Redstone Advisors

Municipal Market Review

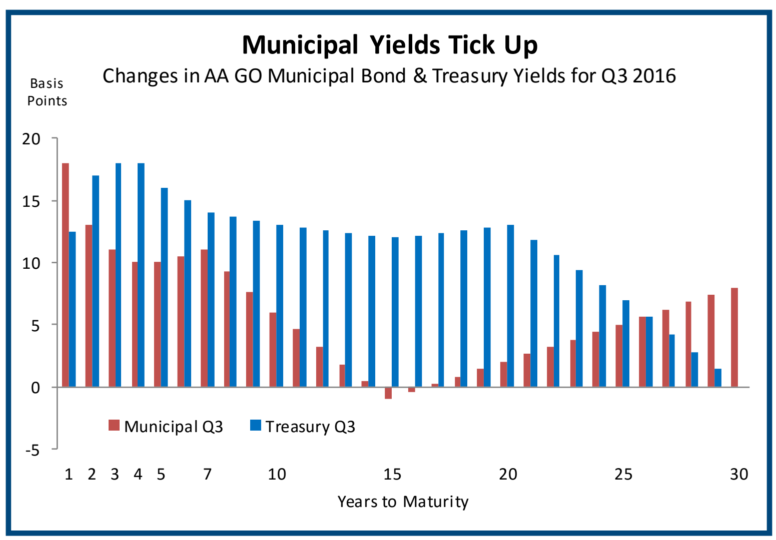
Third Quarter 2016

"Strong investor demand for an income-producing asset class that has high credit quality, low volatility and continues to act as a diversifier against equity and equity-like risk."

Sean Carney, head of municipal strategy at BlackRock Inc.

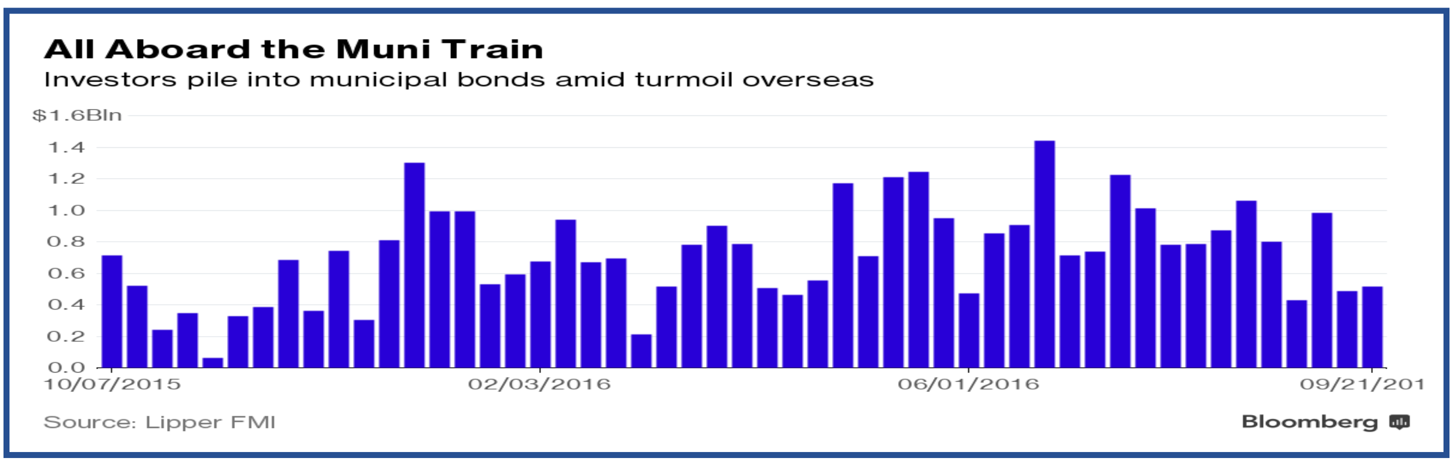
Municipal bond yields ended the third quarter modestly higher than where they started, a slight backup after the strong rally that characterized the first half of this year. Municipals have gained about four percent so far in 2016, according to Bank of America Merrill Lynch data. For the quarter, the most movement was at the short end of the curve, where the 1-year and 2-year maturities rose by 18 and 13 basis points respectively. This slight selloff at the very short end of the curve can be interpreted as the market preparing for a possible December rate hike by the Federal Reserve. Meanwhile, Treasury yields ended the quarter modestly higher across the entire yield curve, ticking up from their record low yields. Relative value ratios remain quite attractive, with ratios above 100 percent for the 1-3 year segment and the 10-30 year segment, and in the high 90s for the 4-7 year segment. The slight reshaping of the yield curve is reflected in **Figure 1** which graphs the changes in municipal and Treasury yields for the third quarter of 2016.

Fig 1



Demand for **high-quality, safe-haven assets** has been a **consistent theme** in 2016, providing a positive backdrop for municipal bond prices. Fundamentals are stable to improving for the majority of the municipal bond market. Our view is that it is underreported in the financial media how much **municipal credit overall has stabilized**. Many municipalities continue to take advantage of historically low interest rates to refinance outstanding debt, reduce interest payments and strengthen their fiscal health. Constructive technicals (low supply/high demand) continue to be the trend. Total demand has outpaced supply so much that even this year's increased issuance levels have been quickly absorbed. As of late September, investors had added cash to municipal-bond funds every week since last October, an **impressive streak of fifty-two consecutive weeks**, the longest since 2010 and the second-longest run since 1992 when Lipper began tracking weekly flows. *"It's been a tremendous run, one I don't think I've ever witnessed before,"* noted Dan Heckman of U.S. Bank Wealth Management. Year-to-date through late September, municipal bond funds have witnessed net inflows of $48.5 billion. The steady buying is due to a variety of factors, including attractive relative valuations, increased global economic uncertainty, and a search for yield in a challenging investment landscape. Municipal bond fund flows dating back to October 2015 can be seen in **Figure 2**. 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 bonds, banks spent $17 billion on munis in the period between March and June, more than they have spent in any other quarter in the past four years. A total of about $526 billion in municipal bonds is currently on bank balance sheets, a ten percent increase over the past year. Banks, much like individual investors, continue to find attractive relative value in the tax-exempt municipal market.

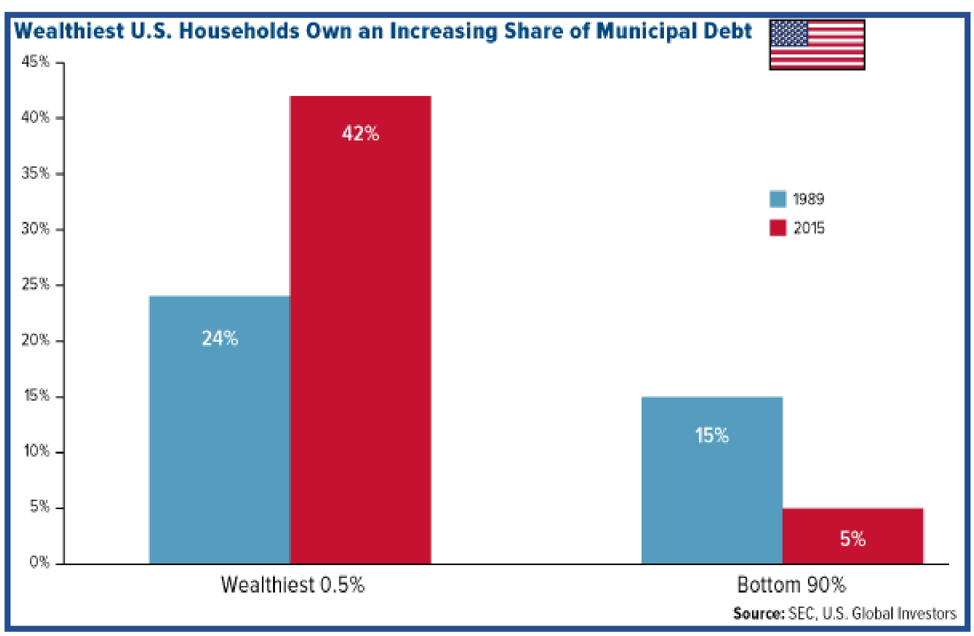
Fig 2



In late August, at a Securities & Exchange Commission (SEC) summit, the SEC's top investor advocate discussed some statistics he found "interesting". Rick Fleming reported that the wealthiest one-half percent of U.S. households currently own 42 percent of all municipal bonds, as compared to ownership of just 24 percent in 1989. Meanwhile, he pointed out that the bottom 90 percent of U.S. households, as measured by net wealth, now hold less than 5 percent of municipal bonds, a decrease from roughly 15 percent in 1989. Municipal bonds' favorable tax exemption was enacted a little more than a hundred years ago to help stimulate infrastructure spending and attract a broad spectrum of investors. High net worth individuals in higher tax brackets certainly have more incentive to invest in munis than investors in lower tax brackets. Munis gained **extra appeal** in recent years as the **top marginal income tax rate increased** from 35 percent to 39.6 percent. In fact, top earners face a 43.4 percent tax rate that includes the mandated 3.8 percent Affordable Care healthcare surtax, a tax from which municipal bond income is exempt. A chart depicting how the wealthiest U.S. households hold an increasing share of municipal debt can be seen in **Figure 3**.

In mid-September, as the market expected, the Federal Open Market Committee (FOMC) left the target range for the benchmark federal funds rate unchanged at 0.25 percent to 0.50 percent. Janet Yellen, the Fed's chairwoman, said the decision did not reflect a lack of confidence in the economy. In a statement, the Fed said *"the committee judges that the case for an increase in the federal funds rate has strengthened but decided, for the time being, to wait for further evidence of continued progress toward its objectives."*

Fig 3



It was of note that three members of the FOMC's 10-member group voted to raise the fed funds rate, the largest number of dissents since December 2014. The Fed also said it expected to increase rates more slowly in future years. Fed officials predicted the central bank's benchmark rate would rise **only to 1.9 percent by the end of 2018**, well beneath their estimate last September that the rate would rise to 3.4 percent by 2018. Also, fourteen out of seventeen Fed officials stated that they expected to raise rates at least once this year. The market-implied probability of a rate-hike in mid-December, the final meeting of the year, is roughly 60 percent. Historically, the most volatile reactions across fixed income markets have been driven by strong and growing inflationary pressures or a more hawkish Fed responding to stronger inflation readings. We do not see either of those conditions existing today or materializing anytime soon.

In late August, the Obama administration selected seven people to serve on the all-important oversight board established by PROMESA (Puerto Rico Oversight, Management & Economic Stability Act). The board's first job will be working with Puerto Rico Governor Alejandro Garcia Padilla on a fiscal plan that will serve as the basis of negotiations with creditors regarding the territory's $70 billion debt burden. As we mentioned last quarter, Puerto Rico has a low correlation to the rest of the market. It is literally and figuratively on its own island apart from the rest of the vast $3.7 trillion municipal market. The clearest signal that the broader market is shrugging off Puerto Rico is the consistent flow of money pouring into tax-exempt bond funds.

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. Our strategy involves favoring high quality, intermediate bonds and reducing potential rate risk with premium coupons. We know how to conduct **in-depth credit research**, **adjust for duration** and **monitor the market for risks and opportunities**. One should not underestimate the power of a strong tax advantage, and that is one reason why we recommend investors look to investment-grade municipal bonds for their **attractive relative value** and **reliable high quality income stream**

Fig 5

AA General Market Yields

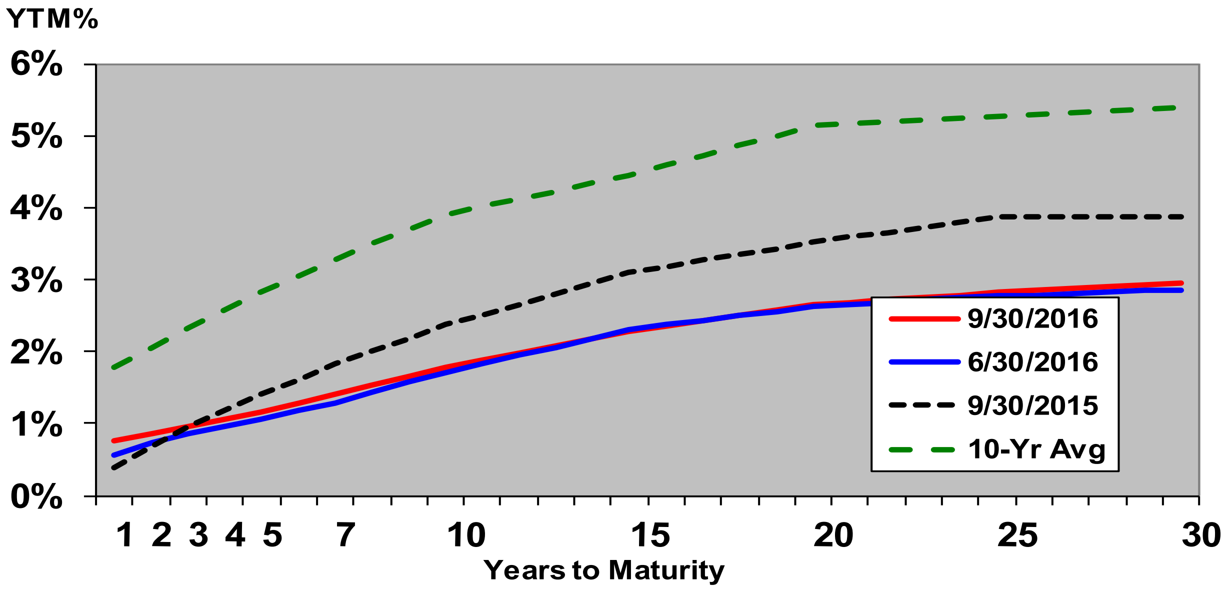
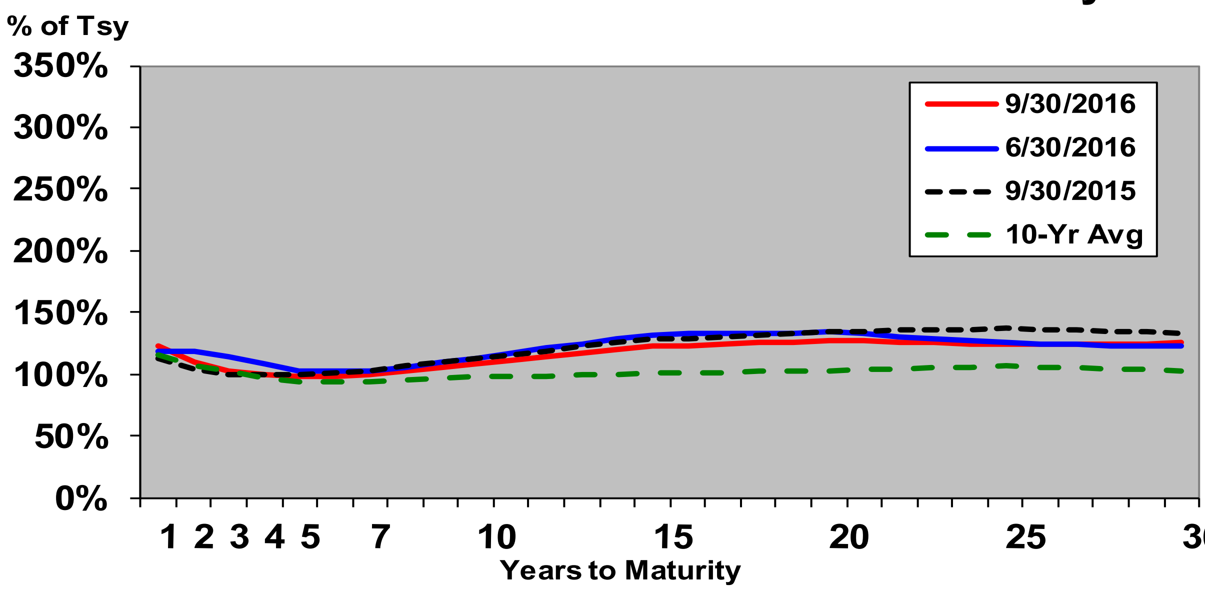


Fig 6

AA General Market Yields as % of Treasury



	10 Yr Avg	6/30/2016	9/30/2016
2-Year AA Municipal	107%	119%	104%
5-Year AA Municipal	93%	103%	99%
10-Year AA Municipal	97%	113%	113%
25-Year AA Municipal	106%	125%	137%