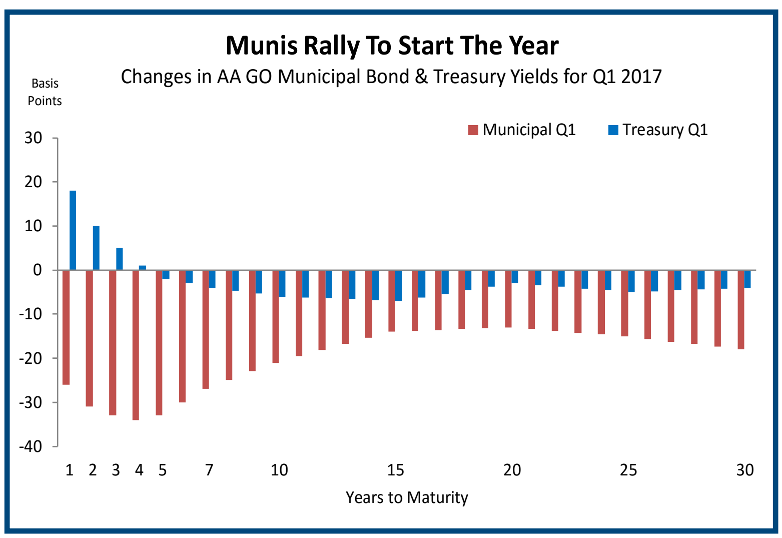
Redstone Advisors

Municipal Market Review

First Quarter 2017

Municipal bonds rallied in the first quarter of 2017, signaling that the sharp selloff and "Trump Tantrum" that sent yields sharply higher during the fourth quarter of 2016 was overdone. Yields modestly declined along the entire curve. The largest drop came at the short end of the curve, where the average decline in the 1-to-7-year range was about 30 basis points. Treasury yields largely moved sideways for the quarter and ended it roughly unchanged, with the largest move coming at the very short end where the 1-year yield rose 18 basis points. For the quarter, the Treasury yield curve underwent a slight flattening. The reshaping of the yield curves is reflected in **Figure 1** which graphs the changes in municipal and Treasury yields for the first quarter of 2017. Municipal relative value ratios decreased at the short-to-intermediate part of the yield curve. Relative value ratios remain above 100 percent at the long end of the curve, in the 15-to-30-year segment.

Fig 1



A top concern of the municipal market for 2017 is the issue of tax reform on the table. Of course, after the initial failure of a GOP-controlled Congress to repeal and replace Obamacare due to resistance from conservative Freedom Caucus members and some moderates, it remains to be seen what kind of tax reform plan Congress will be able to agree

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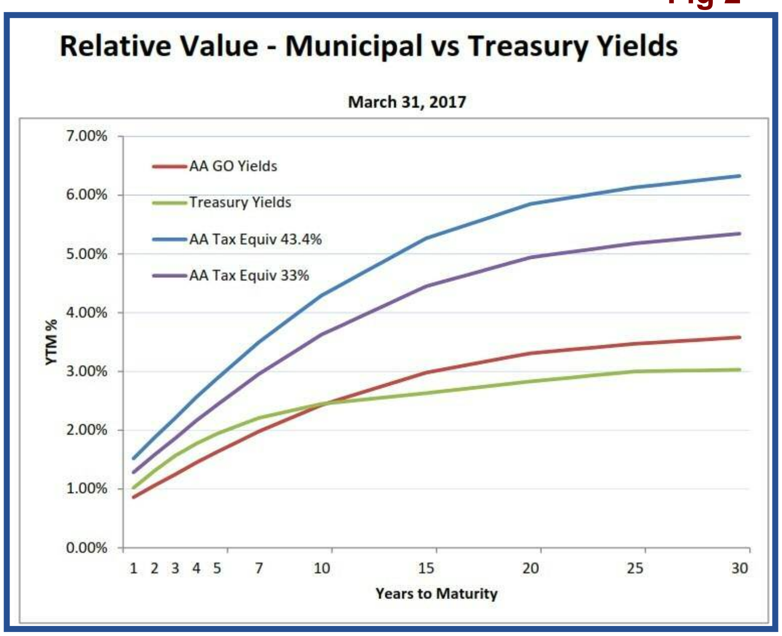
upon and enact. Last quarter we alluded to the difficult political hurdles President Trump would face in attempting the passage of even part of an aggressive agenda comprised of tax reform, a massive increase in deficit spending for infrastructure, and protectionist trade legislation. **As bond prices have recovered and stabilized this past quarter, the muni market has realized that the actual manifestation of assumed Trump policies isn't so clear cut**. Part of the "Trump Tantrum" that impacted the municipal market at the end of last year was the increased likelihood of the GOP being able to reduce marginal tax rates. President Trump's plan as it stands calls for the reduction of the current seven tax brackets down to three and reducing the top personal rate to 33% from 43.4%. As illustrated in **Figure 2**, investors would still capture a sizeable after-tax yield advantage over Treasury bonds, even at a 33% tax rate. As investors sometimes focus just on nominal yields in their portfolio strategy, **this graph is a reminder not to neglect the real value inherent in municipal bonds, their tax exemption.**

Fig 2



Furthermore, since 1982 the top federal tax rate has changed eight times, up and down, without resulting in lasting shifts in the yields municipal investors demand compared with yields on taxable bonds, according to a recent report issued by PIMCO. Certainly, given the murky policy picture, the muni market faces months of headlines from Washington about tax reform and federal spending as the Trump administration's policies take shape. Tax reform involves a series of potential outcomes featuring many variables and complexities. Which reforms if any end up being implemented and to what degree will ultimately determine the extent of the market impact. No doubt, tax policy uncertainty is a factor weighing on the market. However, the **advantages that have made municipal bonds a key holding of income-focused, tax-conscious investors remain intact.**

As tax reform talks begin to take shape, there will be a discussion of what tax breaks might be eliminated or capped to generate revenue to offset planned tax cuts. We continue to see the elimination of the municipal tax exemption as highly unlikely. Cities and states use municipal bonds as a low-cost, efficient means to finance capital improvements and fund infrastructure. Historically, roughly 75% of U.S. infrastructure has been financed using municipal bonds. Trump's grand infrastructure plans would be imperiled if the federal government curtails cities and states ability to sustain their economies and improve the quality of life for citizens. Furthermore, Bank of America analysts say taxing investors' interest on municipal debt wouldn't provide as much as assumed. According to the Treasury Department's figures, the tax break for the $3.7 trillion municipal market cost the federal government about $39 billion in 2016. However, because taxing the interest would likely cause many investors to move their money elsewhere, many bonds would end up with buyers who don't pay income tax, such as overseas companies or IRA plans. Once that's factored in, taxing municipal bonds may only yield roughly $9 billion a year, according to the bank's analysts. The analysts wrote in their report, *"Hopefully, this helps clarify the point that the attack on the tax-exempt status of municipal bonds from time to time appears to be based more on political calculus than economic analysis. This is becoming more widely recognized and we do not expect that the tax exemption would be targeted in any tax-reform legislation."*

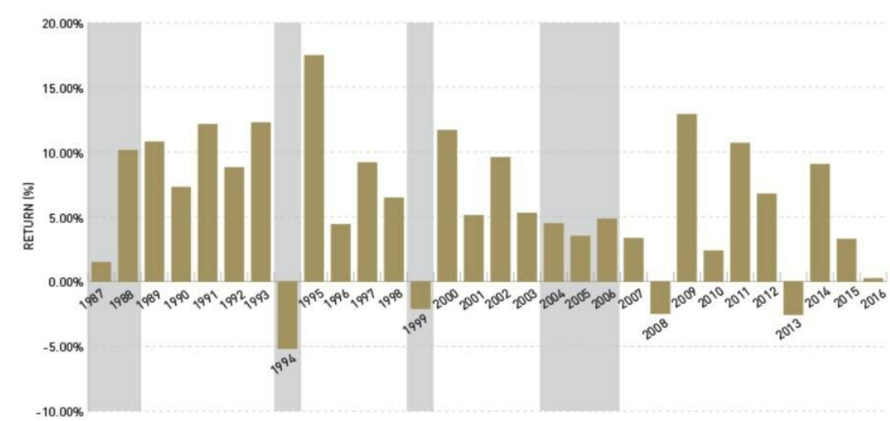
During the Ides of March, in a widely-expected move, the Federal Reserve raised its benchmark lending rate a quarter point. The Federal Open Market Committee (FOMC) cited "realized and expected labor market conditions and inflation" in voting to set the new target range for the federal funds rates at 0.75 percent to 1.00 percent. The Fed said it remains on track for two more quarter point rate increases this year if the economy continues to progress on the path they view it being on. Fed Chair Janet Yellen, in a news conference after the decision was announced, said that the Fed did not share the optimism of stock market investors and some business executives that economic growth is gaining speed. She said the Fed still plans to move slowly because the economy continues to grow slowly. *"The data have not notably strengthened. We haven't changed the outlook. We think we're moving on the same course we've been on,"* Ms. Yellen told reporters. In the range of 0.75 to 1 percent, the Fed's benchmark remains at a very low level historically. We believe it is helpful to have historical perspective when thinking about the Fed and its impact on the municipal market. **Figure 3** shows return data for the broad municipal bond market (as represented by the Barclays Municipal Bond Index) over the past 30 years. We note three key takeaways from this chart. First, **municipals have produced positive returns in 26 of the past 30 calendar years**. Second, only two of these negative years—1994 and 1999—coincided with a period when the Fed was raising rates. Third, **municipals generated positive returns in the last extended campaign of Fed hikes, from 2004 to 2006.**

Overseas investors continue to have strong interest in U.S. municipal bonds, helping support prices with their demand. Foreign investment in munis has doubled since 2009 to $106 billion, despite the fact that foreigners can't take advantage of munis' tax-exempt interest. The trend accelerated in the fourth quarter of 2016, with foreigners adding an unprecedented level of bonds, as one can see in **Figure 4.** Foreign investors, with global bond yields near historic lows, are attracted to munis' relative yield and safety. Many buyers are overseas life insurance companies

Fig 3

Fed or No Fed, Negative Years Have Been Rare for Municipal Bonds

Calendar-year returns of the Bloomberg Barclays Municipal Bond Index, 1987–2016



Source: Morningstar. Shaded areas represent periods during which the U.S. Federal Reserve raised interest rates.

Past performance is not a reliable indicator or guarantee of future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. Due to market volatility, the market may not perform in a similar manner in the future.

looking for long-dated securities to match their long-term liabilities. *"Munis are global now,"* noted Rob Amodeo of Western Asset Management.

Redstone Advisors, with our 25+ years of experience in the municipal bond market, believe we are uniquely qualified to pursue our two primary objectives of wealth preservation and building par value by actively managing municipal bond portfolios for our clients. We know how to conduct independent credit research, adjust for duration and monitor the market for risks and opportunities. As another April 15 is upon us, one should not underestimate the power of a strong tax advantage, and that is one reason why we recommend investors look to investment-grade municipal bonds for their attractive relative value and reliable high quality income stream. For clients, existing or prospective, with cash to invest, the **current elevated level in market yields due to the "Trump Tantrum" is offering an exceptional opportunity to put money into high quality tax-exempt bonds and lock-in higher nominal purchase yields.** We continue to 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. Yes, there will be some short-term price volatility as tax policy uncertainty plays out over the following months, however our long-term goals are completely unaffected by the near-term volatility in bond prices. With the passage of time, that most unique feature of bonds, the maturity date, mitigates and ultimately eliminates market risk as every good bond will always go to par.

Fig 4

Fig 5

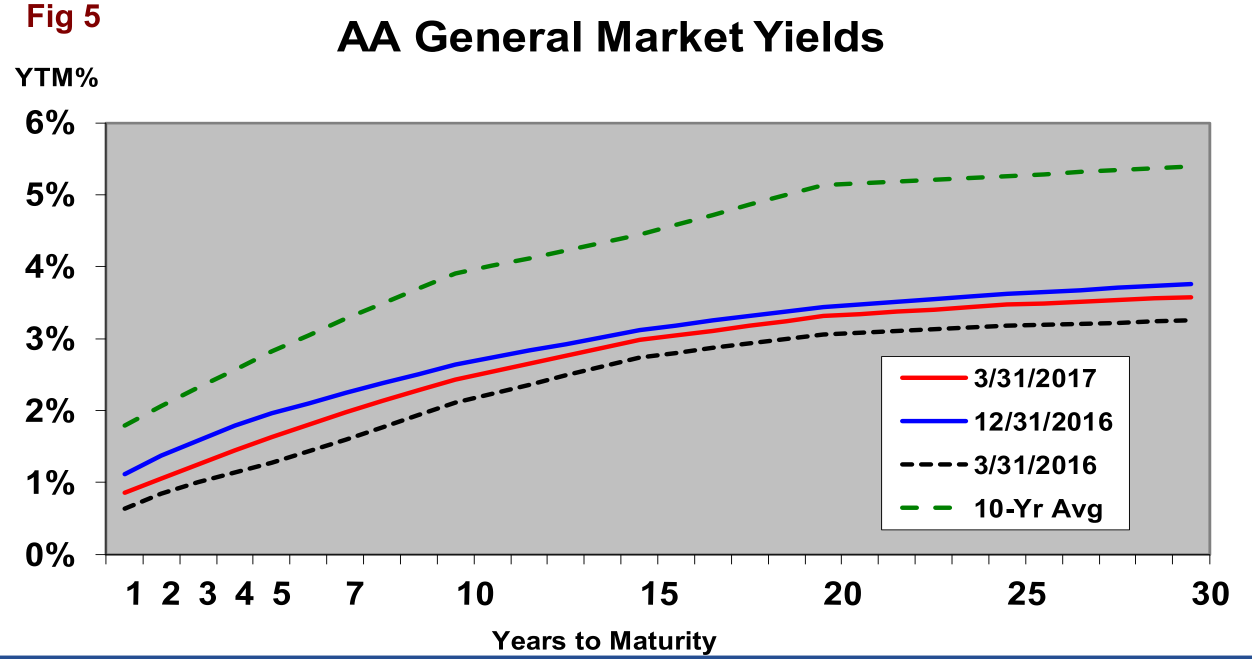
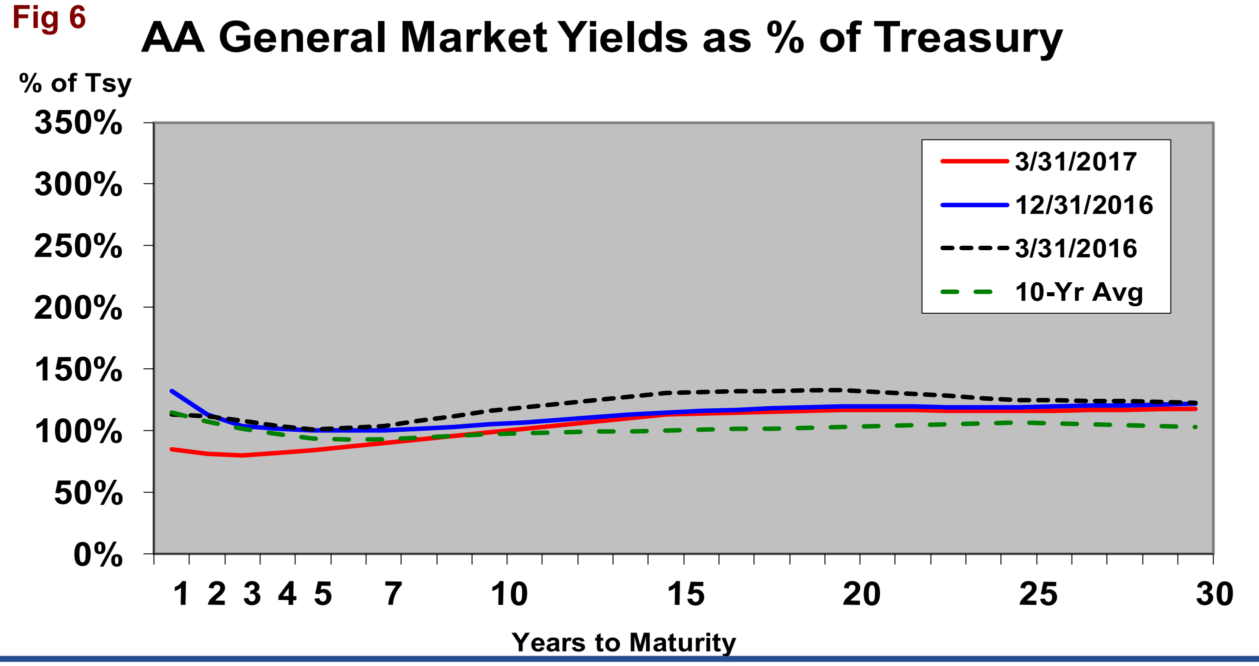


Fig 6



	10 Yr Avg	12/31/2016	3/31/2017
2-Year AA Municipal	107%	113%	81%
5-Year AA Municipal	93%	100%	84%
10-Year AA Municipal	97%	105%	99%
25-Year AA Municipal	106%	119%	116%