Quarterly Muncipal Market Review and Outlook

Q4 2019

CLINTON INVESTMENT MANAGEMENT

The municipal bond market delivered particularly solid performance in 2019, marking the sixth consecutive year of positive total returns. The Bloomberg Barclays Index returned 7.54%, for the year, while Clinton Investment Management's (CIM) Municipal Credit Opportunities and intermediate Market Duration strategies delivered returns of 10.30% and 8.18% net-of-fees, respectively. Our strategy returns were, once again, ranked solidly in the top ten percent of our peer group in 2019, according to PSN/Informais. Our clients benefited meaningfully from our long-held position that US economic growth was likely to slow in 2019. As the ensuing slowdown took hold, it resulted in a bull flattening of the yield curve and ultimately yield curve inversion which forced the Federal Reserve to cut interest rates to ease tightening financial conditions. In our view, the Fed's three, 25 basis point cuts in the Federal Funds rate, are unlikely to arrest the deceleration we witnessed in 2019, both in GDP growth and falling nonfarm payrolls, see Figure 1.

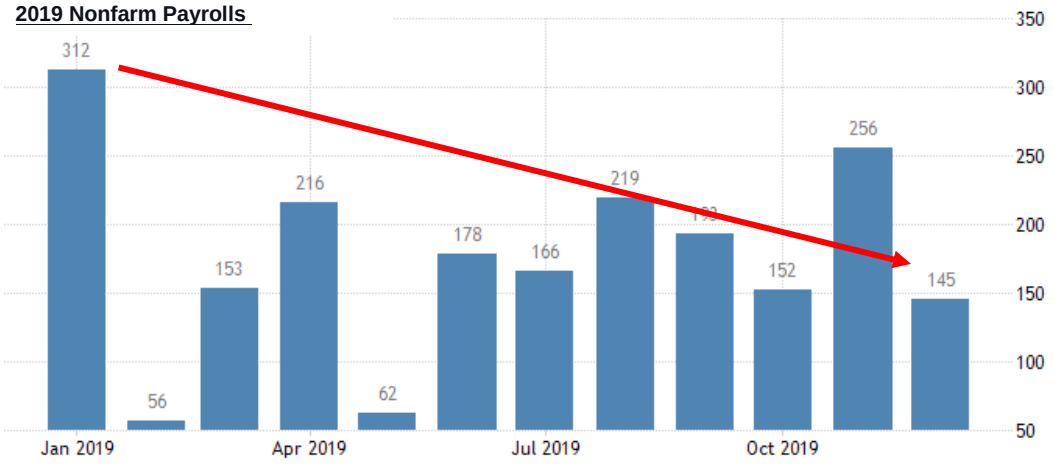

Figure 1

SOURCE: TRADINGECONOMICS.COM | U.S. BUREAU OF LABOR STATISTICS

Our expectation that the yield curve would flatten materially, together with our tactically longer duration position, were both additive to portfolio returns during Q4 and 2019 more broadly. Our clients also benefited from our overweight position in A and BBB rated bonds as credit spreads compressed meaningfully. We continue to believe that the steep slope of the municipal credit curve provides meaningful compensation to investors. We maintained our tactical overweight in lower-rated, investment-grade municipal bonds as they offer attractive yield premiums over the highest quality bonds in our view. This rating segment has also experienced roughly the same frequency of default as AAA-rated securities while offering significantly higher returns over time, according to the Moody's 2018 Municipal Default study.

Almost $100 billion flowed into municipal bond funds in 2019. The flows were driven by record demand from investors who remain under-allocated to the asset class in our view. Wealthy US investors appear to be seeking higher tax-free cash flows, given

SUMMARY

- CIM Muni Credit Opportunities & intermediate Market Duration strategies delivered returns of 10.30% & 8.18% respectively for 2019
- CIM AUM now exceed $805 million. We were awarded PSN/Informais' *Top Gun* designation, for the tenth consecutive quarter
- The fall in shipping volume, year-over-year, was the steepest drop since 2008-2009, the beginning of the credit crisis
- Our tactically longer duration position, was both additive to portfolio returns during Q4 and for the year
- Our outlook for 2020 is based on our fundamental view that global and domestic economic activity continues to moderate

the materially higher taxes they are now paying as a result of the Tax Cut and Jobs Act of 2017. Municipal bond yields fell significantly in 2019 in sympathy with Treasury yields. During the year, ten-year Treasury yields declined by 0.76%, or 76 basis points while muni yields declined by 0.83%, or 83 basis points, according to Refinitiv. The municipal yield curve also flattened by twenty basis points. Long-term bonds out-performed short-term bonds by a significant margin in 2019. Unfortunately, many passive municipal bond investors remain heavily exposed to the shortest maturities and highest rated bonds, both of which delivered the lowest returns within the asset class for the year. Two to four-year municipal bonds returned just 3.67% for the year, according to Bloomberg Barclays.

Our outlook for 2020 is based on our fundamental view that global and domestic economic activity continues to moderate. While there was a good deal of optimism around the lack of escalation in the US trade war with China in the fourth quarter, the resulting "Phase 1" trade deal is unlikely to deliver any meaningful impact on US GDP growth going forward, in our view. The majority of tariffs remain intact, with little likelihood of a "Phase 2" deal in 2020 that would deliver a more positive economic outcome. US GDP growth of 2.1% in 4Q was among the slowest quarterly prints of the year. The declining growth rate is significant in our view as the fourth quarter has historically been one of the strongest for US economic growth. The onset and spread of the Novel Coronavirus (2019-nCoV) in China and across the globe, now reaching pandemic proportions, will undoubtedly weigh heavily on the Chinese economy as well as supply chains and corporate profitability around the world. The fact that the disease is not yet under control and has the potential to spread quickly with grave consequences, will surely weigh on consumer sentiment going forward in our view. The fact that the dramatic proliferation of the disease is happening at a time when the manufacturing sector is already quite weak, only adds to the economic headwinds. In December, before the impact of 2019-nCoV, we saw signs of a significant weakening in shipping and freight activity in the US, see Figure 2.

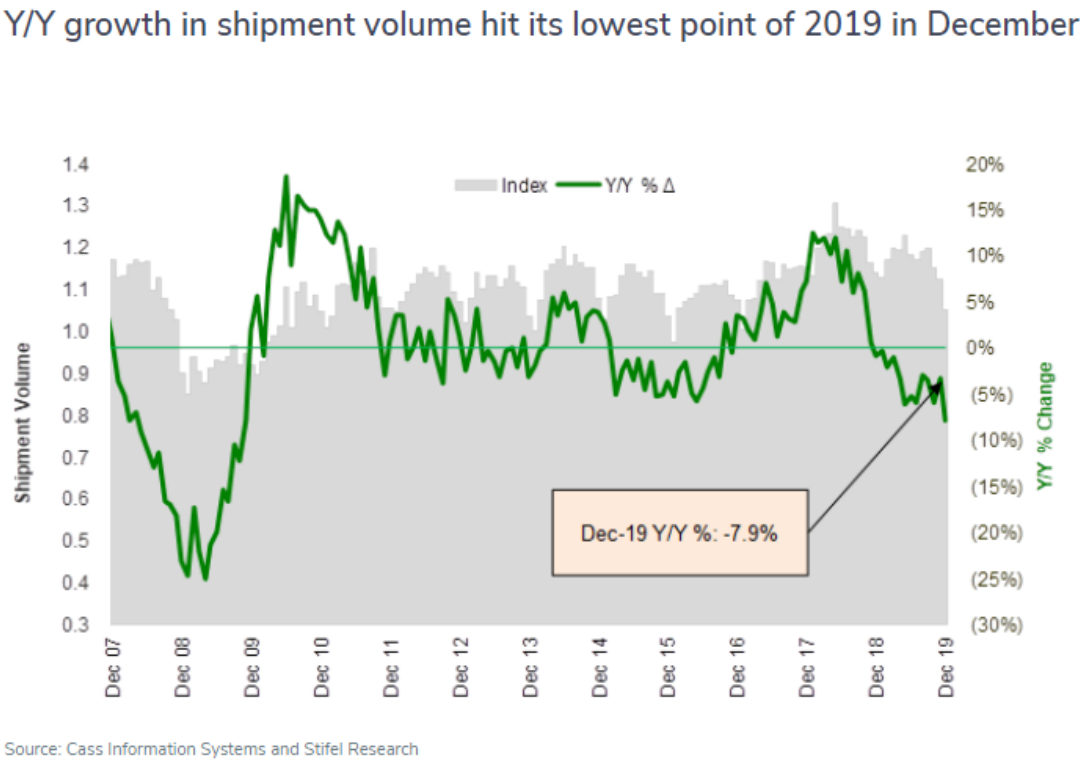

Figure 2

The fall in shipping volume, year-over-year, was the steepest drop since 2008-2009, the beginning of the credit crisis. The current environment raises serious concerns about the longevity of the over ten-year US economic expansion. The risks of a US recession have risen considerably in our view. We, therefore, strongly recommend investors plan accordingly as municipal bonds continue to deliver welcomed stability to investors seeking safety in the face of rising uncertainty.

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CIM UPDATE

CIM grew meaningfully in the past year. In addition to new staff, firm assets under management (AUM) grew by approximately 50% over the last year. Our AUM now exceed $805 million. CIM was once again awarded PSN/Informais' *Top Gun* designation, for the tenth consecutive quarter. Our strategy returns were, once again, ranked among the top ten municipal bond managers, out of the over 150 that make up the PSN/Informais universe.

We would like to sincerely thank each of our clients for their ongoing trust, confidence, and loyalty as they make our success possible.

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