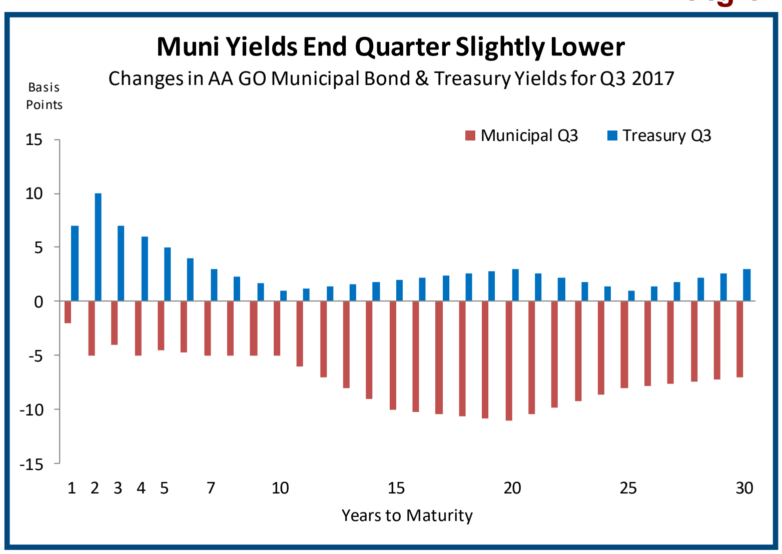
Redstone Advisors

Municipal Market Review

Third Quarter 2017

Municipal bonds rallied in July and August but then reversed course in September, and while yields ended the three-month stretch with a very modest decline, they were essentially unchanged for the quarter. The biggest move came in the 15-year to 20-year segment of the municipal curve, where yields declined by 10 and 12 basis points respectively. Treasuries underwent a similar trajectory as municipals, rallying for the first two months before selling off in September, ending the quarter basically flat. The largest move on the Treasury curve came at the short end, as the 2-year yield rose a modest 10 basis points. The reshaping of the yield curves is reflected in **Figure 1** which graphs the changes in municipal and Treasury yields for the third quarter of 2017. Municipal relative value ratios decreased at the short-to-intermediate part of the yield curve, a repeat of the trend that has occurred over the first two quarters of this year. Strong demand for municipals, particularly at the short end (less than 5 years), have kept prices high and yields depressed relative to Treasuries in that range. (Bond prices and yields move in opposite directions) Relative value ratios remain above 100 percent at the long end of the curve, in the 15-to-30- year segment. Foreign investors continue to have strong interest in U.S. municipal bonds, helping support prices with their demand. Foreign

Fig 1



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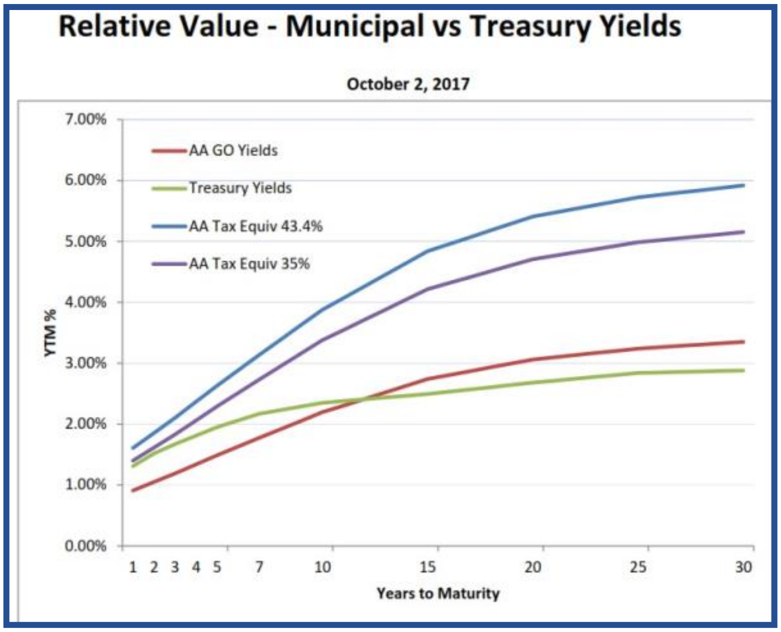
holdings of muni bonds have more than tripled what it was just over a decade ago, according to Federal Reserve data. The safety and relatively attractive yields of U.S. munis has enticed foreign investors who cannot find comparable yields in their home countries.

A top concern of the municipal bond market this year has been the issue of tax reform. In late September, GOP leaders unveiled a framework of their tax plan, filling in some details but also leaving many crucial questions unanswered. The updated plan calls for the reduction of the current seven tax brackets down to three: 12%, 25% and 35%, with the possible option of a fourth higher rate on the highest-income households. One question left unanswered is at what income thresholds would these new tax brackets apply. As we noted last quarter, muni investors would still capture a sizeable after-tax yield advantage over Treasury bonds, even at a 35% tax rate. When viewed from a tax-equivalent yield basis, the relative value advantage of municipal bonds can be clearly seen in **Figure 2**. The GOP plan also calls for a new corporate tax rate of 20%, down from the current 35%. Given the effective corporate tax rate is already around 20%, many municipal strategists estimate a corporate rate in the mid-to-low 20 percent range would not be overly negative for municipals, as banks and insurers would likely still find munis attractive at that tax rate. It remains to be seen exactly what kind of tax reform plan Congress will be able to agree upon and enact. One already controversial part of this reform plan is the proposal to end the state and local tax (SALT) deduction for individuals. Many analysts see this as a bitter pill to swallow for GOP House members from the high-tax states of New York, New Jersey and California among others, who are strongly in favor of keeping the SALT deduction for

Fig 2



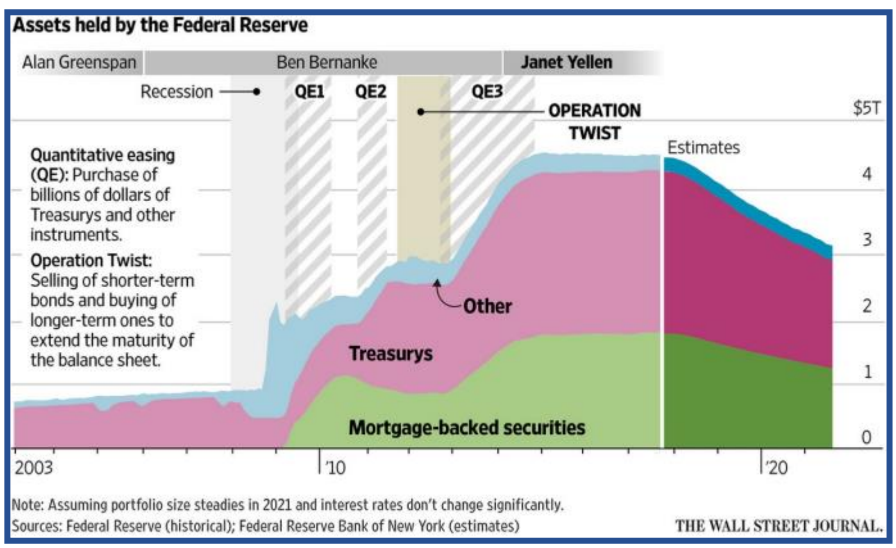
their constituents. The battle over the SALT deduction, with more than $1 trillion at stake over a decade, is an early signal of the difficult and rocky road ahead for Congress in trying to pass a bill with substantial tax reforms that creates winners and losers.

This initial tax plan should be viewed as highly amendable, as it sets in motion negotiations and debate on several key provisions that will be fleshed out by the two tax-policy committees in Congress during the coming weeks and months. Senator Bob Corker (R. Tennessee) who recently announced he would not seek reelection in 2018, said he was "*almost aghast*" at the lack of clarity about tax breaks that would have to go away. As tax reform discussion kicks up in earnest, there will be fierce debate and lobbying over what tax breaks might be eliminated or capped to generate revenue to offset planned tax cuts. We continue to see the elimination of the municipal tax exemption as highly unlikely. Senior Trump administration officials confirmed to the Bond Buyer in late September that the tax exemption for municipal bonds would be fully retained. Justin Underwood, director of the Municipal Bonds for America Coalition, said his group was encouraged by reports that the tax-exempt status of municipal bonds is being retained. *"We remain fully engaged with Congress to defend the value of the tax-exemption for municipal bonds to ensure that the benefits of the exemption to municipalities, U.S. infrastructure, and investors remains unaffected during the legislative process for tax reform,"* he said. Hugh McGuirk of T. Rowe Price added, *"There's enough people in Washington who get how important it is for state and local governments to have a low cost of capital particularly if our governments are going to be the ones funding a lot of the infrastructure initiatives."* Tax reform involves a series of potential outcomes featuring many variables and complexities. Which reforms, if any, end up being implemented, and to what degree, will ultimately determine the extent of the market impact. Regardless of the extent of tax reform, we believe investors will continue to benefit from the very important value inherent in municipal bonds, their tax exemption. Simply put, municipal bonds are the only asset class that produces tax-free income.

The fiscally troubled capital city of Hartford, Connecticut made the headlines this past quarter. In early September, city officials warned they would likely file for bankruptcy in 60 days unless the state legislature passes a budget that gives the city more funding or otherwise provides it with sorely needed cash. An increase of fixed costs for health care and pensions have been largely responsible for driving Hartford's fiscal woes. Also significant is the fact that approximately half the tax-base in Hartford, including state buildings, hospitals and colleges, is tax-exempt, limiting available revenue. For Hartford, the month of September brought downgrades by the main ratings agencies. The most recent was a four-notch "super downgrade" to CC by S&P and a two-notch drop to Caa3 by Moody's. *"The negative outlook reflects ongoing risks from the absence of a plan to restore the city's financial health and uncertainty of state support given the ongoing budget impasse,"* Moody's said in a statement. Clearly complicating matters is that the state of Connecticut has its own fiscal challenges. The state legislature failed to pass a budget before the start of the fiscal year in July to close a two-year budget shortfall of $3.5 billion. State operations have since then been funded by an executive order signed by Governor Dannel Malloy.

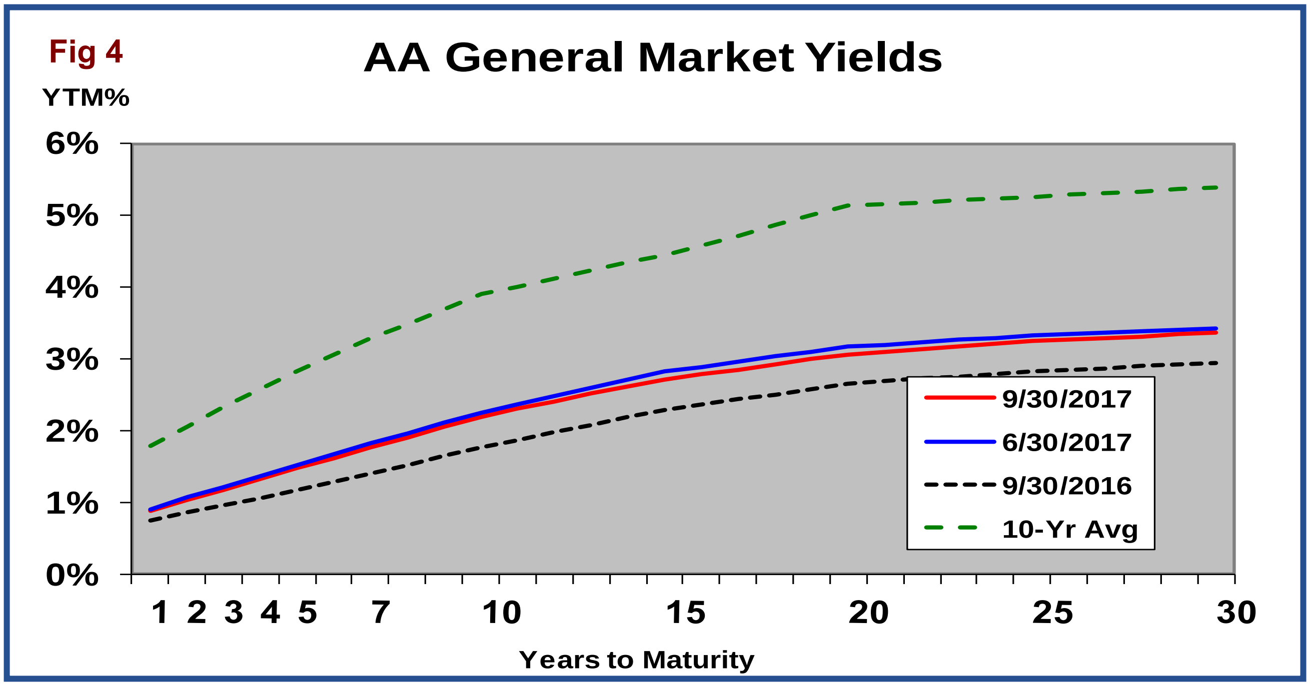
During its mid-September meeting, the Federal Reserve left its benchmark lending rate unchanged in the target range of 1.00 percent to 1.25 percent as expected and penciled in one more possible quarter-point rate hike this year, likely in December. The main news to come out of the meeting was the Fed confirming it would start in October its well-telegraphed plan to very gradually shrink its massive $4.5 trillion balance sheet that ballooned in size with multiple rounds of quantitative easing (QE) over the past few years. The Fed's plan initially calls for a relatively small amount of bonds, $4 billion of mortgages and $6 billion in Treasuries per month, to run off the portfolio without reinvestment. Every quarter, the Fed will let a slightly

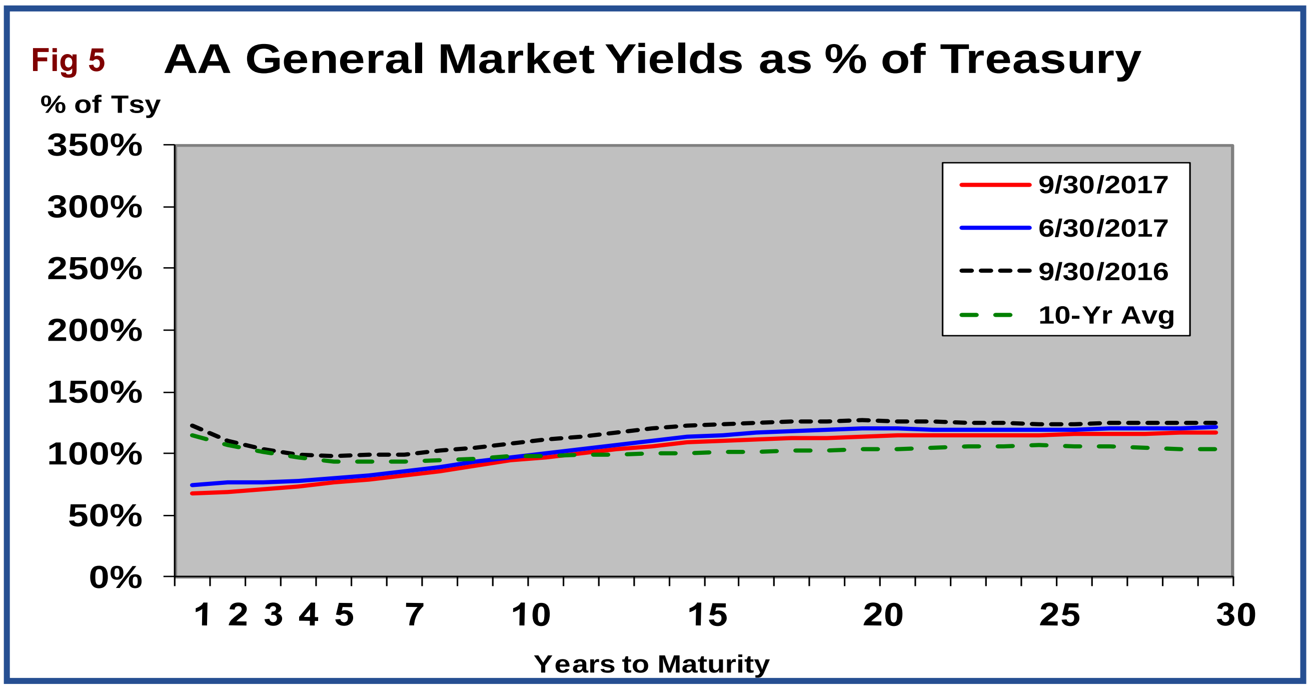
Fig 3



larger amount roll off, up to a maximum of $20 billion in mortgages and $30 billion in Treasuries per month. For perspective, a $10 billion drop in a portfolio of $4.5 trillion is a reduction of just 0.22 percent and a drop of $50 billion equals a reduction of 1.1 percent. The Fed aims for their balance sheet reduction plan to be predictable and passive. Philadelphia Fed President Patrick Harker remarked that it should be as exciting as watching paint dry. One question that remains unanswered is how large the Fed's balance sheet will be at the end of this reduction process. Fed watchers expect the balance sheet to ultimately settle in the range of $3 trillion. A graphic simulation illustrating the gradual wind down by the Fed can be seen in **Figure 3**.

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. We conduct independent credit research, adjust for duration and monitor the market for risks and opportunities. We continue to recommend municipals for their defensive traits and utility in a market in which total return is likely to come more from coupon and less from price performance. Yes, there will be some short-term price volatility as tax policy uncertainty plays out over the coming months, however our long-term goals are completely unaffected by the near-term volatility in bond prices. Bottom line, municipal bonds continue to be a key component of any well-constructed portfolio given their unique ability to provide high-quality tax-exempt income.





	10 Yr Avg	6/30/2017	9/30/2017
2-Year AA Municipal	107%	76%	69%
5-Year AA Municipal	93%	80%	76%
10-Year AA Municipal	97%	97%	94%
25-Year AA Municipal	106%	119%	115%