Redstone Advisors

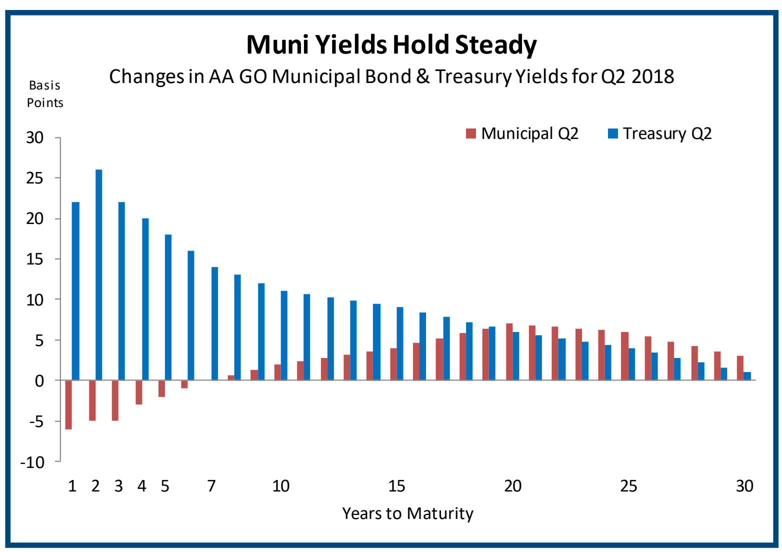
Municipal Market Review

Second Quarter 2018

"If rates are going up and good-quality municipals are giving 4 percent or more in tax-free cash flow, over the long term that's going to be good for people in high tax brackets."
Jim Pratt-Heaney Coastal Bridge Advisors

Municipal bonds had a relatively quiet 2nd quarter, with municipal yields finishing essentially unchanged across the entire yield curve. Munis have continued to outperform other sectors in the bond market including Treasuries and corporate bonds so far in 2018. This is in part due to a favorable technical environment of firm household demand coupled with a sizeable drop in issuance that has cut into supply. "*The overall better total return of munis in 2018 is reflective of low new issue and net supply—driven in part by lack of advance refunding activity—countered by continued good demand driven by the continued attractiveness of muni's after-tax returns*," noted Peter Block of Ramirez & Company. He added, "*The strong mutual fund inflows are indicative of the strong underlying demand, which was reinforced by the 2017 tax reform act that cemented munis as one of the last legitimate tax havens for high-income taxpayers."* Many states are seeing an increase in demand because under the new tax law, the state and local taxes (SALT) deduction is now capped at $10,000. As a result, the taxable equivalent yield for high-tax state bonds from places like New York, California and elsewhere has risen for many investors. Sean Carney of BlackRock wrote, "*It really*

Fig 1



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speaks to the retail demand for the asset class, not only for the tax advantage that municipal bonds possess but also because of the lower volatility." Many analysts see overall improving credit quality combined with constrained new issuance as boding well for a strong second half of 2018 in terms of municipal bond performance.

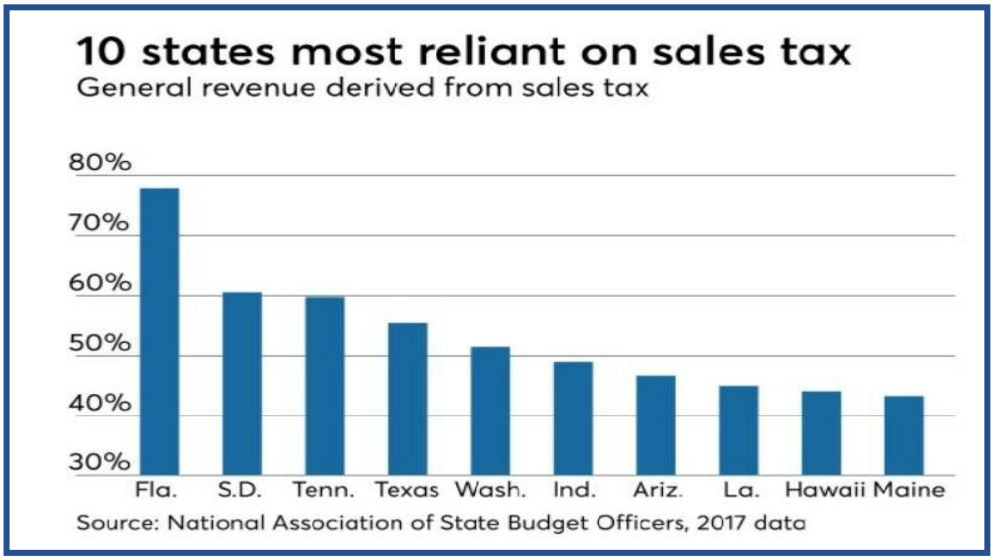
The Treasury yield curve continued its flattening trend this quarter, as short-term yields continued to rise and longer-term yields remained relatively flat. The reshaping of the yield curves is reflected in **Figure 1** which graphs the changes in municipal and Treasury yields for the second quarter of 2018. Municipal relative value ratios decreased at the short end of the curve and were mainly unchanged at the long end of the curve. Munis are yielding just roughly 65% of Treasuries in the 1-to-3- year range. Meanwhile, relative value ratios remain above 100 percent at the longer end of the curve, in the 15-to-30-year segment. The municipal yield curve is noticeably steeper than the Treasury yield curve, as the 5/30-year muni spread is 156 basis points while the 5/30-year Treasury spread is just 25 basis points.

A big Supreme Court decision in June (South Dakota v. Wayfair, Inc.) has significant implications for the municipal market. The court, in a 5-4 decision, overturned a 1992 ruling (Quill Corp. v. North Dakota), that had designated much of the Internet a tax-free domain. The Quill case was based on catalog sales, and came at a time (1992) when the economy did not rely on internet commerce. The gist of this new ruling is that sales done on the internet will now be able to be taxed, generally by the states in which the purchase occurred. The majority opinion, written by the soon to be retiring Justice Anthony Kennedy, described the physical presence rule of Quill as "*unsound and incorrect*." The ruling said, "*the physical presence rule has long been criticized as giving out-of-state sellers an advantage. Each year it becomes further removed from economic reality and results in significant revenue losses to the states."* The decision will allow states and local governments to start collecting billions of dollars from online retailers that currently don't charge sales taxes on their customers. Wider taxing power will let municipal governments collect an extra $8 billion to $23 billion a year, according to various estimates. The head of municipal research at Wells Fargo put it simply, calling the ruling a "big deal." Moody's said the ruling was credit positive for state and local governments, particularly for states that rely most heavily on sales and taxes to support their budgets.

Specifically, the decision is favorable to municipal bonds backed by sales-tax revenue because it will expand the base of goods that can be taxed.

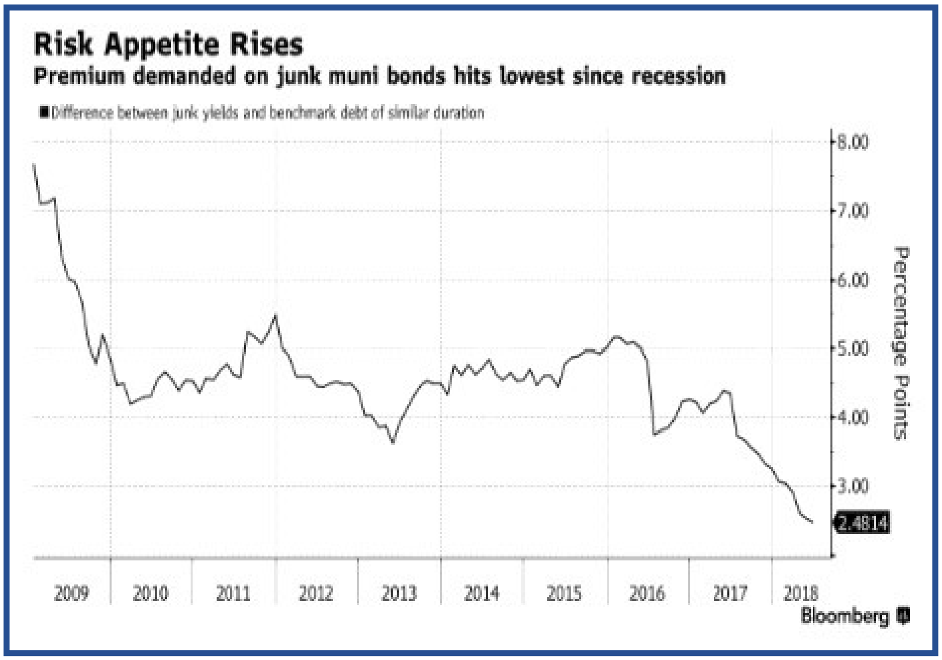
An expanded sales tax would provide a sizeable benefit to California and its local governments, which could have brought in between $1 billion and $1.7 billion in additional revenue from the expanded tax collection authority on out-of-state sales in 2017, according to a U.S. Government Accountability Office (GAO) report. Florida also had a lot at stake on the ruling, as it collected about 78% of its general fund revenues from sales tax in 2017, the most of any state. The ten states most reliant on sales tax can be seen in **Figure 2**. The GAO report said that state and local governments could have gained an additional $8 billion to $13 billion in sales tax revenue in 2017 if they had authority to charge sales tax collection from all remote sellers. That equates to about 2% to 4% of total 2016 state and local government general sales and gross receipts tax revenues. Florida, South Dakota, Tennessee, Texas and Washington are five states that get more than half their revenue from sales taxes, as shown in Figure 2.

Fig 2



Turning to the high-yield muni market, the hunt for yield has intensified over the past few years in this historically low interest rate environment. This past quarter, the difference or spread between the yield on high-yield or "junk" municipal bonds and benchmark debt of similar duration has dropped to about 2.5 percentage points, the lowest since the last recession. The declining premium demanded on high-yield muni bonds can be seen in **Figure 3**. This chart shows that compared to recent history, investors are not being as well compensated as they typically have been for investing in the high-yield sector of the muni market. Many analysts have expressed their opinion that in aggregate, the high-yield market is overpriced for the actual underlying amount of risk. So far this year, investment-grade deals are on average 4.2 times oversubscribed, while high-yield deals are more than 10 times oversubscribed, reflecting the considerable amount of investor money chasing yield. This is a trend that is unlikely to end well.

Fig 3



During its June meeting, the Federal Reserve increased its benchmark fed-funds rate by a quarter percentage point to a new target range between 1.75% and 2.00%. The rate hike itself was largely a market non-event as it had been clearly telegraphed and fully priced in. This was the seventh hike since the end of the Great Recession and part of a gradual series of steps to return rates to historically normal levels. The main news out of the meeting was that the new "dot-plot" constellation now calls for four rate hikes in 2018 (two more this year) rather than the previous estimate of three. We remain of the opinion that the Fed is engaging in an opportunistic reload ahead of the next market reset. With fiscal policy very much accommodative, the Fed is taking the opportunity to reset the funds rate ahead of the next economic downturn. The Fed's preemptive moves of raising rates, telegraphing future hikes and shrinking its balance sheet are part of an effort to curb future inflation; these steps are all ultimately positive news for bonds. Given our position that we are later in both the monetary tightening cycle and later in a weakening economic cycle, we do not think we will see a significant and sustained rise in longer-term bond yields. Nevertheless, in our opinion, even a 100 bps rise in long-term taxable yields from here—from about a 3% 10-year Treasury yield to a 4% 10-year Treasury yield—across a period of one year, would be constructive for municipal bonds as the rise over 12 months would enable the reinvestment of existing cash flow and the deployment of new money at more attractive purchase yields while the negative price impact on existing positions would be moderated across time by the increased carry. For this reason, we believe that this is actually a very good time to lock in the higher purchase yields currently on offer in high-quality municipal bonds.

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. For clients, existing or prospective, with cash to invest, the current elevated level in market yields is offering an excellent opportunity to put cash to work. 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

AA General Market Yields

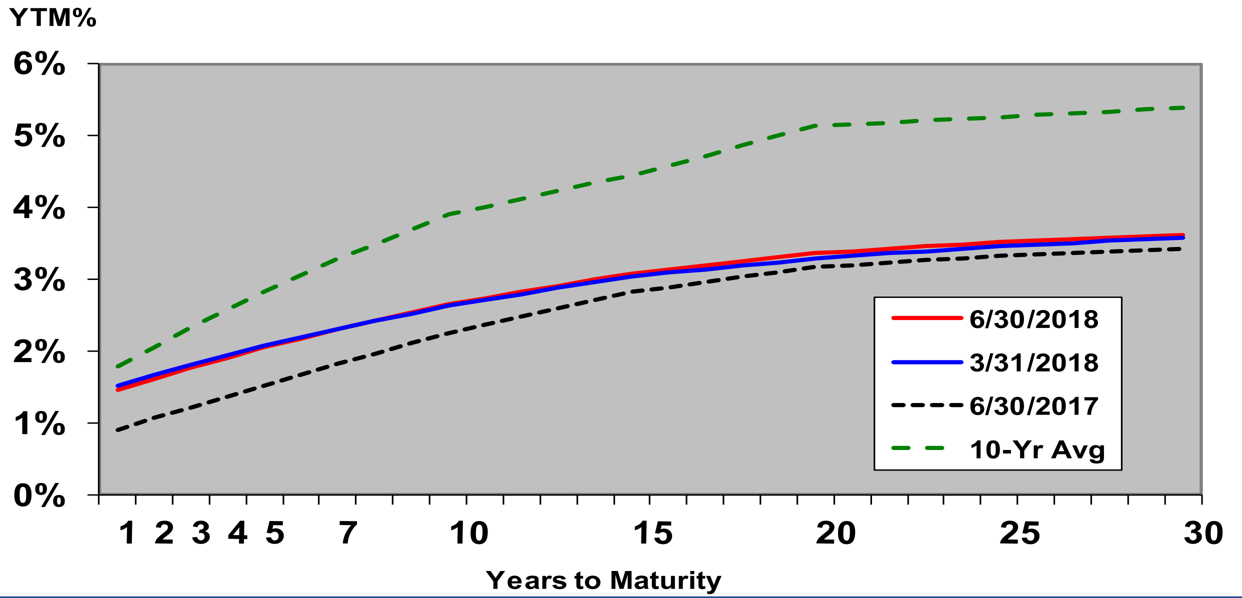
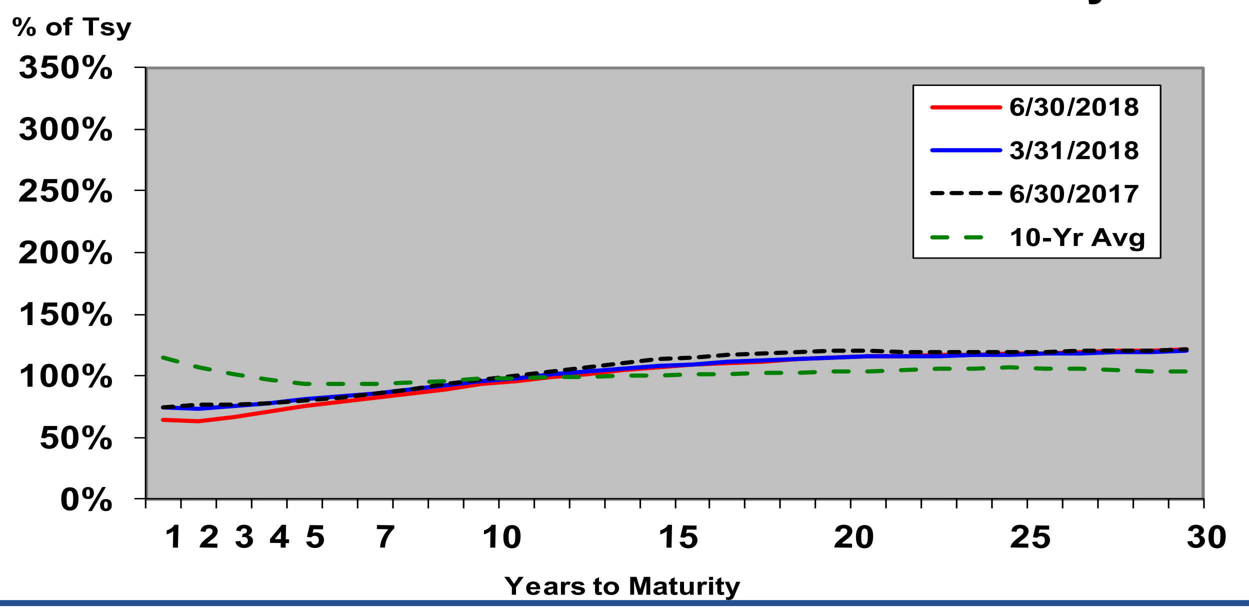


Fig 5

AA General Market Yields as % of Treasury



	10 Yr Avg	3/31/2018	6/30/2018
2-Year AA Municipal	107%	73%	63%
5-Year AA Municipal	93%	81%	75%
10-Year AA Municipal	97%	96%	93%
25-Year AA Municipal	106%	117%	118%