Redstone Advisors

# Municipal Market Review

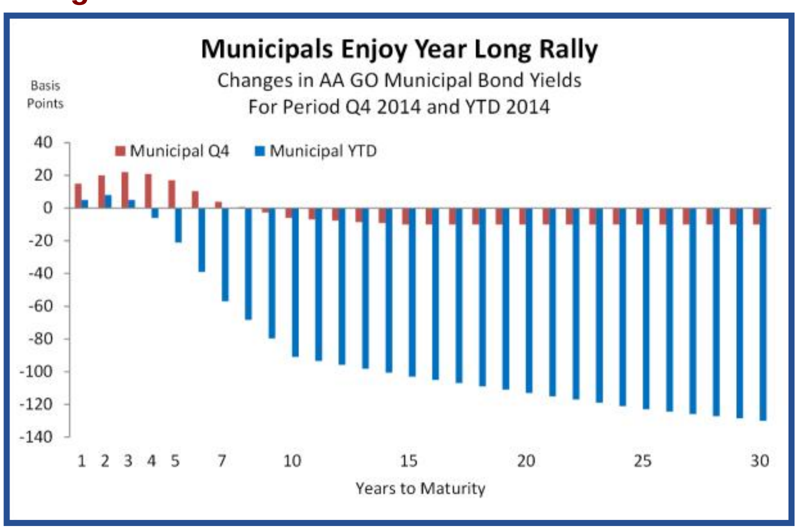
Fourth Quarter 2014

***"Investing in sewage-treatment plants and highway overpasses hasn't always been this consistently lucrative."***

Aaron Kuriloff, Wall Street Journal

This past year saw the municipal bond market come roaring back from a disappointing 2013, with the market returning 9.8% in 2014 as measured by the Bank of America Merrill Lynch index, the most since 2011. Municipals have outpaced investment grade corporate debt and Treasuries, which returned 7.5% and 6.0% respectively in 2014. The gains have been steady this year, with twelve straight monthly advances dating back to January. This hot streak represented an unprecedented stretch to start a year since data collection began in 1989. The year-long rally can largely be attributed to constructive technicals (low supply/strong demand), positive fund flows, and higher tax rates that underscore the inherent tax-exempt appeal of municipals. During the fourth quarter of 2014, the municipal yield curve experienced a bullish flattening as short and intermediate-term yields rose moderately while yields on longer term bonds in the 10-30 year maturity range declined modestly. The reshaping of the yield curve is reflected in Figure 1 which graphs the changes in municipal yields across the curve for both the fourth quarter and for the year-to-date period through December 31, 2014. As we can see in Figure 1, for the year, municipal yields rallied significantly in the 7-to-30 year area. The long 30-year bond rallied the most, declining an impressive 131 basis points in 2014. For the year, yields at the short end of the curve, in the 1-to-4 year segment remained essentially unchanged. Similar to municipals, the Treasury yield curve underwent a bullish flattening as yields at the

**Fig 1**

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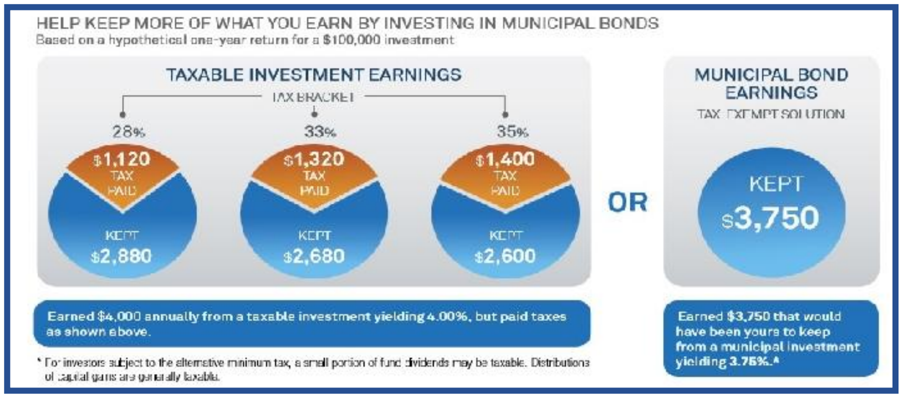
long 15-to-30 year end declined over 100 basis points on average while yields at the short 1-to-4 year end rose moderately. Municipal relative value ratios for the quarter were higher across most of the yield curve. Municipals continue to be attractive as relative value ratios remain above 100 percent for the 10-to-30 year maturities, and in the 70s and 80s for the 2-to-7 year segment.

**Fig 2**



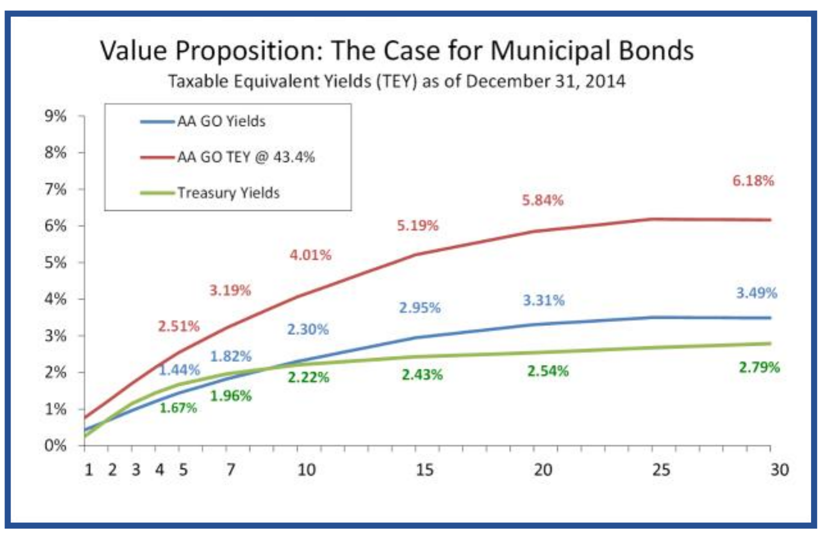

Municipal bonds certainly gained appeal in 2014 as the highest federal tax rates in more than a decade took effect. As you may recall, the top marginal income tax rate increased from 35 percent to 39.6 percent for families with taxable income over $450,000 and single filers over $400,000. As marginal tax rates increase, so too does the value of the tax exemption of municipal bonds. Top earners faced a 43.4 percent tax rate that included a newly mandated 3.8 percent Affordable Care healthcare surtax, a tax, significantly, from which municipal bond income will be exempt. The tax advantage of municipal bonds is evident in Figure 2, which compares taxable investment earnings versus municipal bond earnings based on a hypothetical one-year return for a $100,000 investment. On the left one can see how much taxes would be paid on $4,000 of investment earnings from a taxable investment yielding 4.00%. On the right, an investor would get to keep all $3,750 of investment earnings from a municipal bond yielding 3.75%. The tax-exempt appeal is clear to see in this illustration provided by BlackRock corporation.

In late October, the Federal Reserve as expected, announced the end of its latest round of quantitative easing, as the tapering culminated in a final reduction. QE3, begun in January 2013, ended with the Fed having added $790 billion of Treasuries and $813 billion of mortgage-backed bonds to its balance sheet. At the next Fed meeting in December, the Federal Open Market Committee (FOMC) declared it will be “patient” regarding the timing of the first fed funds rate hike, replacing a pledge to hold rates near zero for a “considerable time.” The Fed said the new guidance is “consistent” with its previous “considerable time” wording. Many analysts interpreted this statement as indicating that the central bank is most likely to begin raising its benchmark short-term rate in mid-to late 2015. We would like to remind our readers that municipal bond yields historically have not been highly sensitive to fed funds moves. One may recall the consensus Wall Street view at the beginning of 2014 that Treasury yields would rise, as the Fed would be winding down its massive bond-buying program. Wall Street's top economists and interest rate gurus were utterly convinced the 30-year old bond bull market was finally ending. Treasuries of course defied that prediction, as prices rose and yields tumbled. Demand for Treasuries throughout the year was robust, as buyers such as foreign central banks, pension funds, and global investors in search of yield increased their purchases. Similarly, municipals enjoyed strong demand for most of 2014. Phil Fischer, head of muni research at Bank of America, noted that munis cheapened up tremendously back when there were negative fund flows, drawing buyers at attractive prices. He emphasized, "The market is more resilient and more liquid than it's given credit for."

While there has been plenty of speculation and attention focused on the short-term direction of interest rates and when the fed funds rate might be raised, we would like to step back and look at the long-term forecast for interest rates. Our reason is that municipal bonds mostly are a buy-and-hold investment for the majority of individual investors. Their flow of tax-exempt income, low volatility, and deserved reputation as a conservative, high quality investment have made municipals an attractive asset class and conducive to longer holding periods. As you know, the Federal Reserve has been relying on inflation and employment data to formulate its monetary policy. If inflation and employment data, specifically wage growth, continues to underwhelm, then it is logical to assume that the Fed is not going to get aggressively tighter with its policy. Last quarter in our Taxable Market Review we discussed how the threat of inflation has largely receded, highlighted by the declining spread between the yield of five-year Treasury notes and inflation-protected securities, known as the breakeven yield. Tepid consumer demand has held inflation, according to the Fed's preferred measure, below its 2 percent target for 29 straight months. Looking back at history, from 1969 to 2007 the baby boomer generation's spending clearly had a powerful impact on driving the economy along. This baby boomer golden age was also marked by a considerable ramp up of financial leveraging. The landscape is quite different today, post Great Recession. Studies and reports, such as those from Pew Research, have shown that today's younger generation has higher levels of student debt and lower levels of wealth and personal income than the two generations prior. Not surprisingly, data shows declining birth rates among the millennial generation that is saddled with debt. Regarding employment, weekly earnings for full-time employees are still lower than in the period just before the Great Recession. Additionally, the buying power of workers' paychecks is no higher than it was in 1999. According to the Employment Benefit Research Institute's 2014 Retirement Confidence Survey, the percentage of workers who expect to retire after age sixty-five has steadily risen over the years from 11% in 1991 to 33% in 2014. Moreover, unemployment rates for the 20-24 and 25-29 age groups are 13% and 9%, respectively, significantly above the national average of 5.6%. The bottom line is that headwinds for wage growth and no obvious engine for rising inflation are likely to keep interest rates subdued for the foreseeable future. And for the record, the Fed has hinted at a relatively gentle rate-hiking cycle with the peak for the target federal funds rate likely to be beneath the long-term average. The Fed is well aware of the economic risk in rising their benchmark rate too much too quickly. Therefore if and when the Fed finally decides to act in the middle or late part of 2015, as most economists and analysts are predicting, it will very likely be done incrementally over the course of several months.

In the past few years a consistent theme that has underscored the appeal of municipal bonds has been their tremendous relative value compared to Treasuries. Over the course of 2014, the relative value of municipals, as measured by the ratio of municipal yields to Treasury yields, continued to remain at historically high levels. For example, at year end, the relative value ratio of the 20-year municipal bond versus the 20-year Treasury bond was at 130 percent, significantly higher than its long-term average of 90 percent. Alan Schankel, managing director at Janney Capital Markets, sums it up well, "With few signs of receding demand given the highest tax rates since 1986 and the demonstrated value of the tax exemption when comparing municipal bond yields to taxable alternatives, elevated ratios may represent an opportune entry point for tax-free investors." Demand has certainly been robust, as municipal bond funds have seen inflows in 40 out of the 47 weeks so far in 2014. As of mid-December, investors have poured just shy of $24 billion into municipal bond funds, according to data from Lipper fund flows. This has been a marked turnaround from last year, when investors pulled $63.5 billion out of muni-bond funds. Figure 3 highlights the relative value advantage of municipals. The advantage is especially apparent when a 43.4% tax rate is factored in. Investors sometimes focus just on nominal yields in the determination of value and fail to consider the real value inherent in high quality municipal bonds, their tax exemption.

**Fig 3**

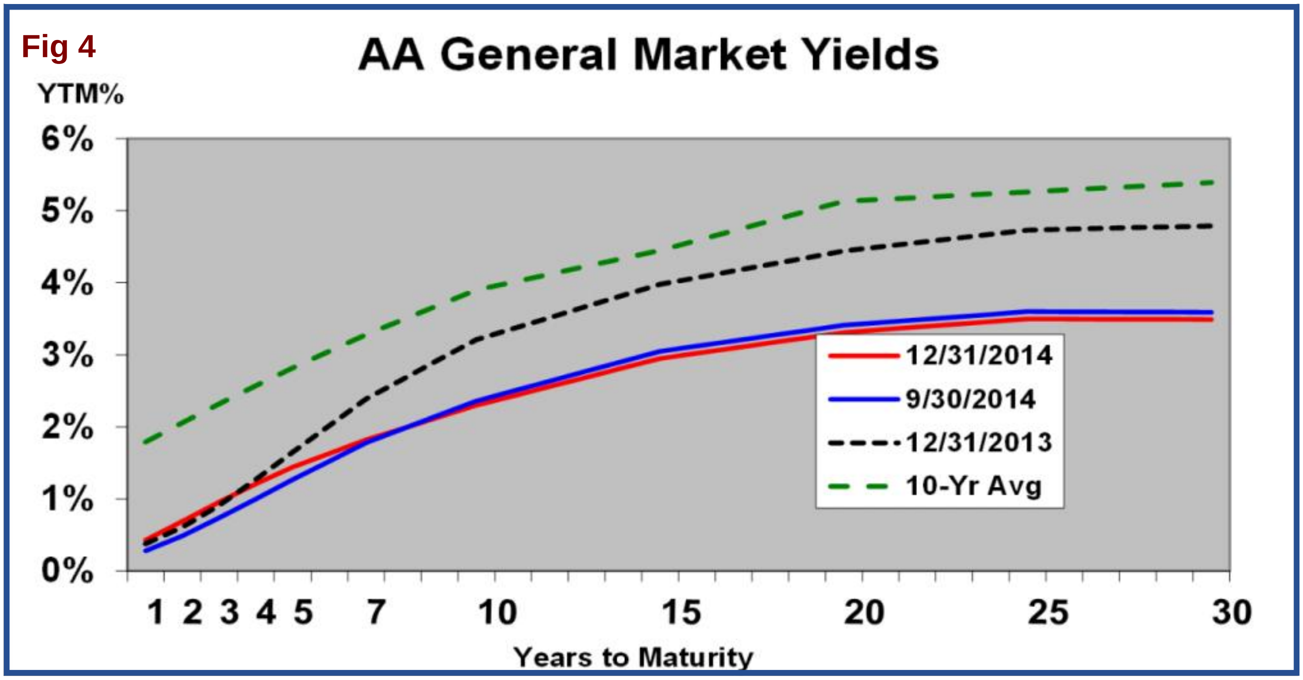


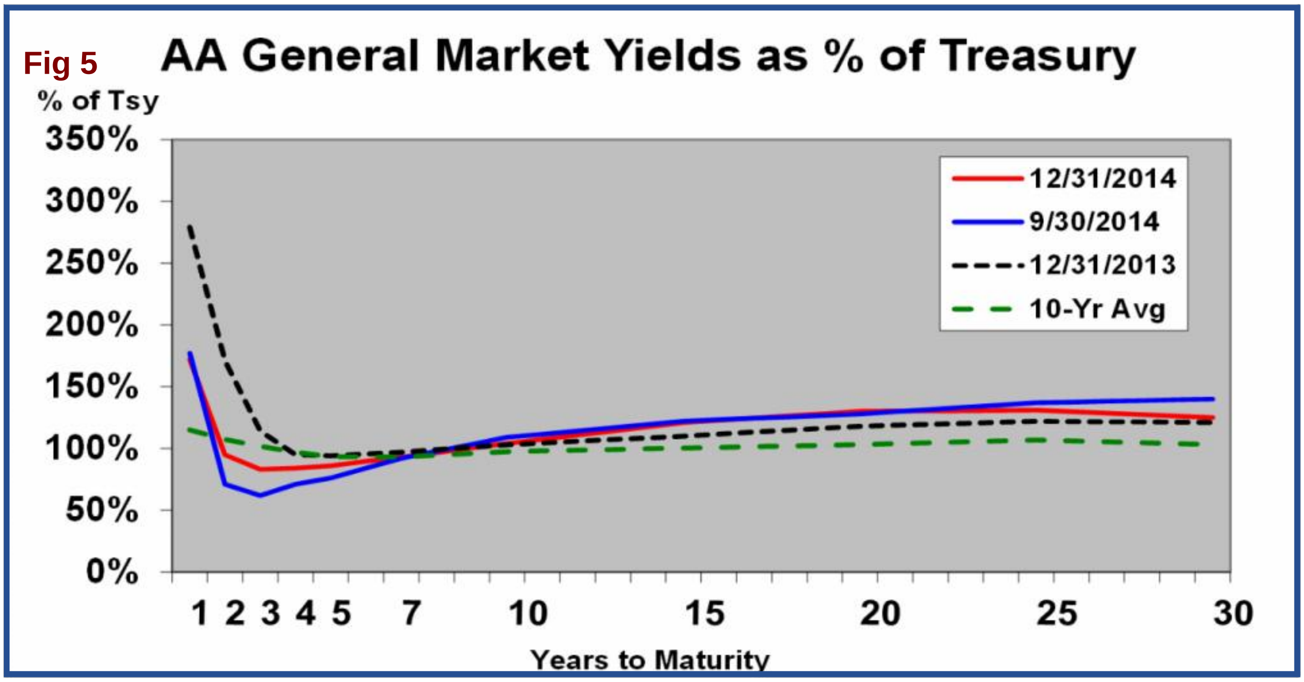

Overall, credit conditions of state and local issuers of municipal bonds have continued to improve this past quarter and year. The municipal market is very fragmented and each credit is unique, but looking at the big picture, most municipalities have strengthened fiscally. This rebound can be attributed to rising revenues, reduced spending and recovering property tax bases. S&P/Case-Shiller index data shows that home prices in twenty major metropolitan areas across the United States are the highest since February 2008. The increase in real-estate values and property tax collections is characteristic of an economy that has steadily grown, even though the pace has been frustratingly slow at times. For the first half of 2014, rating agency Standard & Poor's upgraded 1,255 public-finance issuers while lowering ratings on just 410. As a matter of comparison, S&P upgraded ratings on 794 borrowers while cutting ratings on 585 back in 2011. Recently Moody's Investor Service published a report, "U.S. Municipal Bond Defaults and Recoveries, 1970-2013" that analyzed both ratings migration and defaults in the municipal bond market and compared them to the corporate bond market's rating performance. Defaults and troubled issuers (Detroit and Puerto Rico to name a couple) certainly gather media attention and weigh on the minds of muni investors. Do not let the media and fear-mongers (Meredith Whitney) distort you from the reality of the situation. The Moody's report found that since the beginning of the recession in 2008, the one-year default rate for all municipal bonds was 3/10$^{th}$ of one percent. Going back further, from 1970 to present, the default rate drops to 1/10$^{th}$ of one percent. It should be noted that the majority of those defaults arose from bonds rated "junk", or below investment grade. At Redstone, we are concerned more with ratings migration, the change in a bond's rating due to an upgrade or downgrade. The reason for this is that when a municipal credit strengthens or weakens, it has a direct effect on a given bond's price. One key takeaway from the report is that in terms of ratings migration, municipal bonds have proven to be impressively stable over history. From 1970 to 2013, the average ratings migration for Aaa-rated General Obligation bonds to Aa, one notch lower, was 2.3 percent. In other words, the ratings on nearly 97 percent of Aaa-rated bonds outstanding over the course of the 43-year period didn't move in any given year. The report also looked at single A-rated Revenue bonds and found that downgrades from single A to Baa levels during that period were a miniscule 0.9 percent. Notably, a larger percentage of Baa-rated revenue bonds (1.5 percent) were actually upgraded to single A, Aa or Aaa over that time period. Simply put, more than 97 percent of the single A-rated Revenue bonds from 1970 to 2013 had no rating change.

One might be curious how municipals measured up against corporate bonds. Over the same 43 year period, 8.3 percent of Aaa-rated corporate debt was cut to an Aa rating. Furthermore, 5.5 percent of single-A rated corporates were downgraded to Baa. The findings of the report can be neatly summarized in this way: investors in Aaa-rated corporate bonds were more than four times more likely to see their bonds downgraded than the owners of Aaa-rated municipal bonds. Owners of A-rated corporate bonds were more than five times more likely to experience a credit downgrade than owners of A-rated municipal bonds. These findings should not come as too much of a surprise given the clear differences in municipal and corporate credits. Municipal bonds are typically issued for essential public purpose entities in sectors with mostly inelastic demand. For example, children attend school (education), drivers must pay tolls (transportation), everyone uses water (water & sewer), and everyone pays taxes (general obligation). Corporate bonds simply do not have that advantage of essentiality and thus the risk of rating migration and price depreciation in corporate bonds is greater. A key inherent benefit of municipals is that the vast majority are running balanced budgets every year, and thus are forced to make the tough decisions regarding spending cuts or revenue increases. Municipal bonds earn their reputation as a trustworthy and stable asset class for a reason. The data proves it as this extensive Moody's report indicates.

With interest rates lingering close to generational lows and state and city finances finally returning to health more than five years after the Great Recession, municipalities are gaining confidence in asking taxpayers to allow bonding for infrastructure work postponed amid the financial crisis. In last year's midterm elections, states and localities asked voters to approve roughly $44 billion of municipal bonds, more than double what was sought in 2010. The American Society of Civil Engineers estimates that the United States needs about $3.6 trillion of investment in infrastructure by 2020. In November, 60 Minutes ran a report highlighting the outdated and potentially hazardous condition of numerous roads and bridges throughout the country. With stronger fiscal fundamentals and bolstered coffers, state and local governments are slowly moving back into a capital-investment mode. A Securities Industry and Financial Markets Association (SIFMA) survey of municipal bond underwriters and dealers in December forecasted issuance in 2015 will reach $357 billion, up slightly from $348 billion in issuance for 2014.

Redstone Advisors, with our 25+ years of municipal bond expertise and personalized separate account management, believe we are uniquely qualified to provide wealth preservation through building par value by maximizing tax-adjusted purchase yields while avoiding credit events. Looking to the past, municipal bonds have historically outperformed Treasuries when the Fed has tightened the money supply, and we at Redstone look for that scenario to play out again as the Fed ever so gradually shifts from seven years of very accommodative policy. Ultimately, we believe the increased after-tax benefit of municipal bonds will be very clear and welcoming for investors in the current climate of high federal tax rates. Recall that an Internal Revenue Service report found that the majority of individuals who earned at least $200,000 in 2009 and did not pay any federal taxes cited tax-exempt interest as the most important reason why they did not pay any taxes. The high-quality and tax-exempt income of municipal bonds are the traits that distinguish this asset class and make it the last great tax shelter for individuals in high tax brackets.




| | 10 Yr Avg | 9/30/2014 | 12/31/2014 |
|---|---|---|---|
| 2-Year AA Municipal | 107% | 71% | 95% |
| 5-Year AA Municipal | 93% | 76% | 86% |
| 10-Year AA Municipal | 97% | 109% | 104% |
| 25-Year AA Municipal | 106% | 137% | 131% |