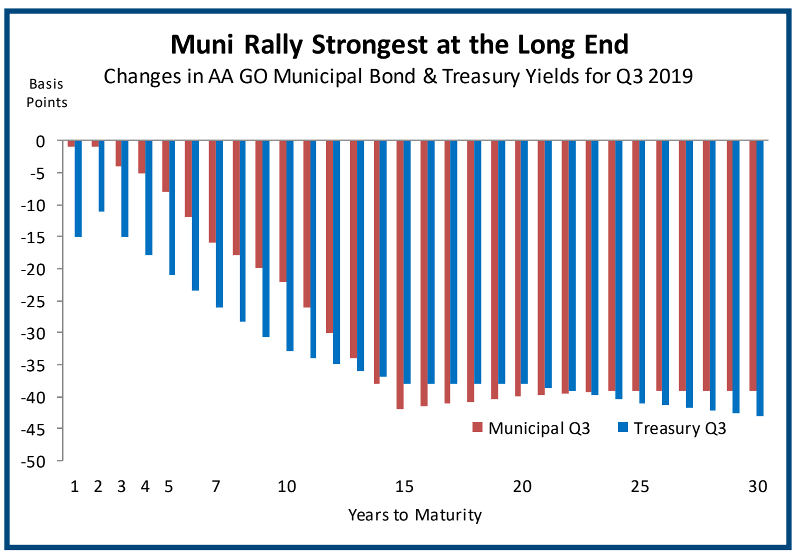
Redstone Advisors

Municipal Market Review

Third Quarter 2019

Municipal bonds rallied once again in the third quarter, the third straight quarter of gains for munis in 2019. The main drivers of this rally continue to be a dovish Federal Reserve which cut rates twice this past quarter, and the tax law's new $10,000 limit on state and local tax (SALT) deductions affecting taxpayers and influencing their asset allocation decisions. Moreover, fears of a global economic slowdown have fueled demand for safe-haven fixed income investments and pushed down bond yields around the world to historically low levels. Lingering risks to the world economy include the trade conflict with China, Middle East tensions, and the October 31 deadline for Brexit. The continued robust demand for tax-exempt munis combined with the limited supply available has kept the rally steadily moving along. *"It's really just amazing how aggressive this market is. They want tax-exempt income, and you can't get that anywhere else except for the muni market"* said Matt Fabian of Municipal Market Analytics.

Fig 1



For the quarter, the largest move came at the long end of the curve, where the average decline in the 15-to-30-year range was 40 basis points (bp). In contrast, yields at the short end 1-to-4-year range were essentially unchanged. Many retail investors have continued to prefer short-term munis, and their high demand has made these munis the most expensive relative to Treasuries. However, a noticeable trend the past couple of quarters is retail investors going further out the curve, looking for more attractive valuations and reaching for yield wherever it is available. As a result, the municipal curve has flattened this past quarter. The 2-yr/10-yr muni spread began the quarter at 46 bp, and by quarter end it was just 25 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.

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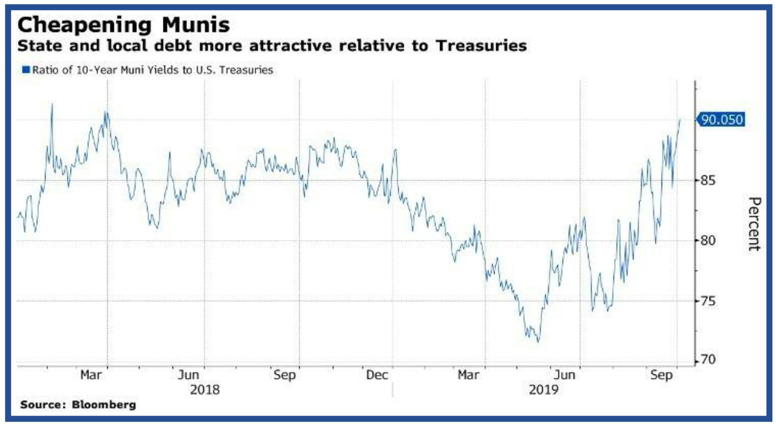
Muni relative value ratios finished the quarter mostly unchanged. Munis finished the quarter yielding roughly 70% to 90% of Treasuries in the short 1-to-5-yr range. The 10-year relative value ratio slightly ticked up to finish the quarter at 95%. Relative value ratios remain above 100 percent at the long end of the curve, in the 15-to-30-yr segment. The recent cheapening of the 10-year muni/Treasury ratio can be seen in **Figure 2**. With the SALT deduction now capped at $10,000, residents from high-tax states have certainly boosted demand for double-exempt bonds from their home states. Muni mutual funds and ETFs containing California, New York and New Jersey bonds have seen a total of $6.5 billion in inflows so far this year through the end of July. That marked the highest inflows for the seven-month period since at least 2014.

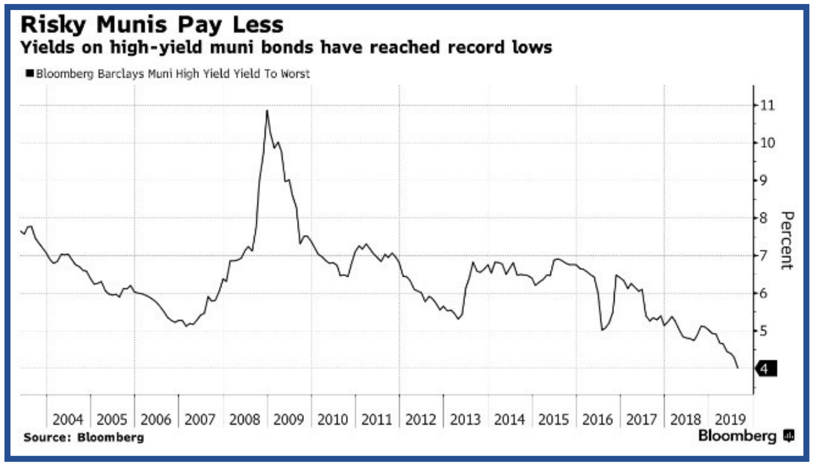
Fig 2



Cash isn't just flooding in from investors in high-tax states, however. According to recent data, more money has poured into municipal bond funds this year through August than any year since at least 1992. *"With Treasury yields falling so low, the worldwide demand for municipals is just unbelievable,"* exclaimed one portfolio manager. Municipal-bond mutual funds and ETFs have raked in about $47 billion over the past 38 straight weeks, which is the largest cash haul since 2010. The steady flow of new money into muni mutual funds suggests that the relatively rich valuations will not affect individual demand, at least not in the short term. *"The classic law of physics—a body in motion stays in motion, is how I would describe the inflows. Our market follows trends and everything that has been in place to stimulate the inflows has not changed as we keep pushing toward the $70 billion number of inflows for the year"* remarked one municipal strategist. We anticipate that the favorable supply and demand dynamic in the municipal market is likely to persist.

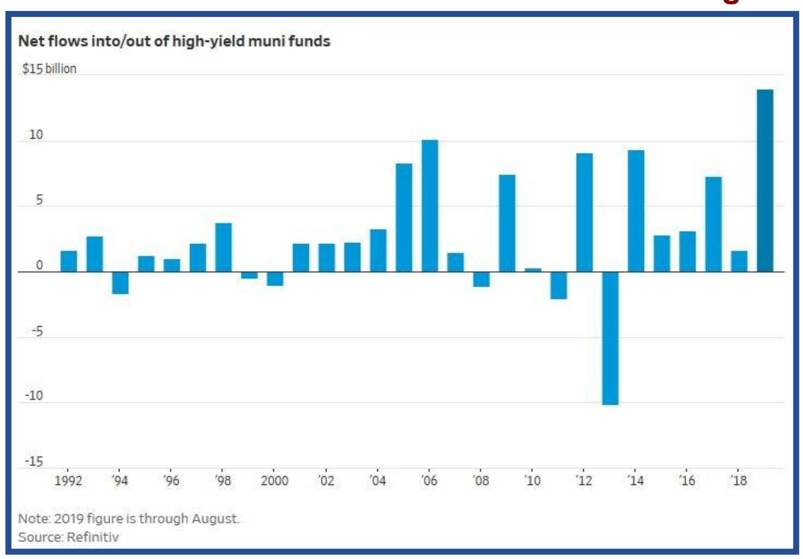
Tax-exempt municipal bond issuance has risen just 5% year-to-date compared to 2018, according to data from the Securities Industry & Financial Markets Association (SIFMA). Meanwhile, taxable municipal bond issuance has surged 34% during the same period. The 2017 tax law eliminated advance refundings for tax-exempt munis.

Fig 3



However, issuers are swapping out tax-exempt municipal debt for taxable municipal debt and still finding savings. Historically, tax-exempt bond yields are lower than those on taxable bonds. Nevertheless, interest rates have fallen so much that municipalities are able to issue taxable bond debt and still save money. *"It's a strange moment that makes this available but it makes perfect economic sense,"* one Morgan Stanley strategist noted. The head of municipal trading at Bank of America said he hasn't seen this phenomena on such a large scale in his entire career. In the current environment, issuers have the opportunity to save as much as 20 percent from such deals, it is estimated.

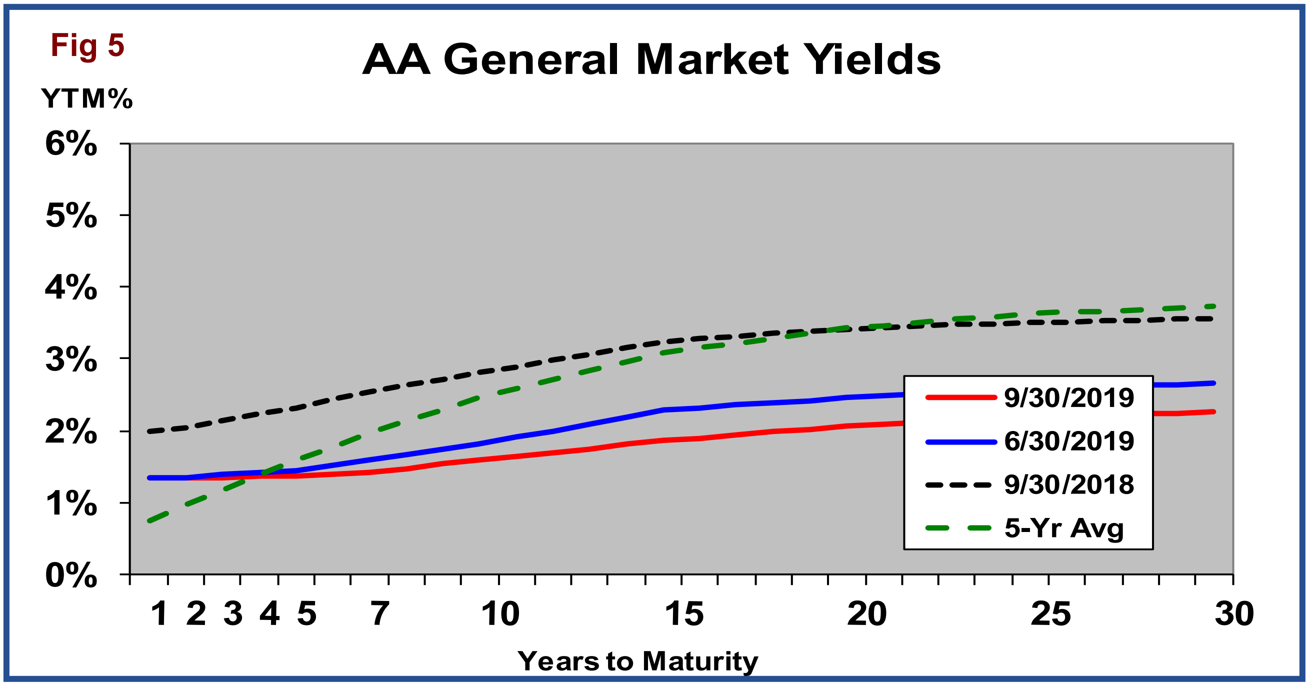
Fig 4

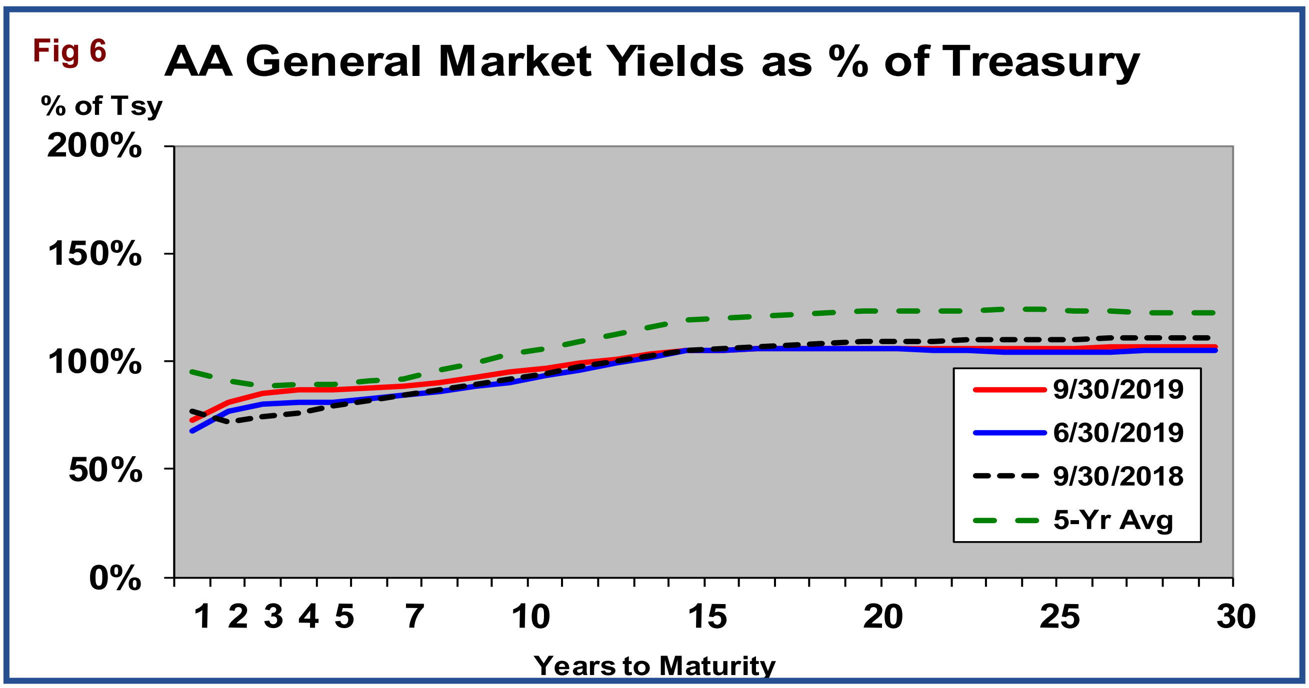


Municipal investors aren't just looking at the longer end of the curve for yield. Continuing the trend from last quarter, there has been significant increased demand in the riskier "high-yield" sector of the municipal market. The strong demand has driven down yields on the riskiest muni bonds to just around 4% on average. This is illustrated in **Figure 3**. In fact, the Bloomberg Barclays Muni Bond High Yield Index hit a record low in August. *"There is so much money coming in – even if 90% of the market rejects it, if 10% wants to buy, they are able to get it done,"* explained one manager. High-yield municipal funds have taken in more cash this year through August than in any other year on record. Net flows into/out of high-yield muni funds going back to 1992 can be seen in **Figure 4**.

During its late July meeting, the Federal Reserve cut interest rates for the first time since 2008. Fed Chair Jerome Powell said the move was designed to "insure against downside risks." Many analysts saw the move as a preventive measure to cushion the economy from a global slowdown and rising US/China trade tensions. Powell said, *"It's not the beginning of a long series of rate cuts"*, he later added, *"I didn't say it's just one cut"*. Powell has repeatedly declared that the Fed's "overarching goal" is to keep growth going. In September, the Fed cut its benchmark rate again, lowering it to a target range of 1.75% to 2.00%. Powell, speaking afterwards, said, *"There will come a time, I suspect, when we think we've done enough. But there may also come a time when the economy worsens and we would then have to cut more aggressively. We don't know."* In his press conference, Powell repeatedly cited the costs of rising trade-policy uncertainty. He showed concern that uncertainty about trade policy was chilling business investment and that a reduction in manufacturing activity would continue. Trade-related risks are beyond the Fed's control and not easy to predict, and Fed officials are divided over how to respond.

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 portfolios for our clients. We conduct independent credit research, adjust for duration and constantly monitor the market for risks and opportunities. We recommend munis for their defensive traits and reliability. Bottom line, munis continue to be a key component of any well-diversified portfolio given their unique ability to provide high-quality tax-exempt income.





	5 Yr Avg	6/30/2019	9/30/2019
2-Year AA Municipal	91%	77%	81%
5-Year AA Municipal	89%	81%	87%
10-Year AA Municipal	103%	90%	95%
25-Year AA Municipal	124%	104%	106%