Redstone Advisors

Municipal Market Review

First Quarter 2019

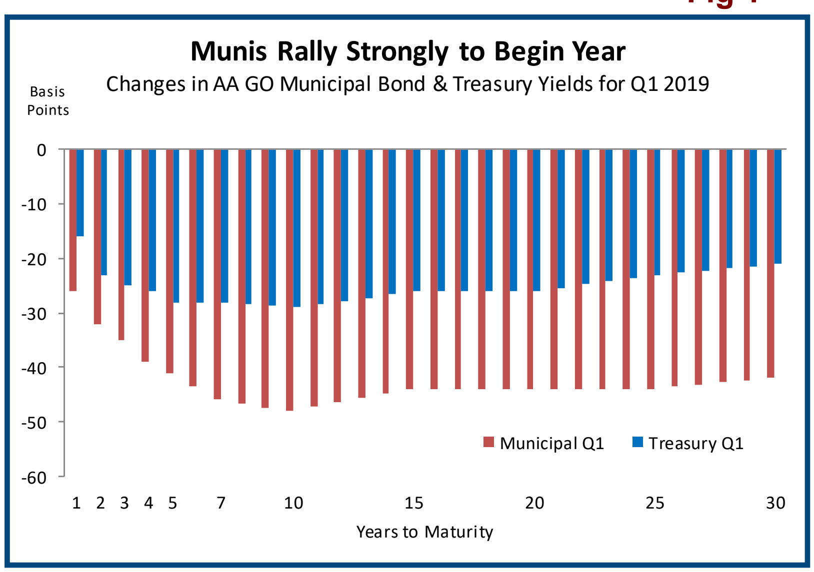
"People are realizing that tax-exempt municipal bonds are one of the easiest and few remaining tax shelters out there."

Rob Wimmel, BMO Global Asset Management

Municipal bonds had a strong rally in the first quarter. The two main drivers of this rally were a more dovish Federal Reserve that signaled it would not raise rates in 2019 and the reality of the tax law's new $10,000 limit on state and local tax (SALT) deductions hitting taxpayers during this tax filing season. The largest move came in the intermediate part of curve, where the 7-yr muni fell by 46 basis points (bp) and the 10-yr declined by 48 bp. Looking at the Treasury yield curve, rates moderately declined, although the movement wasn't as strong as the muni bond rally. Compared to the flat Treasury curve, the muni yield curve has remained relatively steep. At quarter end, the 2-yr/10-yr muni spread was 49 bp. The same 2-yr/10-yr Treasury spread was just 13 bp. We see this divergence as evidence there is value to adding a certain amount of duration in the muni market. The reshaping of the yield curves is reflected in **Figure 1** which graphs the changes in muni and Treasury yields for the first quarter.

Muni relative value ratios decreased across most of the yield curve. In mid-March, the 10-year muni benchmark yielded a little less than 80 percent of Treasuries, near the lowest relative value since at least 2001 according to Bloomberg data. Munis finished the quarter yielding roughly 65% to 75% of Treasuries in the short 1-to-5-yr range. Many retail investors have preferred short-term munis due to

Fig 1



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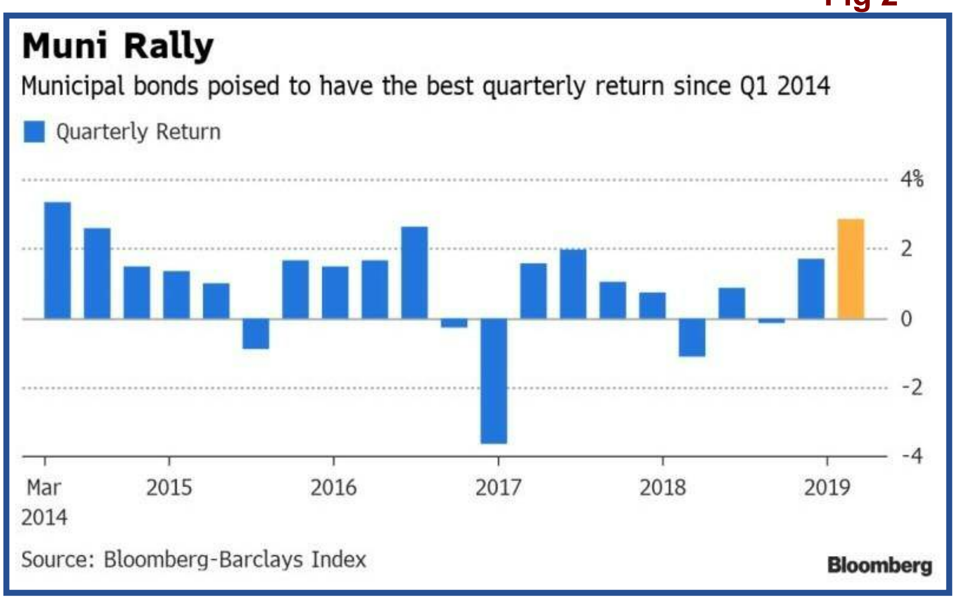
concerns about higher interest rates, and their high demand has made these munis expensive relative to short-term Treasuries. *"There is just such high investor demand 10-years and in. Investors could go further out on the curve and you will definitely get a little more bang for your buck",* reasoned Dawn Mangerson of McDonnell Investment Mgmt. Peter Hayes of BlackRock agreed, arguing that longer-maturity bonds offer "compelling valuations", particularly when compared to the short end. Relative value ratios remain at or above 100 percent at the long end of the curve, in the 15-to-30-year segment.

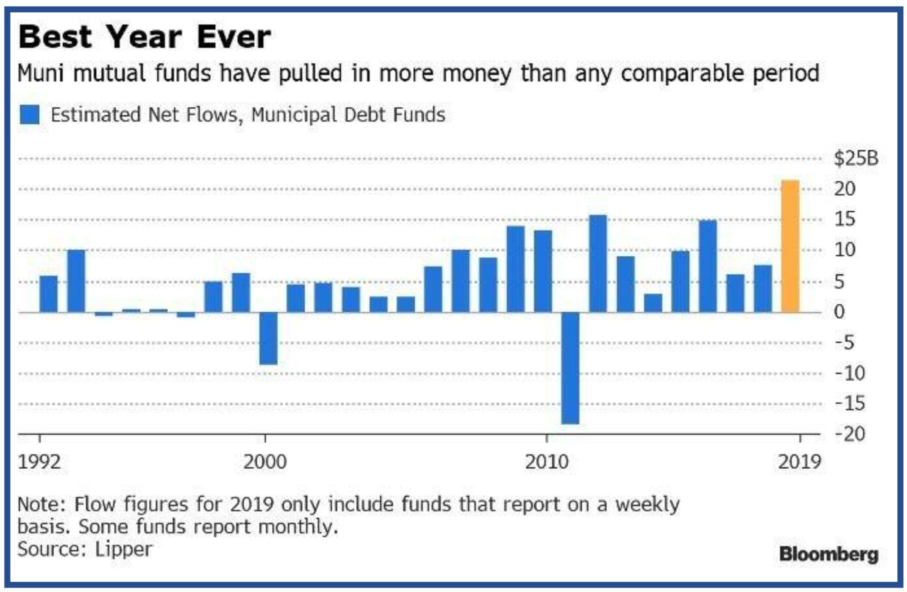
As we mentioned last quarter, with the SALT deduction now capped at $10,000, residents from high-tax states such as New York, New Jersey and California have certainly boosted demand for double-exempt bonds from their home states. The strategy to shelter more income in municipal bonds has become more popular this tax filing season as taxpayers who had been relying heavily on the SALT deduction get an unpleasant surprise in the form of a higher tax bill. People are realizing that *"munis could be one of the few things that protect you. As investors file more and more, they are putting more and more money into muni funds"* noted Mikhail Foux of Barclay's. So far in 2019, the muni market has continued to be impacted by supply (reduced via elimination of advance refunding bonds) versus demand (increase from investors in high-tax states). There's simply been too much investor cash chasing too little supply of bonds, which has sent yields lower and prices higher. Municipal bonds finished the first quarter with a 2.76% gain according to Bloomberg Barclays Index data, which was the strongest quarterly gain since 2014. This is illustrated in **Figure 2**.

Fig 2



The pace of borrowing by cities and states hasn't picked up significantly since last year's slowdown. Municipal borrowers have issued about $50 billion of new bonds during the first two months of 2019, which is less than the supply during the same period in 2015, 2016 and 2017. *"The amount of demand that has come into the municipal market has been sensational,"* proclaimed Sean Carney of BlackRock. He estimated that demand, driven mainly by retail investors, is outrunning supply by about four times. By early March, investors had deposited more than $15 billion of new money into municipal bond funds in the first two months of this year, the most during that period in at least thirteen years, according to Municipal Market Analytics. *"There's certainly very strong retail demand, but you don't have enough supply to meet that demand. You have too much cash chasing too little product"* explained Jeffrey Lipton of Oppenheimer. By quarter end, muni-bond mutual funds had attracted more cash in 2019 than they have during the same period of any other year since 1992, when records began, according to Lipper US Fund Flows. *"The money coming into mutual funds has literally not stopped. This is the last thing in town you can get tax-free with the SALT issue. People are focused on this market,"* one managing director said. This record-breaking demand can be seen in **Figure 3**. Going forward, there is potential for issuers to take advantage of lower rates and for volume to pick up somewhat. Renewed investor interest in muni bonds is being seen across the country, largely credited to the new cap on SALT deductions and a Fed that is seen as "on hold" for the foreseeable future.

Fig 3



During its March meeting, the Federal Reserve left its benchmark fed-funds rate unchanged at the target range between 2.25% and 2.50%. The big news to come out of the meeting was that the Fed cut their projected interest-rate increases this year to zero from two. Chairman Jerome Powell stated that interest rates could be on hold for "some time" as global risks weigh on the economic outlook and inflation remains subdued. *"We don't see data coming in that suggest that we should move in either direction. They suggest that we should remain patient and let the situation clarify itself over time. It may be some time before the outlook for jobs and inflation calls clearly for a change in policy",* Mr. Powell said at a press conference. He added, *"the reason we're on hold is that we think our policy rate is in a good place, and we think the economy is in a good place, and we're watching carefully as we see these events evolve around the world and at home."* Powell said the risks from abroad that the Fed was keeping an eye on included trade disputes, slowing growth in Europe and China, and potential fallout from Brexit, Britain's prolonged and messy exit from the European Union. Analysts see the Fed as having declared they are not going to hike again unless they get faster growth and inflation.

By any historical standard, this new "normal" stance of monetary policy is very accommodative. The fed-funds rate, in the range of 2.25% and 2.50%, is just 0.25% when accounting for long-term expected inflation. In contrast, the real rate was 2.75% at the conclusion of the Fed's last tightening cycle in 2006. Moreover, the Fed will still have more than $3.5 trillion in bonds on its balance sheet in September, equal to 17% of GDP, compared with just 6% in 2006.

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. We recommend municipals for their defensive traits and utility in a market 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

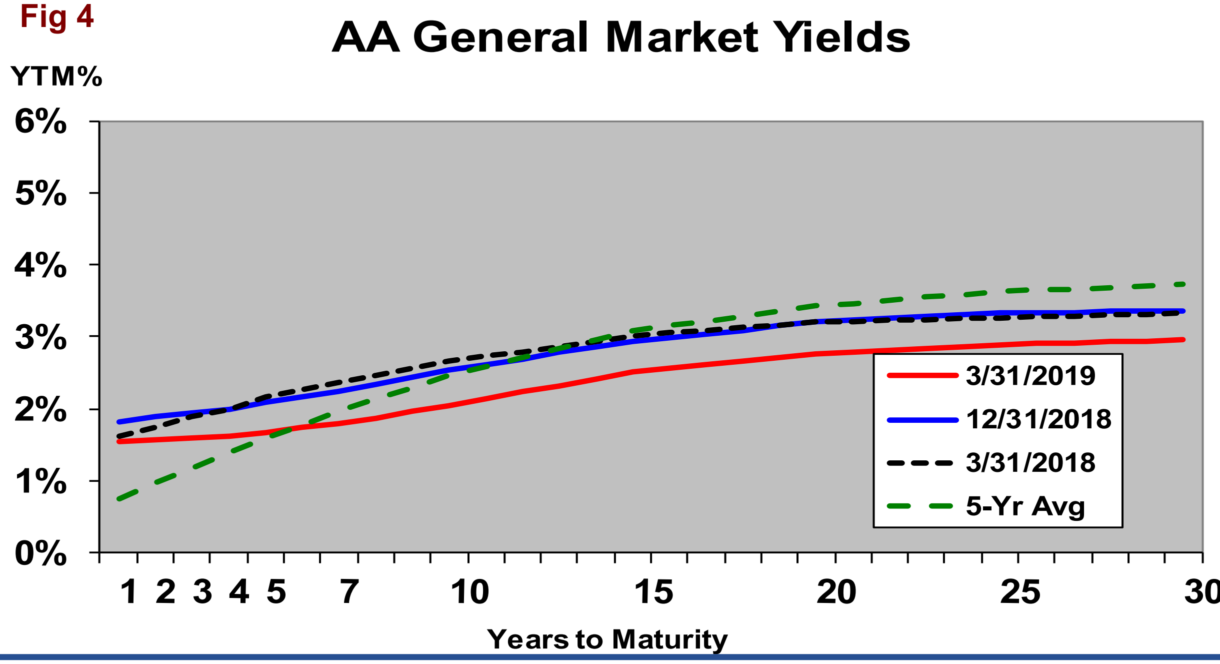
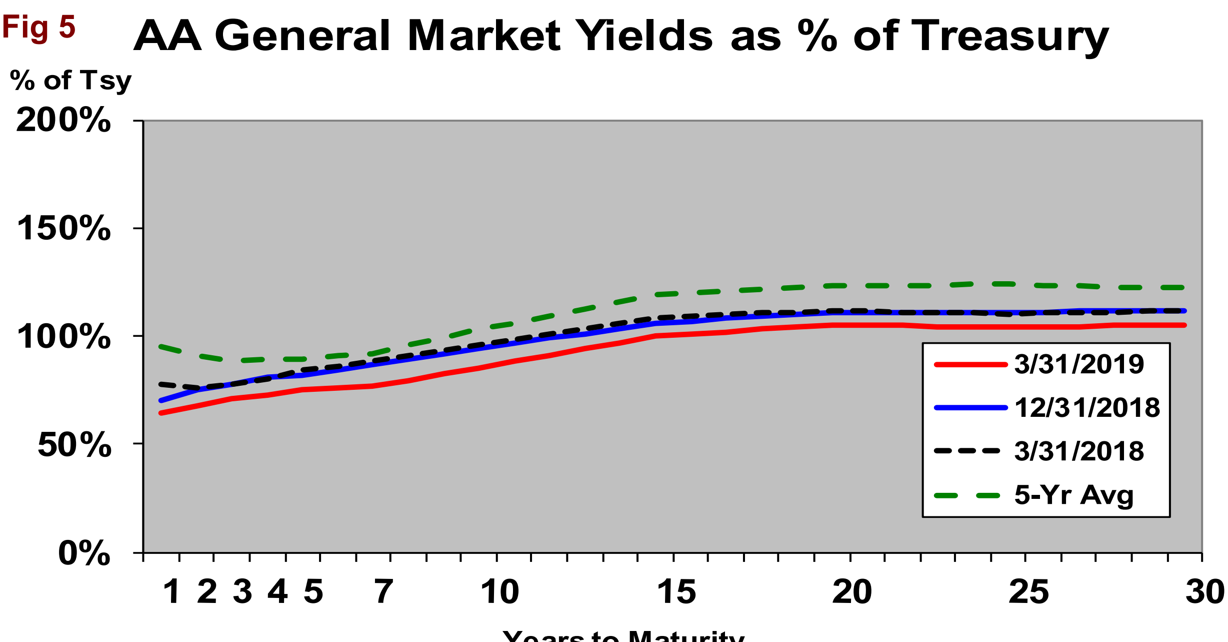


Fig 5



	5 Yr Avg	12/31/2018	3/31/2019
2-Year AA Municipal	91%	75%	68%
5-Year AA Municipal	89%	82%	75%
10-Year AA Municipal	103%	94%	85%
25-Year AA Municipal	124%	111%	104%