Quarterly Commentary 4th Qtr: New Year, New Challenges

Heading into the final stretch of the year there have been more than enough topics to discuss. From China's slowdown, emerging market turmoil, the refugee crisis in Europe, North Korea's nuclear aspirations, Syria, recent Iran vs. Saudi Arabia unrest, terrorism threats, renewed Brexit discussions, further Eurozone easing and the commodity glut have all given investors reason for pause. In spite of this, the municipal market weathered the storm and was the best performing asset class of 2015.

Now, while all the newsworthy items seem hard to digest without feeling somewhat queasy, a closer examination proves that while the world is not expanding rapidly, it isn't falling into an abyss. China's economic slowdown is troubling to be certain, but a rout seems unlikely. China is attempting a shift from an investment economy to a more consumer-based growth model. Even though the IMF has revised China's growth prospect for 2016 down to a growth rate of 6.5% this would still account for roughly one third of global growth targets for the upcoming year. Due to continued low inflation and cheap money and thanks in part to a continued easing posture, economic growth for the Euro arena is starting to show signs of life. The accommodative policies enacted, which are spurring growth, are also reigniting currency war fires thought to have been extinguished. Increased rates are creating a vacuum through which funds are leaving many emerging market economies in anticipation of higher US interest rates and a stronger US Dollar.

Domestically, the Fed finally decided to raise rates for the first time in nearly ten years during their December meeting. Market participants were so enthralled they, in essence, yawned. Anticipated further tightening will be handled cautiously as the Fed continues to monitor economic metrics for signs of slowing growth trends. The Fed's move has enabled the US Dollar's bull run to continue. This continued strength has put pressure on US exports and manufacturing. As a result, the growth in the economy depends on a greater emphasis on consumer spending. With wage growth remaining stagnant and consumers' savings on an uptick, there is a potential for slow domestic growth.

Commodity prices continue to weaken with oil leading the way. Over the past six months, energy commodities, with the exception of natural gas, have lost in excess of 40%. The rout has not be confined to the energy sector. Metals and agricultural commodities have suffered a similar fate, albeit to a lesser extent. The impacts are being felt as Russia has, for the second time in recent months, taken further cost cutting measures. The lifting of sanctions on Iran, weakened emerging market demand and continued robust domestic petroleum production outlines a continued suppression of oil prices. The consumer will continue to benefit from the oil glut. However, their choice to spend or save their new found windfall will have a significant impact on domestic GDP.

2015 proved to be a solid year for the municipal market place. Continued global turmoil and economic uncertainties lead us to believe that 2016 will be more of the same as investors look to reduce investment risk by turning to the relative safety provided by high quality fixed income. This shift has been taking shape over the course of the quarter as inflows into municipal funds were positive for the thirteenth consecutive week, with the final week's inflow of $1.3 billion being the largest in nearly a year. The combination of new contributions, along with the typical dwarfed supply in January, has led to lower municipal interest rates.

While the municipal market seems to be well positioned for 2016, challenges still exist. Puerto Rico continues its dance towards more defaults. A recent January interest payment was made on the Commonwealth's debt at the expense of Infrastructure Finance Authority and Public Finance Corporation debts which were defaulted on. In essence, this amounts to a robbing Peter to pay Paul scenario. Without the capacity to declare bankruptcy, Puerto Rico seems destined to experience more financial difficulties. The House Ways and Means Committee has made it a priority in the first quarter of 2016 to facilitate a solution to the Commonwealth's financial crisis. Additionally, Illinois and Pennsylvania continue to operate, well into their fiscal years, without budgets. This does not bode well for the Chicago Board of Education, which is already stressed by its own budget and pension deficits.

Municipals outperformed US Treasuries during the fourth quarter. US Treasury yields increased all along the yield curve, with the most pronounced movements found in bonds maturing in one to seven years. In comparison, municipal bonds saw a flattening of the yield curve. Bonds had an uptick in yields on the short end and a retrenchment in bonds maturing seven years or longer. Taking some risk was evident as single A rated bonds outperformed their higher rated counterparts in most maturity ranges. Yield ratios of municipals to US Treasuries continued their decline in the fourth quarter, resulting in spread levels dropping below historical norms on bonds maturing in five years or less. However, longer maturities continue to maintain relative value.

US Treasury Yields			
	9/30/2015	12/31/2015	Change
1 Year	0.34	0.72	38 bps
3 Year	0.96	1.40	44 bps
5 Year	1.42	1.80	38 bps
10 Year	2.10	2.34	24 bps
20 Year	2.62	2.76	14 bps
AAA Municipal Yields			
	9/30/2015	12/31/2015	Change
1 Year	0.36	0.50	14 bps
3 Year	0.85	0.97	12 bps
5 Year	1.30	1.33	3 bps
10 Year	2.09	2.00	-9 bps
20 Year	2.89	2.68	-21 bps

As 2015 has concluded, municipals can hang their hat on a solid year for investors. Alas, with a new year comes new challenges as there is more than enough uncertainty for market participants. Ultimately, fundamentals rule the day, and having an investment advisor in your corner to assist is always the prudent approach. We wish you well in the upcoming year and thank you for your continued support.