Change
1 Year	0.56	0.49	-7 bps
3 Year	0.94	0.76	-18 bps
5 Year	1.25	1.03	-22 bps
10 Year	1.83	1.51	-32 bps
20 Year	2.31	1.96	-35 bps
AAA Municipal Yields			
	3/31/2015	6/30/2016	Change
1 Year	0.59	0.50	-9 bps
3 Year	0.86	0.74	-12 bps
5 Year	1.14	0.92	-22 bps
10 Year	1.76	1.36	-40 bps
20 Year	2.38	1.92	-46 bps

Despite the volatility present during the immediate aftermath of BREXIT and PROMESA, most losses were recouped as the markets showed resiliency. While uncertainty exists, metrics continue to trend positively and market appetite for product shows limited signs of slowing. Challenges, both globally and domestically, have paved a path toward risk averse assets, which will support fixed income markets going forward. As Don Henley and the boys would conclude *"It may be raining, but there's a rainbow above you". (The Eagles, Desperado)*

All the best,

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