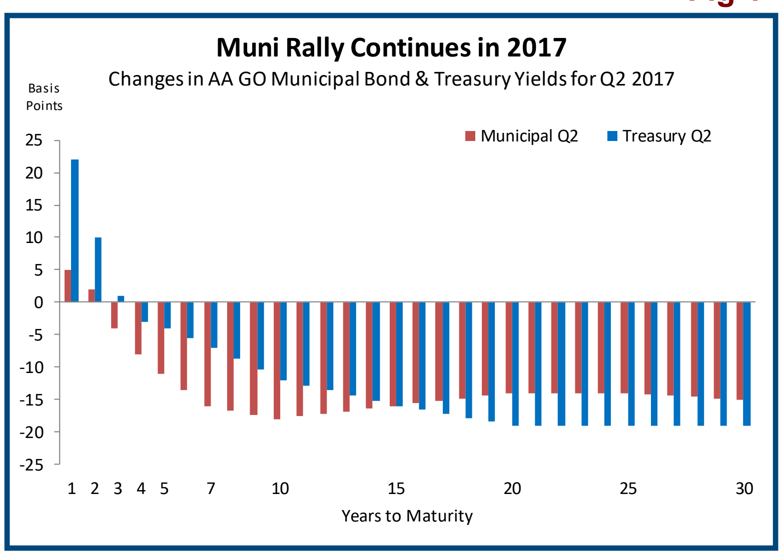
Redstone Advisors

Municipal Market Review

Second Quarter 2017

Municipal bonds rallied again in the second quarter of 2017, as the market continued to signal that the sharp selloff and “Trump Tantrum” that sent yields higher during the final quarter of 2016 was overdone. Yields modestly declined along nearly the entire curve, except at the very short end, in the 1-to-2-year range. For the quarter, the municipal yield curve underwent a slight flattening. The Treasury yield curve underwent a more noticeable flattening this past quarter, as short term yields increased amidst another Federal Reserve hate hike and longer term yields declined due to softening inflation and growth expectations. The largest moves on the Treasury yield curve came at the very short and long ends, as the 1-year increased 22 basis points and the 30-year long bond decreased by 20 basis points. The reshaping of the yield curves is reflected in **Figure 1** which graphs the changes in municipal and Treasury yields for the second 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 primary concern of the municipal market since last year’s election has been the issue of tax reform being pushed by the Trump administration. It remains to be

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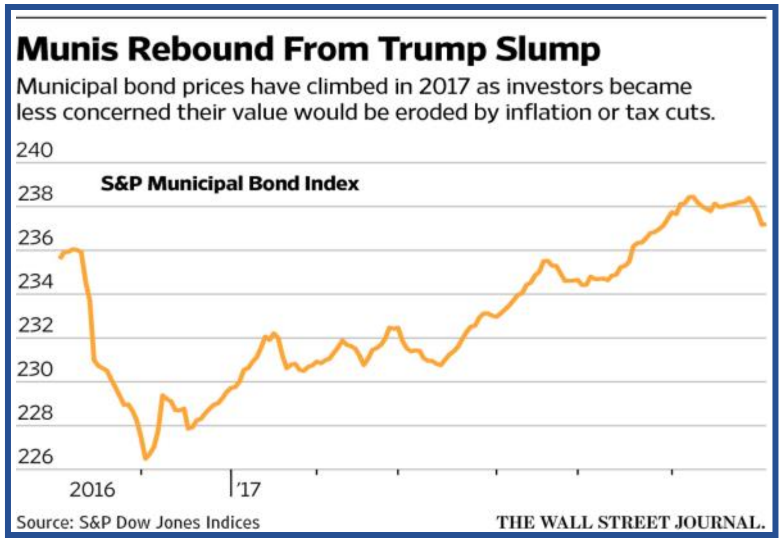
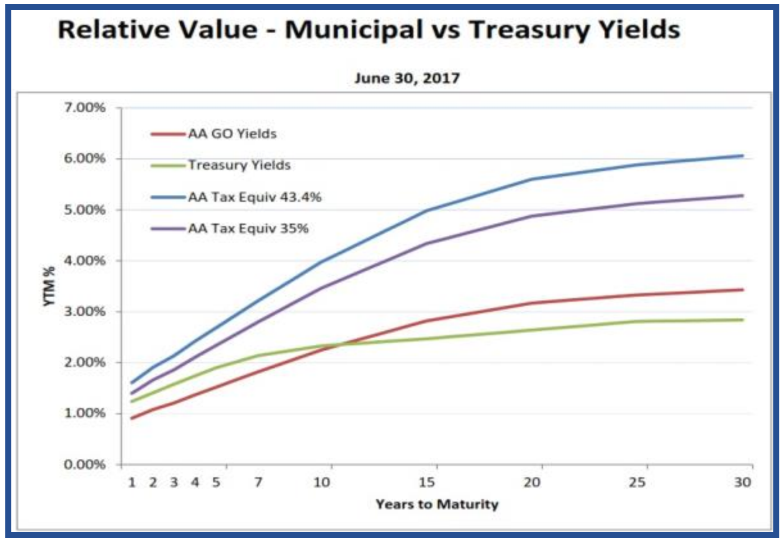
seen exactly what kind of tax reform plan Congress will be able to agree upon and enact. With tax reform up in the air and scant evidence of progress, tax-exempt investments have looked quite a bit more appealing than they did in the immediate aftermath of the November election. The muni market has further accepted this past quarter that the actual manifestation of assumed Trump policies isn't so clear cut, as bond prices have largely recovered and stabilized. The recovery can be seen in **Figure 2**, which shows the rise of the S&P Municipal Bond Index over the first half of 2017. *"I think the bond market had become very much oversold very, very quickly [late last year], and a lot of that sentiment was really based on expectations as opposed to reality, and now we are seeing expectations are being pulled back,"* noted Jeff Lipton, head of municipal research at Oppenheimer. 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.

Fig 2



The Trump administration released a very broad overview of their tax plan in late April. The updated plan calls for the reduction of the current seven tax brackets down to three and reducing the top personal rate to 35% from 43.4%. As illustrated in **Figure 3**, investors would still capture a sizeable after-tax yield advantage over Treasury bonds, even at a 35% tax rate. *"The fact that the top rate may only be going down to 35%--and that is accompanied by either a cap or elimination of certain deductions—you could see it be a net positive for munis,"* said Dan Heckman, a fixed income strategist at US Bank. As investors sometimes focus just on nominal yields in their portfolio strategy, this graph is a reminder not to neglect a very important aspect of the value inherent in municipal bonds, their tax exemption. Speaking of that tax exemption, as tax reform continues to be debated, 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. In late May, before Congress, Treasury Secretary Steve Mnuchin said he would prefer to retain the tax exemption for municipal bonds.

Fig 3



The fiscally troubled state of Illinois was back in the news in early June, as its bond rating was downgraded to one step above junk by Moody's and S&P, at Baa3 and BBB- respectively. Illinois thus attained the dubious distinction of having the lowest ranking on record for a U.S. state. Contributing to the downgrade was the long-running partisan political gridlock over the state budget, woefully underfunded pensions, and a sizeable backlog of $14.5 billion of unpaid bills that are equivalent to about 40 percent of the state's operating budget. In early July, the Illinois legislature narrowly overrode Governor Bruce Rauner's veto to enact a $36 billion budget that includes a $5 billion tax hike. Illinois had been without a budget for the past two years due to a stalemate between the Republican governor and Democratic legislature. Even with the new budget, Moody's put its Baa3 rating on review for a downgrade, arguing that the budget does not address building long-term pressures and in fact adds to the state's debts by borrowing to chip away at the huge backlog of unpaid bills. Moody's has referred to Illinois as "an outlier among states" after weathering eight downgrades in as many years. Illinois, like all other states, cannot file bankruptcy. States aren't eligible to petition the U.S. court system to escape from their debts, in the way cities such as Detroit have in the past. A downgrade to junk would heap further financial pressure on the state by raising its borrowing costs and barring many mutual funds from purchasing Illinois's debt.

Puerto Rico grabbed headlines again in early May as its Oversight Board, installed last year by the U.S. Congress as part of PROMESA (Puerto Rico Oversight, Management & Economic Stability Act), invoked a restructuring process known as Title III under PROMESA, effectively putting the island's government into the largest municipal bankruptcy in history. PROMESA was crafted largely because Puerto Rico, as a U.S. territory, is not covered by Chapter 9 U.S. bankruptcy code. Title III means the next battle in this saga, largely between Wall Street creditors and the struggling commonwealth, is headed before a federal judge. The process will be quite lengthy, given the complexity of the capital structure and the numerous stakeholders. Our view is that Puerto Rico's Title III filing is a unique event that has long been priced into the market for Puerto Rican bonds and will have no impact on the broader municipal market. Municipal defaults have been virtually nonexistent outside of Puerto Rico, and Puerto Rico has a very low correlation to the rest of the market. It is literally and figuratively, an island unto itself, apart from the rest of the vast $3.7 trillion municipal market. Experts do not see the ongoing saga there as a catalyst for a widespread investment-grade municipal market contagion because ownership of Puerto Rico's debt is now 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 renewed flow of money pouring into tax-exempt bond funds this year. Estimated net inflows year to date have totaled about $15 billion, according to the Investment Company Institute.

During its mid-June meeting, in a clearly telegraphed move, the Federal Reserve raised its benchmark lending rate a quarter point, the third time in six months it has decided to increase rates. The

Federal Open Market Committee (FOMC) set the new target range for the federal-funds rate between 1.00 percent and 1.25 percent. The Fed said it remains on track for one more quarter point rate increase this year if the economy continues to progress on the path they view it being on. The FOMC statement was also noteworthy for revealing plans to start slowly reducing the Fed’s massive $4.5 trillion balance sheet at some point this year, provided that the economy evolves broadly as anticipated. The Fed stopped adding to its holdings a little more than three years ago, but it has been reinvesting the proceeds of maturing assets to keep its holdings steady. Fed officials have indicated that there is a good chance the balance sheet normalization process could start this September. They have not yet indicated how large the balance sheet might be when they finish.

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. 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

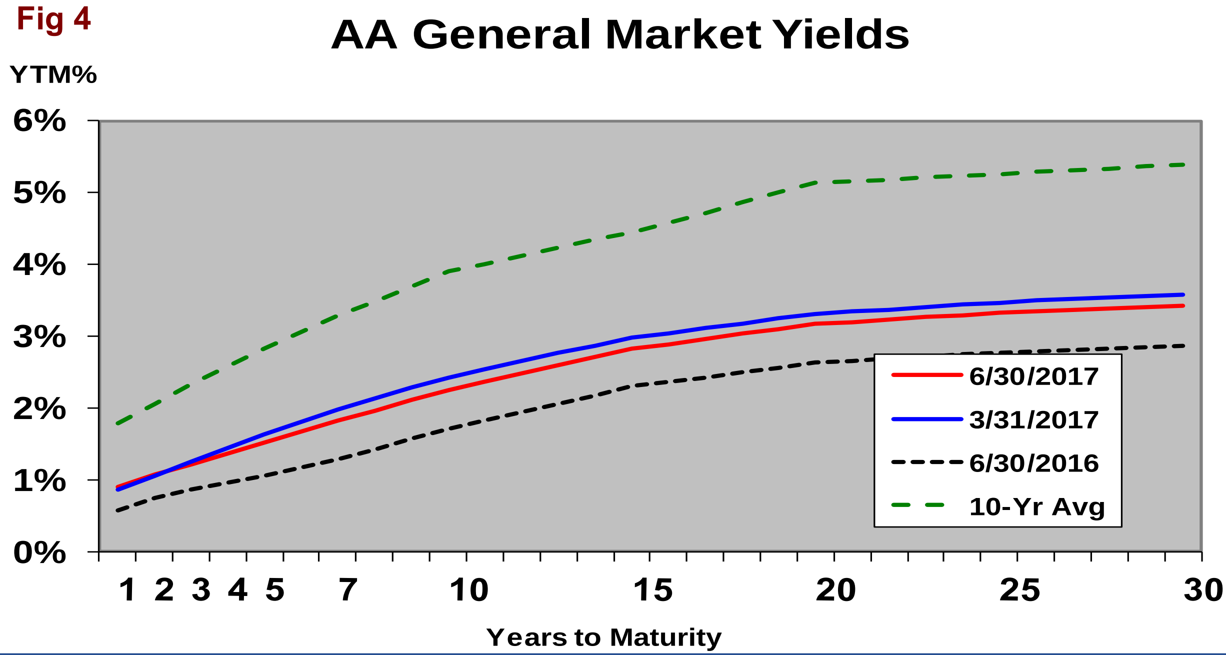
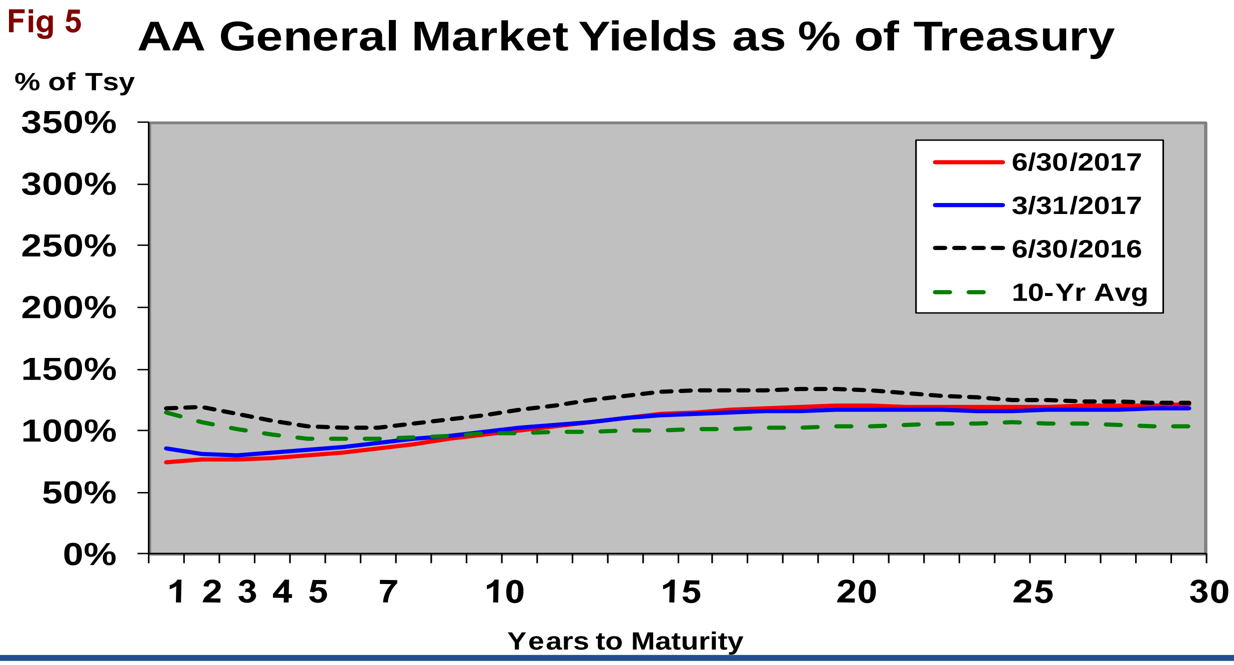


Fig 5



	10 Yr Avg	3/31/2017	6/30/2017
2-Year AA Municipal	107%	81%	76%
5-Year AA Municipal	93%	84%	80%
10-Year AA Municipal	97%	99%	97%
25-Year AA Municipal	106%	116%	119%