Redstone Advisors

Municipal Market Review

Second Quarter 2019

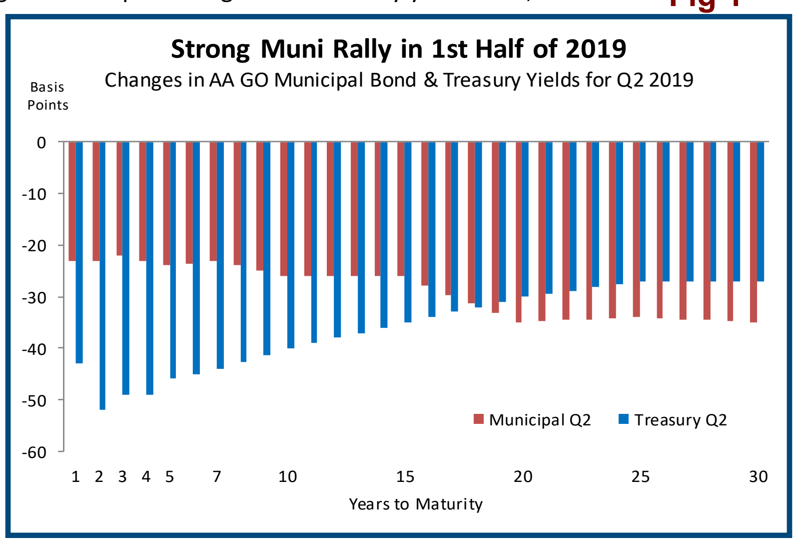
"There is more demand than at any time in recent memory."

Jeff Burger, Mellon Investments Corp.

Municipal bonds rallied again in the second quarter. Coming off the strong performance in the first quarter, the first half of 2019 has been an impressive start to the year for munis. The Bloomberg Barclays Municipal bond index earned a 5.09% total return through June 30th. The credit environment has generally improved as well, with upgrades from all three main rating agencies exceeding downgrades. The main drivers of this rally have been a more dovish Federal Reserve that is expected to cut rates this year, and the tax law's new $10,000 limit on state and local tax (SALT) deductions affecting taxpayers and influencing their investment decisions. The continued robust demand for tax-exempt munis combined with the limited supply available has kept the rally moving full speed ahead. Investor demand for muni bonds doesn't appear to be slowing anytime soon. One CEO of a New York investment firm remarked, *"There's a renewed need for munis. A lot of it is being written off to the SALT, but at the same time, supply is not robust. You've got those two factors that we all learn in Econ 101: supply and demand driving yields down versus Treasuries. It's just that simple."* Many see this backdrop of tremendous demand lasting through the summer or longer.

For the quarter, the largest move came at the long end of the curve, where the 30-yr muni and 20-yr muni both fell by 35 basis points (bp). The average decline in the 1-to-10 yr range was 24 bp. Looking at the Treasury yield curve, the downward movement in yields was greater when compared to the muni curve. Compared to the flat and partially inverted Treasury curve, the muni yield curve has remained relatively steep. At quarter end, the 2-yr/10-yr muni spread was 46 bp. The same 2-yr/10-y Treasury spread was just 25 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 second quarter.

Fig 1



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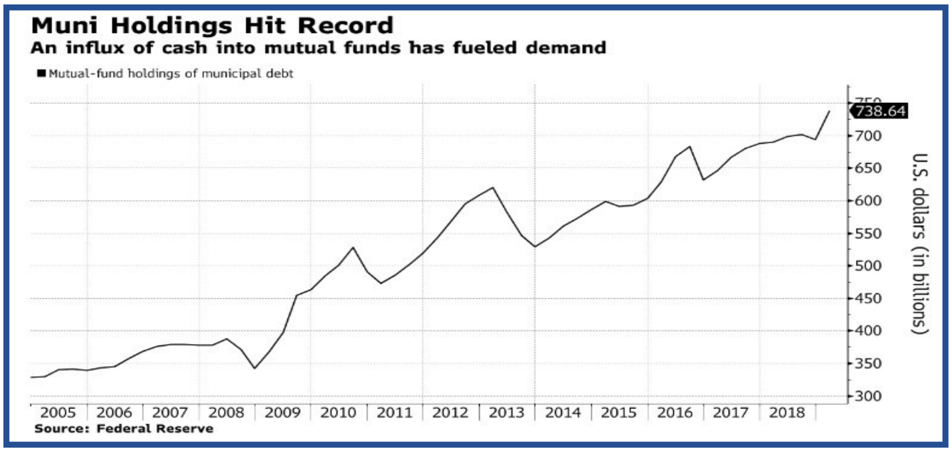
Muni relative value ratios finished the quarter largely unchanged. In late May, the 10-year municipal to Treasury ratio declined to a record low of 72%, according to Bloomberg data going back to 2001. However, the 10-year relative value ratio rebounded in June and finished the quarter at 90%. Munis finished the quarter yielding roughly 70% to 80% of Treasuries in the short 1-to-5-yr range. Relative value ratios remain at or above 100 percent at the long end of the curve, in the 15-to-30-year segment. Daniel Solender, who manages municipal debt for Lord Abbett & Co., noted that municipal yields, *"are still very attractive compared to Treasuries when you look at tax-equivalent yields."* Morgan Stanley also put out a research note in May, arguing that, *"Munis aren't intrinsically overvalued and remain a late cycle haven."* UBS joined the chorus, saying, *"We believe these valuations, as rich as they are, can continue and even move a bit lower."* Many retail investors have continued to prefer short-term munis, and their high demand has made these munis the most expensive relative to Treasuries. However, a noticeable trend this past quarter is retail investors going further out the curve, looking for more attractive relative valuations and reaching for yield wherever it is available. One municipal strategist explained, *"Retail is looking for yield. You have to go out pretty long to get a decent yield on the retail side."* A director of fixed income at another firm added, *"The 30-year was the last holdout. There is a real yield grab out there, people are looking for yield wherever they can find it."*

Municipal investors aren't just looking at the longer end of the curve for yield. There has been significant increased demand in the riskier "high-yield" sector of the municipal market. Investors have put around $8 billion into high-yield muni funds as of the end of May, the most in that period since 1992. Muni bond funds overall have gathered $37 billion across that same period, the most in about thirty years. In late May, robust demand for riskier muni debt drove down the yield on the Bloomberg Barclays Municipal Bond High Yield Index to about 4.54%, close to a sixteen-year low. Recent history of the High Yield Index can be seen in **Figure 2**. One portfolio manager at Thornburg Investment expressed caution, stating he was avoiding high-yield munis. *"Any time in any market when price is as divorced from fundamental value…there tends to be a reckoning,"* he warned.

Fig 2

As we mentioned last quarter, with the SALT deduction now capped at $10,000, residents from high-tax states like New York, New Jersey and California have certainly boosted demand for double-exempt bonds from their home states. Cash isn't just pouring in from investors in high-tax states, however. The surge in demand has also been driven by weaker growth and inflation data and a subsequent shift in expectations regarding the Federal Reserve. The bond market has been increasingly confident the Fed will lower rates this year. Recent data shows that municipal mutual funds saw their holdings grow by $45 billion to a record $738.6 billion at the beginning of this year. This was the strongest annual start to a year in at least a decade. Mutual fund holding of municipal bonds going back to 2005 can be seen in **Figure 3**.

Fig 3



During its June meeting, the Federal Reserve left its benchmark fed-funds rate unchanged at the target range between 2.25% and 2.50%. The main news to come out of the meeting was the Fed signaling they could lower rates in the months ahead if the economic outlook weakens. Fed Chairman Jerome Powell stated that the case for somewhat more accommodative policy had strengthened. A key part of the Fed statement said, *"In light of these uncertainties and muted inflation pressures, the committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion."* As of early July, the bond market is currently pricing in about two rate cuts later this year. Mr. Powell cited a downturn in indicators of global growth and worsening trade tensions as developments behind the Fed's more dovish stance. Sluggish global growth has acted as a brake on how much the Fed can raise rates and how much inflation can emerge. While a level of 2.25% to 2.50% is stimulative by historical standards, it might be slightly restrictive in a "new normal" low-inflation, low-growth world. Regarding interest rates, Mr. Powell has said that, *"an ounce of prevention is worth a pound of cure."*

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 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 reliability. 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

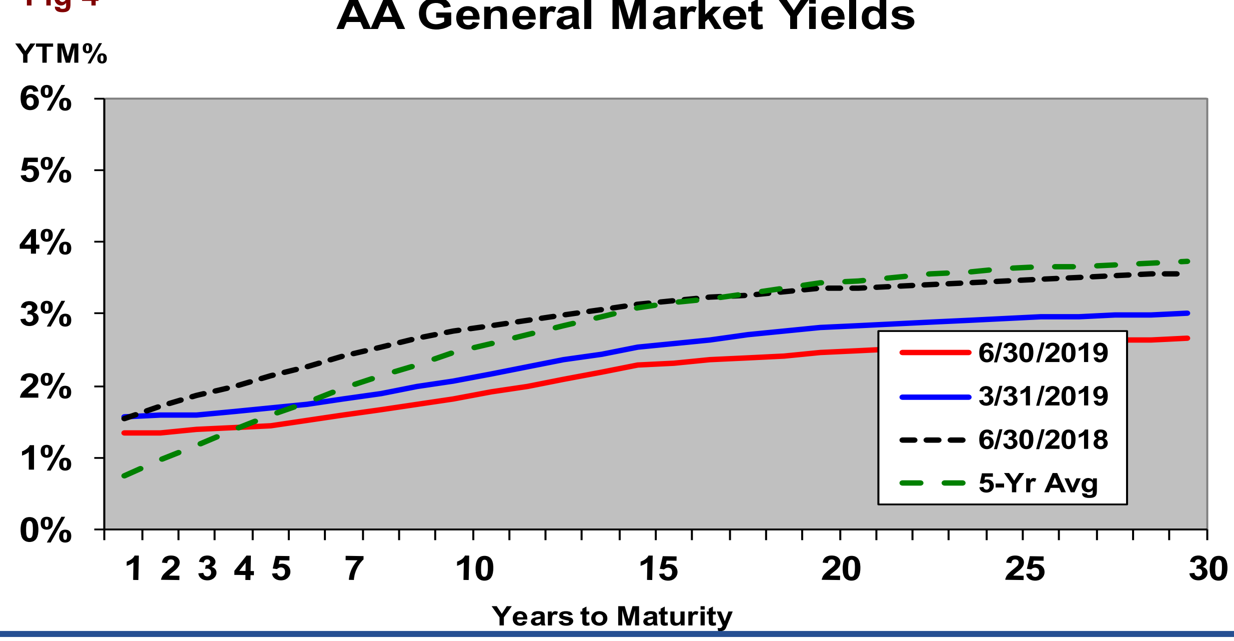
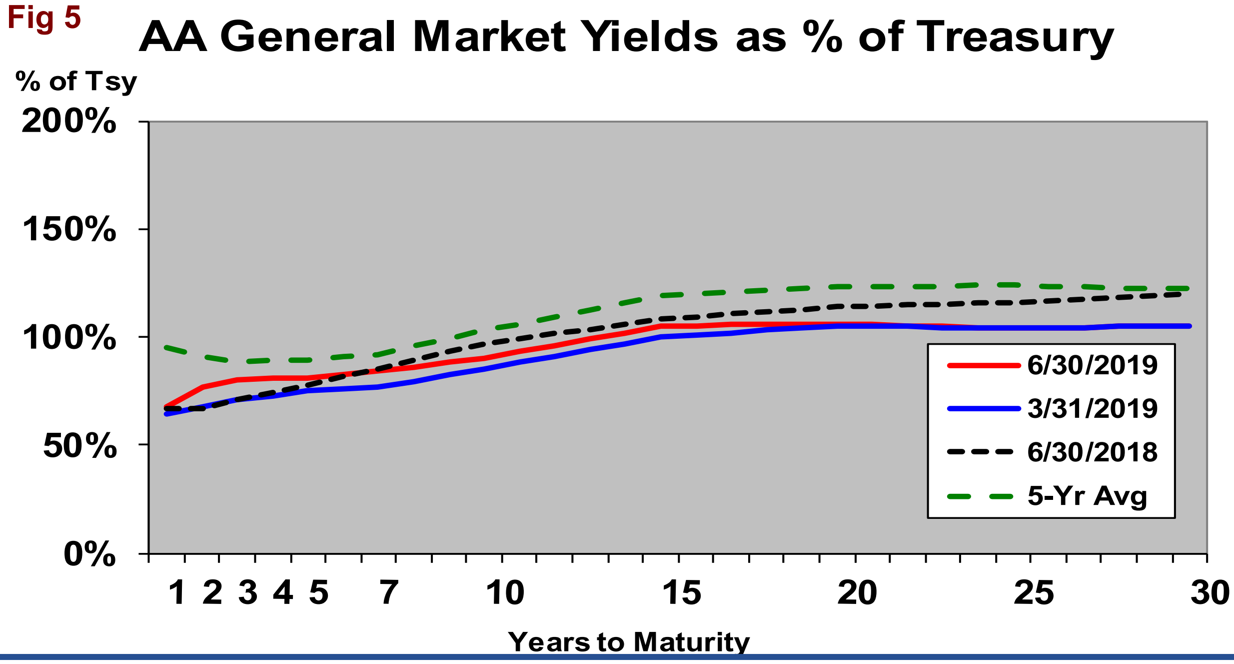


Fig 5



	5 Yr Avg	3/31/2019	6/30/2019
2-Year AA Municipal	91%	68%	77%
5-Year AA Municipal	89%	75%	81%
10-Year AA Municipal	103%	85%	90%
25-Year AA Municipal	124%	104%	104%