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Quarterly Commentary Q3: Analysis Paralysis

Another quarter has come and gone and the Fed continues its dance with raising interest rates. With GDP growth hovering below two percent, suppressed inflation and global growth challenges, the Fed is in a quagmire.

The Fed has sighted continuing labor market strength and further upticks in domestic economic data, as compared to the first half of the year, as positive momentum. The governors concluded that although there has been little movement in the unemployment rate, job growth on average has been solid. They also point to increased household and consumer spending, thanks in part, to lower gas prices. Declines in energy and non-energy imports have contributed to inflation running below their 2 percent target. The Fed believes if this trend continues, any rate increases will be gradual. When the Fed decides to increase rates, it will inevitably raise borrowing costs, increasing an ever-growing debt to GDP ratio. This has the potential to depress growth prospects, which may lead to lower interest rates.

In August, comments made by Janet Yellen, the Fed chair, regarding what actions might be embraced in the event of another recession, gives us reason for pause. According to her statements, taking the Fed Funds rate back down to zero and resuming asset purchases until conditions improved would be potential tools to counter recessionary forces. It appears as though unconventional policy tools are not about to go away just yet.

Further complicating the Fed's decision have been global uncertainties. Brexit fallout fires were stoked once again as Theresa May, the PM, announced a target for March of 2017 to trigger Article 50 of the Lisbon Treaty, which would start negotiations for the UK's exit from the EU. When the announcement came, the US Dollar gained nearly 5%, as fears of a "Hard Brexit" emerged, bringing the pound to levels not seen since the mid-1980s. A "Hard Brexit" would entail Britain leaving the EU forfeiting its access to the single market. In exchange the UK would gain full control over its own budget, law-making and immigration, a sticking point for May. In a Hard Brexit scenario, British leaders would need to quickly land a new trade pact with the EU or they will be subject to standard WTO rules, which includes the imposition of tariffs as well as block the easy access that British banks currently have to the EU. This scenario would be a drag on the UK's recovering economy.

In contrast, municipals provide a mixed bag of information. With PROMESA, the Puerto Rico Oversight Management and Economic Stability Act, having been enacted, the board members and chairman, Jose Carrion III, have been selected. At the first meeting, the board requested the Commonwealth's fiscal plan, which will need to be approved by all members of the board. The next steps include taking assessments of the entities placed under its oversight and addressing a long-term fiscal plan for the Commonwealth. The takeaway is that the road to recovery remains long and uncertain.

On a more positive note, municipalities in most states, according to the latest report by the National League of Cities, have revenues nearing pre-recessionary levels when factored for inflation. The report cites that revenues have recovered to 96% of their 2006 levels. As a result,

more than 80% of city finance officials report that they are better able to meet the financial needs of their communities.

Municipal bond fund flows continue their run towards history by recording their 53rd consecutive week of positive inflows. With the threat of higher taxes potentially on the horizon, combined with attractive relative ratios to US Treasuries, we don't see a dampening of this trend in the short term. An expected uptick in issuance in the coming months against a backdrop of atypical investors, continued fund flows and increased demand may reverse a recent rally in rates.

Treasuries outperformed their municipal counterparts during the quarter, as global economic fears spiked demand for fixed income products. In municipals, investors were rewarded for taking on additional credit risk as single A rated bonds outperformed higher rated credits. With US Treasuries performing better than municipals, ratios of tax-exempts have once again trended back above historical norms, thus providing relative value.

US Treasury Yields			
	6/30/2016	9/30/2016	Change
1 Year	0.49	0.61	12 bps
3 Year	0.76	0.94	18 bps
5 Year	1.03	1.19	16 bps
10 Year	1.51	1.64	13 bps
20 Year	1.96	2.09	13 bps
AAA Municipal Yields			
	6/30/2016	9/30/2016	Change
1 Year	0.50	0.74	24 bps
3 Year	0.74	0.89	15 bps
5 Year	0.92	1.05	13 bps
10 Year	1.36	1.52	16 bps
20 Year	1.92	2.11	19 bps

The Fed's quandary is complex as the governors must weigh domestic growth prospects against global challenges. While expectations of a rate increase are on the rise, the impacts of such an action may be muted as markets have priced in such a decision. Investors are best suited to stay the course and not try to predict what has become a not so painfully obvious course.