Municipal Market Review

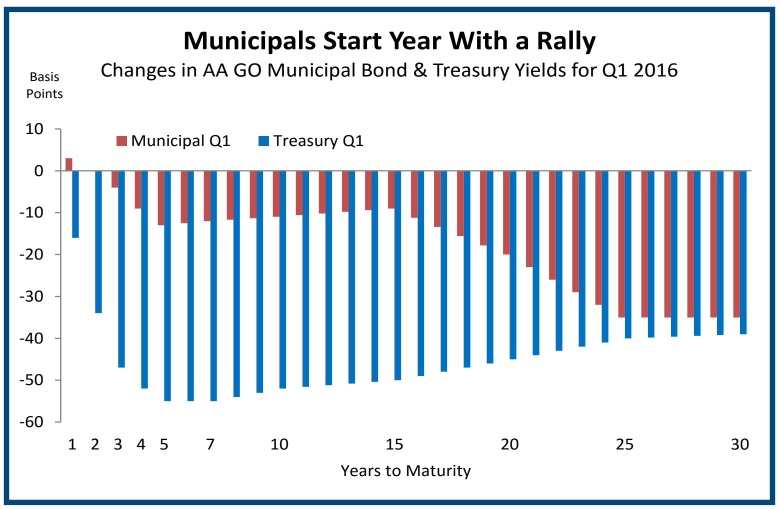
First Quarter 2016

"It's basically been a perfect storm, in a positive way, for munis."

Glenn Williams, A.H. Williams & Co.

Municipal bonds rallied for the first quarter of 2016, an encouraging start to the new year, building off last year's **market-leading performance**. Yields modestly declined along the intermediate part of the curve. The largest decline came at the longer end of the curve, where the average decline in the 20-to-30 year range was 30 basis points. Similar to the fourth quarter of 2015, the municipal yield curve underwent a **bullish flattening**. Treasury yields ended the quarter noticeably lower across the yield curve, rallying more than municipals. The reshaping of the yield curve is reflected in **Figure 1** which graphs the changes in municipal and Treasury yields for the first quarter of 2016. Municipal relative value ratios increased over the entire yield curve. Relative value ratios are currently very attractive, with ratios above 100 percent for the entire yield curve.

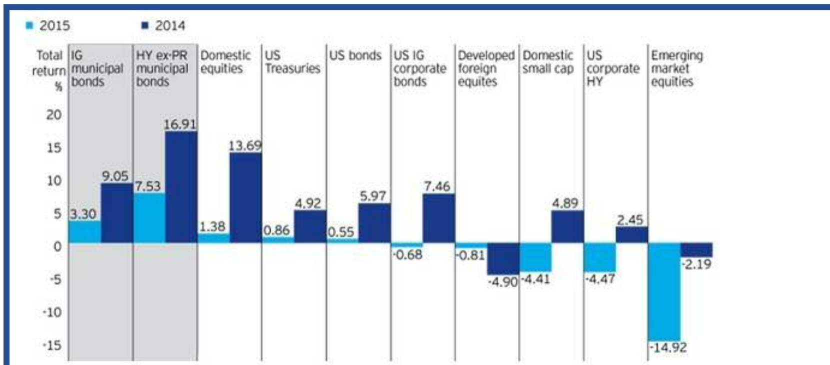
Fig 1



As you might recall, municipals were the **best-performing fixed income asset class in 2015**, returning 3.3 percent according to the Barclays Municipal Index. Demand for high-quality income-producing assets should hold steady in 2016, providing a positive backdrop for municipal bond prices. Constructive technicals (low supply/high demand) have been the trend in the municipal market, as there have been five consecutive years of net negative issuance, meaning more bonds were taken out of the market through calls and redemptions than were added through the sale of new bonds. Many municipalities have taken advantage of historically low interest rates to refinance outstanding debt, reducing interest payments and strengthening their fiscal health. The new supply that has come to market has typically been multiple times oversubscribed, indicating strong ongoing investor demand. Creditworthiness among state and local issuers of municipal debt has continued on a path of steady improvement. Housing stabilization has helped local issuers by increasing property tax collections. Balance sheets are largely improved as issuers have deleveraged, added jobs and avoided taking on more debt. Tax revenues have rebounded to pre-recession levels, and state and local governments recently made their greatest contribution to America's Gross Domestic Product (GDP) since 2009. While the global financial markets have had their share of volatility this past quarter, **municipal bonds have remained relatively non-correlated to the turbulence afflicting nearly every other investment category**. Municipal debt's relative strength and resiliency is a byproduct of a volatile stock market, tight supply of muni bond issuance, stable interest-rate environment and low inflation. Mark Paris, head of municipal portfolio management at Invesco, notes that, *"This isn't just about their tax-exempt status; muni bonds are exemplifying good correlation to the tribulations of equities and the corporate bond markets. Part of that low correlation is because muni bonds are, for the most part, not associated with the problems of lower oil prices."* Additionally, in this New Normal economic landscape, with rates forecast to remain lower for longer and rise only gradually if at all, investors should expect to receive more of their total return from income. Municipals should deliver on that expectation with an attractive tax-efficient income component. Looking back at recent history, municipal bonds have been one of the best performing asset classes two years in a row, as you can see in **Figure 2.**

A possible driver of municipal bond prices for the rest of 2016 will be the words and actions of the Federal Reserve. In mid-March, as many in the market expected, the Federal Open Market Committee (FOMC) kept the target range for the benchmark federal funds rate unchanged at 0.25 percent to 0.50 percent. Significantly, the

Fig 2

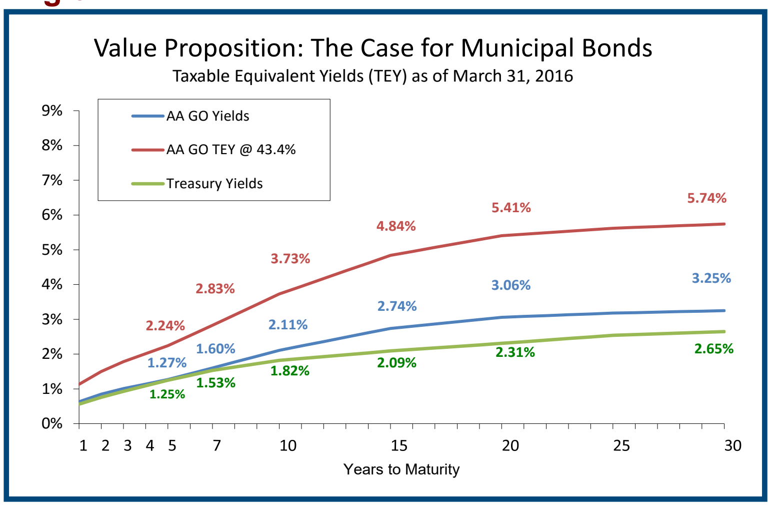


Source: Barclays, as of Dec. 31, 2015. IG municipal bonds are represented by Barclays Municipal Bond Index; HY ex-PR municipal bonds by Barclays Municipal High Yield Bond Index (excluding Puerto Rico); domestic equities by S&P 500 Index; US Treasuries by Barclays U.S. Government Index; US bonds by Barclays U.S. Aggregate Bond Index; US IG corporate bonds by Barclays U.S. Corporate Investment Grade Index; developed foreign equities by MSCI EAFE Index; domestic small cap by Russell 2000 Index; US corporate HY by Barclays U.S. Corporate High Yield Index; and emerging market equities by MSCI Emerging Markets Index. Past performance is not a guarantee of future results. An investment cannot be made directly into an index.

median of the central bankers' updated quarterly projections saw the fed funds rate at 0.875 percent at the end of 2016, implying just two quarter-point increases this year, down from the four increases forecasted back in December. Whatever the number of rate hikes in 2016 ends up being, you still have a fed funds rate in the area of one percent. That is not hawkish monetary policy, and certainly not enough to push long-term rates higher. Fed Chair Janet Yellen stressed that *"the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."* The FOMC statement said that investments by businesses and exports *"have been soft"* and that inflation remained below the central bank's desired 2 percent target. It also referenced *"global economic and financial developments that continue to pose risks."* Most analysts viewed the Fed's statement as dovish, as weaker-than-forecast global growth has muddled the U.S. outlook and led investors to expect a slower pace of tightening since the Fed raised rates last December for the first time in almost a decade. The stability of municipal bond yields this past quarter following the Fed rate hike in December, echoes past history that has shown municipal yields typically have not been highly sensitive to fed funds moves. Looking back at five periods between 1983 and 2006 when the Fed raised the funds rate, the change in high-grade municipal yields was comparably much less than the change in taxable bonds. We recommend municipals for their defensive characteristics and usefulness in an environment in which total return is likely to come more from coupon and less from price performance. **Investment grade municipal debt is simply a conservative, low-volatility source of income with an attractive taxable equivalent yield**, particularly for intermediate to long maturities.

In the past few years a consistent theme that has underscored the appeal of municipal bonds has been their **very attractive relative value compared to Treasuries**. At the end of the first quarter, the relative value of municipals, as measured by the ratio of municipal yields to Treasury yields, hovered at historically high levels. For example, the relative value ratio of a 15-year municipal bond versus a 15-year Treasury bond was at 131 percent, significantly higher than its long-term average of 90 percent. **Figure 3** highlights the relative value advantage of municipals. The advantage is especially apparent when a 43.4% tax rate is factored in. Investors sometimes focus just on nominal yields in the determination of value and neglect to consider the real value inherent in municipal bonds, their tax exemption.

Fig 3



Last summer the Federal Reserve announced its plans to allow banks to hold investment-grade municipal bonds to comply with a new rule aimed at ensuring banks have enough high-quality liquid assets (HQLA) to deal with a financial crisis. The original liquidity coverage ratio rule, which excluded municipals as HQLA, was passed back in 2014. The debate has continued into this year, with Wall Street, Congress and municipal officials challenging bank regulators' skepticism toward municipal debt. There is a current bipartisan effort in advancing legislation to mandate regulators to include municipal securities among the rule's definition of HQLA, a category that currently includes cash, Treasury bonds, and government agency debt like Fannie Mae and Freddie Mac. Senator Mark Warner of Virginia argued, *"We shouldn't make it more expensive for local governments to finance essential investments such as school and road construction by making it harder to access capital markets."* He added that the Senate bill's provisions would be tailored to *"appropriately address financial* *stability concerns while preserving states and municipalities' access to bond markets."* The largest U.S. banks account for about thirteen percent of the $3.7 trillion municipal bond market, making them the third-largest holder after households and mutual funds. In early April, the Federal Reserve released final rule changes to treat more municipal securities as HQLA. Analysts viewed the inclusion of munis as HQLA as underscoring the importance of the municipal bond market. Justin Hoogendoorn of Piper Jaffray said, *"The main point is that the regulators are viewing these securities as an important and acceptable component of the balance sheet."*

Along with Puerto Rico, Chicago has remained in the headlines this past quarter. Unfunded pension liabilities are weighing heavily on the long-term fiscal health of certain locales like the Windy City. This **greater dispersion in municipal credit quality illustrates the importance of forward-looking credit research provided by an experienced active management team**. In late March, the Illinois Supreme Court voided the legislation that would have allowed the city to overhaul two pension funds. The overhaul, which would have increased employer and employee contributions and cut benefits, was signed into law by former Governor Pat Quinn in 2014. In a big setback for Chicago, the ruling made clear that the city bears responsibility to fund the promised pension benefits, even if the pension funds become insolvent. In the long run, the city must now come up with a plan to save the funds which are again headed toward insolvency within the next decade. Analysts are watching closely because setbacks in tackling the city's $20 billion in unfunded pension liabilities could further dent its troubled credit rating. The first rating fallout from the court's ruling came from Fitch. It downgraded $9.8 billion of General Obligation (GO) bonds and $486 million of sales tax-backed bonds from BBB-plus to BBB-minus, the lowest rung on the investment grade scale, perilously close to junk status. The city is in a league of its own in terms of its debt and pension costs. The combined cost to service both consumed 45 percent of fiscal 2013 governmental revenue. The next closest city is San Jose at 28 percent. Many municipal analysts expect that the city will attempt to solve its unfunded pension liabilities problem and high debt burden by increasing residents' property taxes. However, elected Chicago officials have been unwilling to raise property taxes for nearly a decade. Bottom line, some tough and unpopular decisions are going to have to be made. Our view remains that Chicago and Puerto Rico are isolated cases and are not at all indicative of the vast, uniquely fragmented, and largely healthy municipal market.

Redstone Advisors, with our 25+ years of municipal bond experience, believe we are uniquely qualified to pursue our two primary investment objectives of wealth preservation and building par value by actively managing municipal bond portfolios for our clients. We believe the increased after-tax benefit of municipal bonds will be very welcoming in the current climate of high federal tax rates. As tax season is upon us, recall that a recent Internal Revenue Service report found that the **majority of individuals who earned at least $200,000 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 one reason we recommend investors look to municipal bonds for their attractive relative value and reliable high quality income stream.

Fig 4

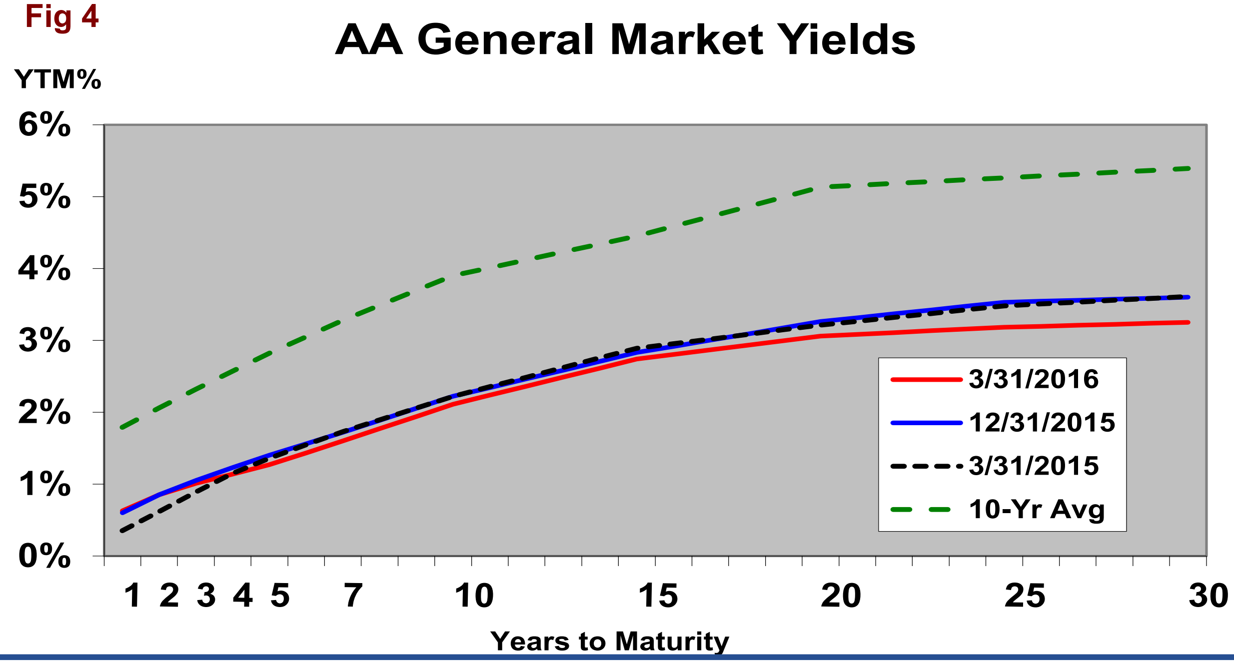
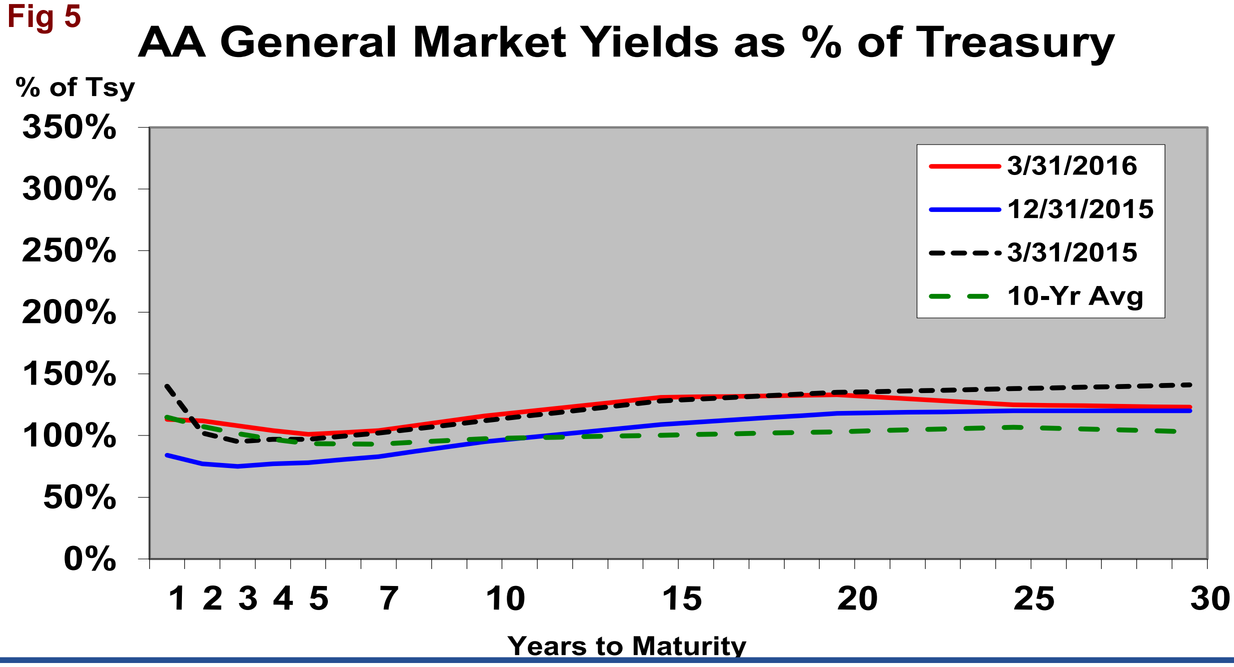


Fig 5



	10 Yr Avg	12/31/2015	3/31/2016
2-Year AA Municipal	107%	77%	112%
5-Year AA Municipal	93%	78%	101%
10-Year AA Municipal	97%	95%	116%
25-Year AA Municipal	106%	120%	125%