Redstone Advisors

Municipal Market Review

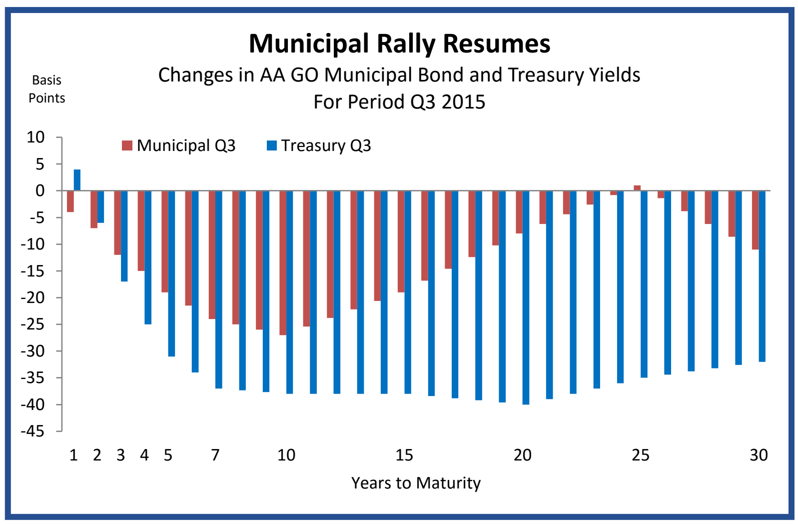
Third Quarter 2015

"It's a high-quality market and it's all domestic-focused. You have this weaker overseas growth, but when you look at munis, they're immune to those concerns."

Chris Alwine, Vanguard Group

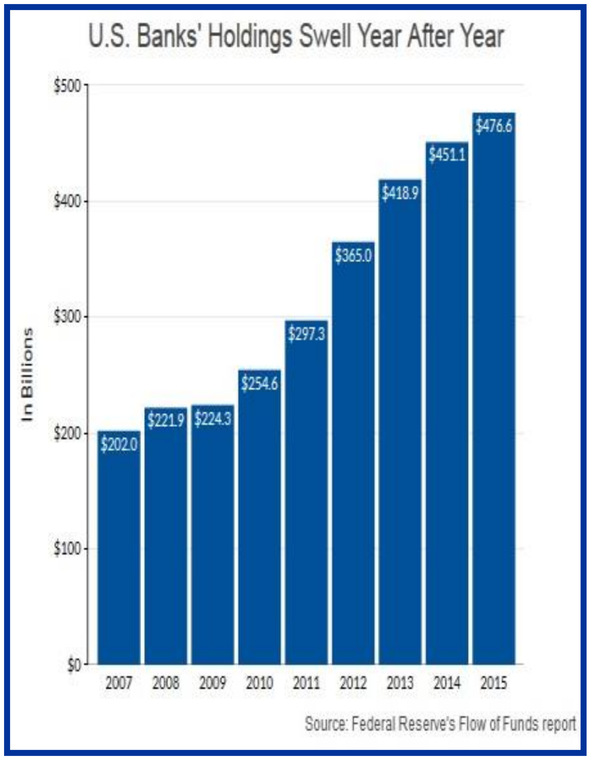
Municipal bonds rallied in the third quarter, as yields moderately declined across the yield curve. The largest decrease came in the middle part of the curve, specifically the 5-to-15 year range, where the average decline was 21 basis points. Treasury yields ended the quarter lower across the yield curve as well, rallying more than municipals particularly at the intermediate and long end of the curve. The reshaping of the yield curve is reflected in **Figure 1** which graphs the changes in municipal and treasury yields for the third quarter of 2015. **Municipal relative value ratios** largely head steady this quarter, and **remain quite attractive with ratios at or above 100 percent** for 1-3 year and 7-30 year maturities, and at 99 percent for the 4-5 year segment. Worries over a global growth slowdown, China's economic troubles and the uncertainty around a possible Federal Reserve rate hike fueled demand for traditionally safe assets like U.S. Treasuries and municipal bonds. Volatility has certainly surged in global financial markets since China's surprise devaluation of the yuan back in August, which increased speculation that Chinese leaders may struggle to prevent a steep slowdown in the world's second-largest economy. Chris Alwine, head of municipals at Vanguard, noted that *"Munis certainly have been an area of relative tranquility. We expect to see higher levels of volatility in the Treasury and credit markets, but*

Fig 1



munis have been removed from that and we expect it'll remain that way." To be certain, the Fed's multi-year quantitative-easing program that is still artificially suppressing interest rates has created an unprecedented scenario for the financial markets in general and fixed income in particular. But as the markets brace for more volatility the rest of this year, the municipal market appears to be among the safest bets.

Fig 2



The Federal Reserve's Flow of Funds data released in September showed that the municipal market grew in size to $3.71 trillion in the second quarter, the highest level since 2012. This growth in the market suggests municipalities are issuing new debt at a faster pace than existing debt is maturing as interest rates hover near multi-decade lows. After individual holders of municipal bonds, which are categorized as the household sector, and mutual funds, the **banking sector has become an increasingly important buyer** in the municipal market. As the third-largest holder of municipal debt, banks increased their holdings in the second quarter of 2015 to $476 billion from $451 billion at the end of 2014 and have more than doubled their holdings since 2010. Analysts see the growth in bank holdings of municipals as defying expectations that stronger economic growth would see regular bank lending activities replace their buying of municipals. Banks, much like individual investors, continue to find attractive relative value in the tax-exempt municipal market. The steady increase in bank holdings of municipal bonds since 2007 can be seen in **Figure 2.**

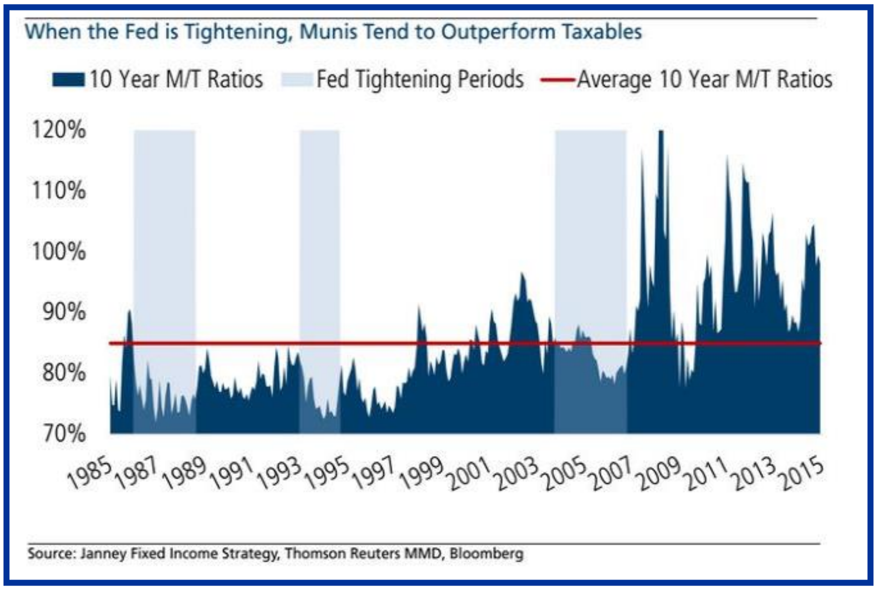
In early August, Puerto Rico triggered the biggest municipal default in United States history. The island commonwealth missed a final deadline for a $58 million payment, handing over just $628,000. Puerto Rico is now in an undesirable legal limbo, facing years of bitter legal battle with creditors, which include a well-heeled pack of hedge funds that scooped up the debt at distressed levels and appear determined to maximally extract what they're legally entitled to in the courts. The U.S. territory is not covered by the Chapter Nine bankruptcy code in the United States and therefore it cannot resort to the sort of orderly debt restructuring that helped the city of

Detroit rebound after defaulting in 2013. That has left the commonwealth facing a chaotic debt restructuring with no legal arbitrator. Puerto Rico's crisis is seen as the result of years of government mismanagement. Declining population, low labor-force participation and a costly business climate have caused the tax base to steadily shrink while a bloated public sector has inflated spending. Puerto Rico had piled on more municipal bond debt per capita than any other American state. The amount of debt the island has issued is equal to 70% of its economic output, more than triple the ratio of the next highest state. Despite the localized, headline-grabbing problems in Puerto Rico and Chicago, the **majority of analysts see the broader municipal bond market performing well**. Experts do not believe recent developments there will act as a catalyst for widespread investment-grade municipal market contagion because ownership of Puerto Rico's debt has dispersed, and now primarily includes a variety of hedge funds and opportunistic speculators. Josh Gonze of Thornburg Investments noted, *"It's amazing how the market has shrugged off these problems, but there is a thirst for fixed income that seems insatiable. The market is saying, 'We'll pass on Puerto Rico and the Detroits and Chicagos, but we'll buy everything else.'"* In September, Puerto Rico said it had $13 billion less than it needs to cover debt payments over the next five years, even after taking into account proposed spending cuts and measures to raise revenue. The commonwealth's advisers plan to present investors with a debt-exchange offer in a few weeks, as well as seeking a moratorium on principal payments. Governor Alejandro Garcia Padilla's administration plans to ask investors to voluntarily exchange their securities for new ones with lower interest rates or longer maturities, a process that could protect some bondholders from losses. Analysts see the island having a real solvency issue and a liquidity crisis that could grow even more dire by the end of the year.

The Federal Reserve kept the **federal funds rate** it controls at **effectively zero percent** at the conclusion of its two-day policy meeting in mid-September. Analysts saw the decision to keep interest rates unchanged as a bow to **worries about the global economy, financial market volatility and sluggish inflation at home**. Fed Chair Janet Yellen said in a press conference after the meeting that developments in a tightly linked global economy had effectively forced the U.S. central bank's hand. Yellen noted how the outlook abroad appeared to have become less certain, driving down U.S. equity prices, pushing up the dollar, and tightening financial conditions in a way that may slow U.S. growth regardless of what the Fed does. *"In light of the heightened uncertainty abroad, the committee judged it appropriate to wait,"* Yellen said. *"Given the significant economic and financial* *interconnections between the U.S. and the rest of the world, the situation bears close watching."* Despite once again lowering its long-term outlook for the U.S. economy, thirteen of seventeen Fed policymakers foresaw raising rates at least once in 2015, down slightly from fifteen at the last meeting in June. The latest Fed projections of slower GDP growth and continuing low inflation suggest that concerns of a so-called secular stagnation may be taking root among policymakers. After the two day Fed meeting, Fed watchers paid close attention to a speech at the University of Massachusetts delivered by Yellen. In the speech, Yellen said she and other Fed policymakers do not expect recent global economic and financial market developments to significantly affect the central bank's policy. *"Most FOMC participants, including myself, currently anticipate that achieving these conditions will likely entail an initial increase in the federal funds rate later this year, followed by a gradual pace of tightening thereafter,"* Yellen declared to her audience. She concluded that, "*the more prudent strategy is to begin tightening in a timely fashion and at a gradual pace, adjusting policy as needed in light of incoming data."* As of early October, based on Fed funds futures contracts, **traders see just a 30% chance of a rate hike coming in December.** The **odds increase to 52% that a rate hike will occur in March** of next year. After a lackluster September jobs report that showed just 142,000 jobs added, Wall Street remains skeptical of the Fed's willingness to tighten before the year is over. The employment report was a disappointment, as average hourly earnings were unchanged and the labor-force participation rate fell to 62.4%, the lowest level since October 1977. Moreover, the August figures were revised lower to show only 136,000 jobs added that month. August and September marked the smallest two -month gain in employment in more than a year and fueled fears that the China-led global economic slowdown is sapping America's strength. Bottom line, the latest payroll report raised **serious new doubts that the American economy is healthy enough for the Fed to raise rates** before the end of the year.

With so much focus on the Federal Reserve and the timing of its initial rate increase, we would like to remind readers that **municipal bonds have historically outperformed Treasuries when the Fed has tightened the money supply.** During the tightening periods of the late 80s, the mid-90s and the middle of the last decade, municipal ratios actually declined meaning that **municipal prices rose relative to Treasuries.** This muni outperformance can be seen in **Figure 3**. When the central bank last began tightening monetary policy in 2004, the municipal market returned 5.5 percent, about 2 percentage points more than Treasuries, according to Bank of America Merrill Lynch data. As the incremental rate increases continued over the next two years, municipals continued to outperform. Analysts see municipal debt as poised to shine again, largely because the bonds are owned mostly by buy-and-hold individual investors looking for **steady tax-exempt income**, which **buffers them from the volatility elsewhere in the financial markets.** Another reason for muni bonds to do better in a rising-rate cycle is growing property-tax revenues. Analysts note how there is typically a three-year lag, with reassessments and rising property-tax revenues. **Even in a rising-rate environment, property-tax revenues are going to continue to go up.** One more factor to favor municipals is the changed dynamic of the market itself. Specifically, the dramatic reduction in rated and insured issuances, which are now about 30% of all fixed-income issuances, down from close to 70% prior to the financial crisis. Jeff Hudson, a manager at Cedar Ridge Partners, explained that, *"People used to buy munis just based on ratings, but now they have to actually look under the hood and understand what's going on with the credit, which has made the muni market more credit-driven and less rates-driven."* As of the end of September, **municipals have outperformed other investments** amid speculation about when the Fed will act. Municipals have returned 1.5 percent so far this year, according to the Bank of America Merrill Lynch index, more than Treasuries and U.S. corporate bonds. Meanwhile the S&P 500 index is down by about 6.5 percent year to date.

Fig 3



Redstone Advisors, with our 20+ years of municipal bond experience and personalized separate account management, believe we are uniquely qualified to provide wealth preservation and build par value by maximizing after-tax returns while minimizing volatility. Ultimately, we believe that the increased after-tax benefit of municipal bonds will be very clear and welcoming in this current climate of high federal tax rates. One should not underestimate the power of a strong tax advantage, and that is why we recommend investors look to municipal bonds for their attractive relative value and high quality income stream.

Fig 4

AA General Market Yields

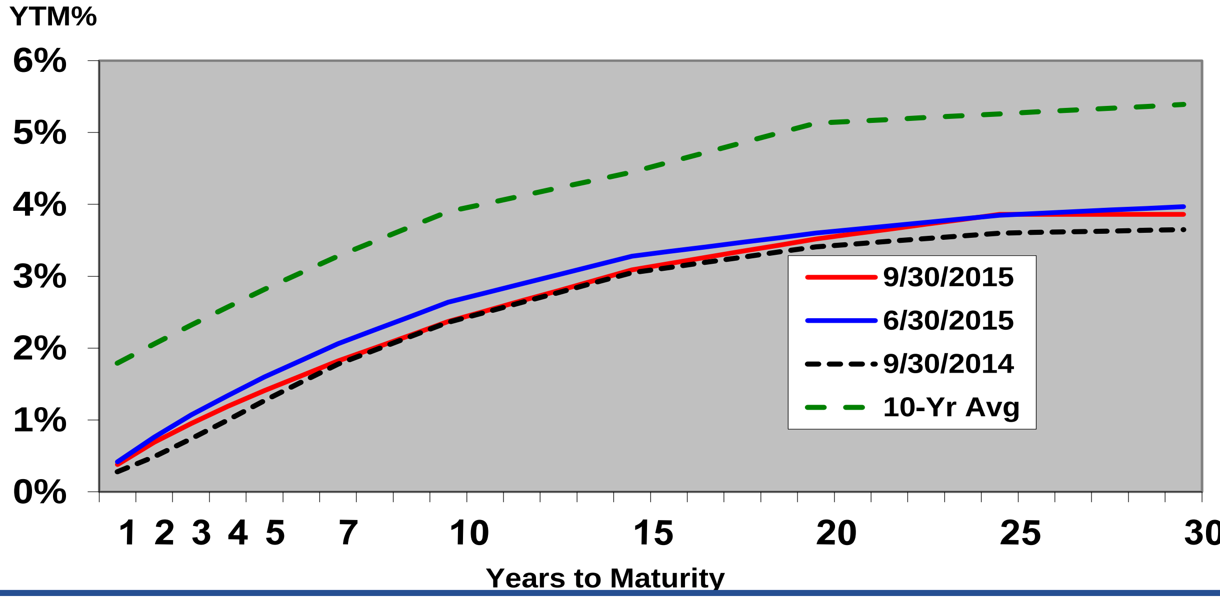
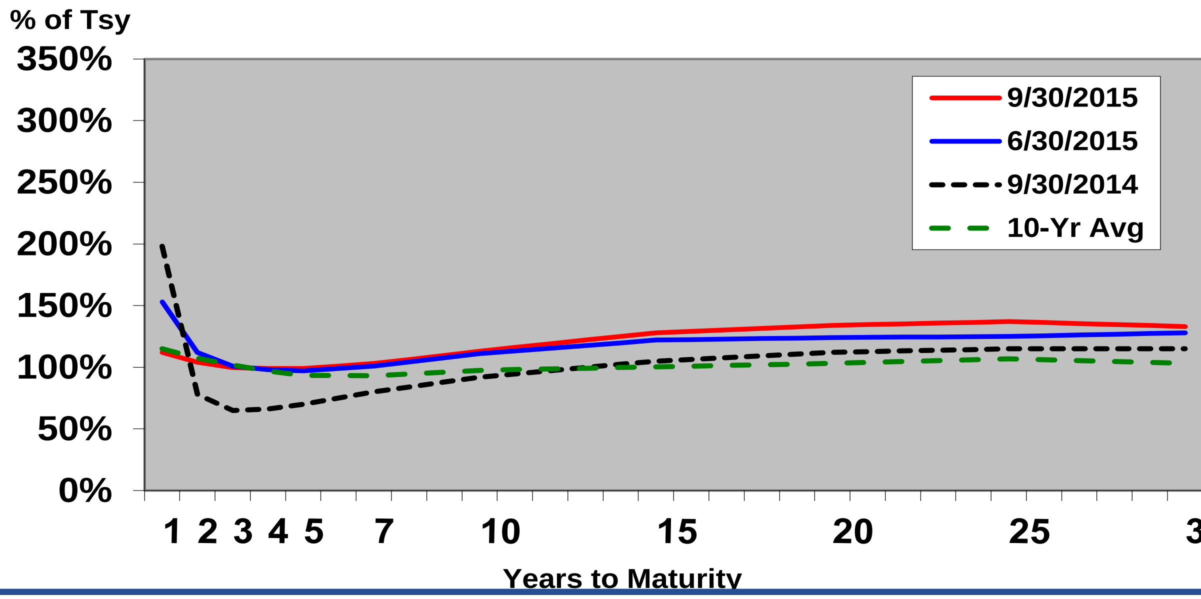


Fig 5

AA General Market Yields as % of Treasury



	10 Yr Avg	6/30/2015	9/30/2015
2-Year AA Municipal	107%	112%	104%
5-Year AA Municipal	93%	97%	99%
10-Year AA Municipal	97%	111%	113%
25-Year AA Municipal	106%	125%	136%