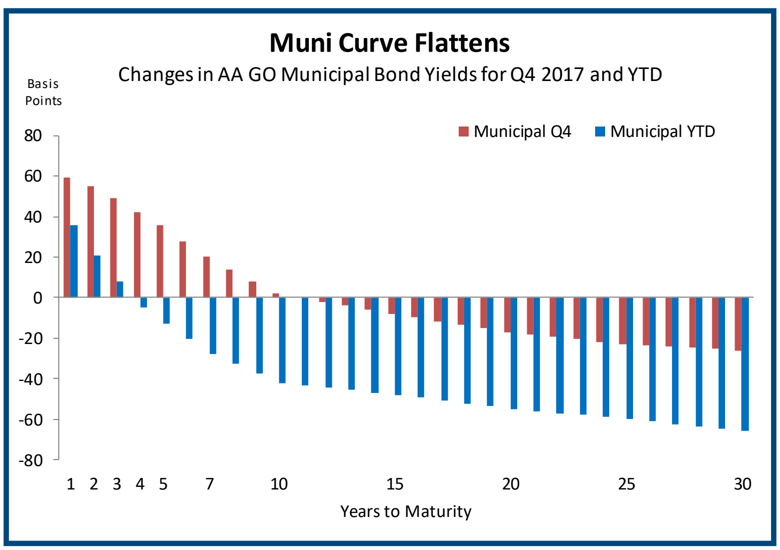
Redstone Advisors

Municipal Market Review

Fourth Quarter 2017

The twists and turns of proposed tax reform legislation that worked its way through Congress and ultimately ended up signed into law was the catalyst for an active fourth quarter in the municipal bond market. Municipal bond yields rose sharply at the short end this past quarter while longer term munis rallied and saw their yields decline, as the municipal yield curve underwent a noticeable flattening. The biggest move came in the 1-year to 4-year segment of the curve, where yields jumped 51 basis points (bps) on average. Meanwhile at the long end, yields in the 15-year to 30-year segment declined an average of 18 bps. For the quarter, the 2-yr/30-yr spread narrowed from 233 bps to 152 bps, and the 2-yr/10-yr spread flattened from 117 bps to 64 bps. For the past year, 1-year and 2-year yields rose 36 and 21 bps respectively while yields in the 10-year to 30-year range decreased on average by 54 bps. 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, 2017. Municipal relative value ratios increased at the short-to-intermediate part of the yield curve, a reversal of the trend that had occurred over the first three quarters of 2017. Relative value ratios remain above 100 percent at the long end of the curve, in the 15-to-30-year segment.

Fig 1

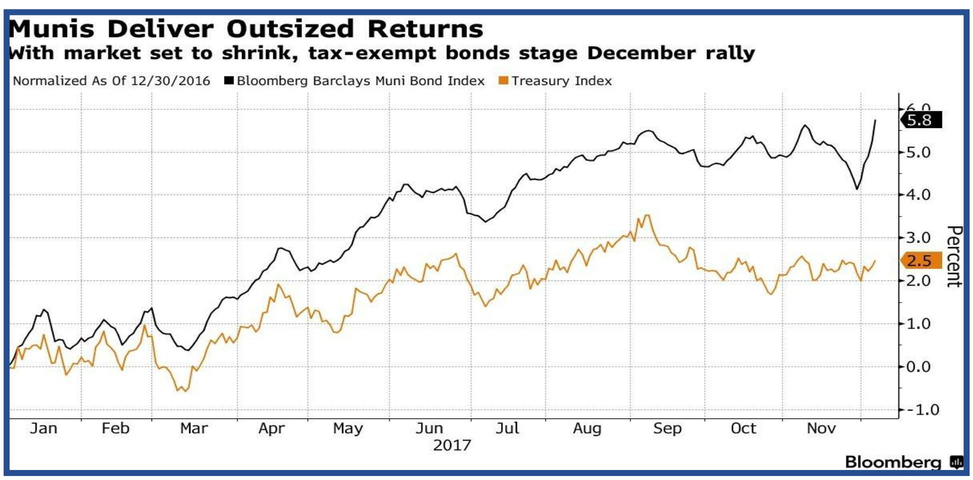


(316) 687-2143 jyeskie@redstoneadv.com

There was a rush to market by issuers in November and especially December as specific details of the proposed "Tax Cuts and Jobs" bill became public. Two types of bonds targeted in the House version of the tax bill were advance refunding bonds and private-activity bonds (PABs). Advance refundings allow municipal governments to refinance old bonds earlier to take advantage of currently low interest rates. Advance refundings have been common practice for decades, and analysts said the move to eliminate them is likely to decrease the supply of municipal bonds going forward and increase borrowing costs for local governments. Municipalities have issued $60 billion on average of advance refunding bonds per year over the past decade, about 15% of total municipal issuance. In 2016, advance refundings surged to $125 billion, approximately 30% of total issuance. Meanwhile, private-activity bonds allow nonprofits and some for-profit firms to issue tax-exempt debt for development projects perceived to have a public benefit. These bonds are typically used by private entities such as charter schools, museums, private universities, hospitals and nursing homes. Engineers, bond lawyers and public officials have argued that ending the tax exemption for these PABs would make it more difficult and costly to complete important projects in the future.

By the time the dust had settled at the end of December, municipal bond issuance soared to $62.5 billion, setting a new monthly record, surpassing the previous record of $54.7 billion in December 1985, just before the last comprehensive tax overhaul became law. What surprised many market participants was how easily digested the record volume was, as many bond deals were multiple times oversubscribed. *"Investors soaked up several weeks of $20 billion-plus supply easier than expected"* noted Tom Kozlik of PNC. This robust demand boosted muni performance in December, and one can see how the Bloomberg Barclays Muni Bond Index has outperformed the Treasury Index over the course of the 4th quarter and all of 2017 in **Figure 2**.

Fig 2



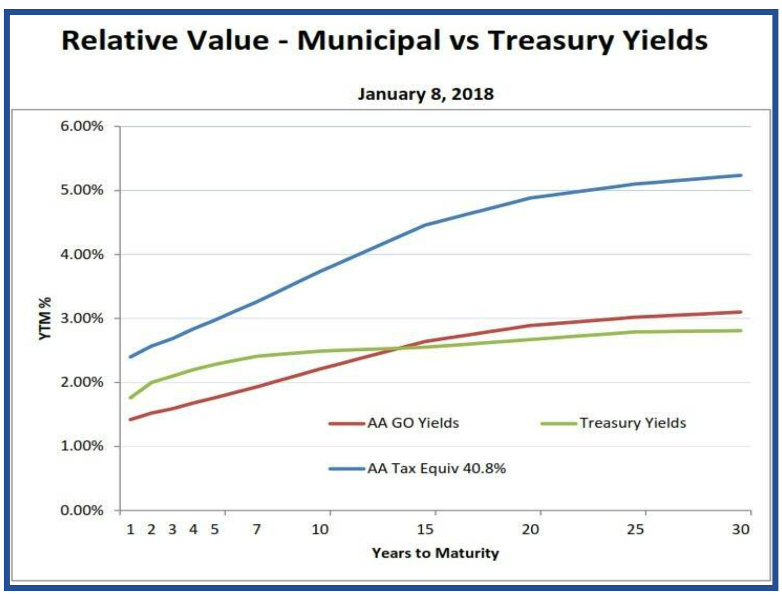
The final version of the tax bill was a mixed bag for the municipal market. The full preservation of the tax-exemption for private activity bonds was celebrated, while the elimination of advance refundings was a disappointment. Regarding the saving of PABs, the counsel to the National Association of Health & Higher Education Facilities Authorities said, *"I'm relieved and gratified. Usually tax bills are like Russian novels: they're long, boring and at the end everybody dies. But we escaped death."* Most PABs currently issued are 501(c)(3) bonds, used by nonprofit organizations like hospitals and universities. PAB proponents warned lawmakers that if these types of bonds were eliminated, thousands of nonprofits would either have lost access to capital or found it only at a prohibitive cost.

Regarding the loss of advance refundings, Bond Dealers of America said, *"The repeal of issuers' ability to advance refund outstanding debt will result in higher borrowing costs and less flexibility when managing debt for vital capital improvement projects."* Florida's bond finance director, Ben Watkins, said recently that his state had saved $3 billion over the past decade by being able to advance refund its bonds. *"The vast majority of state and local government refundings are for economic savings rather than as a budgetary gimmick,"* said Mr. Watkins. Issuers do have some alternatives to advance refundings such as shorter or more frequent calls in bond documents, taxable refundings and tax-exempt current refundings. But those alternatives also include derivative products which could increase issuers' risks in addition to their costs. For many in the municipal market, the big story for 2018 is simply the technical picture—supply and demand. The consensus forecast for 2018 is roughly a 25% drop in supply due to the loss of advance refundings.

Another noteworthy aspect of the final tax bill for the municipal market was the restriction on the ability to deduct state and local taxes (SALT) from individuals' federal income taxes. The SALT deduction was capped at $10,000 for property, income, or sales taxes. High-income earners in high tax states such as New York, New Jersey, Illinois and California would be hardest hit by this new provision. Muni analysts see an increase in demand for in-state double-exempt bonds from residents in these high-tax states as one effect of the new law. John Miller of Nuveen notes that with the SALT deduction capped at $10,000 and the top marginal tax rate barely budging to 37% (from 39.6%), tax-exempt muni income is that much more valuable. Muni investors will still capture a sizeable aftertax yield advantage over Treasuries at the slightly lower top rate. When viewed from a tax-equivalent yield basis, the relative value advantage of munis can be clearly seen in **Figure 3.** The tax-equivalent yield is based on the new top rate of 37% plus the 3.8% tax on net investment income for high earners, a provision retained in the new tax law. 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. Bottom line, the advantages that have made municipal bonds a key holding of income-focused, tax-conscious investors remain intact. The tax bill settled on a final corporate rate of 21%, down from 35%. Given that the effective corporate tax rate is already around 20%, many municipal strategists estimate a corporate rate at 21% would not be overly negative for municipals, as banks and insurers would likely still find munis attractive at that rate.

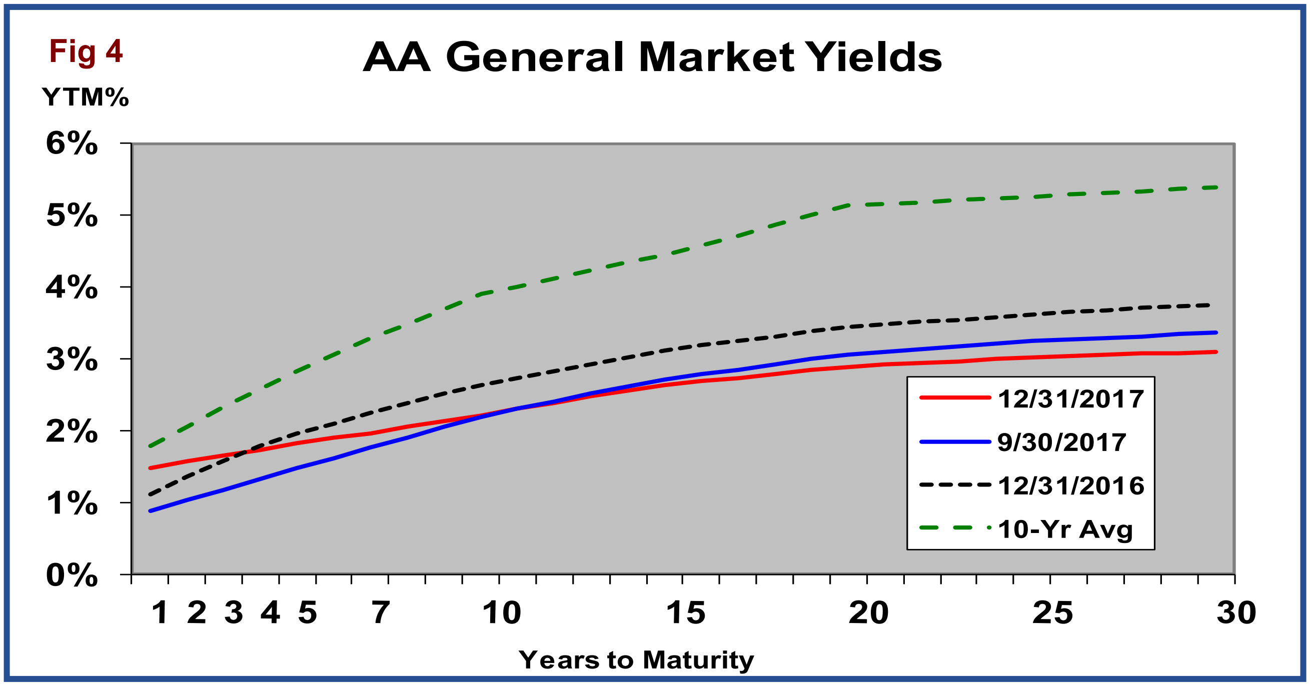
During its December meeting, the Fed increased its benchmark fed-funds rate by a quarter percentage point to a target range between 1.25% and 1.50%. The move had been well telegraphed and was no surprise to the markets. This was the third rate hike of 2017, and Fed officials tentatively forecast three more rate increases in 2018. Meanwhile, Fed projections showed that they don't see the new tax law raising the economy's long-run growth rate, which they left unchanged at 1.8%. Looking at the Fed's statements, they don't see the tax package as a game changer in terms of growth, just some modest upside, concentrated mostly in 2018. Meanwhile, Congress's official scorekeeper, the Joint Committee on Taxation, calculated that the tax law will increase deficits by about $1.4 trillion over the next decade. Chairwoman Janet Yellen's term ends February 3, and then Fed governor Jerome Powell is set to succeed her. Mr. Powell has indicated he could offer a softer touch on financial regulation but has shown few

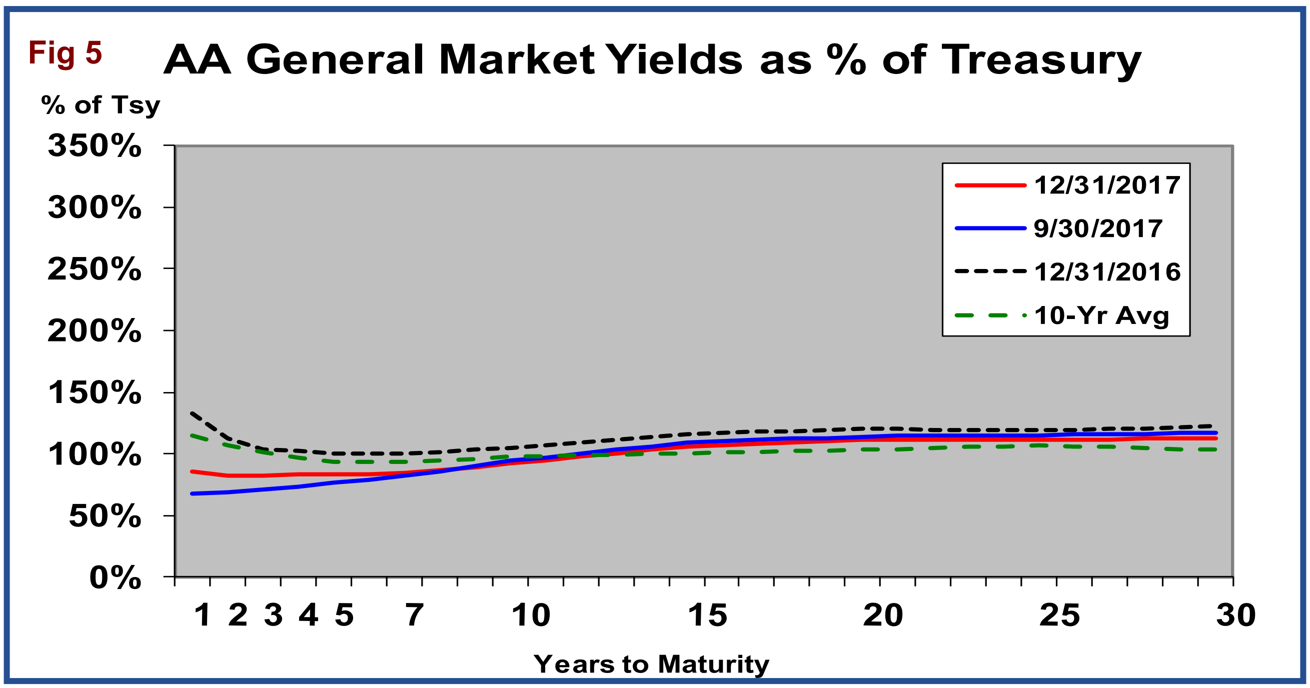
Fig 3



signs of diverging from Ms. Yellen on monetary policy. The market does not expect the Fed's philosophy of normalizing rates to change much as a result of Mr. Powell taking the helm.

Redstone Advisors, with our 25+ years of experience in the municipal bond market, 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 constantly monitor the market for risks and opportunities. We recommend municipals for their defensive traits and utility in a market in which total return is likely to come more from coupon and less from price performance. Bottom line, municipal bonds continue to be a key component of any well-diversified portfolio given their unique ability to provide high-quality tax-exempt income.





	10 Yr Avg	9/30/2017	12/31/2017
2-Year AA Municipal	107%	69%	82%
5-Year AA Municipal	93%	76%	83%
10-Year AA Municipal	97%	94%	92%
25-Year AA Municipal	106%	115%	111%