Redstone Advisors

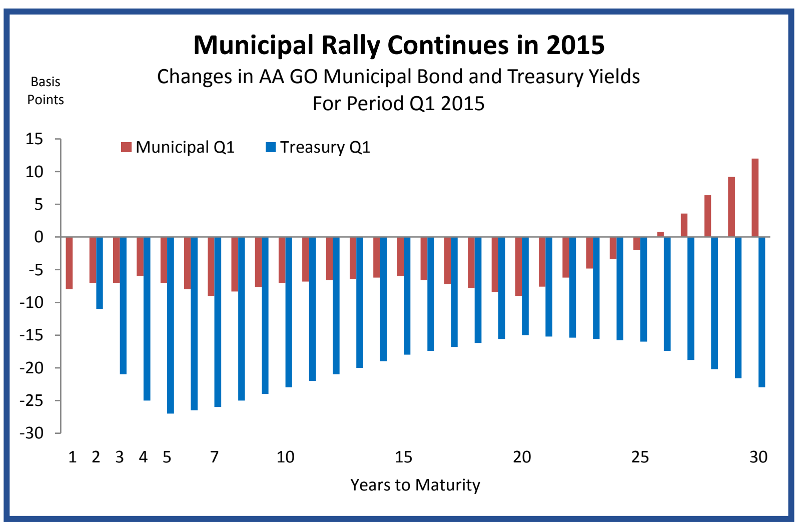
Municipal Market Review

First Quarter 2015

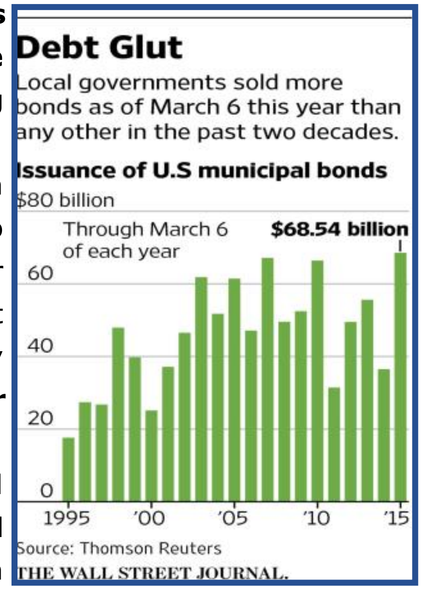
"It makes munis very appealing because the benefit of tax exemption hasn't been any stronger than it is today."

Alan Schankel, Janney Capital   arkets

Municipal bond yields largely held steady for the first quarter of 2015, as a result, municipal bond returns took a breather from the robust 9.8% gain that occurred last year. The Bank of America Merrill Lynch Municipal Index rose 1.1% for the quarter, a respectable gain that **continues the streak of quarterly advances** we saw throughout 2014. Yields modestly declined a few basis points evenly along most of the yield curve. The average decline was 7 basis points in the 1-to-20 year range of the yield curve. The exception was at the long end, where the yield of the 30 year bond increased 12 basis points. Treasury yields ended the quarter lower across the yield curve as well, rallying more than municipals. Treasuries in the 2-to-30 year range rallied on average 21 basis points for the quarter. 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 2015. Municipal relative value ratios increased over the entire yield curve except for the 1 year maturity at the very short end. **Relative value ratios remain attractive**, with ratios above 100 percent for 1-2 year and 7-30 year maturities, and in the mid-90s for the 3-5 year segment.



With interest rates hovering just above five-decade lows, a surge of new issuance by cities, states and other government entities has flooded the municipal market. **First quarter issuance was the highest since 2010**. These issuers have sold $102.5 billion in bonds through the end of March, an impressive 59% increase over the first quarter of 2014, when issuance was $64.5 billion. **Many municipalities have taken advantage of historically low yields to refinance outstanding debt, reducing interest payments and strengthening their fiscal health**. While gross new supply has increased remarkably over last year, the net increase in issuance has been much more manageable. The majority of the increase in gross supply is due to the refunding of existing bonds. Refundings swap out existing debt for new debt, leaving outstanding supply unchanged while lowering interest costs. Moreover, the new supply that has come to market has typically been multiple times oversubscribed, indicating **strong ongoing investor demand**. Demand, which increased in 2014, remains strong in 2015 as investors have poured over $10 billion into municipal mutual funds through the middle of March. **Figure 2** shows how municipal borrowers have issued more bonds through March 6 of this year than any previous year going back to 1995.



We believe there are compelling reasons for investors to favor municipal bonds in 2015. One, municipals continue to be attractive on a tax-adjusted basis. Recall that the **top federal tax rate, 39.6 percent, is the highest since 2000**. Two, relative value to Treasuries remains at a favorably high level. In fact, **municipal bonds are the cheapest compared with Treasuries since April 2013**. Three, issuers' credit quality continues to be mostly positive. Creditworthiness among state and local issuers of municipal debt has continued on a path of steady improvement. **State revenues have risen in sixteen of the last eighteen quarters**. Meanwhile, states' spending generally remains prudent. The National Association of State Budget Officers (NASBO) projects Fiscal Year 2015 general fund spending will rise a modest 3.1% from Fiscal Year 2014. Overall, state balance sheets are in solid shape, budgets have been balanced and passed on time, and quite a few states have been able to replenish rainy day funds. Defaults are on track to be at their lowest level in three years. Yet even as most states have exceeded pre-recession revenue levels, it should not be ignored that some municipal budgets will remain under pressure as state and local governments grapple with the long-term obligations of pension funding and retiree health care costs.

One of the headwinds facing a few municipal bond issuers in 2015 are pensions. Now that municipalities have largely gotten their short-term fiscal house in order, focus has turned to longer-term obligations, the most significant of which are pensions. Illinois is a state of particular concern; it has the biggest pension funding shortfall in the nation at $111 billion. The Illinois State Supreme

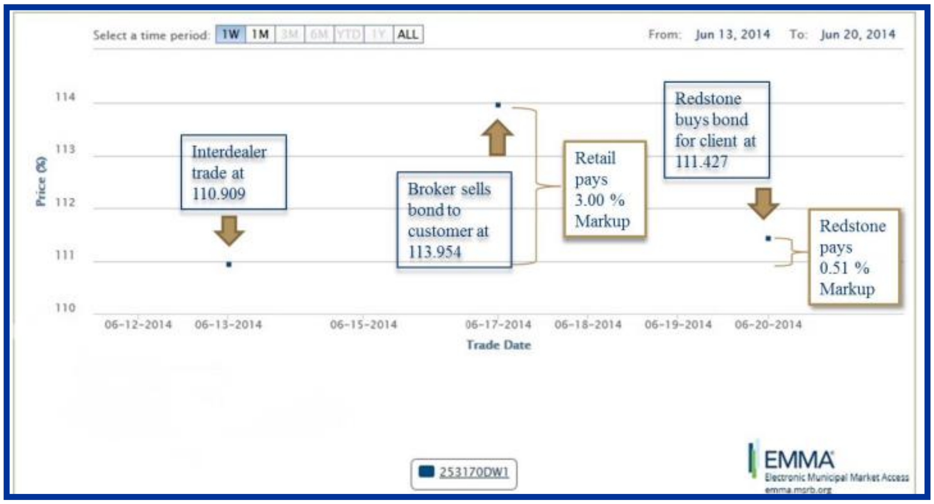
Court is currently hearing an appeal of a 2014 lower-court ruling that the state's fix of its pension system was unconstitutional. If that ruling is upheld, it could put downward pressure on the state's credit ratings, possibly moving Illinois down into the BBB category. New Jersey is on the radar as well, as the continuing underfunding of pensions remains an issue there. Lowering long-term liabilities could have the effect of freeing up funding for long overdue and much needed infrastructure projects. On the brighter side, New York and California have both seen positive ratings momentum. These two states have been bolstered by healthy economies, better fiscal governance, and an improved financial position.

A significant factor and likely driver of municipal bond prices for the rest of 2015 is the actions of the Federal Reserve. As many expected, the Fed dropped the word **"patient"** from its Federal Open Market Committee (FOMC) statement in mid-March, replacing it with language that says current interest rate policy **"remains appropriate".** Many analysts and money managers believe the central bank is on track for either a September or December rate hike, with a slight majority on Wall Street thinking it won't happen until December. Dropping "patient" from the statement doesn't necessarily imply an interest rate hike will occur later this year, particularly because numerous other economic indicators in the last couple of months have been weaker than expected. Yellen herself said in a press conference after the FOMC statement was released that *"just because we removed the word 'patient' doesn't mean we're going to be impatient."* The Fed has taken note of this **recent weaker data, downgrading the pace of activity from "solid" to "moderated".** In addition, they continue to expect inflation weakness to be transitory. Removing the pledge to be "patient" does mark a shift away from the explicit forward guidance on the path of monetary policy that the Fed has used since late 2008 to keep longer-term borrowing costs low. The Fed will now set policy at each meeting based on the latest economic data, making its actions a little less predictable. The Fed said it will be appropriate to tighten *"when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term."* Yellen has the unenviable task of preparing for an exit from the **most aggressive easing in the Fed's 100-year history** as the job market slowly recovers from the damage wrought by the Great Recession. At the same time, the Fed must contend with inflation and wage growth that remain too low and are giving Yellen reasons for caution. Low inflation and stagnant wage growth imply that there's more slack left in the economy than the official government unemployment rate of 5.5% would suggest. Prices as measured by the Fed's preferred gauge rose just 0.2 percent in January from a year earlier, and inflation has languished below the central bank's 2 percent goal for 33 straight months. We would like to remind our readers that **municipal bond yields historically have not been highly sensitive to fed funds moves**.

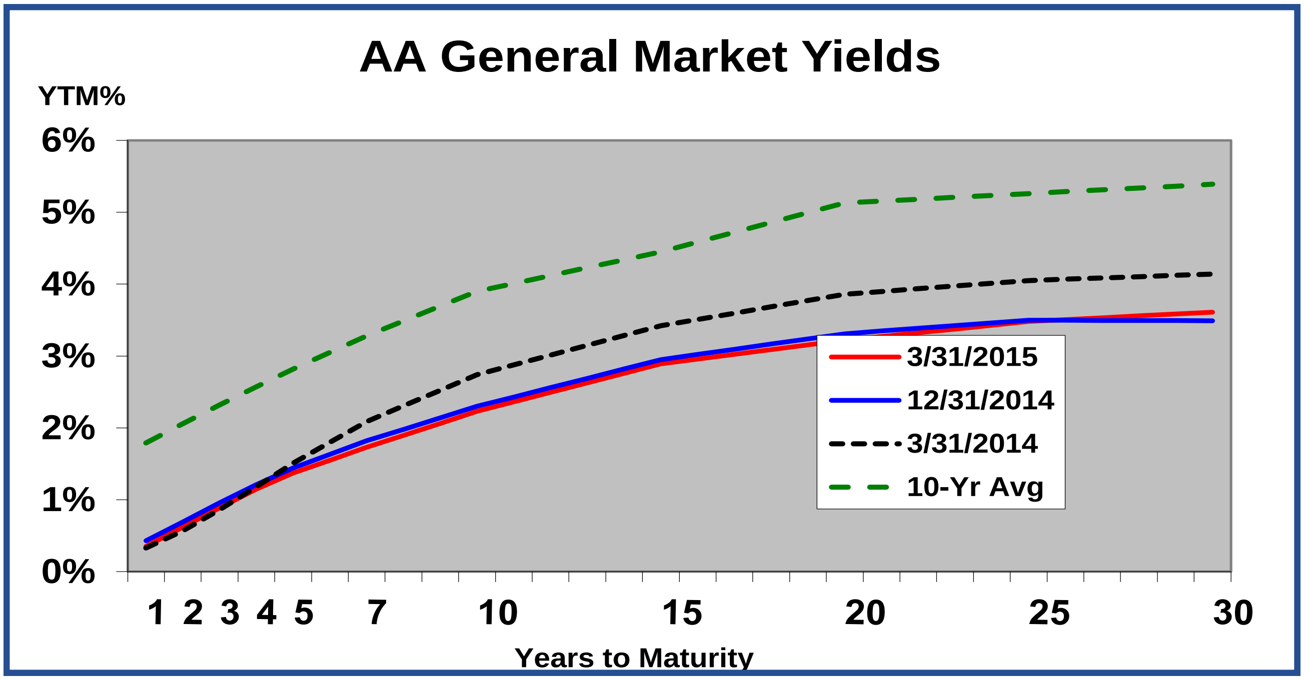
Looking back at five periods between 1983 and 2006 when the fed funds rate was raised, the change in high-grade municipal yields was comparably much less than the change in taxable bonds.

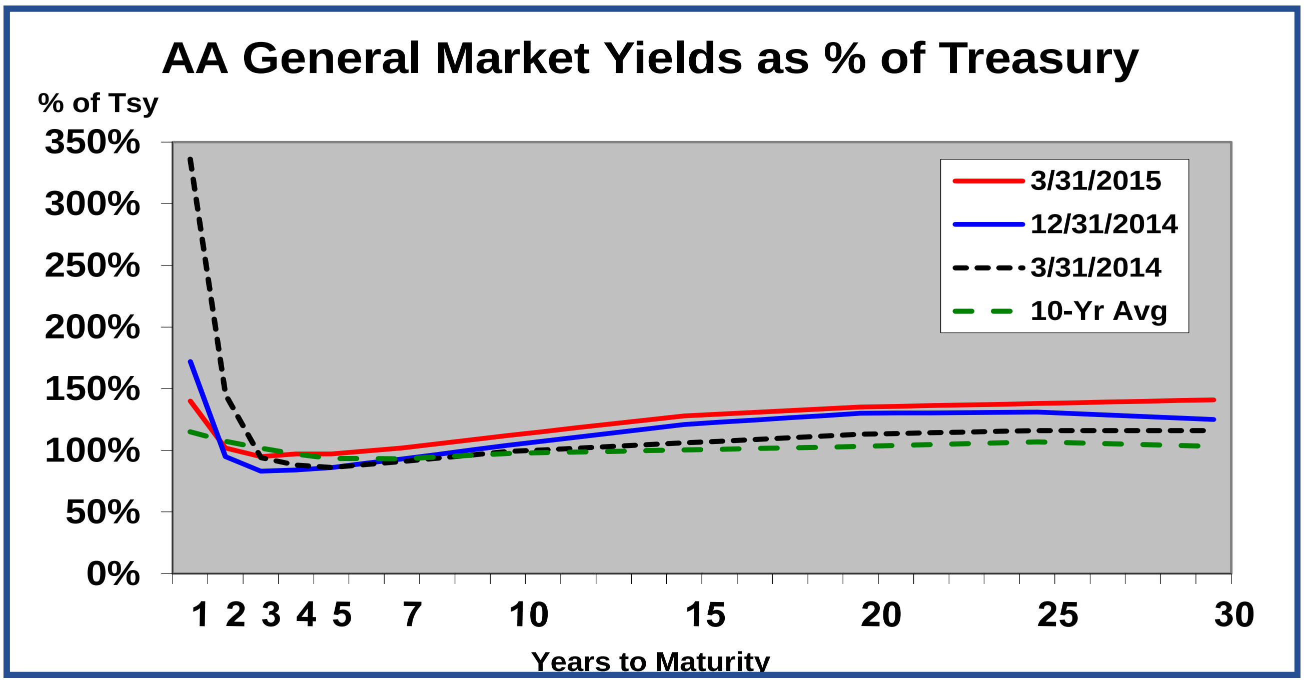
The Federal Reserve is in the process of working to identify municipal bonds that could be classified as high-quality liquid assets (HQLA) under rules requiring banks to maintain liquidity coverage ratios (LCR), Fed chairwoman Janet Yellen told members of a House committee in late February. Some House members have urged the Fed to reconsider excluding municipals as HQLA under rules that require large financial institutions to maintain minimum liquidity coverage ratios so they can be better equipped to deal with financial stress. Assets would qualify as HQLA if they could be easily and quickly convertible to cash with little or no loss of value during a period of liquidity stress. Cities and states have complained for months that this rule, which is designed to make big banks safer, will in fact prompt a Wall Street exodus from the municipal bond market. While the Fed and Ms. Yellen have indicated they are open to making changes, two key regulators are standing in the way. The Federal Deposit Insurance Corp. (FDIC) and the Office of the Comptroller of the Currency (OCC) remain unconvinced of the need to classify municipals as HQLA according to sources involved in the negotiation. The largest U.S. banks account for about twelve percent of investments in the $3.7 trillion municipal bond market. As such, politicians and industry analysts are concerned that unless the rule is revised, it will become more expensive to finance municipal projects. James McIntire, the treasurer of Washington state, argued that, " *o drive up the cost of our debt issuance for no quantifiable reason would be a mistake."* U.S. Senator Charles Schumer has been an outspoken critic of the decision regulators made. At a September hearing last year, the Senator told representatives from the Fed, FDIC and OCC that the rule would undermine ***"the lifeblood of development in this country."*** He reasoned that ***"many municipal bonds are highly liquid and they should count as such."*** Other proponents have made the point that borrowers in the muni market typically default less frequently than corporate issuers. Bottom line, this rule, which banks must fully comply with by 2017, cannot be changed without the FDIC and OCC's consent.

As we have discussed in previous market reviews, we are now firmly in the era of credit discovery in the municipal market. The financial crisis dramatically changed this vast $3.7 trillion dollar market with over 60,000 unique issuers from a Treasury-centric market—with widespread use of insurance—into a credit market. Today, municipal bonds trade to the strength of their underlying creditworthiness, making active management and credit due diligence much more important. Limited liquidity, reduced dealer inventories and higher transaction costs underscore the need for experienced active management. Skilled active managers can quickly take advantage of inefficiencies in the muni market that can arise from Federal Reserve decisions or negative headlines. Compared with more efficient markets where most of the information is "priced in", municipal bonds can offer a real competitive edge to full time municipal bond managers who do their research and nurture a wide network of industry contacts. Munis trade in an over-the-counter (OTC) market, and as such a single visible price does not exist for these 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 bond prices in one of the costly "unknown unknowns" to the individual investor. Markups, or the difference between the dealer cost and the offered price of the bond, represent the dealer's "profit" on the trade. A 2014 Wall Street Journal article detailed how markups of 2 to 5 percent on municipal bonds are common. At Redstone, we actively manage the dealer markup, striving to reduce the markup paid to about 0.50 percent or less. The advantage of having Redstone's active management on your side is illustrated in **Figure 3**. One can see how an unfortunate retail customer paid an egregious 3 percent markup on a Dickinson County, KS bond while Redstone was able to purchase the same bond for our client at only a 0.51 percent markup. Bottom line, we are able to execute at better prices and we won't be "stepped on".



Redstone Advisors, with our 25+ years of municipal bond experience and personalized separate account management, believe we are uniquely qualified to provide wealth preservation and build par value by maximizing after-tax return while minimizing volatility. As it is April and tax season, we believe the increased after-tax benefit of municipal bonds will be very clear and welcoming for investors in this current climate of high federal tax rates. Recall that an Internal Revenue Service report found that the **majority of individuals who earned at least $200,000 in 2009 and did not pay any federal taxes cited tax-exempt interest as the most important reason** why. One should not underestimate the power of a strong tax advantage, and that is why we recommend investors looks to municipal bonds for their tremendous relative value, high quality income stream and consistent cash flows.





	10 Yr Avg	12/31/2014	3/31/2015
2-Year AA Municipal	107%	95%	102%
5-Year AA Municipal	93%	86%	97%
10-Year AA Municipal	97%	104%	112%
25-Year AA Municipal	106%	131%	138%