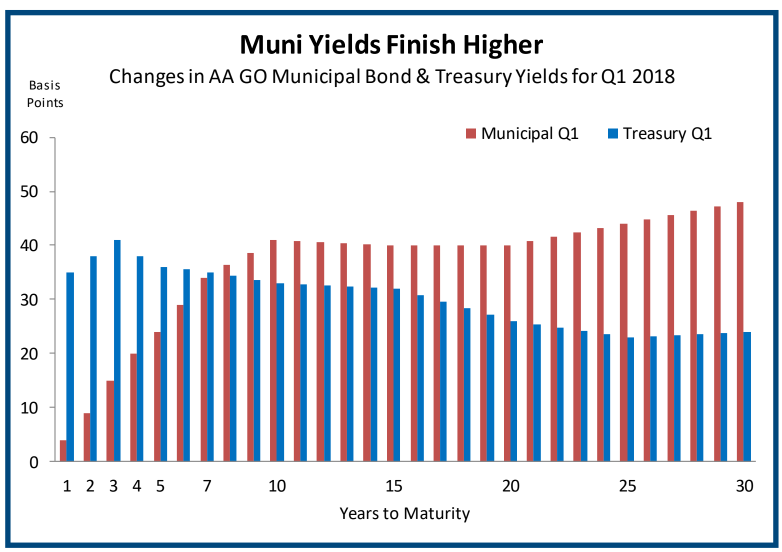
Redstone Advisors

Municipal Market Review

First Quarter 2018

Municipal bonds had an up and down first quarter as the market was going through a discovery period and still digesting the impact of tax reform legislation that passed at the end of 2017. Municipal yields mostly rose in January and February before declining in March. By quarter end, municipal yields finished higher across the entire curve, with the largest increase coming in the 10-to-30-year range where the average gain was 43 basis points (bps). The short end of the muni curve was quieter, with the 1-year rising just 4 bps and the 2-year gaining 9 bps. Peter Hayes of BlackRock noted that, "*yields are more attractive than they've been in a long time, so if someone is comfortable with a more volatile environment, this could be a good time to consider municipal bonds.*" Hayes added that, "*the need for income hasn't changed for retail investors and retirees. People see municipal bonds as a safe investment*." Treasury yields finished higher across the yield curve as well. The increase in Treasury yields was more evenly distributed, with the average gain being 33 bps across the entire curve. 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 2018. Municipal relative value ratios slightly decreased at the short end of the curve and were mainly unchanged at the intermediate-to-long part of the

Fig 1



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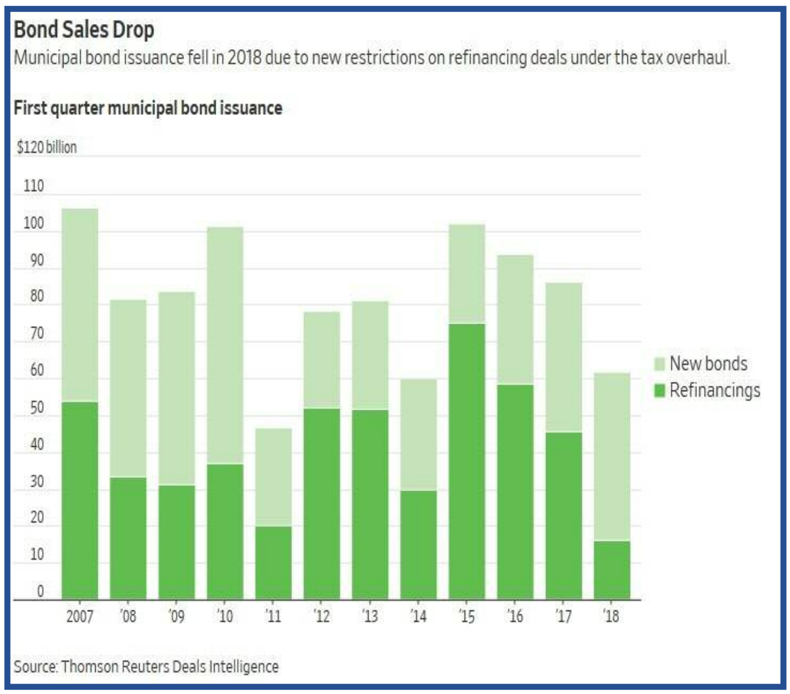
curve. Relative value ratios remain above 100 percent at the longer end of the curve, in the 15-to-30-year segment.

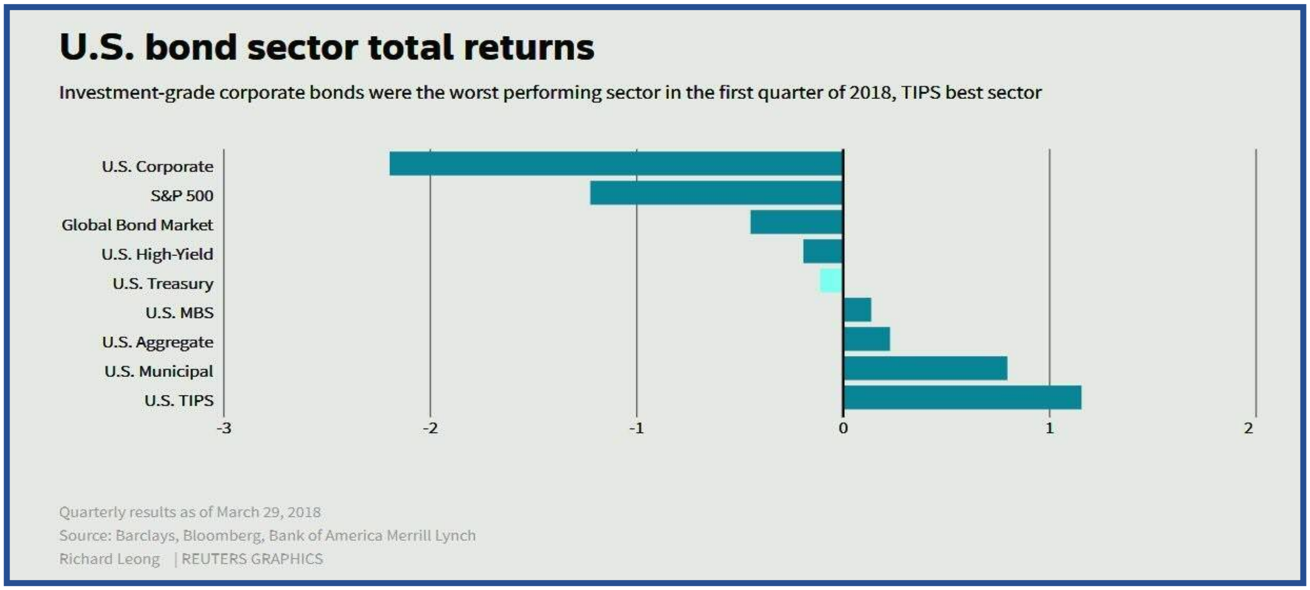
Municipal bond issuance originally scheduled for the first quarter of 2018 was instead moved up to December 2017 in a rush to market by issuers before the "Tax Cuts and Jobs" act was signed into law. The majority of this moved up issuance was in the form of advance refunding issues (which the new tax law eliminated) and private activity bonds (which ended up surviving). Volume for the first quarter was about $61 billion, a widely expected decrease from the first quarter of 2017. The decrease in issuance is illustrated in **Figure 2**, which charts 1st quarter issuance going back several years. Despite higher interest rates weighing down fixed income assets broadly, municipal bonds continued to perform better versus other sectors thanks to a favorable technical environment of firm household demand coupled with a sizeable drop in issuance. With the state and local taxes (SALT) deduction now capped at $10,000 due to the new tax law and the top marginal tax rate only slightly falling to 37% from 39.6%, tax-exempt muni income remains quite valuable to the retail investor. While retail demand was steady, the new tax law made municipal bonds somewhat less appealing for banks and insurance companies. The tax law lowered the corporate rate down to 21% from 35% and thus there was a little less incentive for banks

Fig 2



and insurance companies to buy muni debt. It is debatable how strong the effect of the lower corporate rate was, given that the effective corporate tax rate was widely thought to be around 20%. U.S. bond sector total returns for the first quarter of 2018 can be seen in **Figure 3**. Municipals finished with a positive total return (income plus price performance), trailing only TIPS (Treasury Inflation Protected Securities).

Fig 3



On the topic of municipal credit, two of the main rating agencies, Moody's and S&P, recently reported that upgrades continued to outnumber downgrades for all of 2017. For S&P it was the sixth year in a row of more upgrades, with California having the most upgraded issuers, followed by Texas and Florida. For Moody's it was the third year in a row that upgrades outpaced downgrades. Taking into account low unemployment rates and rising home values, the vast majority of cities and counties are seeing tax revenue increase. Overall, the positive ratings environment is expected to continue, although a few pockets of concern remain. The downgrades of New Jersey, Illinois, Connecticut, Puerto Rico and related issuers accounted for about 70% of downgraded debt.

Regarding Connecticut, we talked about its fiscally troubled capital city of Hartford back in the third quarter of 2017. At the time, city officials were issuing dire warnings about having to file for bankruptcy unless a lifeline was offered. Ratings agencies downgraded Hartford's credit to an abysmal CC and Caa3, and the outlook was bleak. Hartford got good news in late March, as it received a sorely needed bailout from the state of Connecticut. Hartford officials approved a plan that authorizes the state to pay off the city's general obligation debt, totaling some $755 million. While there is some precedent for US states stepping in to rescue fiscally distressed cities, it's quite rare for a state to assume debt payments for a municipality. The agreement shows the measures that some states will undertake in order to prevent their cities and towns from going bankrupt. Some analysts argued Hartford got "too good of a deal" because the agreement does not mandate an emergency manager or any type of state takeover of the city's management. The deal allows Hartford's debt to be refinanced using the state's full faith and credit backing. Historically, there have been a few times that states have intervened to help their distressed cities. Back in 1975, the state of New York approved the creation of a corporation to issue debt on behalf of New York City, which was dangerously close to bankruptcy at the time. Few, if any, states have assumed the debt burden of their cities as a relief measure. Doing so adds to the financial burden of Connecticut, which is now responsible for Hartford's general obligation bond payments through 2036. The state has been struggling with chronic deficits and has some of the highest debt on a per-capita basis. Connecticut's state treasurer defended the bailout, saying "*strong urban centers are vital to the state's well-being. Declining to help Connecticut's capital city could have adversely affected the financial health and vibrancy of surrounding towns*."

During its March meeting, the Federal Reserve increased its benchmark fed-funds rate by a quarter percentage point to a target range between 1.50% and 1.75%. The move had been well telegraphed and was no surprise to the markets. The majority of Fed officials see the central bank raising rates three times this year. Most Fed officials also expect the Fed would need to raise rates at least another three times in 2019. The Fed marked up slightly the estimate of interest rates they expect to prevail over the long run, to a range between 2.75% and 3%. This was the first Fed meeting led by Jerome Powell, the new Chairman. Mr. Powell has indicated he could offer a softer touch on financial regulation but has shown few signs of divergence on monetary policy from the previous Fed chair, Janet Yellen. The Fed's plan to very gradually shrink its massive portfolio of Treasurys and mortgage-backed securities continues on schedule as it slowly attempts to normalize policy.

Redstone Advisors, with our 25+ years of experience in the municipal bond market, believe we are specially qualified to pursue our two primary objectives of wealth preservation and building par value by actively managing portfolios for our clients. We conduct independent credit research, adjust for duration and constantly 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 is offering an exceptional opportunity to put money into 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. Bottom line, municipal bonds continue to be a key component of any well-diversified portfolio given their unique ability to provide high-quality tax-exempt income.

Fig 4

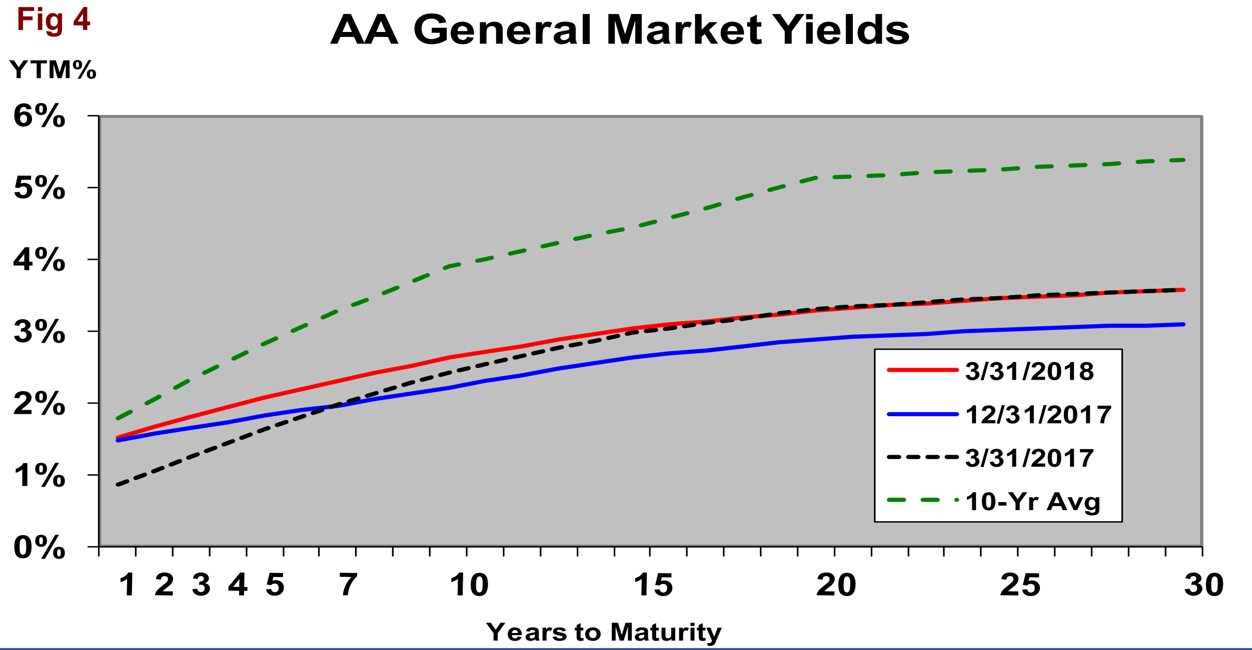
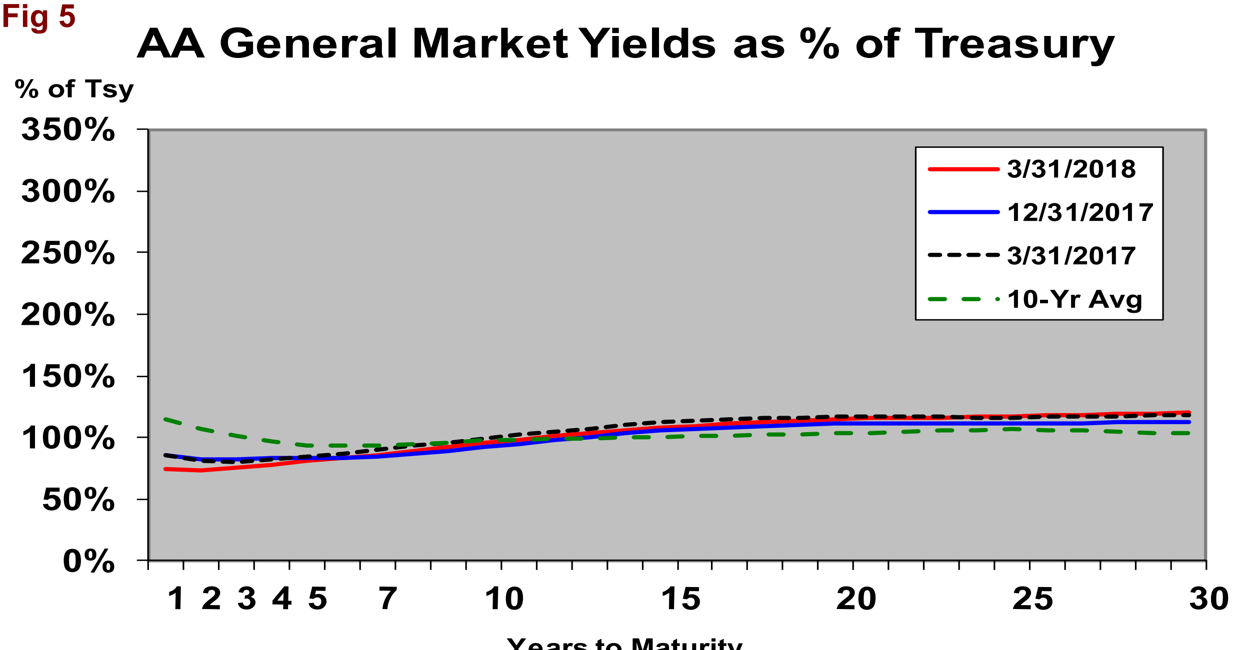


Fig 5



	10 Yr Avg	12/31/2017	3/31/2018
2-Year AA Municipal	107%	82%	73%
5-Year AA Municipal	93%	83%	81%
10-Year AA Municipal	97%	92%	96%
25-Year AA Municipal	106%	111%	117%