Redstone Advisors



Municipal Market Review

Fourth Quarter 2019

Municipal bond yields moved lower in the short-to-intermediate range of the yield curve during the 4th quarter, while yields ticked modestly higher at the longer end of the yield curve. As a result, the municipal yield curve steepened this past quarter. For the year, the S&P Municipal Bond Index finished up a little over 7 percent, which was the best performance for municipal bonds since 2014. *"I would say that munis enjoyed a very strong year thanks to tax reform that capped deductions for state and local taxes, significantly driving up demand for many high-income investors which played out in the form of 51 consecutive weeks of muni fund inflows and underpinned support for tax-exempt paper throughout 2019,"* said one municipal bond analyst at MMD. In addition to the tax law's new $10,000 limit on state and local tax (SALT) deductions, the Federal Reserve's abrupt flip to a more dovish stance in which they lowered rates three times in 2019 helped drive a broad bond market rally. The continued robust demand for tax-exempt munis combined with the limited supply available has kept the rally steadily moving along this past year. Overall municipal credit conditions continue to be positive, although pockets of distress remain. State tax revenue grew for the 10th consecutive year in 2019. More municipal issuers were upgraded in the third quarter of 2019 than were downgraded, marking the ninth consecutive quarter of such a trend, according to Moody's. Meanwhile, 96% of S&P Global Ratings outlooks on municipal bonds are stable.

For the quarter, the largest move came at the short end of the curve, where the average decline in the 1-to-4-year range was 20 basis points (bps). In contrast, yields at the long end of the curve ticked up, where the average increase in the 15-to-30-year range was a modest 10 bps. Many retail investors have continued to prefer short-term munis, and their high demand has made these munis the most expensive relative to Treasuries throughout 2019. Munis finished the quarter yielding roughly just about 70% of Treasuries in the short 1-to-4-year range. For the year, muni yields finished the year significantly lower

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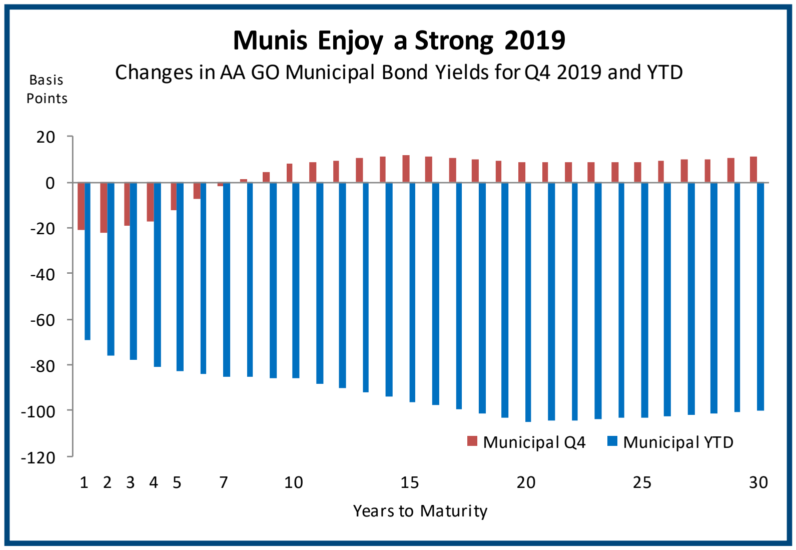
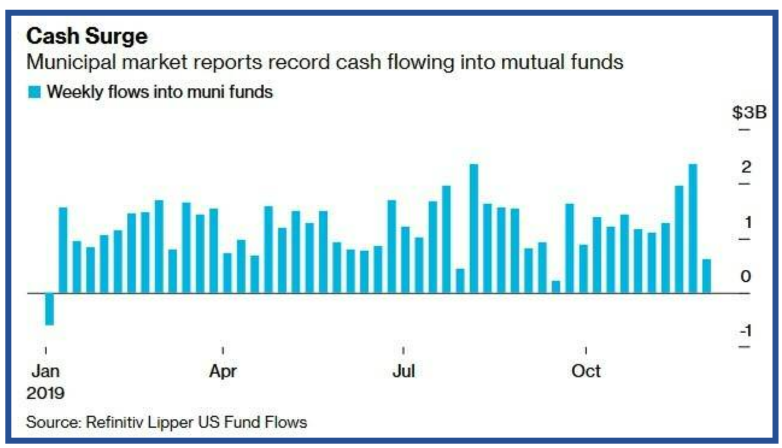
Fig 1



than where they began 2019. The largest decline came at the long end, where the average decline in the 15-to-30-year range was 101 bps. Muni relative value ratios finished the quarter slightly lower. The reshaping of the municipal yield curve is reflected in **Figure 1** which graphs the changes in muni yields for the fourth quarter and the past year.

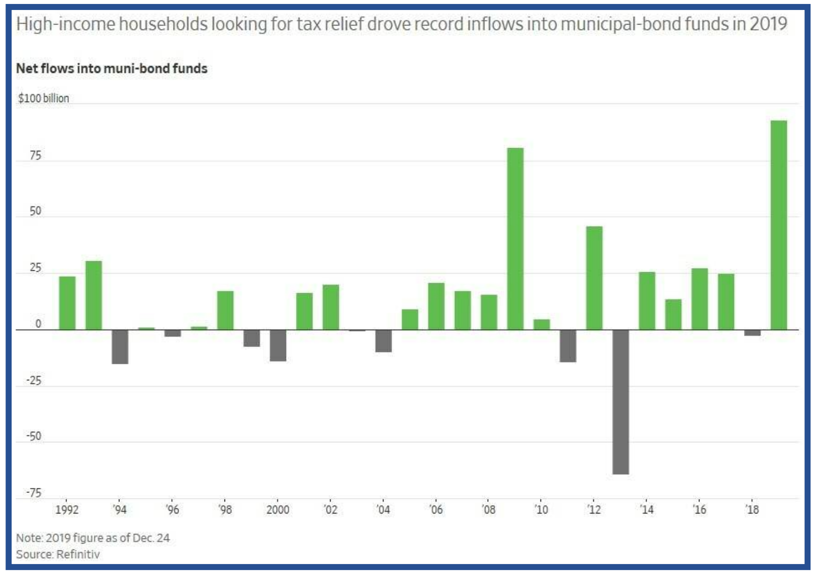
An unprecedented amount of money poured into the municipal bond market in 2019. A little more than $90 billion was added to municipal-bond mutual funds according to Investment Company Institute data, amidst an impressive 51 consecutive weeks of inflows. *"As far as the inflows go, they were unbelievable this year and I don't know if we will ever see something like that again,"* said a senior fixed-income strategist at US Bank Wealth Management. BlackRock, the world's largest money manager, noted that Google searches for municipal bonds jumped last April, when many American taxpayers were perhaps looking for a way to reduce their unexpectedly higher tax bill now that the SALT deduction is capped at $10,000. Residents from high-tax states such as New York, New Jersey, California and Massachusetts have certainly boosted demand for double-exempt bonds from their home states. Demographic factors, like the increasing number of retiring baby boomers, combined with the steady flow of new money into muni funds suggests that the relatively rich valuations will not significantly affect retail demand, at least not in the short term. We anticipate that the favorable

Fig 2



supply and demand dynamic in the municipal market is likely to continue. Weekly flows into muni funds since the beginning of 2019 can be seen in **Figure 2**.

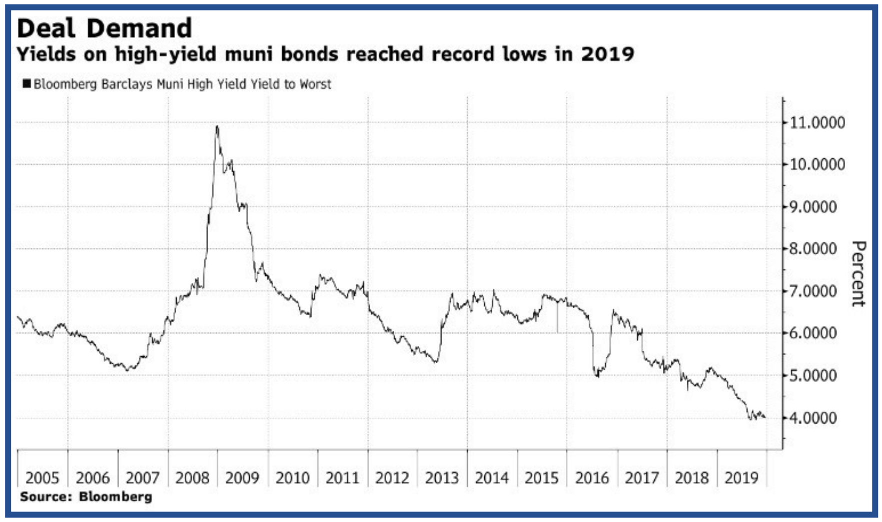
Fig 3



Tax-exempt municipal bond issuance rose about 15% to a total of $323 billion in 2019. Meanwhile, taxable municipal bond issuance surged more than double the amount of the previous year, to about $83 billion in total. This taxable muni total was the most since the federally subsidized Build America Bonds (BAB) program was enacted in the aftermath of the Great Recession. The 2017 tax law eliminated advance refundings for tax-exempt munis, however, interest rates have declined so much that issuers are swapping out tax-exempt municipal debt for taxable municipal debt and still finding savings. *"It was really the surprise shift in monetary policy, the lower interest rate environment, and the interest in and use of taxable advance refundings that jump-started issuance in 2019,"* noted Tom Kozlik of Hilltop Securities. He added that issuers were able to find a way to subvert the limitation placed on their ability to experience savings as a result of the 2017 tax law. Brian Wynne, head of public finance at Morgan Stanley, remarked that the speed at which municipal issuers adapted to issuing taxable bonds was surprising. Net flows into muni-bonds going back to 1992 can be seen in **Figure 3**.

2019 saw a considerable increase in demand for the riskier "high-yield" sector of the municipal market. Investors added a record $19 billion into high-yield muni funds in 2019. On the supply side, issuance of high-yield munis increased 31% to about $16.6 billion this past year, the highest level in at least eight years, according to Bank of America. The strong demand and hunt for yield amid historically low interest rates has pushed down yields on the riskiest muni bonds to just around 4% on average. This is illustrated in **Figure 4**. Some portfolio managers have stepped back from the high-yield sector, as the

Fig 4



shrinking yield "reward" does not justify taking on the additional risk.

During its late October meeting, the Federal Reserve cut rates for the third time in 2019, lowering its benchmark to the target range of 1.5% to 1.75%. Fed Chair Jerome Powell said that the current stance of interest-rate policy is likely to remain appropriate, as long as the economy expands moderately and the labor market stays strong. At its most recent December meeting, the Fed decided to leave rates unchanged. Fed officials signaled they were content with keeping rates steady through 2020, unless conditions were to significantly change and warrant action. After raising rates four times in 2018, the Fed's abrupt policy reversal to lowering rates three times in 2019 has been a a key driver of performance in the bond market this past year. Fed officials have generally given three reasons for cutting rates last year: weakening global growth, trade-policy uncertainty, and tepid inflation.

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 portfolios for our clients. We conduct independent credit research, adjust for duration and constantly monitor the market for risks and opportunities. We recommend municipal bonds for their defensive traits and reliability. Bottom line, municipals continue to be a key component of any well-diversified portfolio given their unique ability to provide high-quality tax-exempt income.

Fig 5

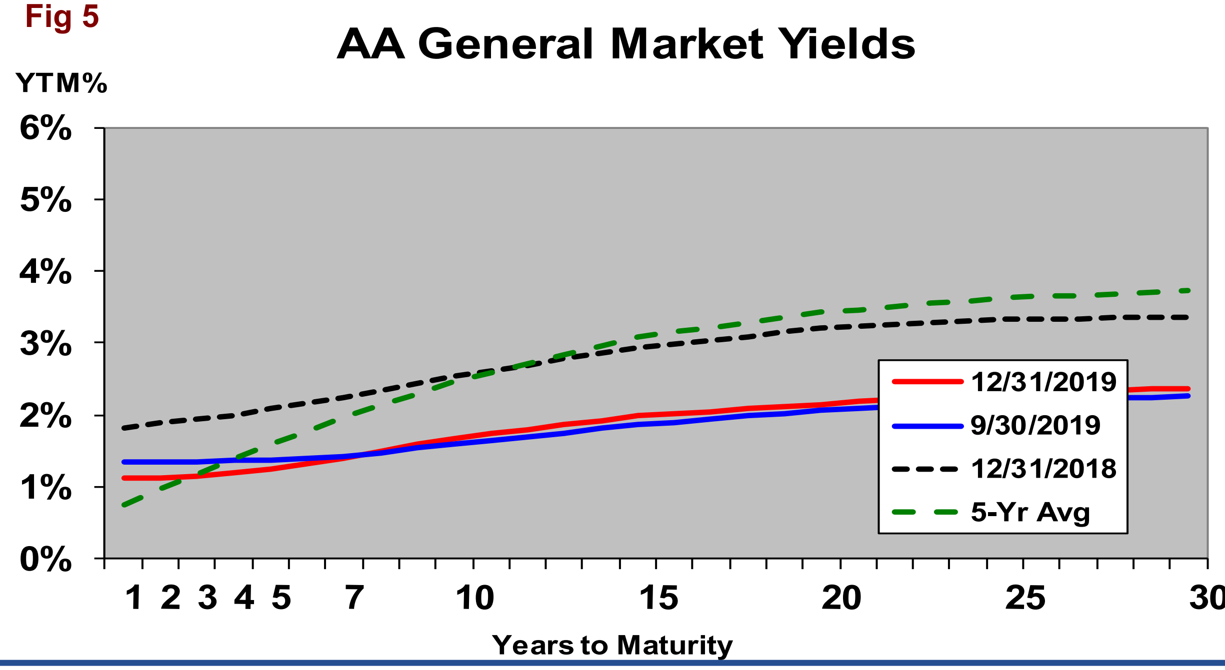
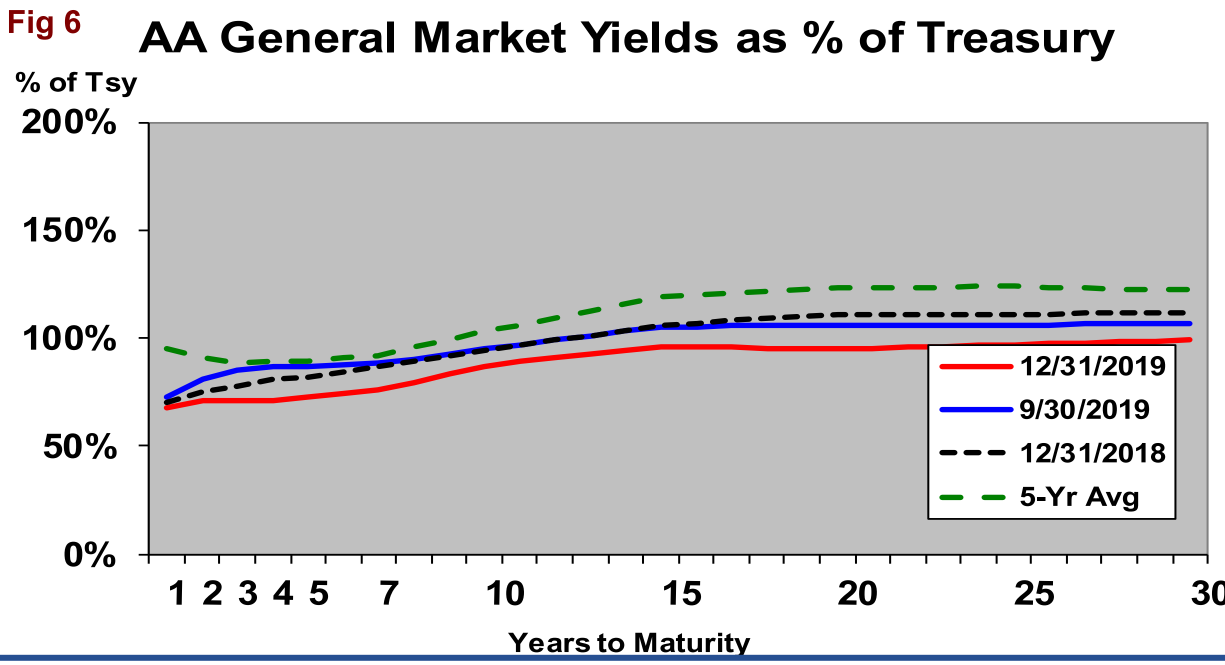


Fig 6



	5 Yr Avg	9/30/2019	12/31/2019
2-Year AA Municipal	91%	81%	71%
5-Year AA Municipal	89%	87%	73%
10-Year AA Municipal	103%	95%	87%
25-Year AA Municipal	124%	106%	97%