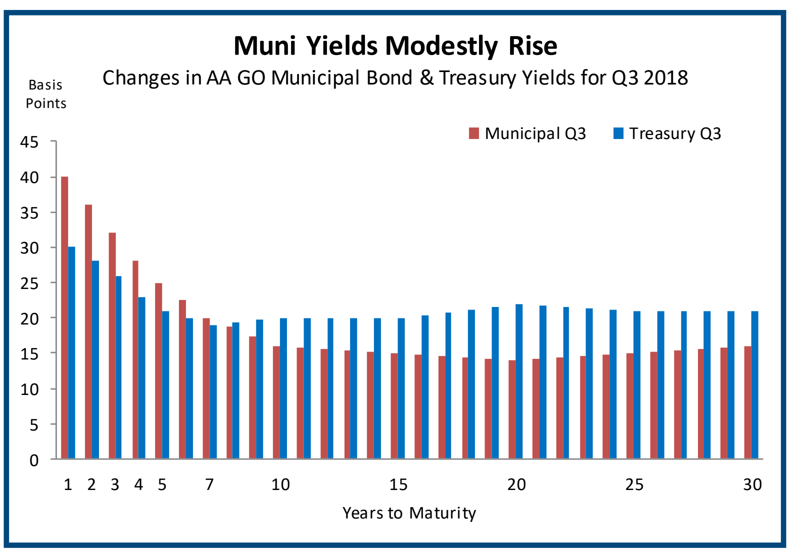
Redstone Advisors

Municipal Market Review

Third Quarter 2018

Municipal bond yields rose higher across the yield curve during the third quarter. The largest increase came at the short end, where the 1-yr muni yield gained 40 basis points (bp) and the 2-yr muni yield rose by 35 bp. The rise in yields was more modest at the long end of the curve, where the average gain in the 10-yr to 30-yr range was about 15 bp. Looking at the Treasury yield curve, rates rose moderately higher across the curve as well. The Treasury curve slightly flattened, with the 2-yr/10-yr spread narrowing to just 22 bp. The reshaping of the yield curves is reflected in **Figure 1** which graphs the changes in muni and Treasury yields for the third quarter. Muni relative value ratios slightly increased at the short end of the curve and were mainly unchanged at the long end of the curve. Munis are yielding roughly 70% of Treasuries in the 1-to-3-yr range. Many retail investors have preferred short-dated munis due to concerns about higher interest rates, and their high demand has made these munis expensive relative to short-term Treasuries. Meanwhile, relative value ratios remain above 100 percent at the longer end of the curve, in the 15-to-30-year segment. On the credit front, state revenues have grown in 24 of the last 26 quarters since the end of 2009, providing a healthy financial climate for municipal issuers as upgrades have outnumbered downgrades.

Fig 1



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Compared to the Treasury curve, the muni yield curve is quite steep. At quarter end, the 2-yr/10-yr muni spread was 83 bp. The same 2-yr/10-yr Treasury spread was just 22 bp. Apart from a brief moment in the aftermath of the financial crisis, that divergence is the largest since 2006. This can be seen in **Figure 2.** Analysts say the divergence can be partly explained by the different investor groups for the two sectors and many years of ultra-accommodative monetary policy by global central banks that distorted bond markets. Tom Kennedy of JP Morgan put it this way, *"The municipal market is actually looking quite attractive. In the front end, we don't see it in your favor, but further out in the municipal curve, there's actually a steepness in that curve. So if you move further out to 10-year muni bonds, you can actually pick up 100 basis points."* We see this divergence as evidence there is value to adding a certain amount of duration in the muni market.

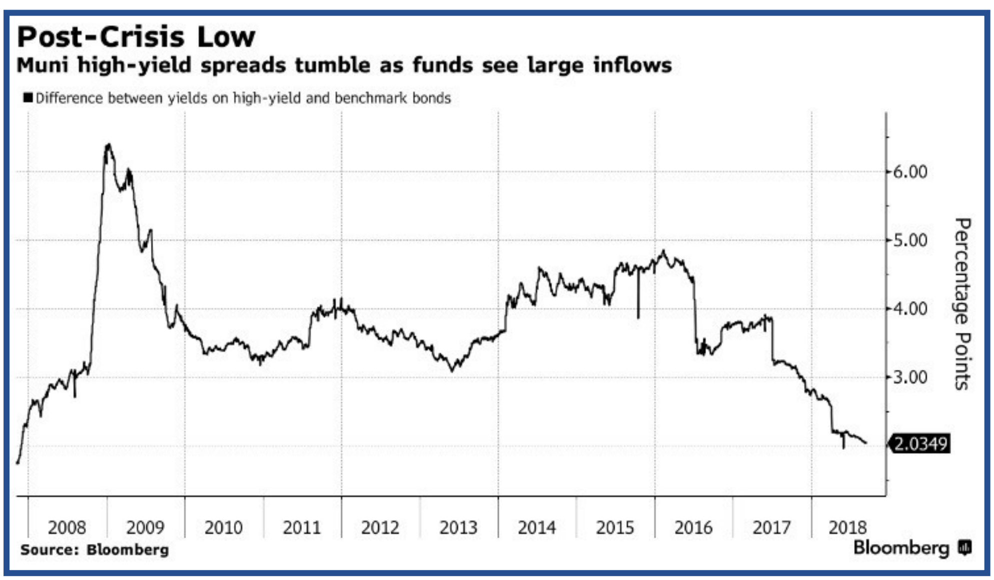
A noteworthy trend is that the muni market has become even more localized or fragmented than usual, largely due to the new federal tax law. With the state and local taxes (SALT) deduction now capped at $10,000, residents from high-tax states such as New York and California have increased their demand for double-exempt bonds from their home states. Many traders see supply versus demand as driving the muni market. Late in the

Fig 2

quarter, the driving force appeared to be muni yields simply following Treasury yields higher. Munis have historically taken their cue from Treasuries to a certain extent. Another effect of the tax law is that for banks, munis became a little less appealing, due to the lowering of the corporate rate down to 21% from 35%. This was confirmed by data from the Federal Reserve, which showed that in the first half of 2018, major banks cut their muni holdings for the first time since 2009. Analysts noted that given that banks used to be some of the largest buyers of longer-dated bonds, the municipal yield curve will likely remain steeper than it would have been otherwise going forward.

Looking at the high-yield muni market, the quest for yield has ramped up over the past few years in this historically low interest rate environment. As of mid-September, the difference or spread between the yield on high-yield or "junk" municipal bonds and benchmark debt of similar duration has declined to a little over 2 percentage points, the lowest level since late 2007. The declining premium demanded on high-yield munis can be seen in **Figure 3**. This chart shows that compared to recent history, investors are not being as well compensated as they typically have been for investing in the high-yield sector. Some skeptical analysts have

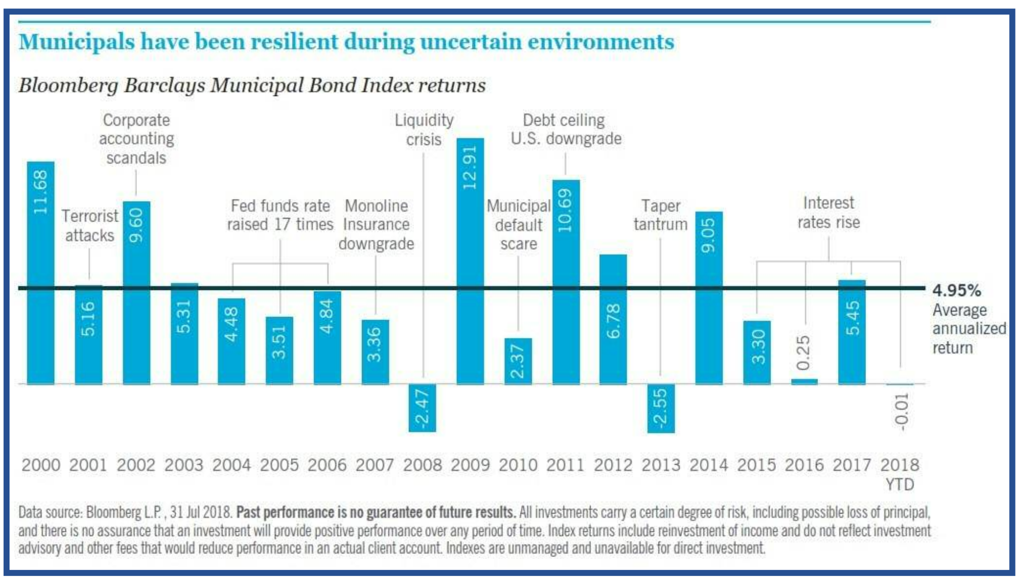
Fig 3



observed that the outperformance of high-yield munis has been largely driven by technical forces, casting doubt on its sustainability. This is a trend that is unlikely to end well.

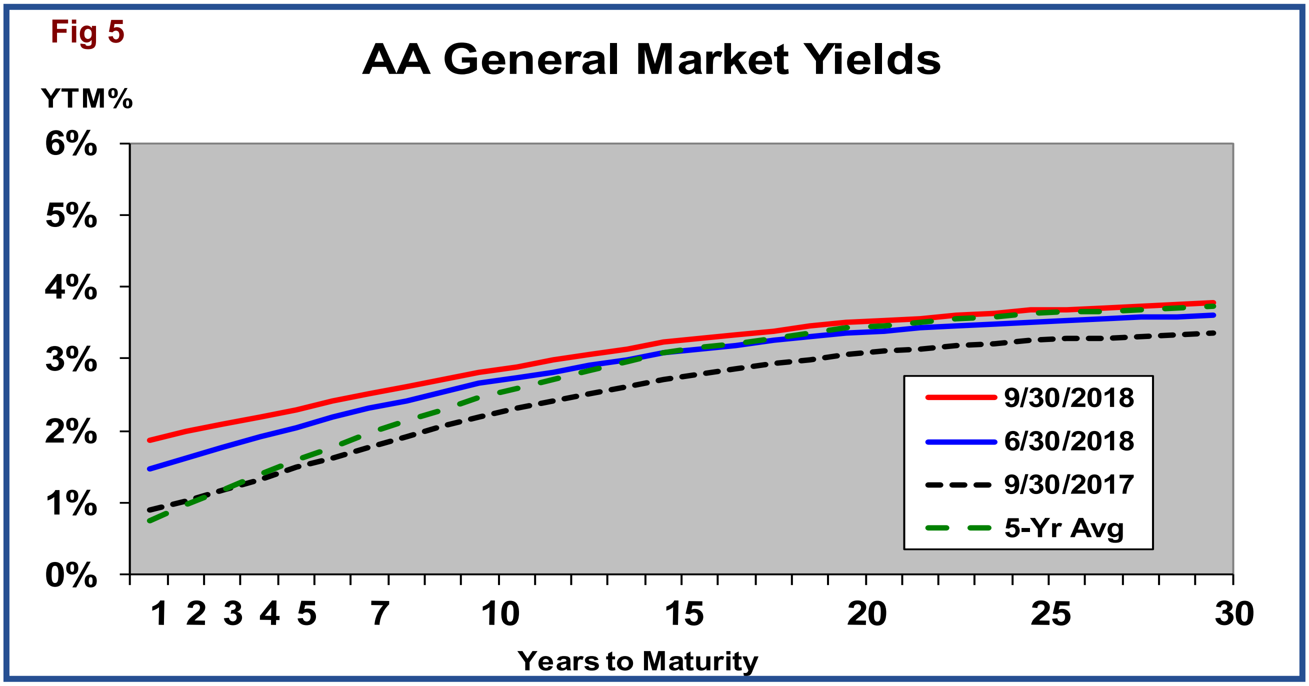
During its September meeting, the Fed raised its benchmark fed-funds rate by a quarter percent to a new target range between 2.00% and 2.25%. The rate hike was telegraphed and priced in. This was the third hike of 2018, with one more expected in December. Most Fed officials have penciled in three more rate increases in 2019. This was the eighth hike since the end of the Great Recession and part of a gradual series of steps to return rates to historically normal levels. We remain of the opinion that the Fed is engaging in an opportunistic reload ahead of the next economic downturn or financial crisis, i.e., the next reset. In our view, even a 100 bps gradual rise in long-term taxable yields—from about a 3% 10-year Treasury yield to a 4% 10-year Treasury yield—across a period of about one year, would be constructive for municipal bonds as the rise over 12 months would enable the reinvestment of existing cash flow and the deployment of new money at more attractive purchase yields while the negative price impact on existing positions would be moderated across time by the increased carry. For this reason, we believe that this is actually a very good time to lock in the higher purchase yields currently on offer in

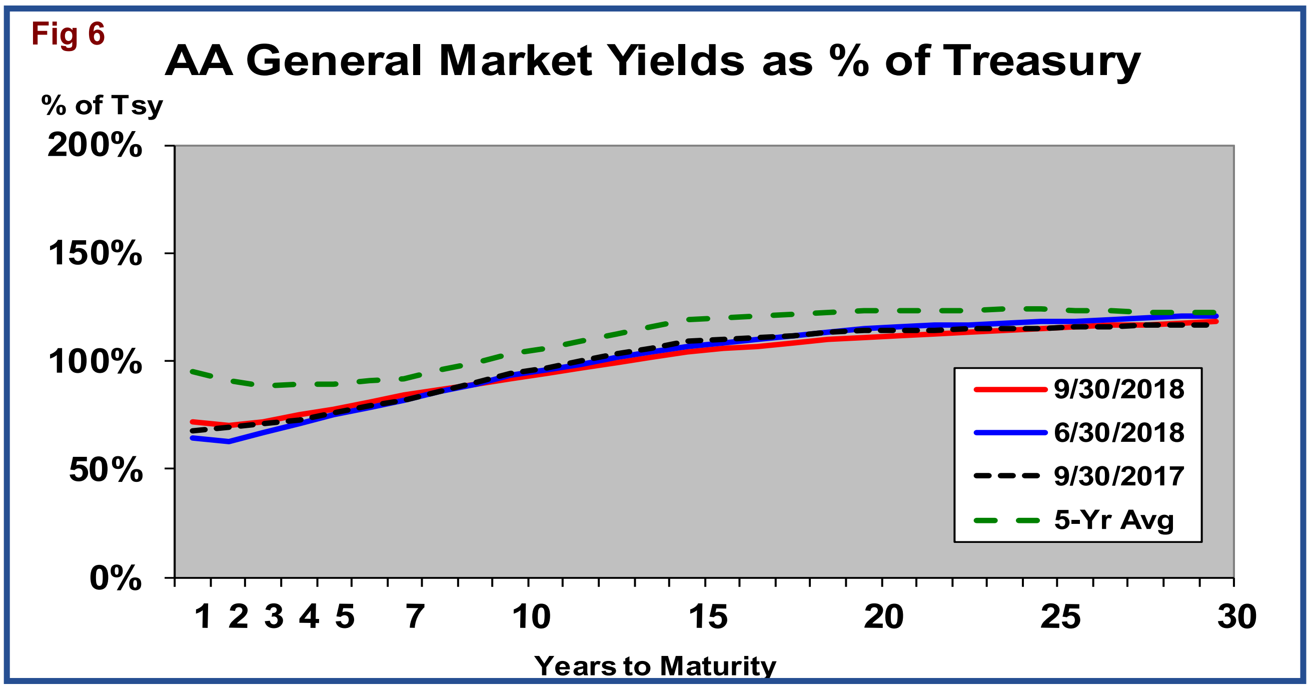
Fig 4



high-quality municipal bonds. As one manager put it last quarter, *“If rates are going up and good -quality municipals are giving 4 percent or more in tax-free cash flow, over the long term that’s going to be good for people in high tax brackets.”* Also consider, that on a pretax basis, munis have outperformed taxable investment grade corporate bonds in three of the last four Fed tightening campaigns. On an after-tax basis, the benefit has been even more significant. Furthermore, munis have outperformed US Treasuries and mortgage-backed securities in all four Fed tightening cycles since 1987. The resiliency of munis across a variety of challenging environments dating back to 2000 can be seen in the chart from Nuveen in **Figure 4.**

We at Redstone have already taken several steps to position your portfolio for a volatile and potential rising interest rate environment. Specifically, we have pursued an intermediate duration structure in an effort to reduce total market risk. Also, as interest rates declined to historically low nominal levels over the past several years, we have emphasized high-coupon premium bonds as a defensive measure since they are less sensitive to a change in rates than par or discount bonds. Our long-term goals are completely unaffected by the near-term volatility in bond prices. With the passage of time, that most unique feature of bonds, the maturity date, mitigates and ultimately eliminates market risk as every good bond always goes to par. With our 25+ years of experience in the muni bond market, we believe we are specially 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 monitor the market for risks and opportunities. For clients, existing or prospective, with cash to invest, the current elevated level in yields is offering an excellent opportunity to put cash to work.





	5 Yr Avg	6/30/2018	9/30/2018
2-Year AA Municipal	91%	63%	72%
5-Year AA Municipal	89%	75%	78%
10-Year AA Municipal	103%	93%	92%
25-Year AA Municipal	124%	118%	115%