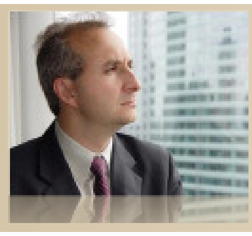
Redstone Advisors



Municipal Market Review

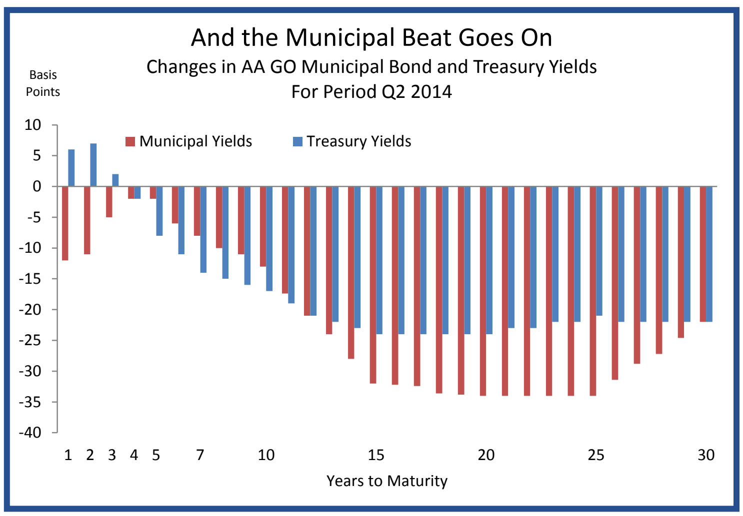
Second Quarter 2014

"I don't think the need for tax-exempt income ever went away, and there appears to be pent-up demand."

John Miller, Nuveen Asset Management

Municipal bond yields rallied moderately during the second quarter of 2014, marking the second consecutive quarter of declining yields. While municipal yields declined all along the yield curve, the **rally was uneven**, with the decline in yields most pronounced in the longer maturities. Specifically, yields in the 15-to-30 year maturities declined on average, by approximately **30 basis points**, while the decline in yields in the short-to-intermediate part of the yield curve was more modest, averaging less than 10 basis points. Thus, much like the first quarter, the municipal yield curve experienced a **bullish flattening** as short-to-intermediate term yields held relatively stable and longer-term yields declined. Overall during the second quarter, the municipal yield curve, as measured by the 2s-to-30s segment, flattened by 12 basis points, from a level of 444 basis points to 432 basis points. Similarly, Treasury yields ended the quarter mostly lower across the yield curve, mainly in maturities greater than 10 years. This 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 second quarter of 2014. Municipal **relative value** ratios held steady and were largely unchanged for the quarter. Importantly, relative value ratios remain **above 100%** for maturities greater than 10 years, and above historical levels for maturities less than 10 years.

Fig 1



Back at the beginning of this year, Morgan Stanley predicted a 4% decline for municipal bonds in 2014. They certainly were not alone, with the consensus Wall Street view being that as interest rates rose from historically low levels, fixed-income securities would get hammered. As the second quarter of 2014 comes to an end, those fearful

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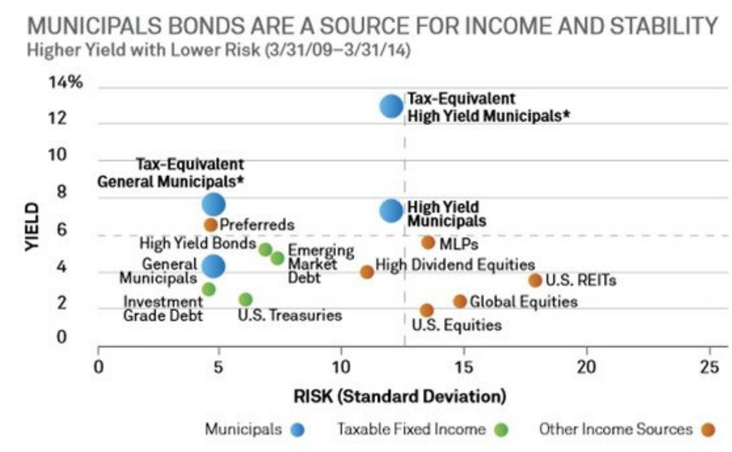
predictions clearly haven't materialized. In early April, Morgan Stanley issued a *mea culpa*, revising its negative view on the muni bond sector. In a note to clients that cited improved tax receipts and investor interest, analysts concluded that *"all in, the muni market appears to have a better tone to it than a month ago."* In other encouraging news, Municipal Market Advisors reported that municipal bonds are defaulting at the slowest pace in at least five years as a growing economy lifts the market. A **rebound in property taxes** and **real-estate values** are cited as factors in the muni market recovery. The fourth quarter of 2013 saw property-tax collections increase to $183 billion, the **highest level in four years**. Evidence of a broad improvement in municipal finances can also be seen in data collected by the Nelson A. Rockefeller Institute of Government, which reports that state tax collections have risen in every quarter since the start of 2010. This past quarter municipal bonds have certainly benefitted from a broad bond-market rally and a drop in new debt issuance by municipalities that are still focusing on tightening their belts and paying down debt in the aftermath of the Great Recession. **The silver lining** of the recession was that it pressured state and local governments to confront some challenges (like pensions), which is leading to **rising revenues**, **spending restraint** and greater **fiscal stability**. As of the end of May, inflows into municipal-bond funds have totaled $3 billion, a welcome and noteworthy shift from the nearly $40 billion that was withdrawn from the funds in the last 31 weeks of last year. The turnaround from 2013, the worst year for the municipal-bond market in roughly two decades, has been impressive. Through the end of June, the **S&P Municipal Bond Index** has earned **6.1%**, **its best mid-year return since 2009**. Comparably, corporate bonds have returned 5.6%, and the S&P 500 has gained 6.0%. Pent-up demand for tax-exempt income and a primary market supply that is quite low have contributed to the strong muni rally. **Figure 2** illustrates how municipal bonds have been an excellent source of income and stability when compared with other investment options over the last five years.

Fig 2



Sources: BlackRock, Morningstar Direct, Bloomberg. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index. * After-tax yield calculated using 43.4% maximum income tax rate. Refer to back page for additional information.

In mid-April news broke that the Treasury Department is forming a new unit to broadly monitor the municipal-bond market, with a special focus on troubled borrowers. The unit will also keep an eye on state and local pensions in addition to the financing of infrastructure projects. A Treasury official is quoted as saying the hope is to better understand the ramifications of municipal-market stresses in the $3.7 trillion market. Important to note, the new unit would not have authority to write and enforce rules for the market like the Securities and

Exchange Commission. The SEC, the market's main regulator, also has increased its inspection of the muni sector. SEC officials say they are in the process of reviewing past disclosures by financially stressed states and municipalities to determine if they have intentionally misled investors about their financial condition. The SEC is also pushing for additional authority from Congress to crack down on municipalities that don't keep the public apprised of their financial health. The SEC's enforcement director stated that the municipal market is **"fertile ground"** for further enforcement initiatives aimed at getting market participants to comply with their obligations under the law. This extra scrutiny from the Treasury and SEC comes as the investor base in the municipal market is expanding. Crossover buyers and non-traditional investors like banks, hedge funds and insurance companies have increased their presence in a market that has historically been the domain of traditional buy-and-hold retail investors.

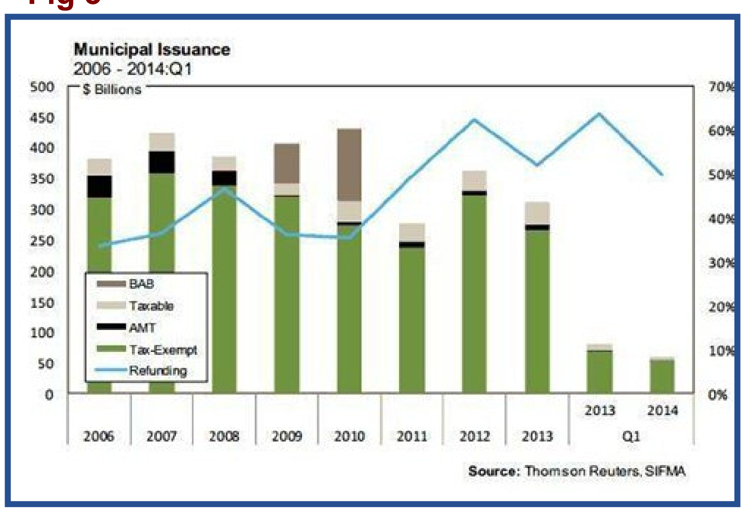
In June the Federal Reserve as expected announced it would continue tapering its bond buying as it sees economic growth rebounding from a rough first quarter which saw Gross Domestic Product contract by 3%. The Federal Open Market Committee trimmed monthly asset buying to $35 billion, its fifth consecutive $10 billion cut, and stated that further reductions in **"measured steps"** are likely. Minutes from the June FOMC meeting show that the Fed said if the economy progresses as it expects, the **final reduction** in asset purchases would occur following the FOMC's **October** meeting. Three rounds of QE have increased the Fed's balance sheet to a **record $4.34 trillion**. Fed Chairwoman Janet Yellen admitted that the central bank **"will continue to have a very large balance sheet for some time."** The Fed reiterated that it's likely to keep the benchmark federal funds rate close to zero for a **"considerable time"** after bond purchases end. In a unanimous decision, the Fed kept its forward guidance on borrowing costs, declaring that it will consider a "wide range of information" in deciding when to raise the fed funds rate. Fed officials predicted the benchmark fed funds rate would rise from near zero today to 1.2% by the end of 2015 and 2.5% by the end of 2016. These levels are slightly higher than previously forecast. Potentially complicating matters for the Fed are signs of creeping inflation. Ms. Yellen stated that recent inflation data have been "a bit on the high side" and "noisy" but she noted the data has generally provided evidence that price levels are moving back toward the Fed's 2% target. Bottom line, the takeaway is that the **Fed sees no need to raise short-term interest rates from historic lows any time soon**. Yellen's dovish statement clearly implies she and the Fed are more concerned about higher-than-normal unemployment rather than inflation.

Last market review we mentioned good news on the bond insurance front, as Assured Guaranty and National Public Finance both saw their ratings upgraded by Standard & Poor's. In the wake of 2008's financial crisis, the percentage of municipal bonds issued with a guarantee plunged. Before the recession, up to 57% were insured. That number dropped to 19% in 2008 and to 3.5% in 2012. With their newly upgraded ratings, the bond insurers are hopeful that more municipalities will be attracted to the savings that can be had with an insurer's guarantee. Bond insurers guaranteed 3.6% of all new bond issues in 2013. That amount is less than a tenth of what it was pre-financial crisis, but it is significant in that it represents the first sign of growth in a decade.

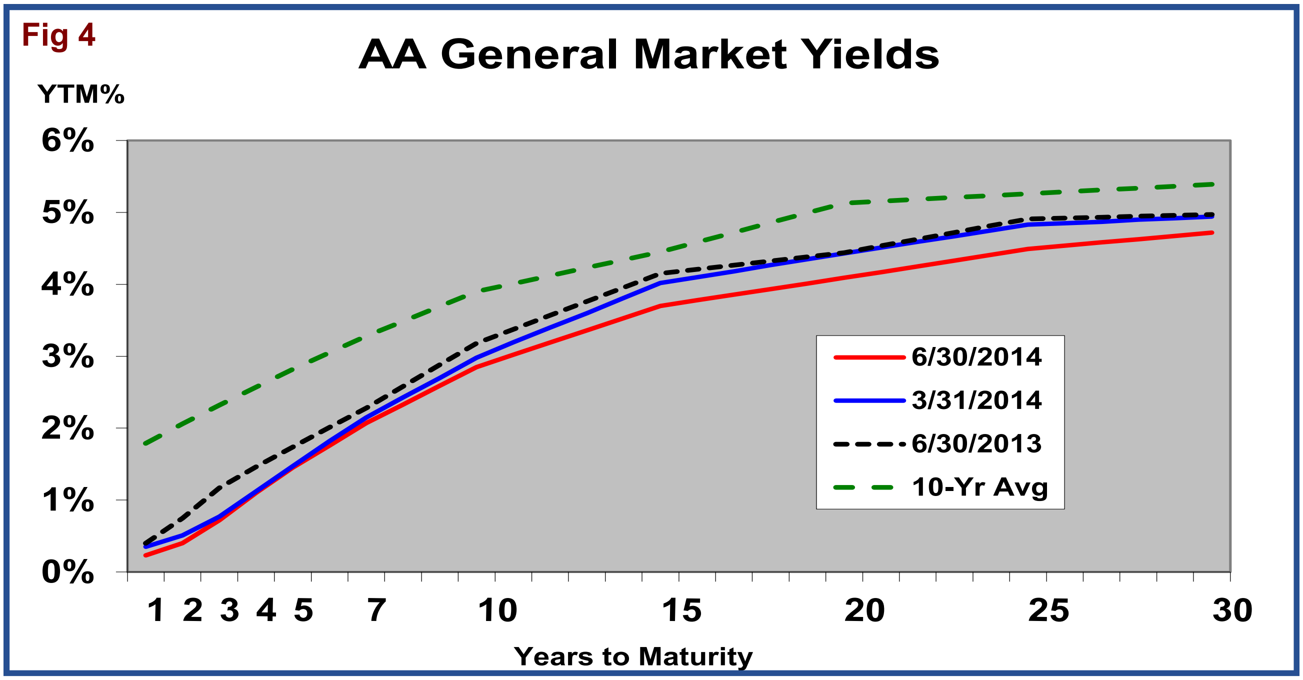
Municipal bonds used to be a "do it yourself" friendly asset class, where the retail investor could simply buy AAA insured paper. We have written in the past how the process of **"credit discovery"** replaced undifferentiated trading. The old way of trading was based on an over reliance on credit ratings which were overly influenced by the presence of municipal bond insurance. The pre-crisis average yield spread or risk premium between AAA and A municipal bonds was just less than 20 basis points. That is very little risk distinction given the vast differentiation in the underlying credit profiles of the numerous issuers of municipal debt, clearly suggesting an over reliance on bond insurance. Now, contrast that period with the post-monoline period and we can observe that since the beginning of the "credit discovery era," there has been a **five-fold increase in the risk premium**, as the vast distinctions in the underlying credit profiles of the issuers are garnering much greater attention. The spread between 10-Year AAA and A as of early June was 118 basis points. This increased market dislocation and credit differentiation continues to offer enormous opportunities for those with both the ability and experience to properly evaluate the underlying municipal credit. This is an area where Redstone believes we can **add value** for our clients. We continue to find attractive value and safety in the high-quality, essential revenue-backed credits and general obligation bonds in the short to intermediate section of the yield curve. Our prudent strategy includes investing inside of 10 years and limiting duration risk. We favor the 6-10 year maturity due to the current steepness of the yield curve and the Fed's continued commitment to anchoring the short end. We are content to let yield-chasing hedge funds speculate on questionable credits like Detroit and Puerto Rico.

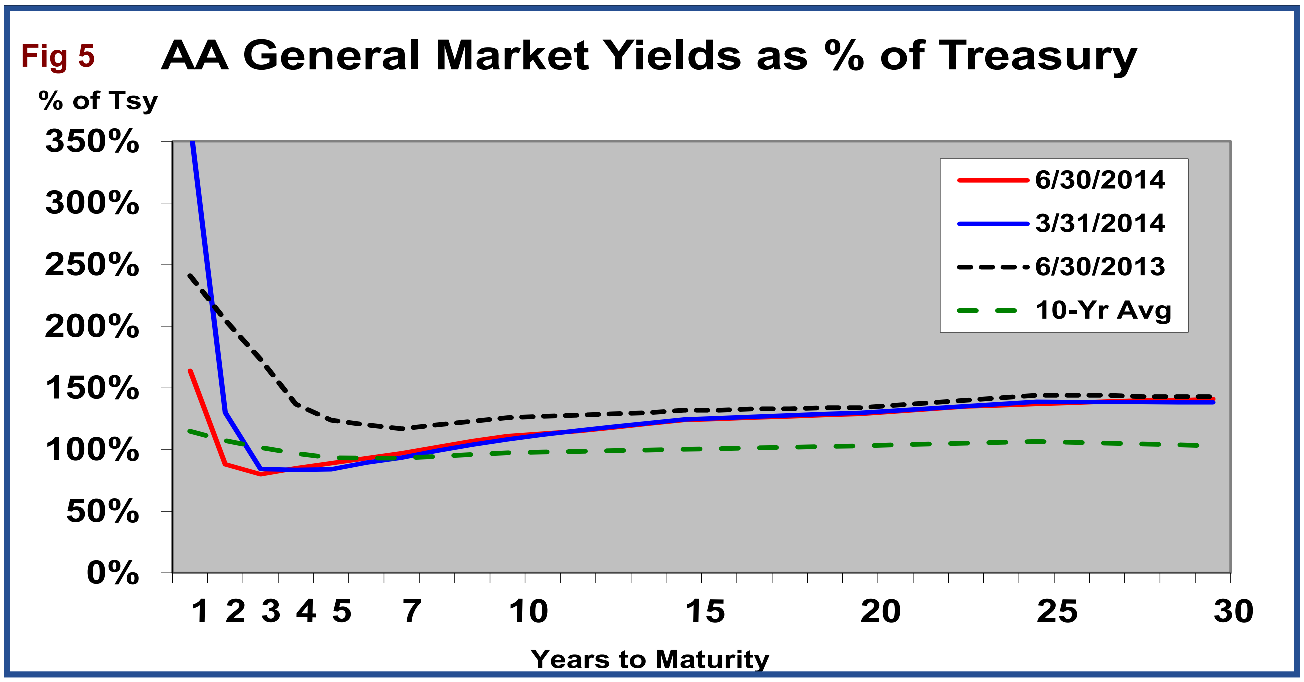
A definite theme this quarter has been the **scarce amount of supply** available in the municipal bond primary market. **Figure 3** shows annual municipal issuance going back to 2006, along with first quarter issuance for 2013 and 2014. Issuance was significantly down this past quarter. Annualizing new money issuance year to date, not since 1996 has new bond sale activity been at these low levels. In May, new issuance was just about $24 billion, an amount which is 20% below the five-year average. In June the Federal Reserve released a report detailing how states, cities and public agencies have cut their debt load by a **remarkable $111 billion** since 2010. This was the **largest drop peak to bottom** since records began in **1945**. Intuitively, higher interest rates lead to lower overall new bond issuance, as it becomes more expensive to finance new debt. It is thus rather interesting that with municipal yields declining in 2014, issuance is still very low. The National Association of State Budget Officers published a report in May that

Fig 3



found most states are not fully utilizing their borrowing capacity and are spending less on infrastructure. Additionally the group reported that the increase in debt for infrastructure in almost all states has been "very minor or flat" despite the climate of low interest rates. Thus one must look at other factors to explain the sharp slowdown in municipal issuance this year. These factors include austerity measures by local governments to balance their budgets, use of alternative debt products such as direct bank loans, and generally weak public support for infrastructure spending. This is all part of an ongoing post-crisis fiscal prudence and a general aversion to taking on new debt. Demand has remained strong, partly due to rising federal tax rates, as more investors realize the **inherent tax benefit of municipals.** Moreover, their stability and attractive relative yield remain strong draws. Bottom line, anemic supply has made the current environment an issuers' market. And in that market, with fierce competition for fewer and fewer bonds, access to inventory is very crucial. Redstone is built for these times, with our over 25 years of fixed income management experience, access to large inventory, and key relationships with specialty regional broker/dealers.





	10 Yr Avg	3/31/2014	6/30/2014
2-Year AA Municipal	107%	130%	88%
5-Year AA Municipal	93%	84%	89%
10-Year AA Municipal	97%	108%	111%
25-Year AA Municipal	106%	139%	