Quarterly Commentary Q2 2017: The Best Laid Plans

Outlining a path to accomplishment is often wrought with hurdles and challenges. These hurdles can sometimes cause diversions and adjustments to meet an end goal. The Trump administration, the Fed and Theresa May all understand this well.

The new administration continues to struggle with gaining consistent momentum to implement their agenda as investigative clouds continue to gather. Acknowledging the ACA has shortcomings, the administration vowed to tackle the issue. Although a celebratory tone was struck when the House passed a repeal and replacement for Obamacare, the push back was noticeable. The Senate's version of the ACA repeal and replacement legislation, which was expected to be a softer version of the House bill, didn't differ much at all. As a result, the Senate version met with a vocal opposition causing the bill to stall making passage seem challenged.

Domestic economic data has shown consistent, albeit sluggish growth. While job growth continues, GDP is trending below its 2% target and wages remain stagnant. The Fed continues to strive for a 2% inflation target and full employment even though these targets have proved challenging. Somewhat hawkish messages coming from the Fed have caused market trepidation. A point of contention for the Fed governors has been the lack of progress on inflation, citing "transitory" factors for the recent slowdown. If these factors continue, future policy moves may be delayed. Another Fed decision in the spotlight is the timing of the reduction of the Fed's balance sheet even though no definitive timetable presently exists. Such a reduction would serve to place upwards pressure on interest rates.

As we discussed in our last Quarterly Commentary, the UK finally began the two year window to exit from the European Union. In order to drum up additional support for her base, Theresa May, the UK Prime Minister, held a snap election in June in hopes of gaining a larger majority and stronger mandate during Brexit negotiations. Unfortunately, the election results proved damaging to May's Conservative party as they lost seats to its main rival, the Labour Party. The surprising results have put May into forced discussions with rivals in order to shore up what had been a solid base going into Brexit negotiations.

In other election news, the French election was won by Emmanuel Macron, the moderate candidate, as he was able to defeat the more right winged counterpart. This victory had broken away from what was becoming a more nationalized fever which had been sweeping over parts of Europe. This bodes well for the Euro, as the election of Macron makes the likelihood of a referendum vote to leave the European Union seem unlikely. Next up, German elections on September 24th, which the world will be watching closely.

Municipals performed well again in the face of headline risk. On July 1st, the State of Illinois officially entered its third consecutive year without a budget. While the governor called special sessions in order to force continued discussions, he ultimately vetoed an agreed to budget proposal citing concerns about tax increases. On July 6th, the House of Representatives, following the Senate's lead, voted to enact the budget against Governor Rauner's objections. Moody's says the cuts may not necessarily go far enough, especially when it comes to dealing with the state's $251 billion in unfunded pension liabilities. The passage of the budget will help institutions, such as mental health and educational facilities, which rely on state funding. Overall, the short term prognosis is still weak as the state's finances remain strained and vulnerable to unanticipated economic stresses.

With redemptions and income outpacing new issuance, municipals exhibited continued strength in the second quarter. Overall, municipals outperformed their taxable equivalents all along the yield curve as the municipal supply/demand imbalance was a main driver of the outperformance. From a quality standpoint, A rated municipals outperformed their AAA rated counterparts as investors are once again searching for yield as rates grind lower. With this outperformance, relative value between municipals and US Treasuries has contracted again. Ratios on the short end of the yield curve are now trending around historical norms, while longer dated issues continue to offer relative value.

US Treasury Yields			
	3/31/2017	6/30/2017	Change
1 Year	1.02	1.24	22 bps
3 Year	1.57	1.58	1 bp
5 Year	1.94	1.90	-4 bps
10 Year	2.45	2.33	-12 bps
20 Year	2.83	2.64	-19 bps
AAA Municipal Yields			
	3/31/2017	6/30/2017	Change
1 Year	0.85	0.84	-1 bps
3 Year	1.22	1.11	-11 bps
5 Year	1.58	1.35	-23 bps
10 Year	2.26	1.96	-30 bps
20 Year	2.93	2.68	-25 bps

While the best laid plans often times have the appropriate intentions, the devil is in the execution. As we've seen during the quarter, when the plans don't go as outlined, adjustments occur and at times, the trajectory changes. Remaining flexible and nimble is the key to obtaining the longer term goal. This is true in both governing and investing.

All the best,

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