CIM January 2019 Market Commentary

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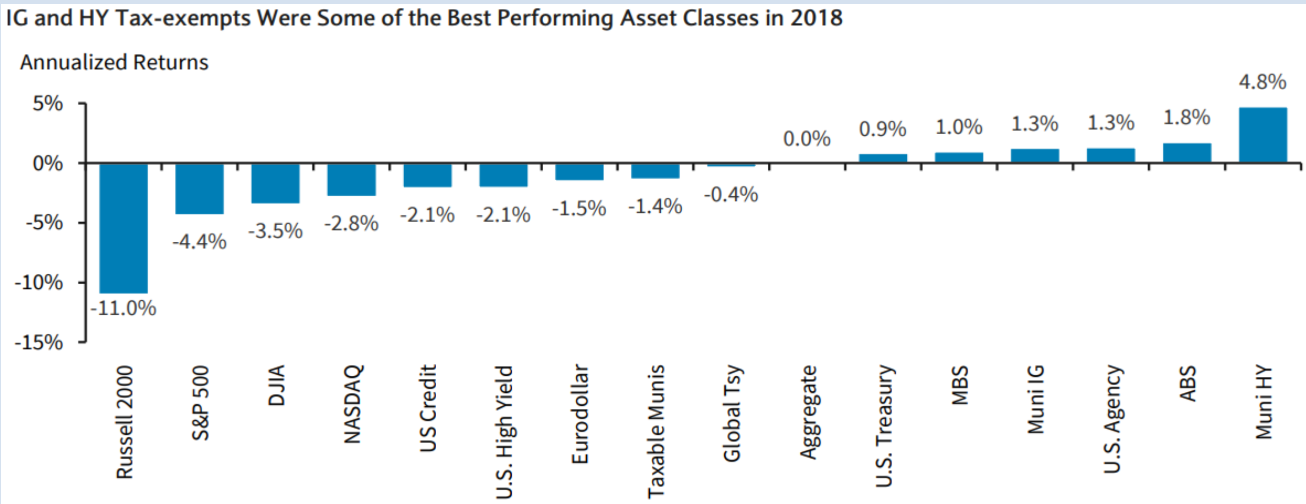
- **It appears the Fed did not fully anticipate the degree to which financial conditions had tightened in response to its consistent increases in short-term interest rates.**
- **European growth is slowing considerably, as evidenced by the contraction in Germany GDP growth in the third quarter**
- **The municipal bond market, once again, delivered some of the strongest absolute returns of any asset class in 2018**
- **Many investors remain dangerously, underweight municipal bonds and fixed income more broadly**.
- **CIM received Informa's *TOP GUNS* award for the seventh consecutive time**.
- **In Q4 18 CIM was selected by both Wells Fargo and UBS for addition to their recommended, single contract, municipal bond manager platforms**.

The significant collapse in global equity prices, during the fourth quarter, caught many by surprise, including the Federal Reserve (Fed). As we touched on in our Q3 18 Market Commentary, it appears the Fed did not fully anticipate the degree to which financial conditions had tightened in response to its consistent increases in short-term interest rates. It also appears the Fed failed to recognize how quickly the positive impulse from tax reform would fade. The Fed's concern was evident in Chairman Jerome Powell's recent reversal of his interest rate outlook. In only a matter of weeks, Powell shifted from his position, in October, where he stated that he believed interest rates were a "long way" from the neutral rate. The neutral or terminal rate is the rate at which economic growth is neither inflationary nor deflationary, while also supporting full employment. In fairness, recognizing when the economy has reached the neutral rate can be very difficult. It couldn't have help matters that, in just a few weeks, the precipitous decline in global and domestic equity markets destroyed trillions of dollars in value, thus provoking a significant increase in fear among market participants, including, perhaps, Chair Powell himself. Powell hastily modified his outlook, stating that US interest rates were now "just below" neutral. Statements such as those made by Chair Powell, made separately over an extended business cycle, are not uncommon. However, Powell's reversal, occurring in a just matter of weeks, raises serious concerns about the trajectory of US economic growth going forward. In spite of palpable market distress, the Fed chose to move forward with yet another 0.25% increase in the Fed Funds rate in December 2018. In the early days of 2019, however, the Fed softened its messaging considerably. Chairman Powell announced, that financial conditions had now tightened materially and may no longer warrant the aggressive path of interest rate increases and quantitative tightening the Federal Open Market Committee (FOMC) was anticipating for the coming year. The Fed's actions support our view, which we shared many times in 2018, that Fed interest rate increases would serve to meaningfully slow economic growth and bring forward the next US recession. The Fed is now on hold for the foreseeable future, in our view. The FOMC may even consider easing financial conditions by cutting interest rates going forward.

Considering that European growth is slowing considerably, as evidenced by the contraction in Germany GDP growth in the third quarter, our concerns for the durability of the current global economic expansion have increased significantly. While some have suggested that the recent German contraction in GDP was a one-time event, we believe it is important to note the -2% decline in German retail sales in January 2019, was among the deepest declines in history. Forecasts for 2019 GDP growth in Asia and the EU have now been revised lower and global, synchronized deterioration in growth is taking hold in our view. Therefore, we believe the recent recovery in US equity prices may prove fleeting and provides investors with an ideal opportunity to de-risk their portfolios in anticipation of, what we expect will be, a much more challenging environment for the economy and equity markets, in particular, going forward.

The municipal bond market, once again, delivered some of the strongest absolute returns of any asset class in 2018, see Figure 1. There were very few, other than ourselves, who believed municipal bonds were well positioned to deliver solid results on a relative basis in 2018.

Figure 1



Source: Bloomberg Barclays Indices, Bloomberg, Barclays Research

Unfortunately, too many investors followed the advice of the numerous strategists who suggested, as they have every year since the Great Recession, interest rates were surely headed significantly higher. While the relative outperformance of the municipal bond market may not seem significant, given how poorly almost every other asset class performed, municipal bonds continued to demonstrate the essential, stabilizing role they play in an investor's broader asset allocation. Many investors remain dangerously, underweight municipal bonds and fixed income more broadly, in our view. Therefore, investors should seriously consider adding to their municipal bond holdings in the near-term before economic growth slows more materially and interest rates fall further.

From a sector perspective, the most glaring opportunity in that exists in the municipal bond market is reflected in the relative richness or extremely low yields of California tax-exempt bonds. We witnessed a meaningful reduction in new issue supply in CA, during 2018, together with very high demand resulting from the loss of State and Local Tax (SALT) deductions, due to tax reform. This has resulted in CA tax-exempt yields declining to a point where yields are more attractive on bonds **outside** the state of CA, on an after-tax basis. Investors, as well as CA residents, can increase the absolute and after-tax yields of their portfolios by selling CA exempt bonds and investing in general market securities with the similar if not lower risk. Given the prohibitive tax regime in CA, this is an extraordinary opportunity. Before the market normalizes, we believe all investors with exposure to CA tax-free bonds should take advantage of this inefficiency.

On the national stage we, believe the current political acrimony that persists in DC, will result in further political gridlock. The upcoming Presidential election will likely add to negative sentiment and will impact consumer confidence going forward. This environment, while not ideal, should prove constructive for holders of municipal bonds. Rising uncertainty, slowing global and domestic growth, together with geopolitical risks, will likely serve to cap any risk of rising rates, thus providing an ideal backdrop for municipal bond outperformance now and in the future. We expect municipal bonds to deliver attractive risk-adjusted returns relative to the broader market in 2019.

Clinton Investment Management (CIM) 2018 Achievements

CIM was, once again, recognized in 2018, by PSN/Informa, as we were among the best municipal bond managers in the country. CIM received Informa's *TOP GUNS* award for the seventh consecutive time. This designation is awarded to municipal bond managers who's returns consistently rank in the top ten out of the over 150 managers that make up the Informa Municipal Bond Manager Universe.

Firm Assets under management grew by over 25% in 2019 now totaling over $570 million.

In Q4 18 CIM was also selected by both Wells Fargo and UBS for addition to their recommended, single contract, municipal bond manager platforms. CIM is one of roughly 25 managers across the country to have earned this distinction. Our municipal bond investment solutions will now be available to over 30,000 financial advisors and their clients across the country.

I want to sincerely thank each of our clients for their ongoing trust and loyalty. We are honored and privileged to serve you. We are deeply grateful for the confidence you have placed in us over the past decade. Please do not hesitate to reach out to me if you should have any questions regarding this commentary or the municipal bond market more broadly.

Best Regards,

Andrew Clinton

CEO

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