Municipal Market Review

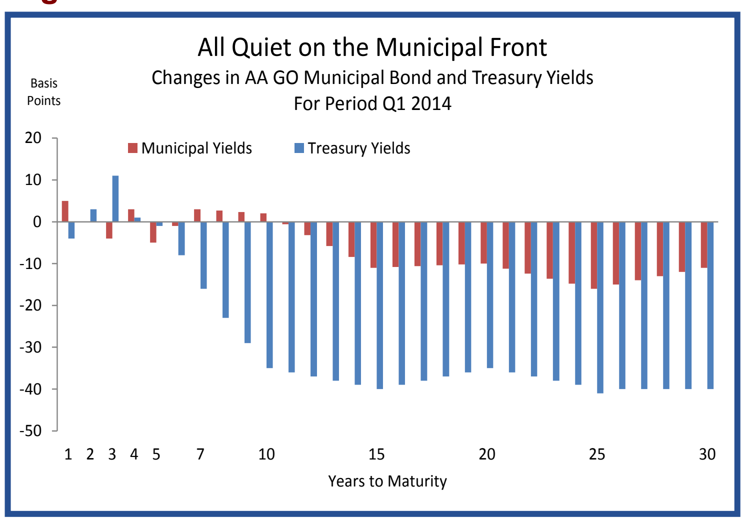
First Quarter 2014

"People are going to be shocked by their tax bills this year. More people will seek out tax-free income, which makes muni bonds more valuable."

Patrick Bittner, Silvercrest Asset Management Group

Municipal bond yields largely held steady for the first quarter of 2014, a continuation of the stabilization that characterized the fourth quarter of last year. The exception to this firming of yields was the longer part of the curve, specifically the 15-to-30 year area which experienced a modest rally. Thus the municipal yield curve experienced a slight bullish flattening as short to intermediate-term yields were essentially unchanged while yields on longer term bonds declined modestly for the quarter. Treasury yields ended the quarter mostly lower across the yield curve, rallying more than municipals especially in the 7-to-30 year range. The slight reshaping of the yield curve is reflected in **Figure 1** which graphs the changes in municipal and treasury yields across the curve for the first quarter of 2014. Municipal relative value ratios mostly increased for the quarter, particularly in the 7-to-30 year area of the curve. Relative value ratios decreased or remained unchanged in the 2-to-5 year section of the curve. Relative value ratios remain above 100 percent for 1-2 year and 10-30 year maturities, and in the 80s to 90s for the 3-7 year segment.

Fig 1



Municipals started the year off strongly in January, driven by favorable technicals including increased demand after traditional year-end tax selling and low issuance. For the rest of the quarter, the market's technical backdrop continued to be supported by limited supply. The just under $60 billion of issuance for the quarter was the lowest since the second quarter of

2011. Through the end of March, municipal bonds had returned **3.3 percent**, according to the Barclays Municipal Bond Index, a **strong rebound** from last year's performance, in which the index dropped 2.6 percent. The municipal performance rally in the first quarter can be credited to declining interest rates throughout the fixed-income sector, the realization of higher tax rates kicking in, and fear diminishing over Detroit and Puerto Rico. In addition, the recent weak employment reports that were attributed partly to the harsh winter have eased concerns of a faster tapering by the Fed.

So far in 2014 the market has weathered and recovered from last year's storm of Federal Reserve tapering, Detroit's bankruptcy filing and Puerto Rico's financial troubles. Investor fear that trouble in these headline-grabbing areas would spread into the larger $3.7 trillion municipal market have mostly subsided. For the first two months of the year, investor flows into municipal -bond funds have exceeded $2 billion according to Lipper fund data. This **positive inflow** is noteworthy, as it reverses the 10 consecutive monthly outflows that characterized most of 2013, outflows that came to symbolize the anxiety of many investors in the market. Last year's exodus culminated with nearly $10 billion flowing out of municipal bond funds in December, capping off a year in which $57 billion was pulled from municipal bond funds. The *Wall Street Journal* reported in early March that the budget outlook for many states and cities has been bolstered by reduced spending and higher-than-expected tax revenue, mostly due to improving economic conditions. This cutback in spending has helped municipals in that there is less of a need to float new issues, leading to a more favorable supply-demand dynamic in the market. Tax collections have grown for 16 straight quarters, according to the Nelson A. Rockefeller Institute of Government. Also, Moody's has revised its broad 2014 outlook for U.S. local governments to stable from negative as housing markets recover and fund balances remain steady. Additionally, this quarter saw good news on the bond insurance front. Assured Guaranty and National Public Finance (formerly MBIA) both saw their ratings upgraded by Standard & Poor's. The emergence of stronger municipal bond insurers certainly bodes well for the market and investors. We see municipals as an asset class where the majority of issuers still boast a solid credit profile and where offered prices are cheaper following last year's major sell-off.

In mid-February, Fitch joined S&P and Moody's as the third major rating agency to downgrade Puerto Rico's debt to junk status. It has been our view that Detroit and Puerto Rico are isolated cases that are in no way indicative of the vast, uniquely fragmented, and largely healthy municipal market. The downgrade certainly made big waves considering that the U.S. commonwealth's debt is held in about 70 percent of municipal mutual funds. While having roughly the same population as Connecticut, the territory enjoys an outsized role in the market. A big part of the allure of Puerto Rico bonds is that they are exempt from federal and state income tax, no matter where a bondholder lives. The island has outstanding debt of roughly $50 billion and its economy is struggling amidst an eight-year recession. Astute money managers already regarded Puerto Rico's bonds as junk before the ratings agencies made it official, and the market largely priced them as such. Puerto Rico bought itself some time to rebuild with a $3.5 billion general obligation offering on March 11 of this year, which was the largest sale of junk bonds in municipal market history. There was tremendous demand for the high-yield bonds, with $16 billion worth of orders submitted. The deal was structured as a single term bond with a 2035 maturity and a sinking fund beginning in 2021, meaning that the territory will have some time to get fiscally responsible before making significant payments on the bonds. Essentially the deal can be seen as Puerto Rican officials kicking the can down the road, as the island still must confront a very heavy debt burden.

As tax paperwork is filed for 2013, investors will certainly appreciate the value of the tax-free status of municipal bond income as federal tax increases that went into effect last year are felt. Indeed, municipal bonds have gained appeal in 2014 as the highest federal tax rates in more than a decade take effect. As you may recall, the top marginal income tax rate increased from **35 percent** to **39.6 percent** for families with taxable income over $450,000 and single filers over $400,000. As we have discussed before, as marginal tax rates increase, so too does the **value of the tax exemption** of municipal bonds. Top earners will in fact face a **43.4 percent** tax rate that includes a newly mandated **3.8 percent Affordable Care healthcare surtax,** a tax, importantly, from which municipal bond income will be exempt. As an example, let's take a municipal bond that yields 3.00 percent on a pre-tax basis. Applying the 2012 maximum tax rate of 35 percent, that is equivalent to a 4.62 percent taxable bond. But when you apply the new 2013 maximum rate of 43.4 percent, the taxable-equivalent rate leaps to 5.30 percent. It is not often the case when an investor receives an added benefit while avoiding additional risk, but that is the situation here, thanks to rising tax rates.

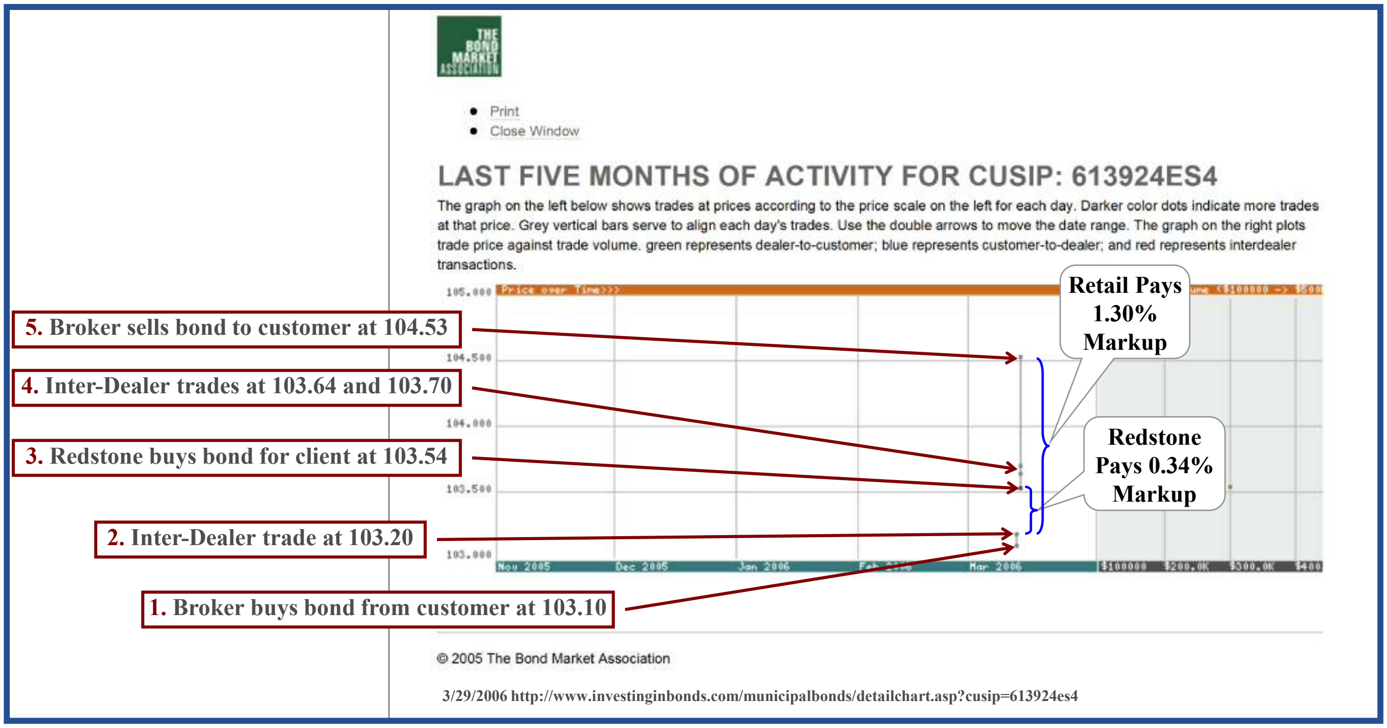
Moreover, due to the phase out of itemized deductions for singles making over $250,000 and couples making over $300,000, people in lower tax brackets will see their **effective tax rate rise** as they are allowed fewer deductions, increasing their level of taxable income. This means that for these people, even though their marginal tax rates did not go up, the actual amount of taxes they pay will. And because municipal bonds are not affected by this phase out of deductions, municipal bonds can help these investors keep more of their income.

In addition to higher marginal tax rates, the tax rate on capital gains and dividends increased from **15 percent** to **20 percent** for those in the new top tax bracket. Importantly to note, the Affordable Care healthcare (Obamacare) surtax of **3.8 percent** will also apply to capital gains, and will be levied on capital gains and dividends for those with incomes greater than $250,000 for families and $200,000 for individuals. Therefore, families with incomes between $250,000 and $450,000 ($200,000 and $400,000 for individuals) will pay a combined capital gains tax rate of 18.8 percent, and for those in the top marginal tax bracket, it rises from **15 percent** to **23.8 percent**, an increase of **59 percent**. This will clearly have an impact on an investor's decision regarding their choice of an income source as dividend income has become significantly more expensive on an after-tax basis, particularly as compared to tax-exempt municipal bond income. Simply put, with tax rates at these elevated levels, there is no fixed-income alternative with similar opportunity to offer investors such attractive after-tax income. When you combine federal and state taxes, numerous investors are **crossing the 50 percent threshold**, especially residents in high-tax states. In this environment, we believe the intrinsic value of municipal bonds is as appealing as ever. The intrinsic value of their tax advantage and overall safety, compared with stocks and other assets, nearly always make them a prudent and appropriate investment for individuals.

The largest factor on municipal bond prices in the foreseeable future arguably remains the actions of the Federal Reserve. New Fed Chairwoman Janet Yellen rattled some nerves in the bond market on March 19 after stating that the fed funds rate, near zero since 2008, could potentially be increased about six months after the Fed ceases buying bonds. That would be a little sooner than most investors were expecting. However it should be noted that in its official policy statement, the Fed said it planned to keep short-term rates below what it sees as appropriate for a normal economy even after the unemployment rate and inflation revert to normal levels. Moreover, on March 31, Yellen backtracked from her seemingly hawkish statements. She stressed that the Fed *"remains committed to providing extraordinary support for the economy for some time to come."* The market saw this latter speech as reassurance that the Fed would not be tightening monetary policy earlier than forecast or anytime soon. Regarding Fed policy, we would like to point out that municipal bond yields historically have not been highly sensitive to fed funds moves. Looking back at five periods between 1983 and 2006 when the fed funds rate was raised, the change in high-grade municipal yields was comparably much less. Considering a falling yet still elevated unemployment rate that depicts plenty of slack remaining in the job market, the Fed still pouring in billions of dollars in stimulus each month, and stagnant wage growth, we remain skeptical of the general consensus among market prognosticators and analysts that the 30 year bull market in bonds is over and that a new secular period of rising rates is dawning upon us.

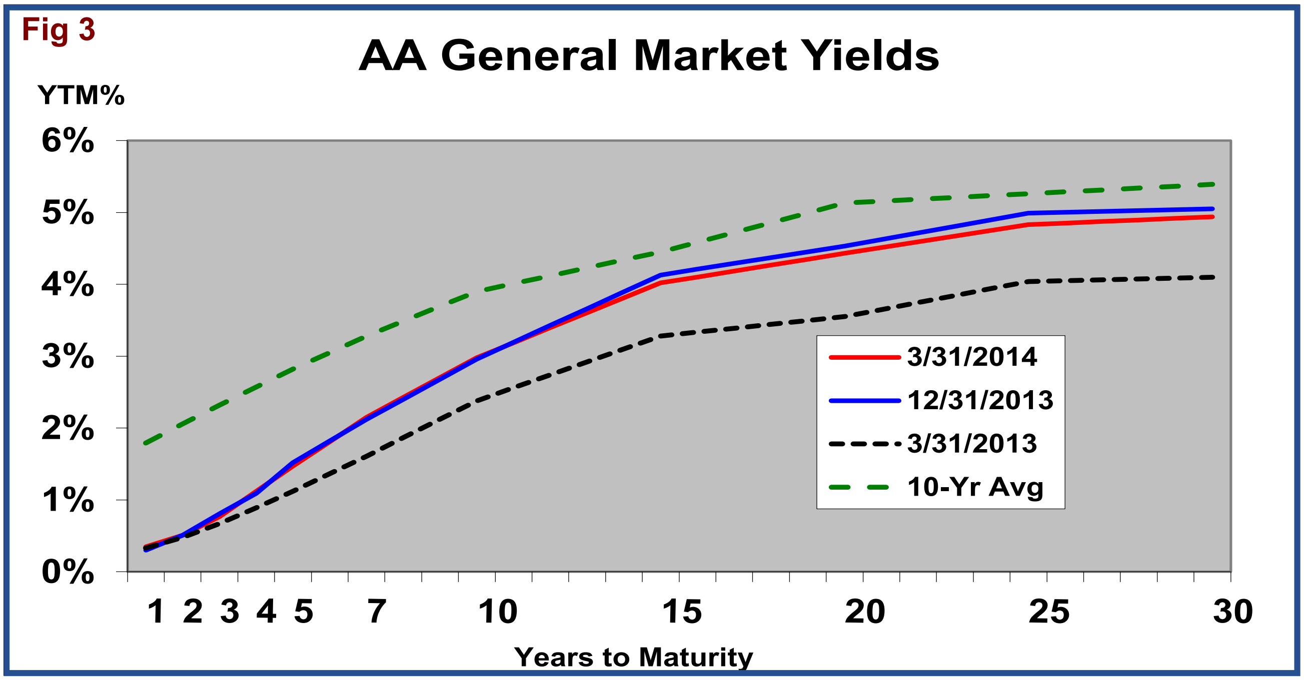
A March 11 front page *Wall Street Journal* article titled Muni Bond Costs Hit Investors In Wallet certainly grabbed the attention of municipal bond investors. The gist of the article is that municipal bond investors are paying roughly twice as much in trading commissions as they would for corporate bonds. We have discussed this issue before in our market reviews as you may recall. Most recently, in first quarter of last year we described how municipal bonds trade in an over-the-counter (OTC) market, and as such a single visible price does not exist for municipal bonds. Trading takes place directly between two parties with prices determined on a negotiated basis. Therefore, the broker-dealer does not charge a "called-out commission", instead the broker/dealer marks up the price of the bond offered for sale. This markup in bonds prices is one of the costly "unknown unknowns" to the individual investor. The investor simply does not know how much they are paying in the markup of the price of a bond issue, and hence how much purchased yield they are permanently losing. Markups, or the difference between the dealer cost and the offered price of the bond, represent the dealer's "profit" on the trade. As the WSJ article alludes to, **markups of 2 to 5 percent** on municipal bonds are common, often because bonds are marked up or **"stepped on"** multiple times in interdealer trades before finally being sold into a portfolio. At Redstone, we actively manage the dealer markup, striving to reduce the markup paid to less than **0.50 percent**. The municipal market is fragmented and inefficient, and relationships with specialty regional broker/dealers like Redstone has are

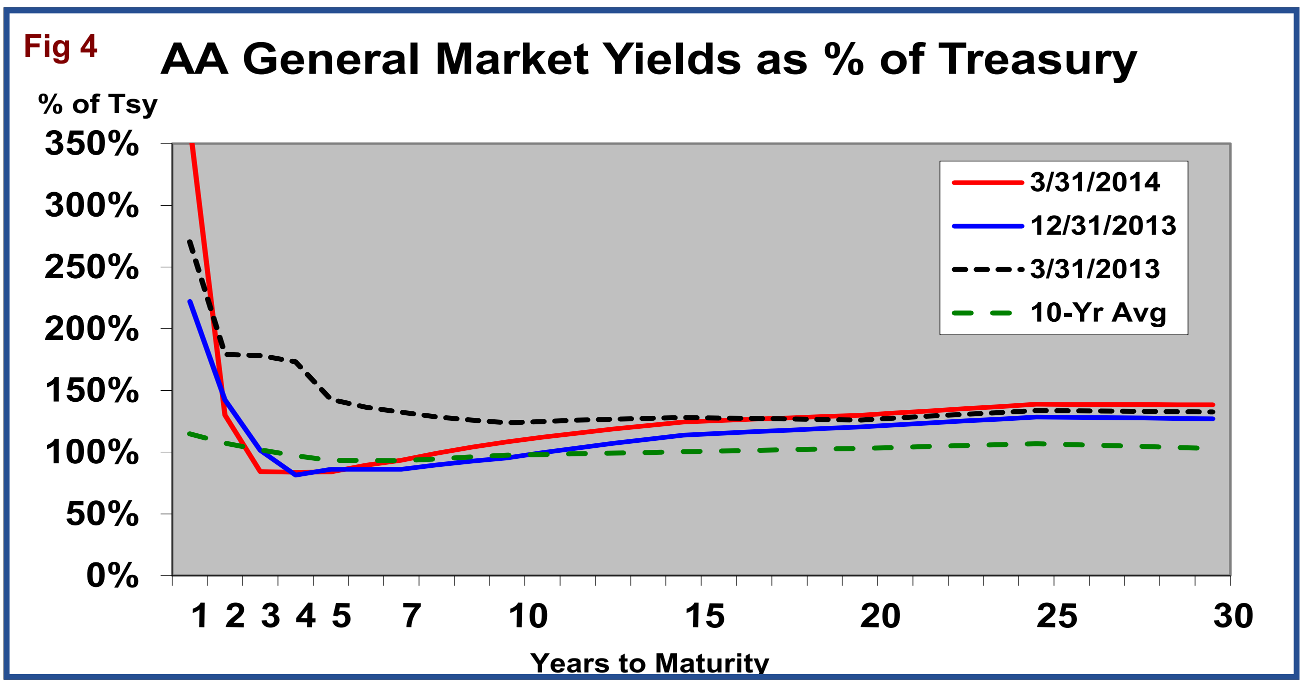
Fig 2



paramount. The benefit of having Redstone's active management on your side is illustrated in **Figure 2**. Bottom line, at Redstone, we are able to execute at better prices and we won't be "stepped on".

While conditions in municipalities across the United States generally continue to improve, given the size, fragmentation and complexity of the municipal bond market, sound management remains as important as ever. With the number of different issuers growing to over 90,000, each with a unique credit profile coupled with the proliferation of increasingly complex structures, we believe investors will benefit from the 25+ years of fixed income management experience and municipal bond expertise that Redstone Advisors can offer. Our mission remains the same: preserving client wealth and building par value by maximizing after tax return while minimizing volatility. One should not underestimate the power of a strong tax advantage, and that is why we recommend investors look to municipal bonds for their lower relative volatility, high quality income stream and mandatory and consistent cash flows, the very traits that make them the gold standard for building par value and preserving wealth.





	10 Yr Avg	12/31/2013	3/31/2014
2-Year AA Municipal	107%	143%	130%
5-Year AA Municipal	93%	86%	84%
10-Year AA Municipal	97%	95%	108%
25-Year AA Municipal	106%	128%	