Redstone Advisors

Municipal Market Review

Second Quarter 2016

"The market for munis has been strong and this (Brexit) will only add to the dynamic."

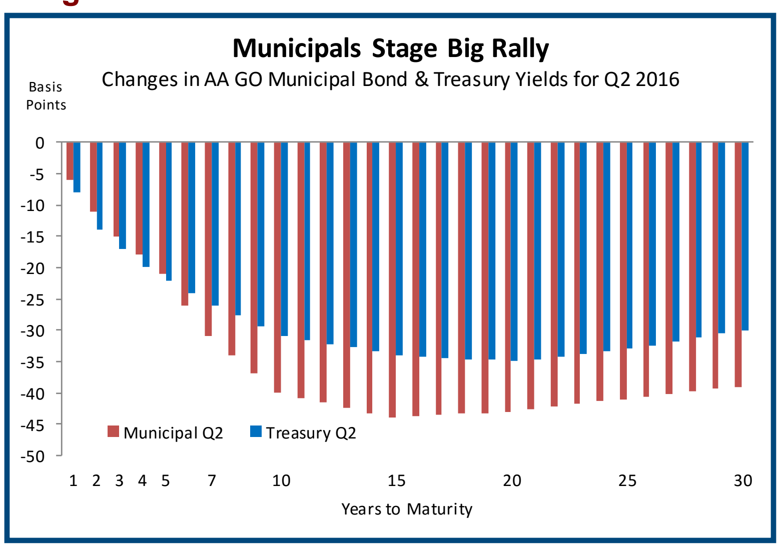
Dan Heckman, U.S. Bank Wealth Management

"Muni bond buyers have been nicely rewarded just by staying invested and clipping their coupons."

Jeffrey Lipton, Oppenheimer & Co.

Municipal bonds rallied strongly in the second quarter of 2016, building upon the gains experienced in the first quarter and last year's market-leading performance. The rally accelerated in late June in the aftermath of "Brexit", Britain's vote to leave the European Union. In the global flight to safety, yields on many benchmark muni maturities dived significantly lower. For the quarter, the largest decline came at the longer end of the curve, where the average decrease in the 10-to-30 year range was 40 basis points. With a massive and growing total of $11.7 trillion of negative-yielding sovereign debt in Japan and other countries, municipal bonds had already become attractive to foreign investors and the Brexit vote was, *"kind of the icing on the cake"* according to one municipal analyst. Thus the immediate impact of Brexit on the muni market was lower yields and higher dollar prices on most investment-grade bonds. Municipals have gained every month so far this year, only the second time that has happened since 1999. Treasury yields also ended the quarter noticeably lower across the yield curve and municipal relative

Fig 1



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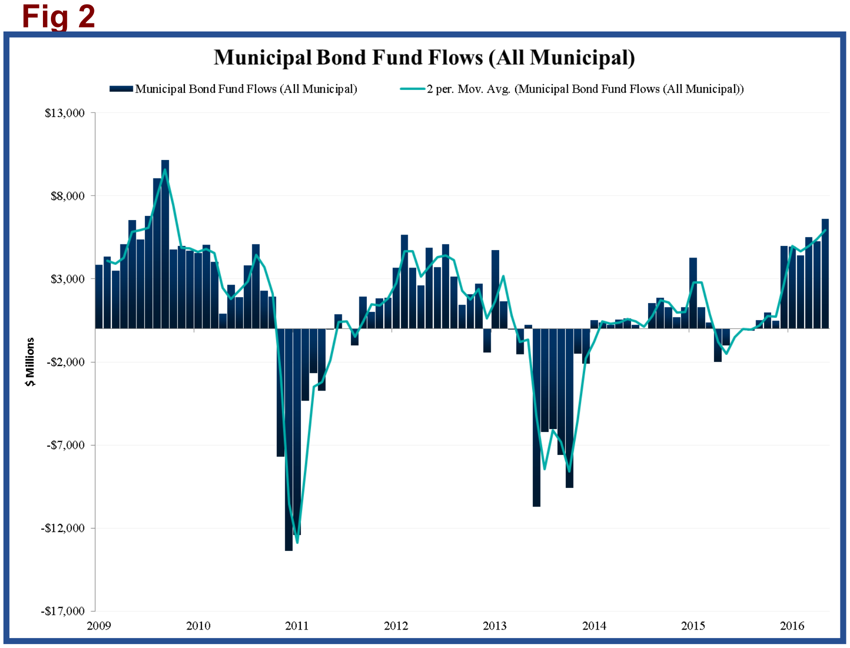
value ratios largely held steady this quarter. Relative value ratios remain attractive, with ratios above 100 percent for the entire yield curve. The reshaping of the yield curve is reflected in Figure 1 which graphs the changes in municipal and Treasury yields for the second quarter of 2016.

Demand for high-quality, safe-haven assets has noticeably increased in 2016, providing a positive backdrop for municipal bond prices. Fundamentals are stable to improving as city and state revenues continue to increase for the majority of the municipal bond market. In fact, revenues at both the state and local levels have eclipsed the peaks they experienced prior to the Great Recession. While it's natural to focus on a few troubled outliers like Puerto Rico, Illinois, & Atlantic City, investors should remember that the **municipal market includes almost 50,000 distinct issuers with a wide variety of credit profiles.** S&P Global Ratings has upgraded more municipalities than it has lowered for thirteen straight quarters, the longest streak since 2001. Meanwhile, Fitch Ratings announced it upgraded twenty-nine issuers and lowered just nineteen in the first quarter, and said positive outlooks were the highest since at least 2001. Many municipalities continue to take advantage of historically low interest rates to refinance outstanding debt, reduce interest payments and strengthen their fiscal health. **Constructive technicals (low supply/high demand)** continue to be the trend. Municipal-bond funds had more than $632 billion in assets as of the beginning of June, a record high, according to Lipper data going back to 1992. As of late June, investors had added cash to municipal-bond funds every week since October, a streak of thirty-eight consecutive weeks that is the longest since 2010. The heavy buying is due to a variety of factors, including attractive relative valuations, increased global economic uncertainty, and a search for yield in a challenging investment landscape. Municipal bond fund flows dating back to 2009 can be seen in Figure 2.

Fig 2



It's not just American investors who are responsible for the high demand. Overseas investors, desperate for yield, are also turning to U.S. municipal bonds, despite being ineligible to take advantage of munis' tax-exempt interest feature. John Miller of Nuveen Asset Management put it this way: *"Even though munis are at low yields relative to history, they're at high yields relative to the rest of the world."* At the end of 2015, foreign investors held more than $85 billion in American municipal bonds, an increase from $72 billion in 2010 and just $29 billion in 2005. $85 billion is a relatively small share of the $3.7 trillion municipal market, yet with remarkably almost $12 trillion of global sovereign debt carrying negative yields (Figure 3), many analysts see the foreign buying as not slowing down anytime soon. As Natalie Cohen of Wells Fargo noted, *"Even if foreign investors are not subject to the US tax code, a plus two is better than a minus one. It's just basic math and that has made municipals attractive."* The relative value of 10-Year AAA U.S. Municipal Bond yields vs. their German and Japanese counterparts can be seen in Figure 4.

Fig 3

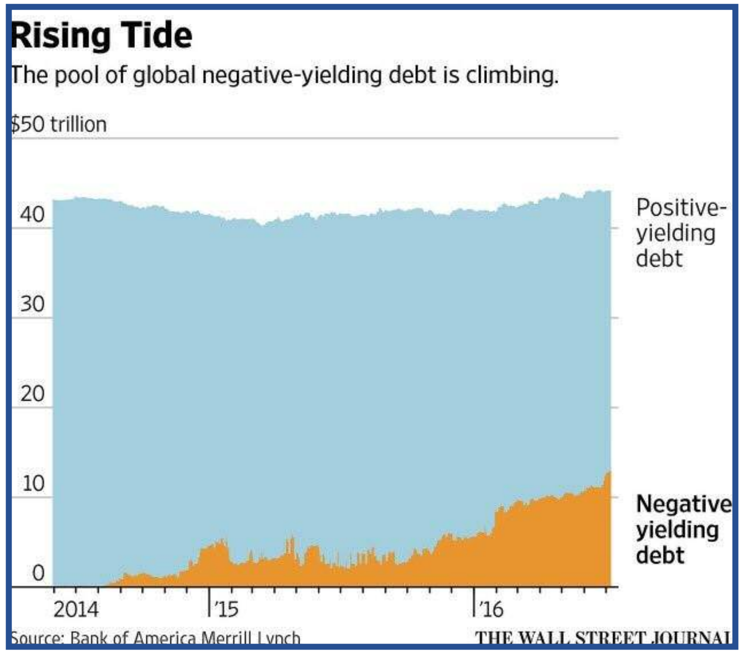
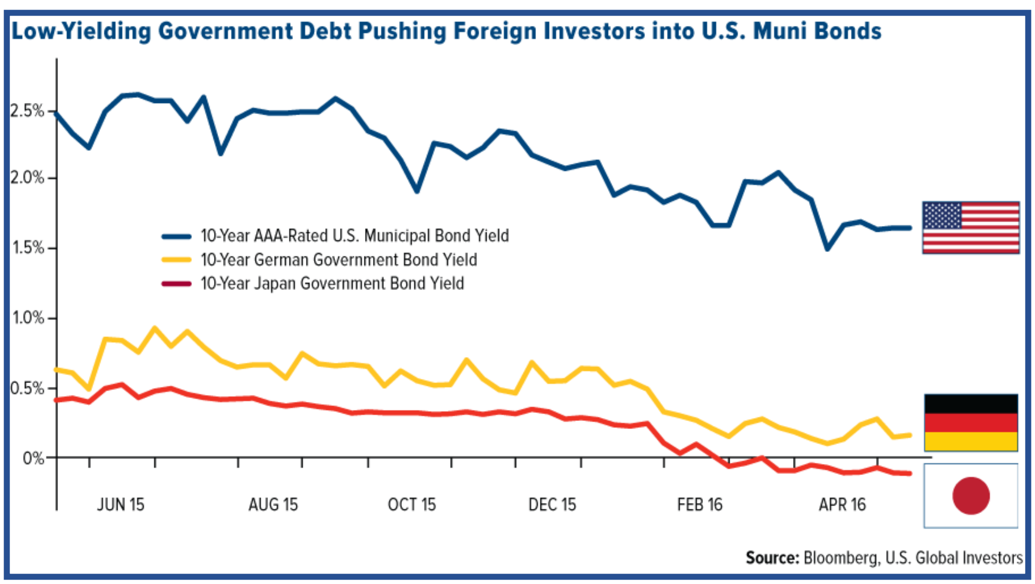


Fig 4



Along with Puerto Rico, Illinois remained in the headlines this past quarter.

Illinois, already the lowest-rated state in the nation, was downgraded again in early June when Moody's Investors Service dropped $26 billion of general obligation (GO) bonds one notch to Baa2 from Baa1, just two steps above junk. The troubled state is headed toward the start of a second fiscal year without a balanced budget in place. In its statement, Moody's wrote that, *"the rating downgrade reflects continuing budget imbalance due to political gridlock that for more than a year has kept Illinois from addressing revenue lost due to income tax cuts that took effect in January 2015."* Stop-gap measures to keep the government running have left it spending more than it takes in, with a deficit as high as $6 billion projected for the fiscal year ending June 30. The gridlock has also kept Illinois from finding a way to pay down its $111 billion pension-fund debt, which is the largest among the 50 U.S. states.

Regarding Puerto Rico, in late June the U.S. Senate passed a rescue package bill known as PROMESA (Puerto Rico Oversight, Management & Economic Stability Act). Essentially, the bill would allow the troubled territory to restructure the $70 billion it owes bondholders in exchange for new federal oversight over its locally elected government. PROMESA was crafted largely because Puerto Rico, as a U.S. territory, is not covered by Chapter 9 U.S. bankruptcy code. Importantly, the seven-member oversight board established under the bill would have broad powers to manage the island's fiscal affairs, including the power to enforce balanced budgets and negotiate with creditors. The bill would not send any federal taxpayer funds to the island. The bill was signed into law by President Obama on June 30, and a key provision gives the island a stay against creditor litigation arising from any defaults on its debt load. As expected, on July 1, Puerto Rico defaulted on roughly $911 million in debt payments out of a total $2 billion due, including $780 million in general obligation bonds. *"The market has been waiting for this default for two years, but really it's been 15 years in the making,"* noted Matt Fabian of Municipal Market Analytics. Municipal defaults have been virtually nonexistent outside of Puerto Rico, and Puerto Rico has a low correlation to the rest of the market. It is literally and figuratively on its own island apart from the rest of the vast $3.7 trillion municipal market. Experts do not see the ongoing saga there as a catalyst for widespread investment-grade municipal market contagion because ownership of Puerto Rico's debt has largely dispersed, and now is primarily concentrated among a variety of hedge funds and risk-taking speculators. A clear signal that the broader market is shrugging off Puerto Rico and Illinois is the heavy flow of money pouring into tax-exempt bond funds.

In mid-June, as many 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. The Federal Reserve said it expected to increase rates more slowly in coming years, an acknowledgment that economic growth had again disappointed its expectations. Fed Chair Janet Yellen said one factor in the Fed's decision to leave rates unchanged was concern about the potential impact of Brexit, Britain's June 23 referendum on its continued membership in the European Union (EU). In the aftermath of Britain's vote to leave the EU, many analysts see the Fed as being forced to seriously question any notion of rate hikes for the rest of the year amid the global uncertainty and a flattening yield curve. The market-implied probability of a rate hike by year-end was about 25 percent in early July, a decrease from the 50 percent chance assigned before the June 23rd Brexit vote.

Redstone Advisors, with our 25+ year 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. Our strategy involves favoring high quality, intermediate bonds and reducing potential rate risk with premium coupons. 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.

Fig 5

AA General Market Yields

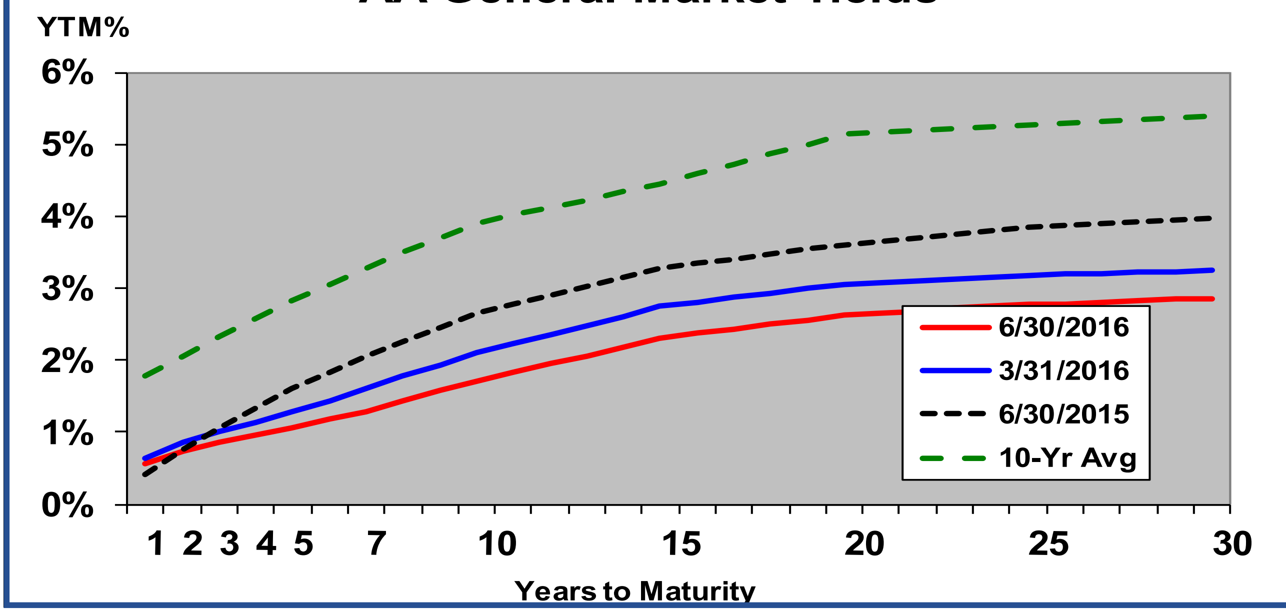
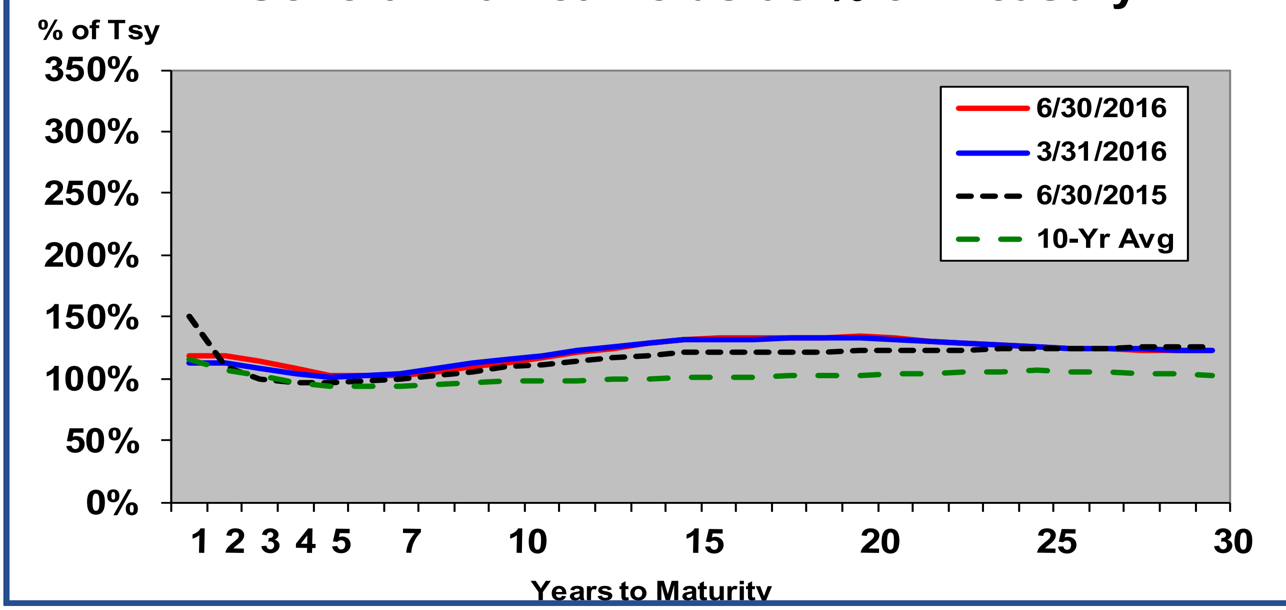


Fig 6

AA General Market Yields as % of Treasury



	10 Yr Avg	3/31/2016	6/30/2016
2-Year AA Municipal	107%	112%	119%
5-Year AA Municipal	93%	101%	103%
10-Year AA Municipal	97%	116%	113%
25-Year AA Municipal	106%	125%	125%