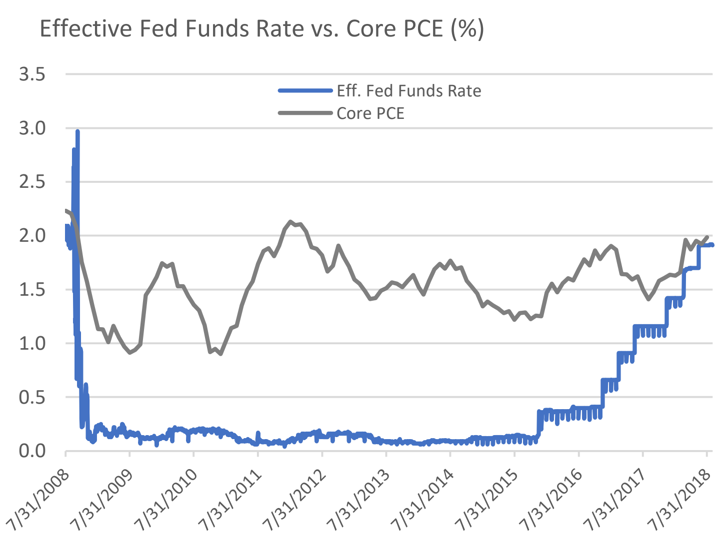
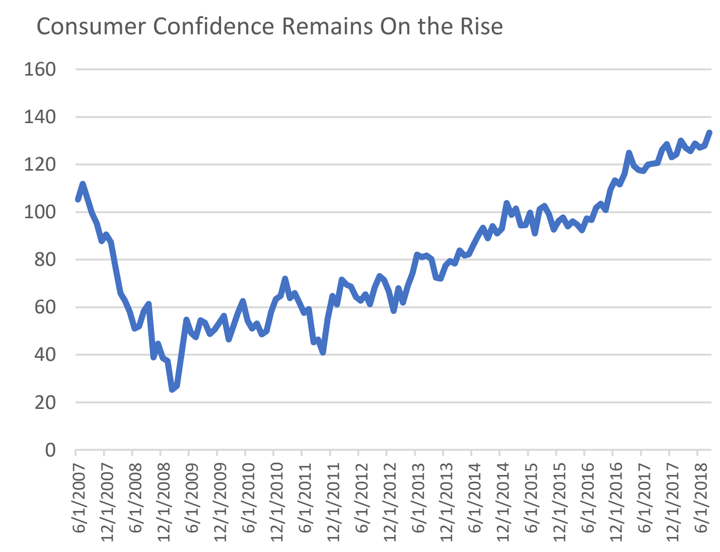
INSIGHTS & OBSERVATIONS

ECONOMIC, PUBLIC POLICY, AND FED DEVELOPMENTS

- The economic picture continues to diverge at home and abroad. ***Domestically, the primary consumer confidence reading surged to 133.4, the highest level in 18 years. This is an exceptionally strong number that supports an expectation of sustained spending in a demand-driven US economy***. Global conditions have been much less robust, with weakness in China and many emerging markets.
- Meanwhile, Q2 GDP increased from 4.1% to 4.2% in the first revision. The drag from inventory declines was slightly less than originally reported, though while the adjustment to net trade was positive, it was largely the result of net exports being revised down by less than net imports, hardly an encouraging revision. ***Despite strong consumer confidence, our Q3 outlook – a modest slowdown from an elevated Q2 to a still healthy Q3 reading - is unchanged.***
- Negotiations to revise NAFTA broke down at month end, after a Toronto newspaper leaked off-the-record comments indicating the US would refuse to make concessions to the Canadians. Some form of a deal had looked increasingly likely after the administration had announced the parameters of a potential US-Mexico deal earlier that week. ***However, with Trump now threatening, over bipartisan opposition, to push for a termination of NAFTA and forge ahead with the bilateral deal with Mexico, the twenty-five-year-old trade agreement's future has become uncertain.*** Mexico has indicated they are not interested in pursuing a bilateral deal that excludes Canada, and the power of the President to reverse a Congressionally-approved trade agreement has not yet been tested.
- ***The setback in NAFTA talks may also have negative implications for trade talks with China.*** The Trump Administration has indicated they will only turn to China after they have renegotiated NAFTA, delaying any potential resolution. Complicating matters, Trump has indicated he will move forward with an additional $200B of 25% tariffs on Chinese imports with a formal announcement due any day as of present writing, and surprised the markets by mentioning a further $267B in tariffs "ready to go on short notice." For now, both the US and Chinese have committed to continue discussions.
- The Federal Reserve is widely expected to hike short term interest rates to a range of 2-2.25% on September 26th, with the implied probability of a hike standing at nearly 95% at month end. With the effective Fed Funds Rate at 1.91% and Core PCE inflation at 1.99%, ***the expected hike would move the "real" overnight rate from modestly negative to modestly positive for the first time since the Great Recession.*** Indeed, the Fed indicated they may soon drop the word "accommodative" from their assessment of the current policy stance. ***After more than a decade of stimulus, the return to a normalized short term rate environment is a healthy development and speaks to the strength of the US economy.***



Source: Bloomberg

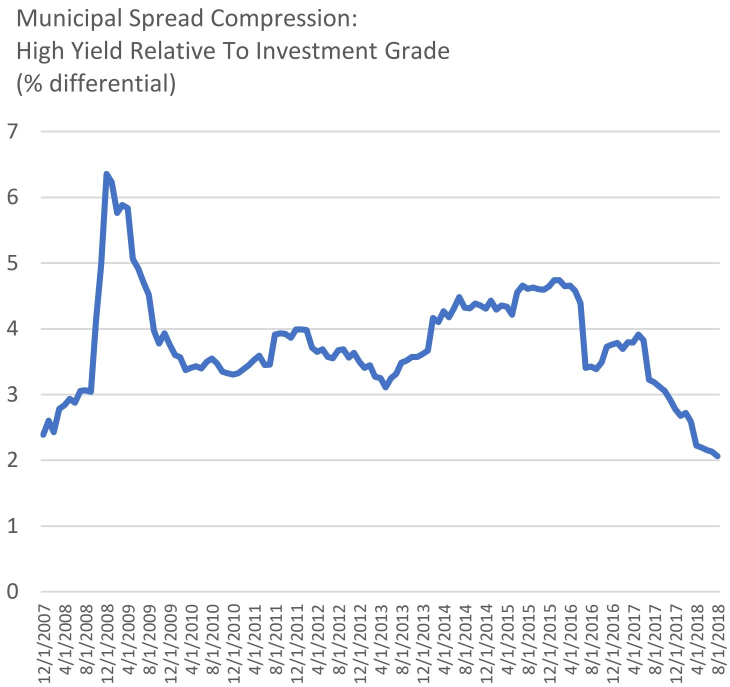


Source: Conference Board Consumer Confidence Index

FROM THE TRADING DESK

MUNICIPAL MARKETS

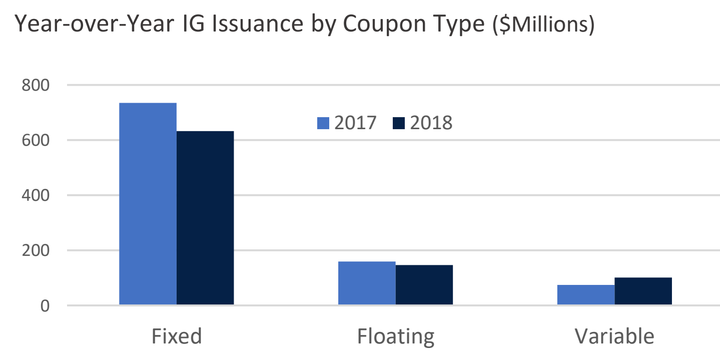
- A long era of accommodative monetary policy, favorable credit conditions, and a thirst for tax-advantaged income have driven yields in the tax-exempt high yield market to record low levels. In fact, the ***Barclays High Yield Municipal Bond Index yield to worst of 4.74% recorded on 8/31/18 represents the lowest level since the Index's 1/1/95 inception.*** The extent to which muni high yield spreads have compressed relative to the investment grade market is also noteworthy. The accompanying chart details the spread between the Barclays Municipal High Yield and Investment Grade indices measured on a yield to worst basis***. August ended with a paltry spread of 2.06%, the lowest relative risk premium since 11/30/07,*** prior to the onset of the Great Recession, a time that also reflected widespread use of 3rd party bond insurance guarantees, a credit backstop that has since largely dissipated.
- In our view, today's tight high yield spreads introduce a relative value consideration, as advisors and investors assess the adequacy of tax-exempt high yield risk premiums. While nominal tax equivalent high yield coupons may still appear attractive, an extended "risk-on" environment has given investors an opportunity to consider the merits of reallocating a portion of their portfolio into more liquid, higher grade tax-exempt exposure.



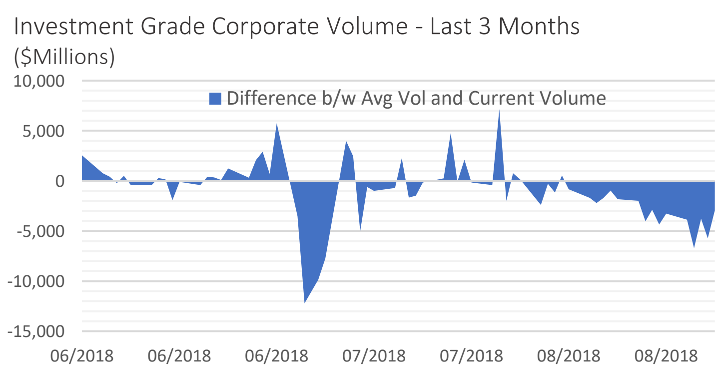
Source: Bloomberg

TAXABLE MARKETS

- Investment Grade credit markets were calm throughout the month of August. The dog days of summer lived up to their reputation as market participants took advantage of the summer slowdown. Market volatility and deal volume was low, with issuers only pricing $75.4 billion of new bonds during the month, 23% lower than the same time during 2017. Most of the issuance was in the first two weeks, the most notable offering being an $11 billion seven part deal brought by United Technologies to fund its acquisition of Rockwell Collins. ***This was the largest M&A-related deal to come to market since June and, at four times oversubscribed, it offered reassurance that appetite for high grade credit remains strong.***
- ***A noticeable trend hitting the new issuance market has been an increase of short dated floating rate notes (FRNs).*** The flattening of the yield curve is providing an opportunity for issuers to take advantage of investor demand for shorter dated bonds yielding nearly as much as longer maturity issues. The combination of low volatility, sluggish transaction volume, and minimal recent issuance kept credit spreads tight as summer came to a close.



Source: Bloomberg



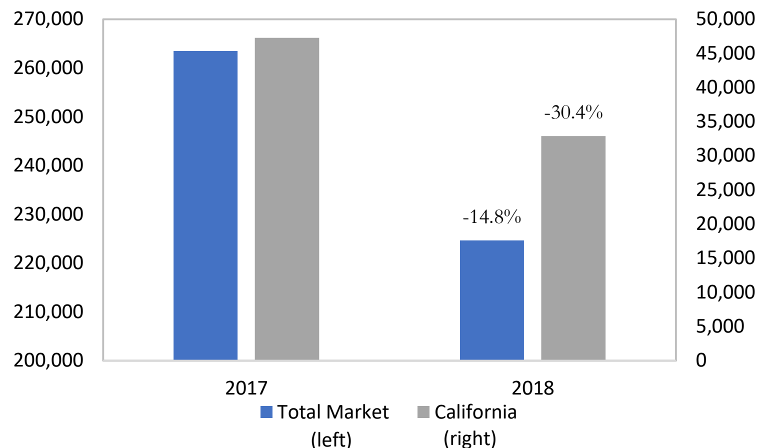
Source: Bloomberg

PUBLIC SECTOR WATCH

CREDIT COMMENTS

- The cap on state and local tax deductions under the Tax Cuts and Jobs Act has stimulated demand for tax-exempt paper, particularly in California where the peak marginal income tax rate is 13.3%. And while investors clamor for bonds, the State and its local governments have pared back issuance. California municipal bond issuance through August 31st is down 30.4% year-over-year, more than double the overall market's 14.8% decline. Some California debt is trading richer than the tax-equivalent yields illustrated in the accompanying table. ***As a result, in-state investors may be able to opportunistically benefit from out-of-state exposure, subject to individual portfolio and tax strategy. This dynamic illustrates the value of customized, active tax-exempt bond management.***
- Despite a large increase in state unfunded pension liabilities in fiscal 2017, ***Moody's indicates that funded ratios should improve in fiscal 2018 and 2019.*** Strong median investment performance of 12.4% and 8.2% in 2017 and 2018, respectively, should translate into declining funding gaps. Moody's also noted that continued economic expansion and strong tax revenue growth have improved states' capacity to service pension costs. Despite these positive developments, we remain wary of underfunded plans lacking a clear and credible commitment to fully funding liabilities.
- On August 20th the SEC announced changes to the municipal securities disclosure rule 15c2-12, creating a requirement for issuers to disclose private placements and bank loans in a timely manner. Coupled with Government Accounting Standards Board's Statement No. 88 requiring disclosure in financial statements for all financial instruments, ***the new SEC requirement is a favorable development that should increase market transparency.*** The amended rule sheds light on a growing area of the municipal market and should improve the ability to analyze risks that in some instances have been difficult to unearth. ***We applaud these developments, as comprehensive assessment of issuer financial obligations remains an important part of our research process.***
- The Treasury Department proposed a rule change on August 24th that would end workarounds passed by states such as Connecticut, New Jersey and New York aimed at allowing taxpayers to make charitable donations outside the limitations of the state and local tax deduction cap. ***Despite potential legal challenges to the Treasury Department rule, we believe these charitable donation programs are not likely to be adopted.*** As noted in previous editions of Review and Outlook, the cap on state and local tax deductions may ultimately reduce the flexibility of certain state and local governments to raise tax revenue.

California is Experiencing a Steeper Drop-off in Supply in 2018 ($Millions)



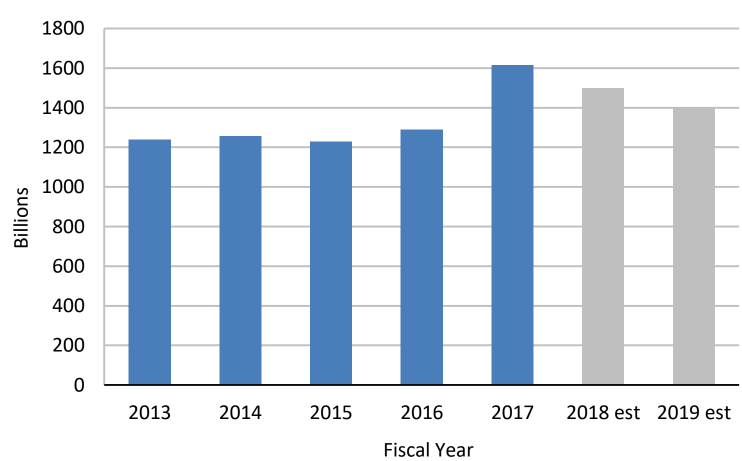
Source: Thomson Reuters

Tax Reform Drives Strong Demand for California Bonds				
Maturity	1yr	3yr	5yr	10yr
AAA MMD Benchmark (9/4/2018)	1.60%	1.81%	2.02%	2.44%
California Equivalent*	1.39%	1.57%	1.75%	2.12%
Required Spread Break-Even (basis points)	21	24	27	32

*Assumes 13.3% top state income tax rate

Source: Thomson Reuters

Strong Investment Returns Should Lower State Adjusted Net Pension Liabilities in 2018 and 2019



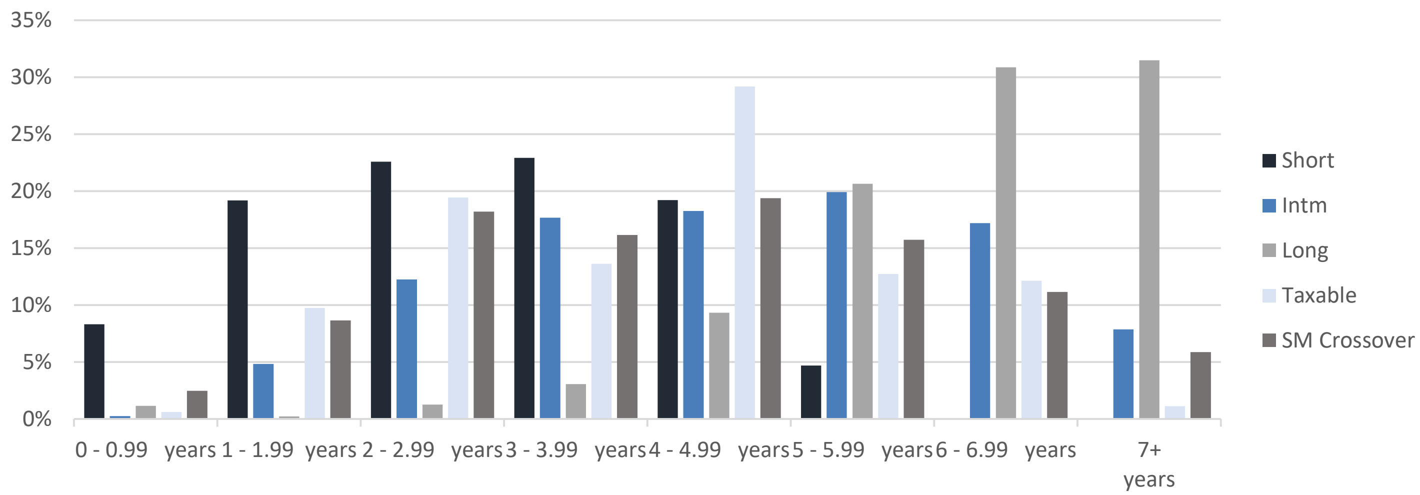
Source: Moody's Investors Service

STRATEGY OVERVIEW

PORTFOLIO POSITIONING (As of 8/31/2018)

	Short Municipal	Intermediate Municipal	Long Duration Municipal	Taxable Fixed Income	Strategic Muni Crossover
Average Modified Duration	2.85 years	4.65 years	6.09 years	3.93 years	4.05 years
Average Maturity	3.21 years	6.32 years	11.36 years	4.47 years	5.16 years
Yield to Worst	1.87%	2.18%	2.54%	3.18%	2.64%
Current Yield	4.33%	4.29%	4.18%	3.79%	4.23%
Average Quality	AA+	AA	AA	AA-	AA-

Duration Exposure by Strategy (as of 8/31/2018)



Source: Investortools Perform, Appleton Partners, Inc.

OUR PHILOSOPHY AND PROCESS

- Our objective is to preserve and grow your clients' capital in a tax efficient manner.
- Dynamic active management and an emphasis on liquidity affords us the flexibility to react to changes in the credit, interest rate and yield curve environments.
- Dissecting the yield curve to target maturity exposure can help us capture value and capitalize on market inefficiencies as rate cycles change.
- Customized separate accounts are structured to meet your clients' evolving tax, liquidity, risk tolerance and other unique needs.
- Intense credit research is applied within the liquid, high investment grade universe.
- Extensive fundamental, technical and economic analysis is utilized in making investment decisions.

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