Q1 Municipal Market Developments

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Key Points:

- Rates have declined and the curve has steepened, defying market expectations
- New municipal supply is below year-ago levels as refunding volume has slipped
- Market inflows continue as demand easily matches new issuance
- Puerto Rico and Chicago dominate the municipal credit headlines
- Tax reform has been a secondary issue in the Presidential race, so far

Municipal Rates, Curve and Supply

The municipal market has surprised investors with the strong rally in just the first two months of 2016. Yet, it has not kept pace with the even more significant decline in rates in the Treasury market. Weaker growth, lower commodity prices, and global market turmoil have all contributed to a more muted Fed outlook than what existed at year end. The most meaningful yield changes have occurred among short-term maturities where tax-free yields have fallen as much as 25 bps. Intermediate and long-term yields have also slipped, but to a lesser extent. Thirty-year municipal yields, for example, are just 2 bps lower in the first two months, leading to a steeper yield curve. Market expectations at the start of the year were looking for higher rates and a flatter curve – just the opposite of what has occurred.

New supply has been modest relative to last year's robust start, as total issuance is 13% lower year-over-year. While new money financings have risen, actually running ahead of expectations and year-ago levels, the slower pace of refundings has more than offset this. With rates lower now than at year end, the refunding volume is likely to improve in coming months. The demand is certainly sufficient to accept more supply. Despite low absolute yield levels, cash flow into tax-free funds remains consistently positive.

Credit

Puerto Rico released a Restructuring Proposal last month that received a rather cool reception from bondholders. The proposal would cut the $49.2B of tax-supported debt by 46% to $26.5B. Unaddressed completely were the unfunded pension liabilities or other necessary structural reforms. The plan would involve a voluntary exchange of existing bonds for two new securities. The first is a "Base Bond," the initial value of which would vary depending upon the issuing authority, with interest payments beginning in 2018 at a 3% coupon rate, rising to 5% in 2021 and beyond. The second exchange security would be a "Growth Bond," with interest and principal paid only if Commonwealth revenue exceeds certain target levels. Congress is also working on a comprehensive solution of its own with a target deadline for release by March 31. Preliminary reports suggest Congress will recommend a Financial Control Board be established with power over budgetary and debt matters, modeled after the successful board responsible for overseeing the financially stressed District of Columbia in the 1990's. Whether or not Congress will also grant the authority to restructure some or all outstanding Puerto Rico debt remains uncertain.

The other significant municipal credit in the news recently was the Chicago Board of Education (BOE). Illinois' largest school district paid as much as an 8.5% tax-free yield to issue $752 million in debt, reflecting significant investor credit concern. Those concerns were shared by the major credit agencies which assigned ratings below investment grade. Yet, the BOE has historically had sufficient state revenue to cover debt service, while also having the authority to levy property taxes if necessary. Until the political stalemate within Illinois is resolved the BOE credit will remain under pressure. The good news is that this issue likely eliminates the need for further borrowing in 2016.

Politics

The U.S. Presidential race has been as volatile and vitriol as any in recent memory. Although numerous important topics have been debated, tax reform has not, to-date, been a major focus for either party. We expect that tax policy will take on greater significance once the nominees are selected, perhaps leading to greater market volatility. We continue to believe, however, that the hurdles for meaningful tax reform are very high. That said, taxes are an important topic at the state level. Several state governors are seeking to reduce taxes in an effort to increase economic competitiveness (e.g. IL, MD, and NM, among others). Nearly as many, however, are discussing ways to enhance revenue, particularly those most heavily dependent upon energy prices and production (e.g., AK, and LA). Other important policy discussions at the state level relate to how best to meet rising pension costs and funding significant infrastructure needs; two topics that will remain an ongoing challenge for most states.

Summary Overview and Strategy

The municipal market is off to a good start in 2016. Concerns over multiple increases in the federal funds rate this year have faded, for now. Unless rates reverse course and begin to rise, we expect that new municipal issuance will pick up over the next several months as refunding volume improves. More supply would be welcomed by a market that continues to see steady inflows and strong investor demand for tax-free income. The credit backdrop remains favorable, as tax revenues are rising, but so too are the needs to fund long-term liabilities.

From a portfolio perspective, we continue to target a neutral duration posture with a modest barbell curve structure, anticipating the resumption of a flattening trend over the course of 2016. In our core municipal strategies a moderate overweight to credit is desired as fundamentals remain supportive. Tax revenues continue to rise, albeit slowly with the slow pace of economic growth. We are biased to Revenue bonds in our core strategies, with an above-market weight in Hospitals, Housing, and Water/Sewer issues. The portfolios have sufficient liquidity to take advantage of market opportunities and inefficiencies as they arise.