Redstone Advisors

Municipal Market Review

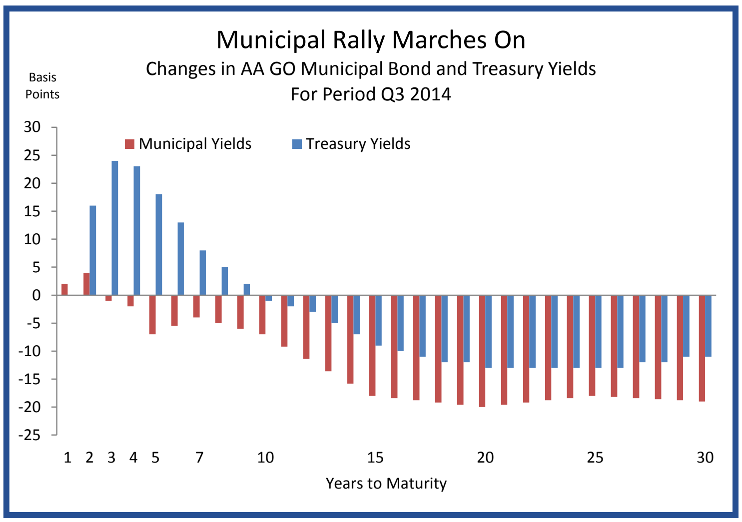
Third Quarter 2014

"People have stopped holding their breath waiting for rates to go up, and that's one of the reasons why you're seeing demand continue."

Peter Hayes, Head of Municipal Bonds Group, BlackRock Inc.

Municipal bond yields rallied yet again during the third quarter of 2014, marking the third consecutive quarter of declining yields and adding to the **year-long rally**. The rally was again uneven, much like last quarter, 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 20 basis points, while the decline in yields in the intermediate 5-to-10 year part of the yield curve was more modest, averaging about 5 basis points. Municipal yields at the short end of the curve were essentially unchanged. Thus, much like the previous two quarters, 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 third quarter, the municipal yield curve, as measured by the 2s-to-30s segment, flattened by 23 basis points, from a level of 432 basis points to 409 basis points. The Treasury yield curve underwent a more pronounced bullish flattening this past quarter, as yields in the 15-to-30 year range modestly declined while yields of shorter maturities in the 2-to-5 year range rose higher by an average of 20 basis points. The selloff at the short end of the Treasury yield curve can be attributed to the market adjusting to the imminent end of QE3 and anticipating a fed funds rate increase sometime in the middle of next year. The muted reaction of short-term municipal bonds in contrast to short-term treasuries follows historical precedent that munis are less sensitive to shifts in the fed funds rate. Municipal relative value ratios for maturities 10 years and longer held steady for the quarter and remained **above 100%**. Meanwhile, relative value ratios declined for maturities less than 10 years, in light of the divergence between short-term munis and treasuries this past quarter. The reshaping of the yield curve is reflected in **Figure 1** which graphs the changes in municipal and treasury yields across the curve for the third quarter of 2014.

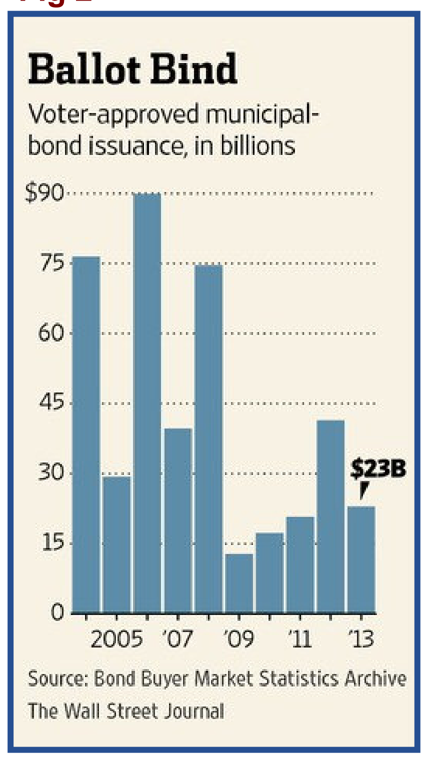
Fig 1



(316) 687-2143 jyeskie@redstoneadv.com

In mid-September the Federal Reserve as expected announced it would continue tapering its bond buying. The Federal Open Market Committee trimmed monthly asset buying to $15 billion, its seventh consecutive $10 billion cut. All signs point to a final reduction on October 29. Thus by Halloween, the asset purchase program will officially be history, and thankfully the specter of quantitative easing is unlikely to spook the market. Fed Chairwoman Janet Yellen was hesitant to clarify when the much anticipated increase in the benchmark federal funds rate would occur in her speech at the annual central bank conference in Jackson Hole, Wyoming. Current market consensus, based on Fed Futures contracts, has the first rate increase occurring in the middle of next year. Yellen sounded a cautious tone regarding raising rates, stressing that the U.S. labor market remains bruised from the Great Recession. She reiterated her belief that significant slack remains in the labor market and argued for a pragmatic approach that relies on incoming data without binding the Fed to a predetermined policy path. There was no wavering from the Fed's stated intent to keep the **fed funds rate close to zero** for a **"considerable time"** after bond purchases end in October. Yellen acknowledged the counter-arguments of some of her more hawkish colleagues, who are concerned that more months of zero interest rate policy or ZIRP will unleash inflation and/or potential asset bubbles. A month later in her press conference after the Fed's September meeting, Yellen's message was largely consistent with her Jackson Hole speech. With inflation being subdued according to the Fed's preferred measurements, there is little need at the moment for the Fed to signal that tightening is imminent. Bottom line, the takeaway is that Yellen and the Fed want to be sure employment has rebounded as fully as possible before raising interest rates. Lastly, Yellen expressed her intentions for the Fed to be flexible. Some have expressed concern that the Fed could be behind the curve when it finally does start to raise rates. Yellen explained that rates could rise sooner than expected, and further increases could be faster, if gains in the labor market continue to be stronger than anticipated. On the other hand, if labor growth stagnates or weakens, then policy would stay accommodative for longer. One final note regarding Fed Policy should be mentioned. We have written previously that municipal bond yields historically have not been highly sensitive to fed funds moves. Looking back at five periods between 1983 and 2006 when the fed funds rate was raised, the change in high-grade municipal yields was comparably much less.

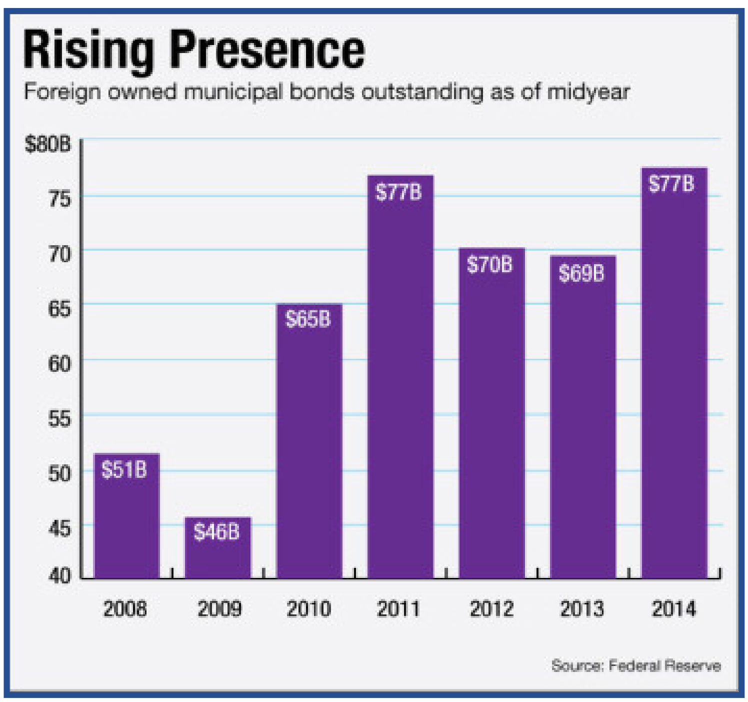
Fig 2



Continuing a theme from last quarter, the supply of municipal bonds in the primary market has remained scarce. According to data from the Securities Industry and Financial Markets Association (SIFMA), municipalities issued about $30 billion less debt during the first eight months of this year compared to the same period of last year. That means issuance is running a sizeable 14 percent below last year's pace. Looking further back, this year's anemic issuance is the slowest pace in 13 years. Many states, cities and communities are simply unwilling or unable to borrow in the wake of the Great Recession. **Figure 2** shows this year's decline in voter-approved municipal bond issuance in the context of data going back to 2004. This scarcity has driven prices higher and has helped municipals defy predictions made by many Wall Street analysts that investors would take losses on tax-exempt debt in 2014. In fact, as of the beginning of August, the S&P Municipal Bond Index has gained 7 percent, outpacing Treasuries and corporate bonds. To put the gains in historical perspective, this is the strongest start since 2009. Municipals have notched gains the first eight months of this year, a historically unprecedented streak of gains and a testament of steady investor demand in 2014. Demand has remained robust, partly due to rising federal tax rates that have underscored the appeal of municipal bonds' tax-free interest payments. As of the beginning of August, investors have poured money into municipal bond funds for 25 out of 32 weeks this year. Inflows year to date have totaled $11 billion, a welcome and noteworthy shift from the record outflow of $64 billion that occurred in 2013. We have previously discussed how top earners now face a **43.4 percent tax rate** that includes a newly mandated 3.8 percent Affordable Care healthcare surtax. Significantly, municipal bonds are the **only** investment exempt from this surcharge, thus delivering an additional tax advantage relative to other fixed income instruments.

Another factor in the current low-supply/high-demand market environment has been foreign investors' growing presence in the U.S. municipal market. Foreign investors held $77 billion of U.S. municipal bonds as of June, a sizeable 12 percent increase from $69 billion in holdings from June of last year. This data from the Federal Reserve rebuts the consensus analyst prediction that foreign investors would leave the U.S. muni market after the federally subsidized Build America Bond program was ended in 2010. The main reason foreign investors are boosting their U.S. municipal bond ownership is simply the appealing relative value of U.S. interest rates, especially compared to the historically low rates in Europe, Japan and other developed countries. Moreover, many of our U.S. muni issuers have stronger credit profiles than their foreign counterparts. That attribute, along with the higher U.S yields, makes municipal debt quite attractive, even though foreign investors cannot take advantage of the tax exempt status. **Figure 3** shows how the foreign presence has increased since 2008. The impact of foreign investors has been the subject of some debate. In the short term, many see this influx as contributing to the low-supply/high-demand dynamic that has characterized the market for most of 2014. While in the long term, some see these new buyers as ultimately beneficial. The logic being that more buyers would help increase the liquidity of municipals, especially in times of stress, and thus be an important contributor to the stabilization of the muni market.

Fig 3



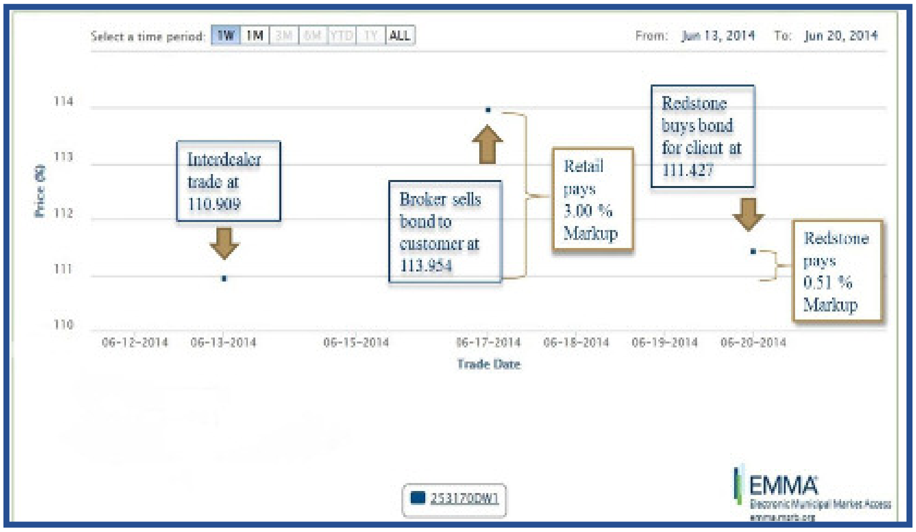
It was announced in mid-August that the Securities and Exchange Commission would embark on a two-year initiative to examine a **"significant percentage"** of the approximately 1,000 companies registered with the SEC as municipal advisers. These advisers are not affiliated with banks and are usually hired to work with cities and states to time, market and price municipal bond offerings. The SEC has previously targeted municipalities that have failed to keep investors apprised of their financial situation. Kevin Goodman, national associate director of the SEC's examination program, was quoted in the Wall Street Journal as saying that the exams *"will focus on the areas that are most important to protecting issuers, investors and municipal taxpayers."* Furthermore, the SEC stated their intent was to scrutinize whether municipal advisers were following their **fiduciary duty**, which requires them to **put their clients' interests ahead of their own**, as mandated by the 2010 Dodd-Frank law. We at Redstone Advisors, as an SEC Registered Investment Advisor, take our fiduciary responsibility to clients seriously.

Last quarter we commented on how a **rebound in property taxes** and **real-estate values** are helping propel along the **muni market recovery**. Those positive trends have continued this quarter as Moody's reported on July 29 that they **upgraded more debt than they downgraded for the first time in six years**. Among the upgrades were New York to Aa1 and California to Aa3. Notably, these two states rank one and two on the list of largest issuers of municipal bonds. On the flip side, those states grappling with pension reform, which include Illinois and New Jersey, recently experienced pressure from the ratings agencies. Recent gains particularly in the equity markets have certainly been welcome news for public pensions. However, many pension systems still have to deal with being underfunded in the aftermath of the Great Recession. Pension reform should not be neglected when it is necessary for long-term fiscal stability.

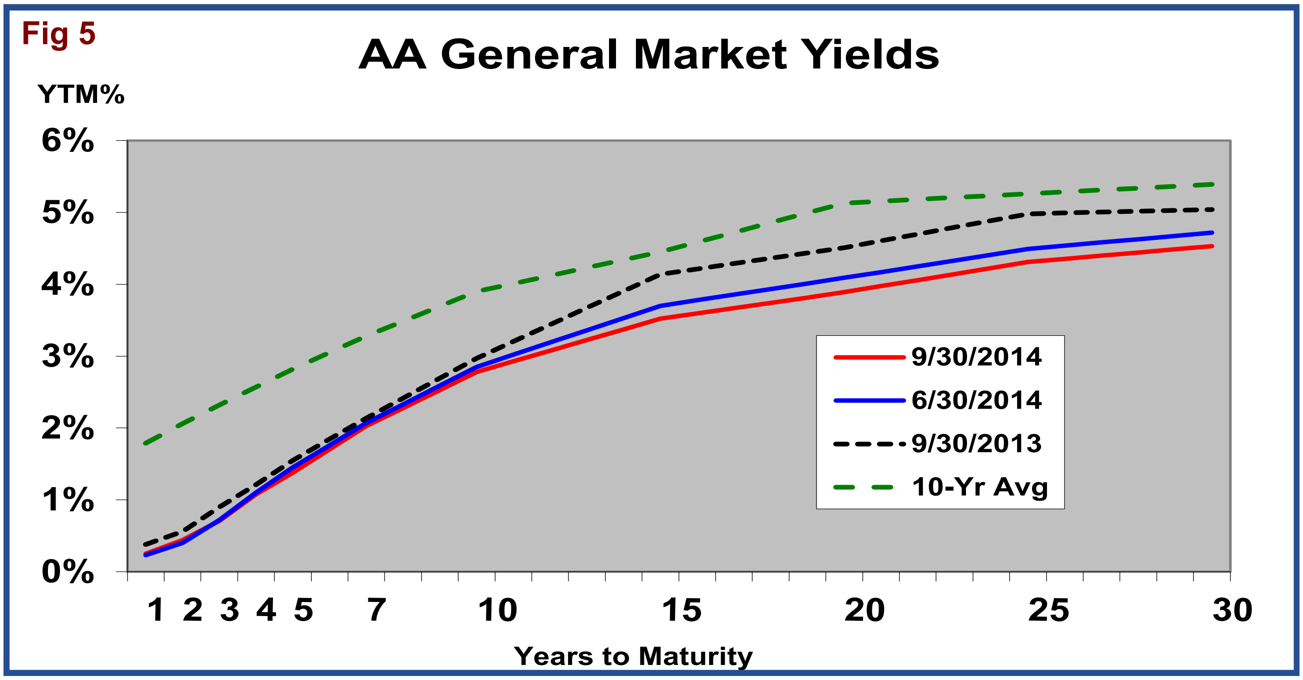
Regulators that include the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation approved a bank liquidity rule in early September which notably excluded municipal bonds from the group of **high-quality liquid assets (HQLA)** that banks can hold to show they're able to withstand a credit crisis. These regulators based their rule on an accord reached by the 27-nation Basel Committee on Banking Supervision, and the new federal liquidity coverage ratio rule is set to take effect on January 1. It should be noted that Federal Reserve Board officials did say they are formulating a proposal that would include *some* municipal bonds as HQLA at an undetermined later date. Many see this ruling giving banks less incentive to buy municipal bonds and therefore leading to less demand for municipal securities over time. Howard Marsh, head of the municipal division of Citigroup, wrote in a letter to regulators that the **municipal asset class** should be fine for emergency liquidity because it has ***"high credit quality, low historic default rates and limited exposure to the aggregate financial sector."*** Last quarter we wrote about how crossover buyers, banks and non-traditional investors like hedge funds and insurance companies have increased their presence in the municipal market. U.S. chartered banks increased their holdings to $425 billion at the end of the first quarter of 2014, a jump up from holdings of $222 billion in 2008, according to data from the Federal Reserve. Banks have been an important source of demand in the muni market, holding just over 11% of the market. Therefore these newly proposed bank liquidity rules likely are just a minor headwind for the municipal bond market. Treasury market movement, Federal Reserve policy, and changes in supply are likely to have more influence regarding municipal bond prices.

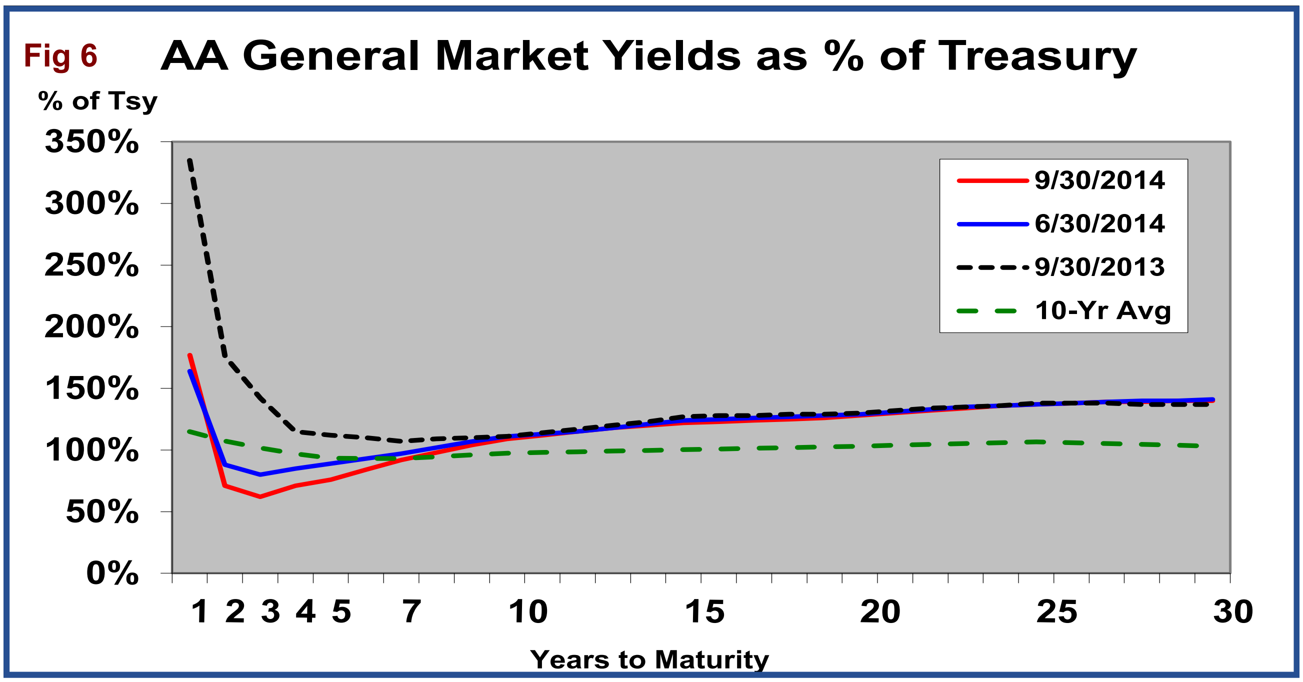
We have previously discussed how municipal bonds trade in an over-the-counter (OTC) market, and as such a single visible price does not exist for these bonds. Trading takes place directly between two parties with prices determined on a negotiated basis. Therefore, the broker-dealer does not charge a "called-out commission", instead the broker-dealer marks up the price of the bond offered for sale. This markup in bond prices is one of the costly "unknown unknowns" to the individual investor. The investor simply does not know how much they are paying in the markup of the price of a bond issue, and hence how much purchased yield they are permanently losing. Markups, or the difference between the dealer cost and the offered price of the bond, represent the dealer's "profit" on the trade. A Wall Street Journal article earlier this year detailed how **markups of 2 to 5 percent** on municipal bonds are common. At Redstone, we **actively manage the dealer markup**, striving to reduce the markup paid to **about 0.50 percent or less**. The municipal market is fragmented and inefficient, and the relationships with specialty regional broker-dealers like Redstone has developed over the past 25-plus years are significantly beneficial. The advantage of having Redstone's active management on your side is illustrated in **Figure 4**. You can see how an unfortunate retail customer paid an **egregious 3 percent markup** on a Dickinson County, KS bond back in June of this year while Redstone was able to purchase for our client at only a 0.51 percent markup. Bottom line, we are able to execute at better prices and we won't be **"stepped on"**.

Fig 4



The important macro picture from this past quarter is that conditions in municipalities across the United States generally continue to improve. Given the size, fragmentation and complexity of the municipal bond market, solid and disciplined management is as significant as ever. Their inherent tax advantage, low price volatility, and high quality income stream continue to make municipals appealing in our judgment. We believe investors will benefit from the 25-plus years of fixed income management experience and expertise that Redstone Advisors provides in our continued mission of preserving client wealth and building par value.





	10 Yr Avg	6/30/2014	9/30/2014
2-Year AA Municipal	107%	88%	71%
5-Year AA Municipal	93%	89%	76%
10-Year AA Municipal	97%	111%	109%
25-Year AA Municipal	106%	137%	137%