

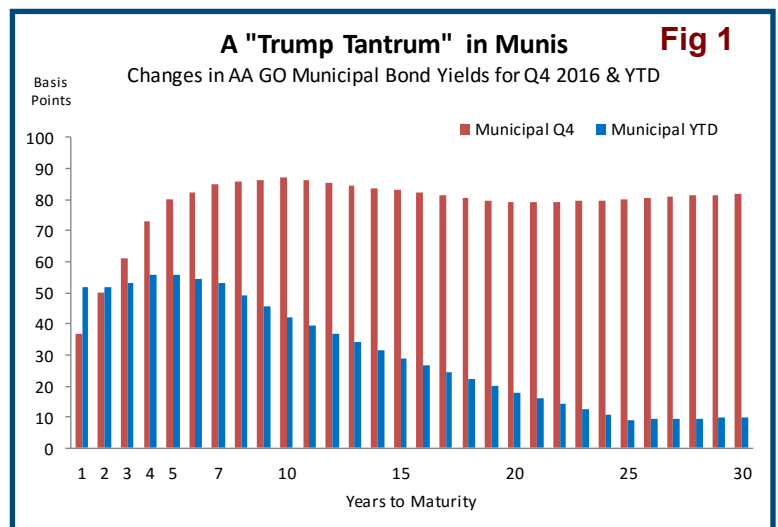


Municipal Market Review

Fourth Quarter 2016

This past year was a tale of two halves for the municipal bond market. The first half was characterized by a strong rally, historically low bond yields, and an impressive streak of continuing inflows into municipal bond funds. Municipal bond volume climbed to an all-time high in 2016, helped by a surge of refundings in the middle of the year as issuers looked to lock in low borrowing costs. Then, after a slight increase in yields in the 3rd quarter, the market escalated into a full-blown “**Trump Tantrum**” after the election results in November. During the fourth quarter, yields on both municipal and Treasury bonds moved sharply higher. The municipal yield curve underwent a slight steepening, as intermediate and long-term yields rose more than short-term yields. For the quarter, the average rise in yields for the 7-to-30-year maturity range was considerable, at 82 basis points. The reshaping of the yield curve is reflected in **Figure 1** which graphs the changes in municipal yields for both the fourth quarter and for the year-to-date period through December 31, 2016. As we can see, for the year, municipal yields rose the most in the 1-to-10-year segment of the curve, where the average gain was just over 50 basis points.

While painful, the “Trump Tantrum” has acted to **restore value** in an overbought market that had plunged to **all-time low yields just this past summer**. This is reflected by the higher entry yields available across the municipal yield curve. As municipal and Treasury yields rose in tandem, relative value ratios largely held steady for the quarter and remain attractive at or above 100 percent for the entire yield curve. Beneficially, this sell-off has opened a



Municipal Market Review

Fourth Quarter 2016

window of opportunity in which to deploy capital at higher entry yields for those who are positioned to do so. For example, at the end of 2016, an investor could buy highly rated 10-year munis yielding near 3%, which is more than Treasuries and high-quality corporate bonds. That is roughly equivalent to a 5% taxable yield for investors in the highest marginal tax bracket. It should be noted as well that 2016 was a solid year for municipal credit quality. Ratings assigned by the three major rating agencies during the 3rd quarter included 182 more upgrades than downgrades, representing the 13th consecutive quarter of overall positive rating activity.

As we mentioned in our November “Trump Tantrum” market update, the election of Donald Trump was, for the financial markets, a rare “black swan” event. The bond market response to the consensus pundit forecast of *higher growth, higher interest rates and higher inflation* can be understood for what it was, a correction in which markets, dominated by leveraged speculation and caught leaning one way, had to suddenly scramble to close out losing positions. In light of this “Trump Tantrum”, let’s consider what has supposedly changed. In our opinion, fundamentally nothing has changed. Post-election, **deflation-driven secular stagnation is still the fact confronting policy makers**. The election of Mr. Trump has not overturned this economic reality. Certainly, the bond market’s fear of inflation has been heightened by the potential of an expansive fiscal policy. Such an agenda is not only ill-timed, but it is, in our opinion, likely to be ill-advised. Aside from the obvious political difficulties Mr. Trump will face in attempting the passage of even part of such an aggressive agenda comprised of tax cuts, a massive increase in deficit spending for infrastructure, and protectionist trade legislation, the market ramifications of such an agenda are far from certain.

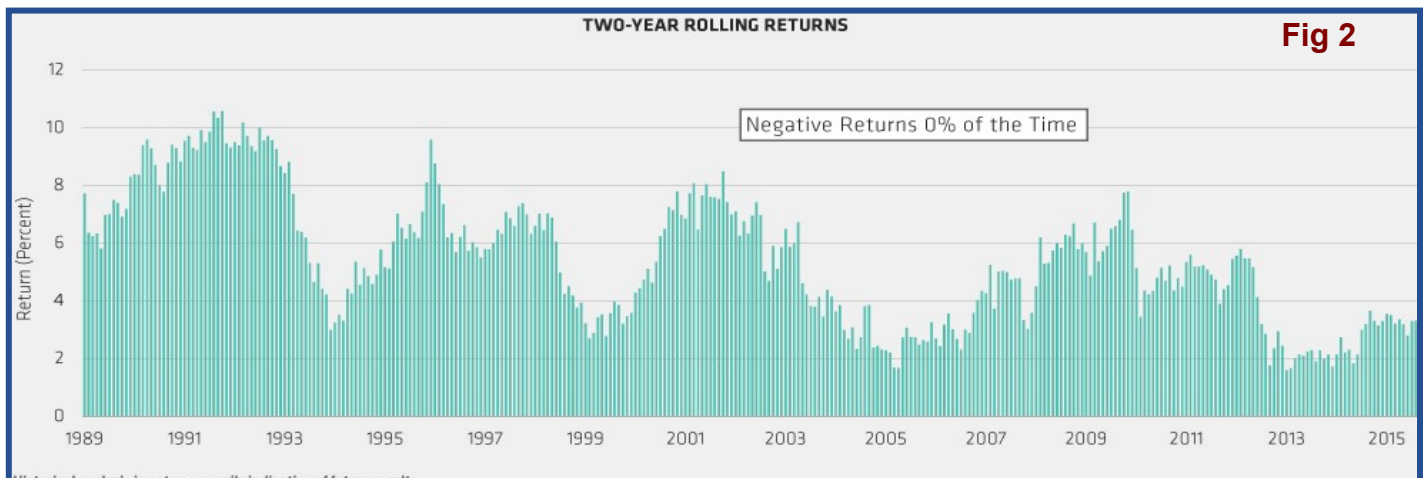
The municipal market seems to be already pricing in a significant cut in federal tax rates. Of course, it remains to be seen what tax and spending plans Congress will actually be able to enact. Some analysts have said that a potential tax risk to munis is the GOP goal of reducing marginal tax rates. Trump’s plan as it stands calls for the reduction of the current seven tax brackets down to three and reducing the top personal tax rate to 33% from 39.6%. In theory, a tax cut would make tax-free muni interest slightly less valuable to investors in the top tax brackets. However, **since 1982 the top federal tax rate has changed eight times, up and down, without resulting in lasting shifts in the yields municipal investors demand compared with yields on taxable bonds**, according to a recent report issued by PIMCO. Regarding tax cuts, there is likely to be a battle over their size, revenue offsets, and the net addition to the deficit. Our view is that the **muni market overreacted and was oversold post-**

Municipal Market Review

Fourth Quarter 2016

election. It is true that the odds of lower tax rates and more infrastructure spending have risen as a result of Trump's victory. Yet it is also true that **the advantages that have made municipal bonds a key holding of income-focused, tax-conscious investors remain intact.**

For certain, given the murky policy picture, the muni market faces months of headlines from Washington about tax reform and federal spending as the Trump administration's policies take shape. In the midst of this uncertainty, we believe it's helpful to look at the municipal market historically and how it has handled volatile and difficult periods. **Since 1988**, intermediate high-quality municipals (as measured by the Bloomberg 1-10 Year Municipal Bond Index) have had negative monthly returns about 30% of the time. **Stretching out returns over a 12-month rolling period, the frequency of a negative return has been just 4%.** Furthermore, the municipal market has **never undergone a negative return over a**



rolling 24-month period as you can see in **Figure 2**. The bottom line here is one should not overanalyze the month-to-month volatility of bond returns and prices. The muni market has weathered periodic sell-offs over the past two decades, and investors should remember that times of turmoil often generate the best opportunities. The last significant muni decline happened back in the second quarter of 2013, when the Federal Reserve talked about cutting back its extraordinary quantitative easing program. This was commonly dubbed the "Taper Tantrum". Then things calmed down and later in 2013 and 2014 bond values recovered and the bond bull market roared on. Before the Taper Tantrum there was the infamous 60 Minutes interview in December 2010 when analyst Meredith Whitney predicted hundreds of billions of dollars of defaults in the municipal market which never materialized. Municipal bond funds saw 26 consecutive weeks of outflows and performance dropped 6%. However once again the resilient

Municipal Market Review

Fourth Quarter 2016

municipal market recovered and returned 8.5% in the successive 2-year period from January 2011 to December 2012 that followed this rough patch.

Whether the US economy outperforms or underperforms, or whether tax rates fall more or less than expected, one thing is pretty certain: the yield and “curve roll”—the tendency of a bond’s value to rise as it approaches maturity—of a well-managed bond portfolio, combine to produce positive returns over time. As noted in our November market update, **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, over the past several years, as interest rates declined to historically low nominal levels, we have consistently **emphasized high coupon premium bonds as a defensive measure** since they are less sensitive to a change in rates than par or discount bonds. In addition, the premium paid on high coupon bonds results in larger periodic cash flows due to the return of a portion of that premium with each coupon payment, effectively bringing forward the payment stream and allowing reinvestment of those monies in a rising rate environment. Yes, there will be some short term price volatility as the “Trump Tantrum” plays out over the following months, however **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.

At their final meeting of the year in December, in a widely-expected move, the Federal Reserve raised interest rates for just the second time since 2006. The Federal Open Market Committee (FOMC) cited *“a labor market that has continued to strengthen”* in voting to set the new target range for the federal funds rate at 0.50 percent to 0.75 percent. The Fed said in its statement that *“market-based measures of inflation compensation have moved up considerably but still are low; most survey-based measures of longer-term inflation expectations are little changed, on balance, in recent months.”* New projections by the Fed show they expect three quarter-point rate increases in 2017, up from the two seen in the previous forecast in September. Higher interest rates have the potential to blunt the impact of any fiscal stimulus passed by the incoming Trump administration. Another factor that could limit the effectiveness of any fiscal stimulus efforts is the U.S. debt load. Some analysts see inflation staying low due to the sheer size of the nation’s \$19.8 trillion debt. Studies have shown that the more debt that is outstanding, the less bang for any given dollar of spending. According to the nonpartisan Committee for a Responsible Federal Budget, the national debt could increase by \$5.3 trillion over a decade should

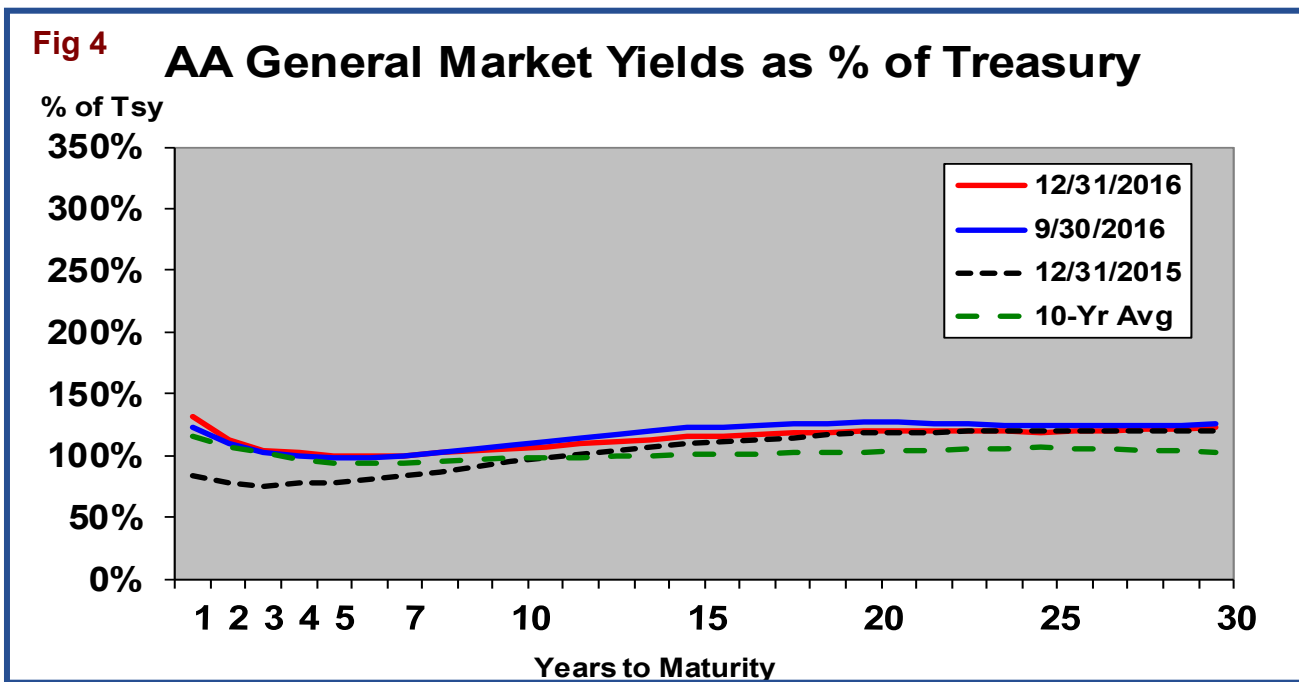
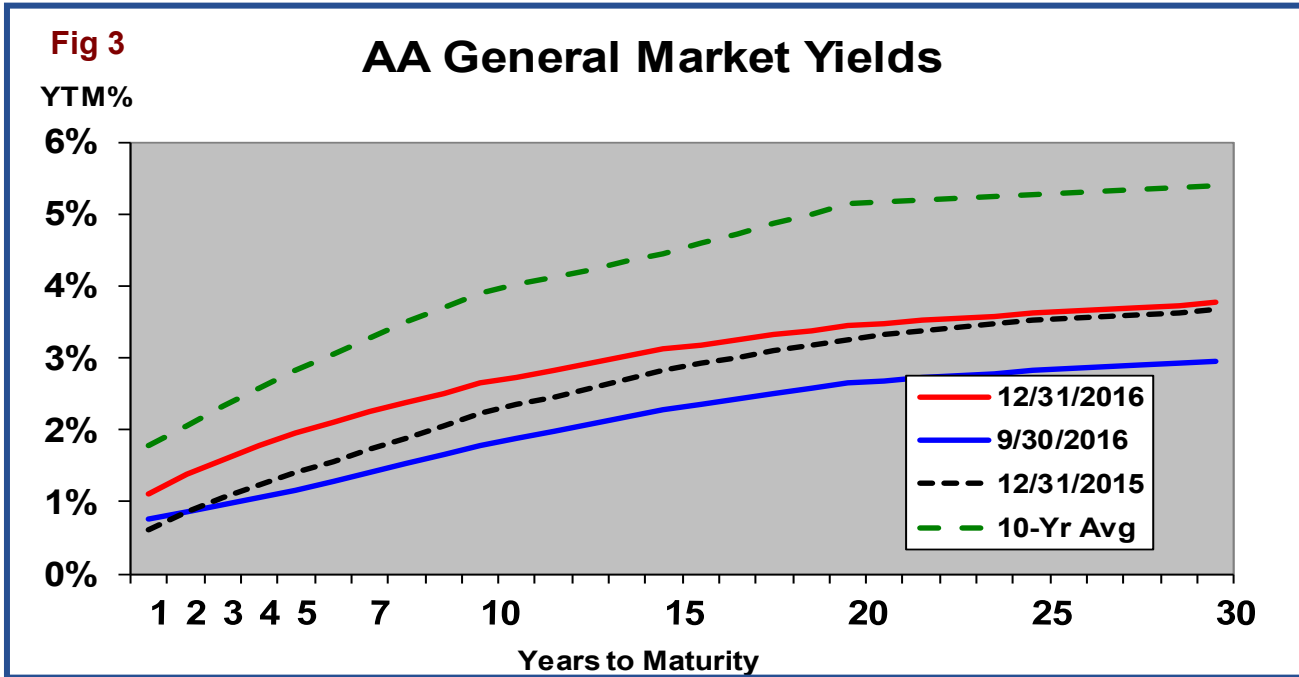
Trump cut taxes and increase spending as he has said during his campaign. How much of Trump's key initiatives end up actually getting passed by Congress is of course an open debate.

In mid-December, it was reported that Trump told the U.S. Conference of Mayors during a conversation on his infrastructure plan that he plans to maintain the tax-exempt standing of municipal bonds. The general counsel for Bond Dealers of America called Trump's support of the muni exemption an "*encouraging development*". John Miller, of Nuveen Asset Management, reasoned that "*if you want to pump up infrastructure spending you don't tear down the base of the muni market*". At this point, Trump's 10-year infrastructure plan utilizes \$137 billion of tax credits that he says will leverage \$1 trillion of private investments. Despite Trump's plan of using tax credits to spur private sector infrastructure projects, many industry analysts expect municipal bond issuance to remain the primary source of infrastructure funding. Historically, roughly 75% of U.S. infrastructure has been financed using municipal bonds. Cutting the tax exemption of munis would work against Trump's grand infrastructure plans and is ultimately very unlikely to happen, in our opinion.

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 know how to conduct in-depth credit research, adjust for duration and monitor the market for risks and opportunities. As April 15 is almost upon us, one should not underestimate the power of a strong tax advantage, and that is one reason why we recommend investors look to investment-grade municipal bonds for their attractive relative value and reliable high quality income stream.

Municipal Market Review

Fourth Quarter 2016



	10 Yr Avg	9/30/2016	12/31/2016
2-Year AA Municipal	107%	110%	113%
5-Year AA Municipal	93%	98%	100%
10-Year AA Municipal	97%	108%	105%
25-Year AA Municipal	106%	124%	119%