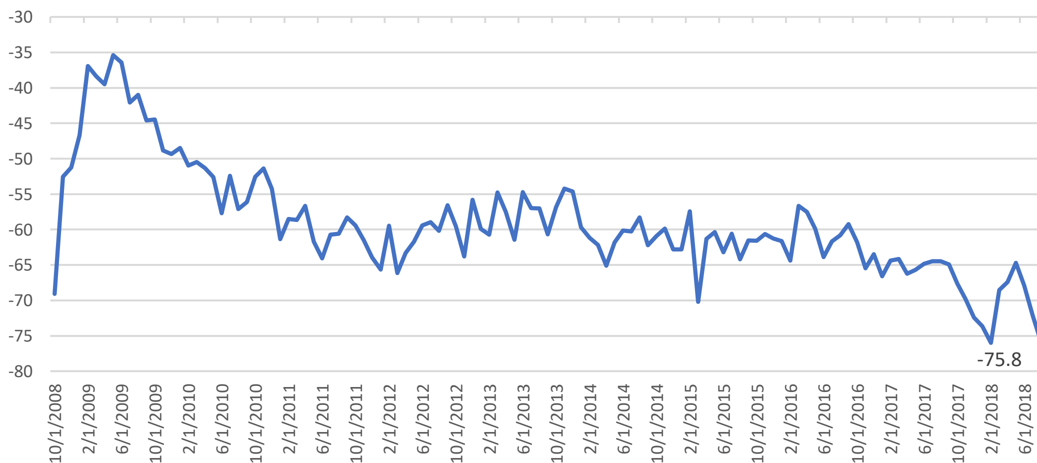
INSIGHTS & OBSERVATIONS

ECONOMIC, PUBLIC POLICY, AND FED DEVELOPMENTS

- ***As expected, the Federal Reserve raised the Fed Funds Rate to a range of 2-2.25% in September and dropped "accommodative" from their assessment of monetary policy.*** The Fed's "dot plot" shows 12 of the 16 officials favor a fourth hike in 2018, and the median projection is for a further three in 2019. This would bring the Fed Funds Rate to a range of 3-3.35%, slightly above the Fed's long-range projection of 3.0%. The odds of a fourth hike in December implied by futures markets now stand at about 71.5%, up from roughly a coin flip at the start of the month.
- That said, while the market has priced in a December hike, ***the inflation picture cooled slightly in September.*** Headline CPI declined from 2.9% to 2.7%, while core fell from 2.4% to 2.2%. Meanwhile, the core PCE deflator, the Fed's preferred inflation measure, came in flat in August, missing expectations for modest 0.1% monthly growth. While year-over-year inflation remains at 2.0%, that rate may start to trend downwards as more robust growth at the start of the trailing year period begins to drop out. ***If this were to happen, we believe the Fed will struggle to raise the Fed Funds Rate the anticipated three times in 2019.***
- ***On September 19th Trump announced the nomination of former Fed economist Nellie Liang to the Federal Reserve board***. This is somewhat of a surprising choice; Liang was the former head of the Division of Financial Stability and has been a staunch defender of both Dodd Frank and the Fed's response to the Great Recession. She is also a registered Democrat. Ms. Liang is an excellent, highly qualified pick; our only concern with her selection is that it furthers the tension between Trump's public criticism of Fed policy, and his nomination of moderates who are likely to continue those policies. ***We see this dynamic as raising the risk of a destabilizing showdown should the economy begin to falter.***
- As usual, it was also a big month for trade news. Despite the Trump Administration's prediction that Chinese negotiations would take a back seat to negotiations with Canada, Chinese trade tensions dominated September. After two weeks of delay, Trump announced tariffs on $200B in goods on the 24th, initially at 10% but stepping up to 25% on January 1st. China responded with $60B in tariffs of their own, as well as cancelling planned trade talks, indicating they would not resume so long as the US continued to threaten further tariffs. ***The delayed step-up in the latest round of tariffs appears to be a tacit acknowledgement that the tariffs are beginning to effect US consumers, and the step-up pushes the impact past the holiday shopping season.*** A widening trade deficit to near-record highs in August provides further evidence that retaliatory tariffs may be impacting the balance of trade and leaves us more confident in our view that GDP growth will slow in Q3.
- Meanwhile, after a month of little incremental news, the Trump administration announced a renegotiated NAFTA, named the United States Mexico Canada Agreement (USMCA), on the 30th. ***Markets rallied on the news, less because of actual changes to the trade pact than in relief that the risk of the US terminating NAFTA was taken off the table.*** The new agreement now heads to Congress for a vote, although one is not likely until early 2019.



The international trade balance measures the difference between the movement of merchandise trade and/or services leaving a country (exports) and entering a country (imports). This measure tracks the value of the merchandise trade balance.

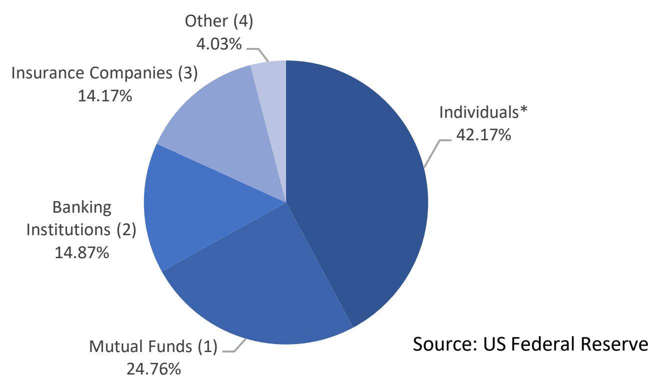
Source: Bloomberg

FROM THE TRADING DESK

MUNICIPAL MARKETS

- ***The municipal market is presenting considerable challenges to investors despite strong overall issuer credit strength.*** Primary issuance is running 14% behind last year's pace. Lack of supply and investors' desire for tax-advantaged yield has kept the credit curve very tight. At month's end, the average spread between AAA and A bonds stood at just 47 basis points. ***Tight risk premiums across the quality spectrum makes credit selection particularly important***, as investors are not being well compensated for taking on greater risk. Furthermore, ***a modest upward shift in the yield curve over the course of 2018 has contributed to more or less flat muni returns.*** With yields drifting up, reinvestment rates should increase, although navigating today's tight market requires research and trading expertise, as well as tactical flexibility.
- ***Who owns municipal securities?*** Households account for 42.2% of muni ownership, with mutual funds the next largest holder, at 24.8%. ***These predominantly retail buyers are supported by a healthy institutional asset base.*** Banks hold 14.9% of outstanding muni issues after selling $26.7 billion YTD. The net selling was largely a result of a decrease in corporate tax rates. P&C Insurance and Life Insurance companies added moderately to their muni holdings over the quarter. The overall muni market now stands at $3.853 trillion, down $92 billion from a 4Q2010 peak of $3.945 trillion. ***As we look at the first three quarters of 2018, it is worth noting that the muni market has weathered major changes in corporate and personal income tax rates well, with aggregate demand remaining strong.***
- ***According to MMA, in the years following the Financial Crisis the number of independent ratings on bond transactions has steadily declined.*** Through 2017, triple-rated (Moody's, S&P, and Fitch) transactions dropped to 34% from 55% in 2007, while dual-rated and single-rated par transactions increased. YTD dual and triple-rated par transactions have declined for the first time, while single-rated par has picked up, growing to 25% of par vs. 21% in 2017. Strong demand, thin supply, compressed spreads, and a search for yield give issuers little incentive to pay for multiple ratings. ***This speaks to the value of independent credit analysis and proprietary ratings.***

Q2 2018 Holders of Municipal Securities

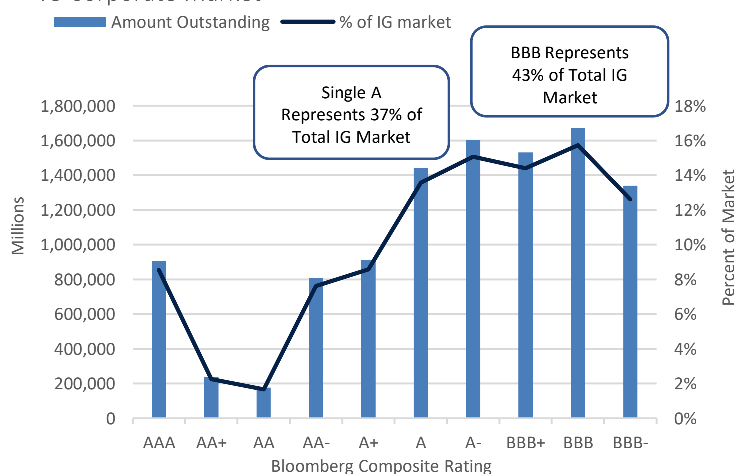


Source: US Federal Reserve

1 Includes mutual funds, money market funds, closed-end funds and exchange traded funds
2 Includes U.S. chartered depository institutions, foreign banking offices in the U.S., banks in U.S. affiliated areas, credit unions, and broker dealers.
3 Includes property-casualty and life insurance companies.
4 Includes nonfinancial corporate business, nonfinancial noncorporate business, state and local governments and retirement funds, government-sponsored enterprises and foreign holders.
* Household holdings is revised up by about $840 billion, on average, from 2004 forward.

TAXABLE MARKETS

- Investment Grade issuance was just over $940 billion on a YTD basis, down 6% vs. 2017. Of that total, $131 billion came to market in September, the largest monthly figure this year. Of note is that 47% of YTD issuance was within the BBB bucket, the first stop above high yield. This is down from last year's 52%, although ***outstanding Investment Grade Corporate debt rated BBB has been steadily rising and now represents 43% of the entire Investment Grade market.*** We see this trend continuing, driven by robust M&A activity and a willingness to add leverage in a low rate environment. While there is slightly higher yield available in the low tier of BBB, we feel the risk premium for going down in credit is quite modest and may prove insufficient in many cases. ***Maintaining high quality can help portfolios better absorb a risk-off environment, as lower tier quality and spread credit deterioration can occur quickly.***

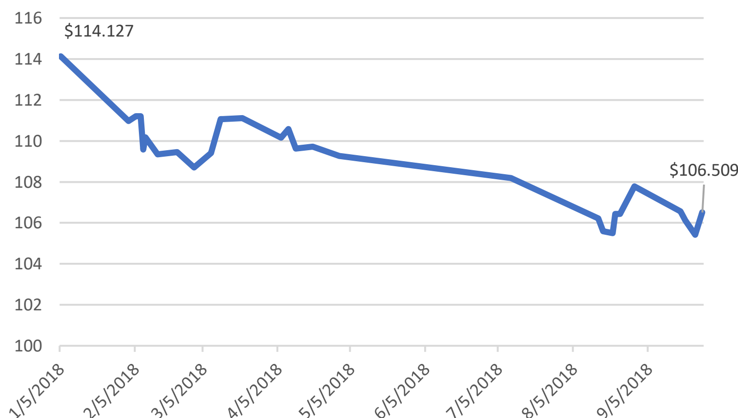


Source: Bloomberg

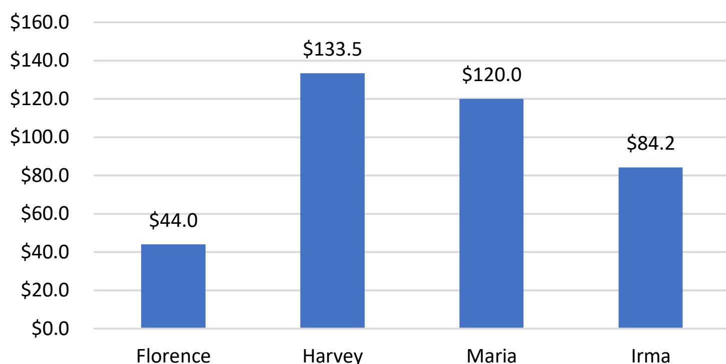
Public Sector Watch

Credit Comments

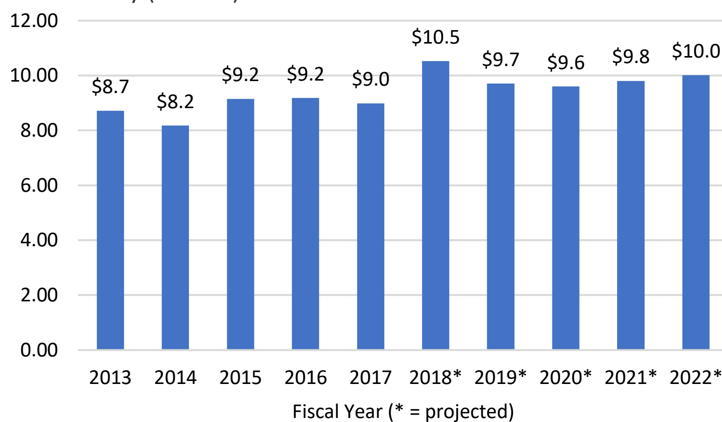
- ***The last remaining U.S. nuclear plant under construction received a green light to continue development, but not without its largest owner agreeing to shoulder a heavier financial burden.*** Co-owners Georgia Power, Municipal Electric Authority of Georgia (MEAG), and Ogelthorpe Power agreed to continue building the Vogtle Nuclear Units 3 and 4, despite $2.1 billion of newly projected cost increases. The plant is now expected to cost $28 billion, double the original estimate. Investor-owned Georgia Power will take on a greater share of potential future expense overruns, while also giving MEAG and Ogelthorpe the option to sell their stakes if certain thresholds are crossed. The plant has been an overhang on public power entity MEAG's credit profile and bond prices. Although the agreement will likely be viewed somewhat favorably, ***MEAG's experience is a reminder of the importance of factoring construction risk into credit analysis. Appleton Partners continues to avoid MEAG bonds, given the financial and legal risks associated with the plant.***



- Hurricane Florence made first landfall near Wilmington, NC on September 14, exposing the Carolinas region to torrential rain, heavy flooding, and dangerously high winds. The ultimate cost may range from $38 - $50 billion, according to Moody's Analytics. The storm's greater impact – loss of life, as well as damage and destruction of homes and businesses – cannot be as easily quantified. ***Despite these daunting figures, we expect most impacted issuers to avoid permanent credit deterioration***, continuing a trend of municipal resiliency in the face of natural disasters. Communities and businesses affected by natural disasters typically receive substantial financial support through state grants, FEMA disaster relief, and insurance proceeds. Over a longer period, rebuilding often serves as a boon to economic activity. ***While public issuers have a history of limiting credit deterioration from natural disasters, our credit assessment continues to factor in the extent to which state and local governments are financially prepared for such events.***



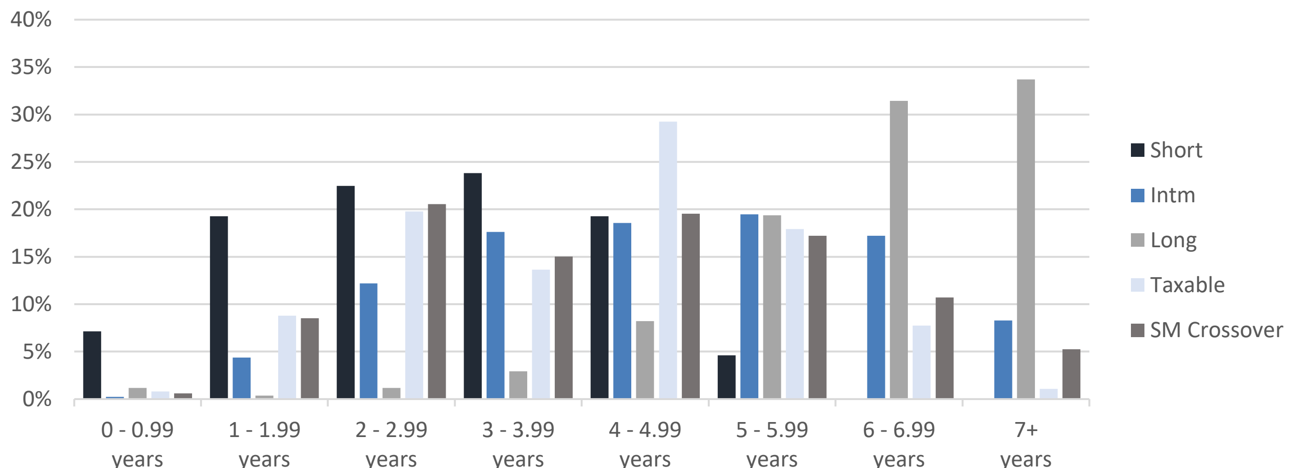
- ***According to Connecticut's Treasurer's office, the State may issue its first income tax-backed bonds as soon as this November.*** As part of the State's final budget approved in November 2017, legislators authorized the treasurer to issue income tax-secured bonds, a financing vehicle that other governmental entities have used successfully. With single-A General Obligation ratings, Connecticut officials are looking to lower overall borrowing costs by offering a higher-rated credit backed by dedicated revenue. Yet to be released details of the potential debt issue will help determine creditworthiness. ***Although we believe dedicated revenue bonds can boost credit quality compared to the sponsoring government's general credit, ultimately the "secured" debt is still linked to economic and fiscal conditions of the underlying entity.***



STRATEGY OVERVIEW

PORTFOLIO POSITIONING (As of 9/30/2018)

	Short Municipal	Intermediate Municipal	Long Duration Municipal	Taxable Fixed Income	Strategic Muni Crossover
Average Modified Duration	2.86 years	4.64 years	6.15 years	3.92 years	4.07 years
Average Maturity	3.23 years	6.36 years	11.78 years	4.45 years	5.17 years
Yield to Worst	2.10%	2.35%	2.72%	3.34%	2.81%
Current Yield	4.34%	4.31%	4.24%	3.81%	4.25%



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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