Redstone Advisors

Municipal Market Review

Fourth Quarter 2018

“After April, investors likely will appreciate munis even more, and regulators should note muni credits’ continuing strength, along with their steady yields—even as it is rock’n’roll for most other markets. Tax-adjusted muni returns were favorable and even better on a risk-adjusted basis.”

Bank of America Merrill Lynch

Municipal bonds rallied in the fourth quarter as yields declined, reversing the trend of higher yields that had characterized the market for the first three quarters of 2018. The largest move came in the intermediate 7-year to 15-year segment where yields declined on average 28 basis points (bp). Muni relative value ratios were mainly unchanged across the yield curve for the quarter. Munis continue to yield roughly 70% to 80% of Treasuries in the short 1-to-3-yr range. Many retail investors have preferred short-term munis due to concerns about higher interest rates, and their high demand has made these munis expensive relative to short-term Treasuries. Relative value ratios remain above 100 percent at the long end of the curve, in the 15-to-30-year segment. Compared to the flat Treasury curve, the muni yield curve has remained steep. At year end, the 2-yr/10-yr muni spread was 65 bp. The same 2-yr/10-yr Treasury spread was just 19 bp. Meanwhile the 5-yr/30-yr muni spread was 129 bp compared to just 50 bp on the Treasury curve. We see this divergence as evidence there is value to adding a certain amount of duration in the muni market. Looking at the big picture for the whole year, municipal yields finished moderately higher across the yield curve. The largest increase for the year came at the long end of the curve, where the average gain in the 20-to-30-year range was 38 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, 2018.

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Tax reform and four Federal Reserve rate hikes were two significant issues that the muni market contended with in 2018. Despite these headwinds, munis continued to provide investors with steady tax-free income and low volatility over the past year. On the credit front, upgrades continued to outpace downgrades, as states overall saw their ninth consecutive annual tax revenue increase. There are areas of concern, as pension burdens and retiree healthcare costs continue to increase. Also there are a few states such as Illinois and Connecticut that continue to have budgeting and management challenges. However the big picture is that the vast majority of municipalities have a stable or positive outlook. Municipal bonds finished 2018 with positive returns as other asset classes experienced increased volatility and negative returns, as seen in **Figure 2.**

Fig 1

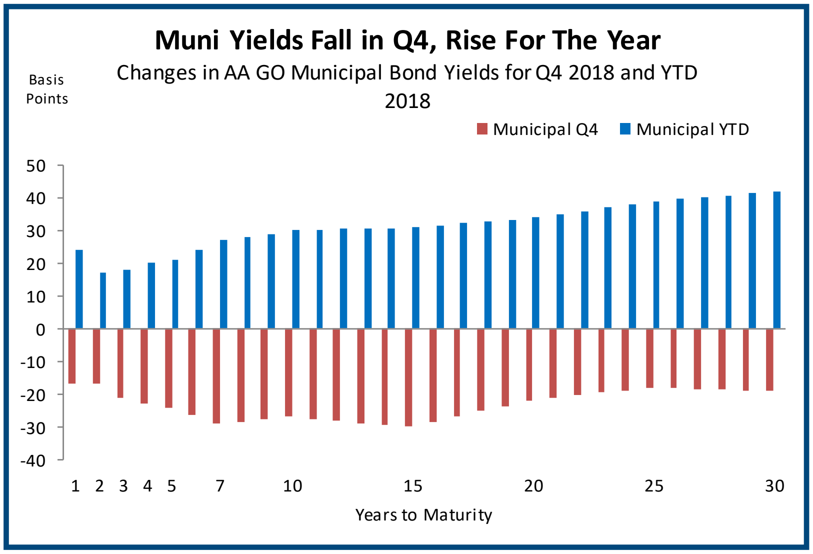
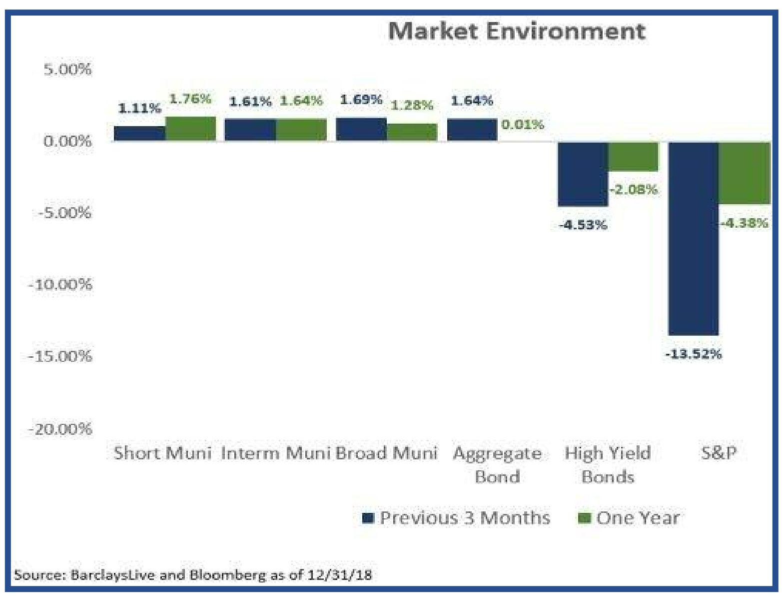


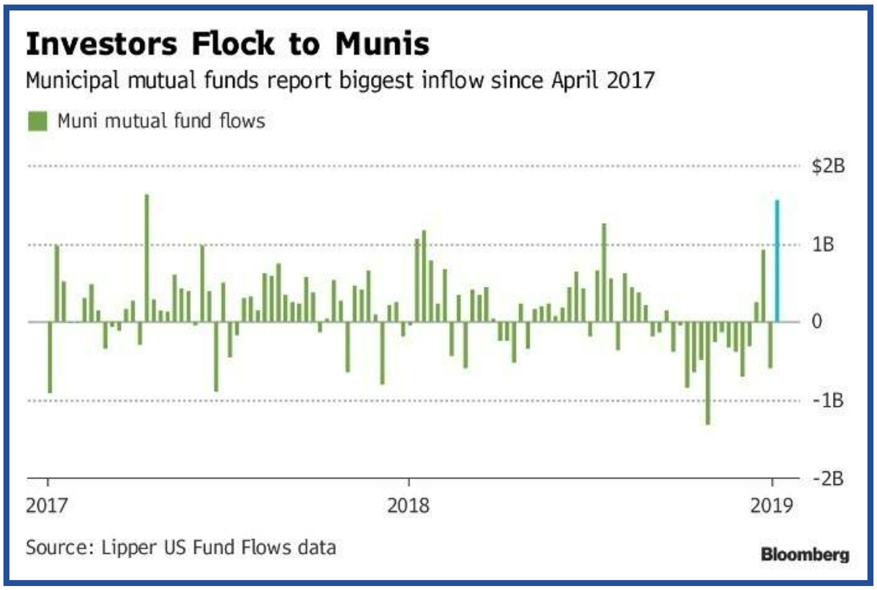
Fig 2



After having a year to digest the Tax Cuts and Jobs Act, it's a good time to review the impact that it had on the municipal market. The elimination of advance refunding, a valuable cost-saving tool for bond issuers, reduced refinancing activity as expected. Overall volume in the market was down a little over 20% from 2017. Some analysts speculated that local governments would find another way to replace the savings opportunity with other types of bonds, but that hasn't materialized. Municipal Market Analytics' Matt Fabian noted that, "*The dominant response has simply been to not refinance the bond.*" Another effect of the tax law is that for banks, munis became less appealing, due to the lowering of the corporate rate down to 21% from 35%. Since the tax bill was enacted, banks' muni bond holdings decreased every quarter of 2018. This comes after decades of annual increases. However, the scope of the reduction has been relatively modest. Data shows banks' total municipal holdings have dropped by just about 7 percent over the past year.

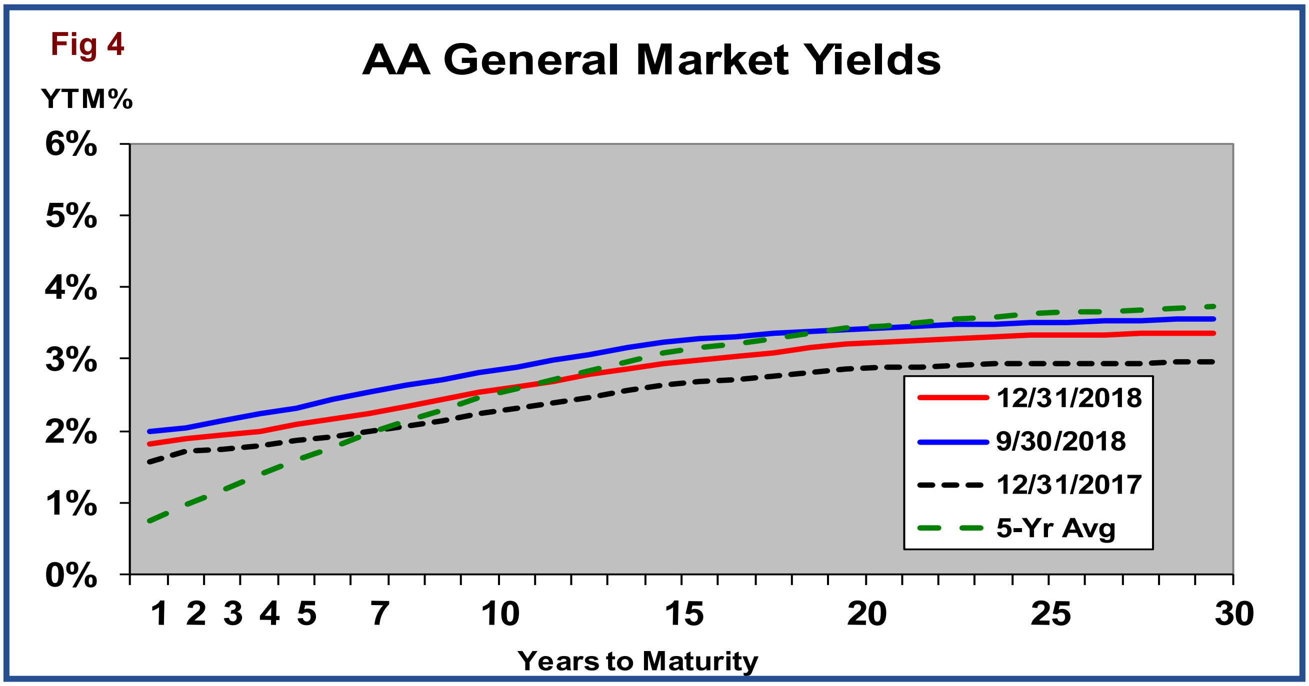
One more effect of the tax law is that the muni market became even more localized or fragmented than usual. With the state and local taxes (SALT) deduction now capped at $10,000, residents from high-tax states such as New York, New Jersey and California have boosted their demand for double-exempt bonds from their home states. The strategy to shelter more income in municipal bonds might become even more popular after this tax filing season as unsuspecting taxpayers who had been relying heavily on the SALT deduction get a rude awakening when they do their taxes. Throughout 2018, supply (reduced via elimination of advance refundings) versus demand (increase from investors in high-tax states) has shaped the muni market. Muni-bond mutual funds saw their largest investor inflow of cash in almost two years in early January. One industry CEO believed two main things were driving the flows. One being the Federal Reserve signaling a more dovish approach to monetary policy and the other being the global economic slowdown. A history of muni mutual fund flows dating back to 2017 can be seen in **Figure 3**. Many analysts see munis maintaining a firm tone for the next several months due to favorable market technicals. "*We generally find municipal valuations attractive and an economic slowdown coupled with continued reduced supply as a result of the new tax legislation should limit supply while demand may increase*," reasoned Anthony Valeri of Zions Bancorp. "*You have an environment where your market is shrinking. More bonds are being removed then coming in new supply. That's a strong technical and it should help aid performance in 2019,*" argued Sean Carney of BlackRock.

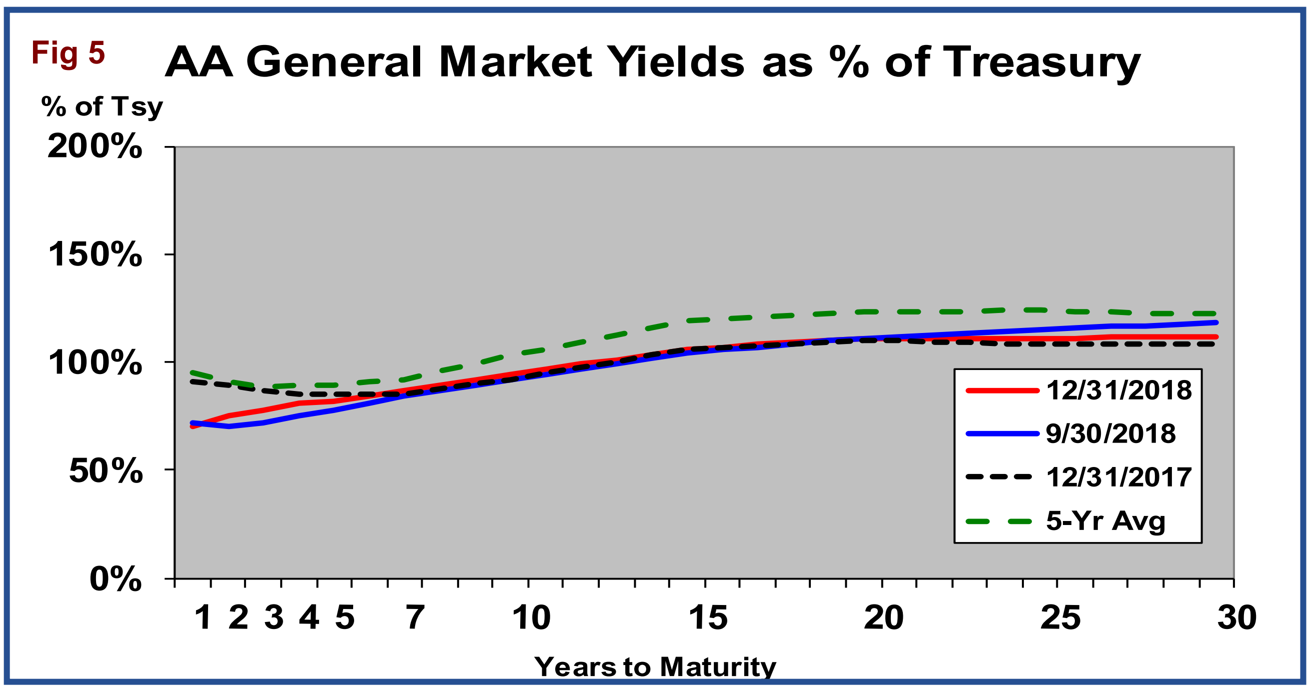
Fig 3



During its December meeting, the Fed raised its benchmark fed-funds rate by a quarter percent to a new target range between 2.25% and 2.50%. There was some uncertainty about whether the Fed would hike, given the sharp increase in stock market volatility during December. Municipals have been a haven of low volatility, in contrast to the gyrations rocking other markets. The muni market has seen issuers regularly come to market distributing bonds within historical spreads, as it continues to function with little disruption. This was the fourth rate hike of 2018 and the ninth such increase since December 2015, part of a gradual series of steps to return rates to historically normal levels. One noteworthy development of the Fed meeting was that the Fed reduced its forecast of rate hikes in 2019 from three down to just two. The bond market has a more pessimistic view than the Fed, betting on just one hike at most in 2019, according to recent fed-funds futures prices. The Fed's median projection of the so-called neutral interest rate, a level that neither boosts nor cools growth, dropped slightly down to 2.75% from 3%. That leaves the Fed approximately one interest rate hike away from that neutral level. We remain of the opinion that the Fed is engaging in an opportunistic reload ahead of the next economic downturn or financial crisis, i.e., the next reset.

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.





	5 Yr Avg	9/30/2018	12/31/2018
2-Year AA Municipal	91%	72%	75%
5-Year AA Municipal	89%	78%	82%
10-Year AA Municipal	103%	92%	94%
25-Year AA Municipal	124%	115%	111%