Redstone Advisors

Municipal Market Review

Fourth Quarter 2015

"It's really the sweet spot for muni investors: The U.S. growing fast enough to improve credit quality, but not too fast to generate a lot of inflation. Investors are going to focus on the income portion of their portfolio to drive total returns. Munis fit perfectly into that."

David Hammer, Pacific Investment Management Co.

This past year saw the municipal bond market deliver **steady results**, returning 3.3 percent in 2015 according to the Barclays Municipal Index, **outpacing corporate bonds, Treasuries and many other supposedly higher-performing asset classes.** This marks the second year of near market-leading performance from a sector primarily known for its tax benefits and defensive characteristics. U.S. equities dropped briefly into a correction before finishing the year essentially flat, commodities plunged to new lows, Treasuries were on a rollercoaster at the whims of the Federal Reserve, and corporate debt finished negative with high-yield funds particularly hard hit. Meanwhile, the municipal market finished the year strongly, posting six straight monthly gains. The positive performance of municipal debt can 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. According to Municipal Market Analytics, the supply of bonds for new borrowing has dropped, even as state and local governments rushed to take advantage of historically low interest rates. Despite issuers having sold nearly one-third more bonds than during the same period of last year, most refinanced outstanding bonds, constricting the total supply available. At a time of meager returns and high volatility in other markets, the few concerns facing municipal bonds seem relatively manageable to many investors. Especially when compared with the risk of a steep pullback in stocks or other riskier assets. For certain, municipals have acted as a **stabilizing force** in many investor portfolios, given their **low volatility, low correlations to equities and positive returns year to date.**

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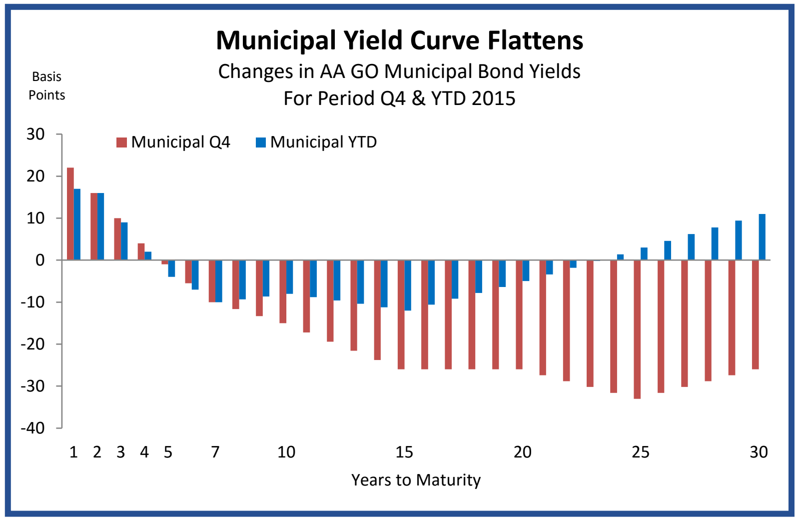
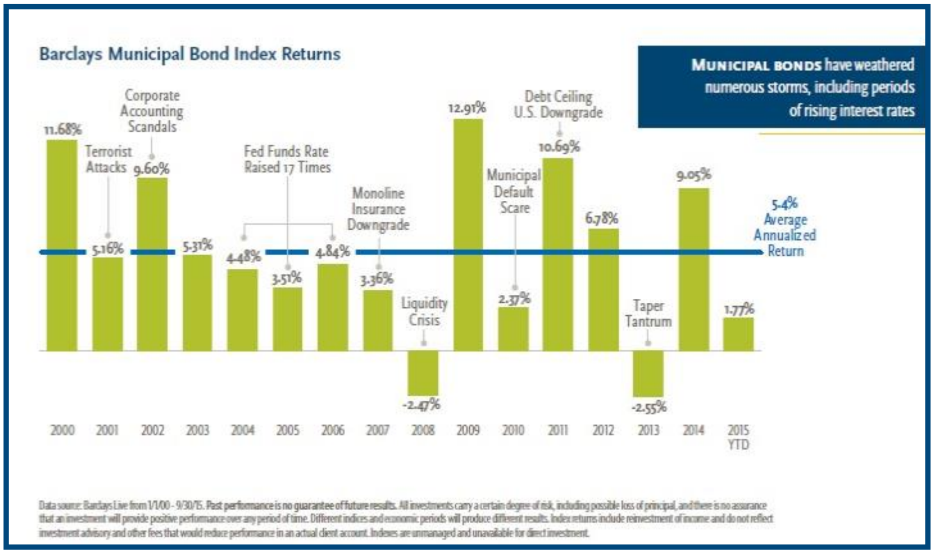
Fig 1



During the fourth quarter of 2015, the municipal yield curve underwent a **bullish flattening** as short-term yields rose modestly while yields on longer term bonds in the 10-to-30 year maturity range declined moderately. 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, 2015. As we can see in **Figure 1**, for the year, municipal yields largely held steady except for the very short end of the curve where the 1-year yield rose by a modest 17 basis points and the 2-year yield rose by 16 basis points. Much of the selloff at the very short end of the curve was due to anticipation of the Federal Reserve's rate hike, which ultimately occurred in December. Municipal relative value ratios for the quarter were lower across the yield curve. Despite the decrease, relative value ratios remain above 100 percent for the 15-to-30 year maturities and at 95 percent for the 10-year maturity.

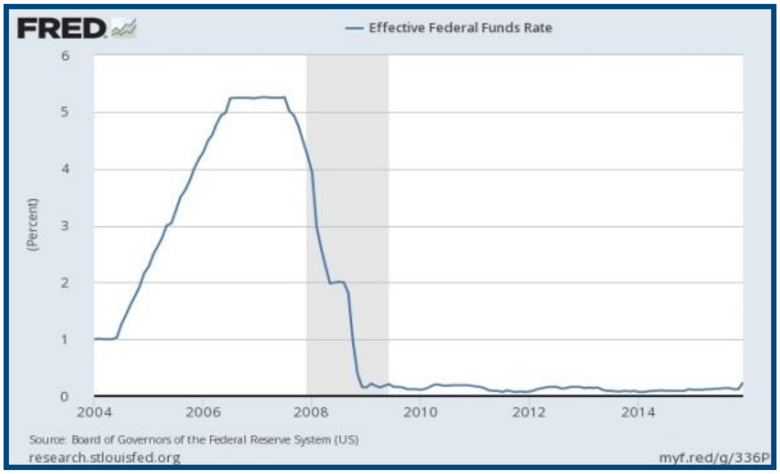
Municipal bond market credit conditions were largely favorable in 2015 and we see credit quality as remaining stable for most municipalities in 2016. The vast majority of issuers have actively adjusted to the new post Great Recession fiscal reality. 2015 was the first year since 2008 that state and local government **upgrades (Moody's rated) outpaced downgrades.** Moody's upgraded the most states and cities in seven years during the first three months of 2015. Defaults fell for the fifth straight year. States and cities are being **bolstered by an influx of tax revenue**, thanks to rising real estate prices and declining unemployment. The Rockefeller Institute of Government reported that state tax revenue rose by 6.8 percent in the second quarter from a year earlier. Furthermore, a survey by the National League of Cities released back in September found that 82 percent of cities said they were better off than a year earlier, the most since 1990. Fitch Ratings said in December that for the first time since 2009, all fifty states have a stable rating outlook for the year ahead, although Fitch and Moody's recently downgraded their ratings of Illinois. *"Demand for munis has been tremendous. There's just so much cash in our market looking to get invested"* noted John Bonnell, a senior portfolio manager at USAA Investment Management Company. Part of the appeal of municipals is how **resilient they have been in various investing environments.** The chart in **Figure 2** from Nuveen Asset Management shows Barclays Municipal Bond Index returns going back to 2000. As you can see, the municipal index posted an impressive 5.4 percent average annualized return for that time period. In early December, investors added $742 million into tax-exempt funds, the most since January, according to Lipper U.S. Fund Flows data. More than $3 billion was poured into long-term municipal funds over the last ten weeks of 2015 and for the year Lipper data showed more than $11 billion was invested into municipal mutual funds.

Fig 2



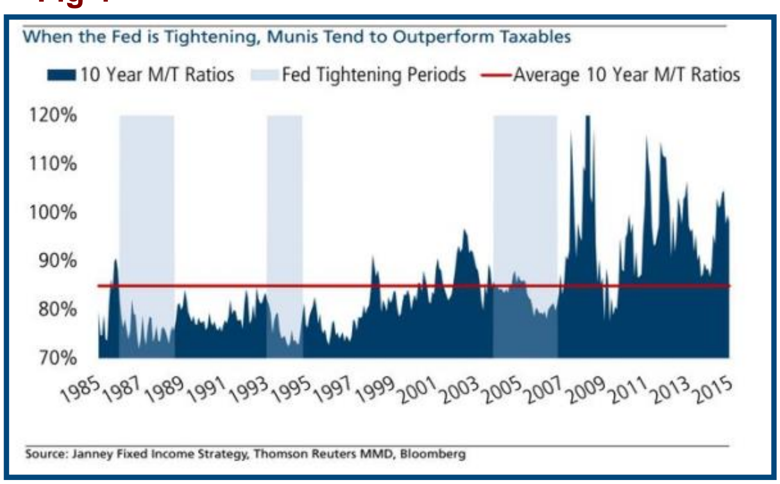
December saw arguably the most well-advertised rate hike in Federal Reserve history. The **Fed raised interest rates for the first time since 2006** in a clearly telegraphed move while indicating that the pace of subsequent increases will be "gradual" and in line with previous projections. The Federal Open Market Committee (FOMC) unanimously voted to set the new target range for the federal funds rate at 0.25 percent to 0.50 percent, up from zero to 0.25 percent. The move is small, as you can see in **Figure 3,** but it amounts to a **vote of confidence that the American economy will stand resilient amidst a slowdown in China and weak global growth.** The central bank separately forecast an appropriate rate of 1.375 percent at the end of 2016, implying four quarter-point increases in the target range this year. The bond market expects the Fed to proceed in a very measured and cautious manner with future increases, given the current environment of modest domestic growth, benign inflation and slowing global growth. In a statement following its two-day meeting, the FOMC said *"The committee judges that there has been considerable improvement in labor market conditions this year, and it is reasonably confident that inflation will rise, over the medium term, to its 2 percent objective."* The FOMC also said it expects to maintain the size of its massive balance sheet *"until normalization of the level of the federal funds rate is well under way."* The Fed stressed that monetary policy is still *"accommodative after this increase, thereby supporting further improvement in labor market conditions and a return to 2 percent inflation."* Inflation as measured by the Fed's preferred gauge hasn't reached the Fed's 2 percent target since April 2012. This rate hike finally brings to a close an unprecedented period of zero interest rate policy (ZIRP) that was part of extraordinary and controversial Fed policies designed to stimulate the U.S. economy in the wake of the worst financial crisis since the Great Depression.

Fig 3



The last time the Fed began tightening in 2004, the yield curve flattened and municipal prices increased and total returns were actually positive across every maturity range within three months of the initial hike. **Buy-and-hold investors were rewarded for staying the course,** despite conventional wisdom that rising rate environments are bad for bond investors. As we discussed last market review, municipal bonds have historically outperformed Treasuries when the Fed has tightened the money supply. During the last tightening period that began in the middle of the last decade, municipal ratios declined meaning that municipal prices rose

Fig 4



relative to Treasuries. This muni outperformance can be seen in **Figure 4**. 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 soon. While a little volatility or noise remains a concern as the Fed commences "lift-off", we recommend municipals for their defensive characteristics and usefulness in an environment in which total return is likely to come more from coupon and less from price performance. Most analysts are positive on municipal debt, largely because the bonds are primarily owned by buy-and-hold investors looking for steady tax-exempt income, which buffers them from the volatility found elsewhere in the financial markets. Chris Alwine, head of municipals at Vanguard Group Inc. said that, *"Munis have been a very attractive asset class for taxable investors when you look at the alternatives. In particular when you look at the yield volatility, the returns don't jump around as much. And then you have the tax advantage."* In fact, the degree of daily price-swings on municipals last year was half what it was for other fixed-income assets and miniscule compared with stocks and commodities, which **boosted munis' risk-adjusted returns.** Another reason for muni bonds to do better in a rising-rate cycle is growing property tax revenues. Analysts note how there is typically a three-year lag, with reassessments and rising property tax revenues. Even in a rising-rate environment, property tax revenues are going to continue to go up.

Puerto Rico remains in the headlines, as cold hard fiscal realities have weighed on the U.S. commonwealth. In late December, Puerto Rico Governor Alejandro Garcia Padilla announced that his territory will default on $37.3 million out of nearly $1 billion of debt payments due on January 1, a "mild" default as one analyst described it. Puerto Rico will be able to make the remaining payments, according to the governor, including $328.7 million of interest on guaranteed general obligation (GO) bonds. However, the GO payment is only possible because of "clawback" measures the governor ordered in November that allow the commonwealth to divert funds to constitutionally guaranteed payments from those that do not have the same guarantee. Municipal defaults have been virtually nonexistent outside of Puerto Rico, and it is important to remember that **Puerto Rico has a low correlation to the rest of the municipal market.** It is literally and figuratively on its own island apart from the rest of the vast $3.7 trillion municipal market. Experts do not see the ongoing saga there as a catalyst for widespread investment-grade municipal market contagion because ownership of Puerto Rico's debt has largely dispersed, and now is primarily concentrated among a variety of hedge funds and opportunistic speculators. It is possible that a complex debt restructuring involving much of the island's roughly $72 billion debt will eventually occur. This would likely transpire over a protracted period of time lasting months if not years and be subject to contentious legal battles and creditor lawsuits. Puerto Rico thus remains in an undesirable legal limbo, as the U.S. territory is not covered by the Chapter Nine bankruptcy code in the United States. The default follows the governor's failed attempt to persuade Congress in December to include a provision in the $1.1 trillion spending bill to allow commonwealth agencies to file for bankruptcy protection. House Speaker Paul Ryan set a deadline of March 31st for House committees with jurisdiction over Puerto Rico to come up with a workable solution for the beleaguered commonwealth.

Redstone Advisors, with our 25+ years of municipal bond experience, believe we are uniquely qualified to pursue our two primary investment objectives of wealth preservation and building par value by actively managing municipal bond portfolios for our clients. Ultimately, we believe that the increased after-tax benefit of municipal bonds will be very clear and welcoming in this current climate of high federal tax rates. Recall that a recent Internal Revenue Service report found that the majority of individuals who earned at least $200,000 and did not pay any federal taxes cited tax-exempt interest as the most important reason why. One should not underestimate the power of a strong tax advantage, and that is one reason we recommend investors look to municipal bonds for their attractive relative value and high quality income stream.

Fig 5

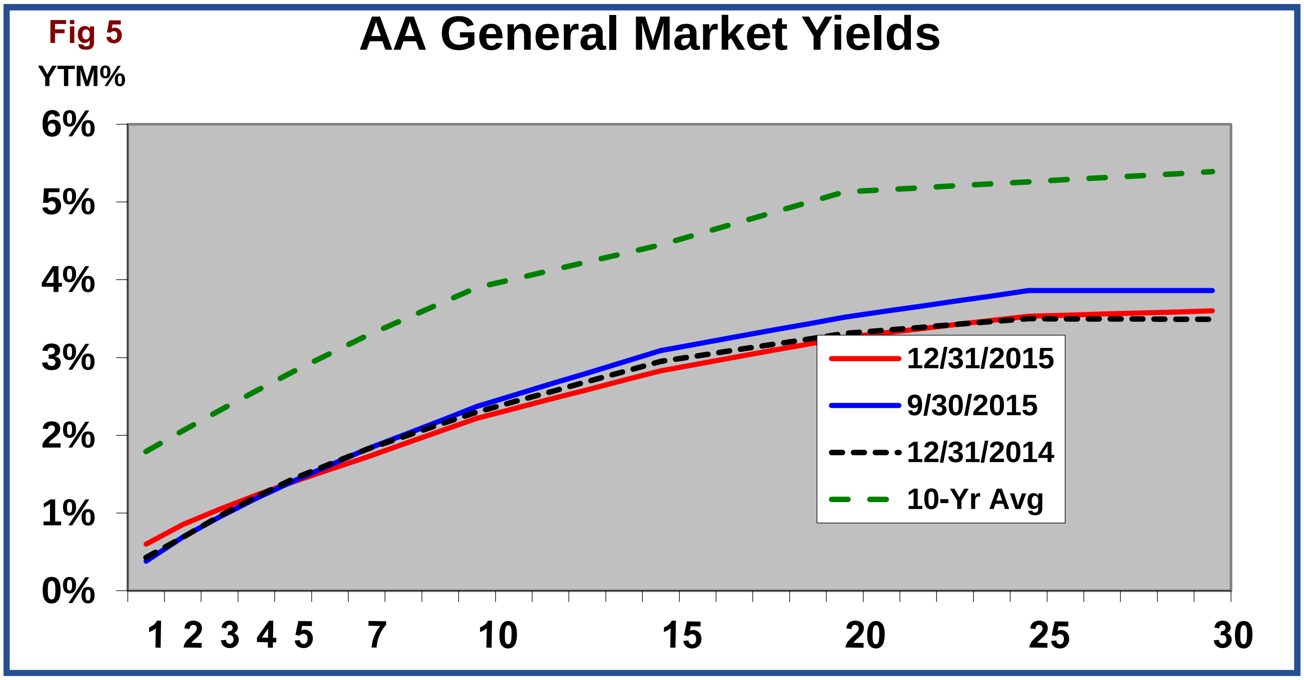
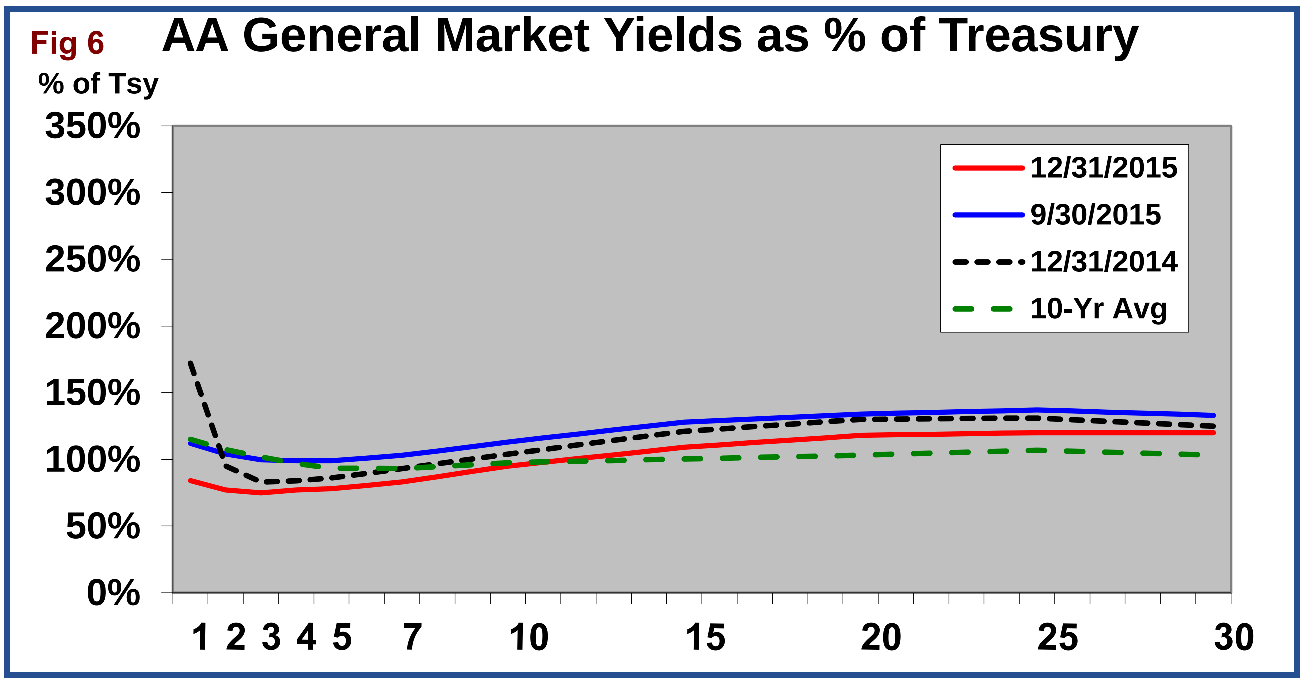


Fig 6



	10 Yr Avg	9/30/2015	12/31/2015
2-Year AA Municipal	107%	104%	77%
5-Year AA Municipal	93%	99%	78%
10-Year AA Municipal	97%	113%	95%
25-Year AA Municipal	106%	136%	120%