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Private Wealth Management

Muni Fortnightly

Treasury curve flattens despite better than expected economic data on the more hawkish than expected FOMC and trade tariff wars. Municipal yield were mixed. COFINA bonds rally more on tentative agreement on sales tax revenues.

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Bottom Line:

- **Treasury yield changes were mixed and the curve flattened (to the flattest since 2007) amidst economic data otherwise supportive of higher yields, a more hawkish Fed and a more dovish ECB.**
- **Muni yields were mixed.**
- **Illinois pension legislation short-term positive but plans remain challenged.**
- **State budgetary performance improves from last year.**
- **Muni ETF usage increases.**
- **COFINA bonds rally some more on a tentative agreement on restructuring.**
- **S&P Puerto Rico Total Return Index was 0.78% last week; 17.6% YTD.**

What Happened in the Bond Markets Last Week?

- Treasuries had a full opportunity to display their true colors during a week full of higher profile economic data and a heavy slate of central bank meetings. Up until just before Wednesday's FOMC meeting, economic data were generally supportive of higher yields (Factory Orders, ISM Non-Mfg., Unit Labor Costs, CPI and PPI were all higher than expected). Yield changes remained very subdued throughout. The FOMC Meeting resulted in the fully expected rise in Fed Funds Rate but came through with a slightly more bullish view on the economy and a Dot Plot that on average indicates the intentions of two more rate hikes through the reminder of the year (the market implied probability for a fourth hike later in the year is only about a coin flip). Yields spiked on the FOMC information. Longer-end yields then abruptly retreated but short-end yield remained higher i.e. the curve flattened. The rest of the week was impacted by a blend of the ECB's dovish stance on QE and rate hikes (none until late 2019) and the threat and implementation of trade tariff wars. Strong Retail Sales should have given yields a boost but long-end yields fell below where they began the week. The 2's-10's spread, now at ~37 bps is at the lowest level since 2007.
- Municipal bond yields changes were mixed during the past week. The short-end continues to get more expensive.

Yields (Figure 1):

- For the week ending 6/15/18 Treasury yields were mixed and the curve ever flatter; 2-year Treasury Note yields were +5.5 bps at 2.55%, 5-year Notes yields were +2.4 bps at 2.80%, 10-year Notes yields were -1.5 bps to 2.93% and 30-year bonds yields were -3.7 bps at 3.05%.

- Bloomberg Municipal Index curve yields were little changed; AAA-rated GO yields; 2-year bonds were -3 bps to 1.64%, 5-year bond yields were +1 bps to 2.00%, 10-year bond yields were +2 bps to 2.48% and 30-year bonds were +1 bps to 3.04%.
- The Ratio of 10-year AAA GO debt to 10-year Treasury yields rose to 85.0 from 83.5 last week. The year-to-date average is 85.5 and the 12-month average is 85.3.

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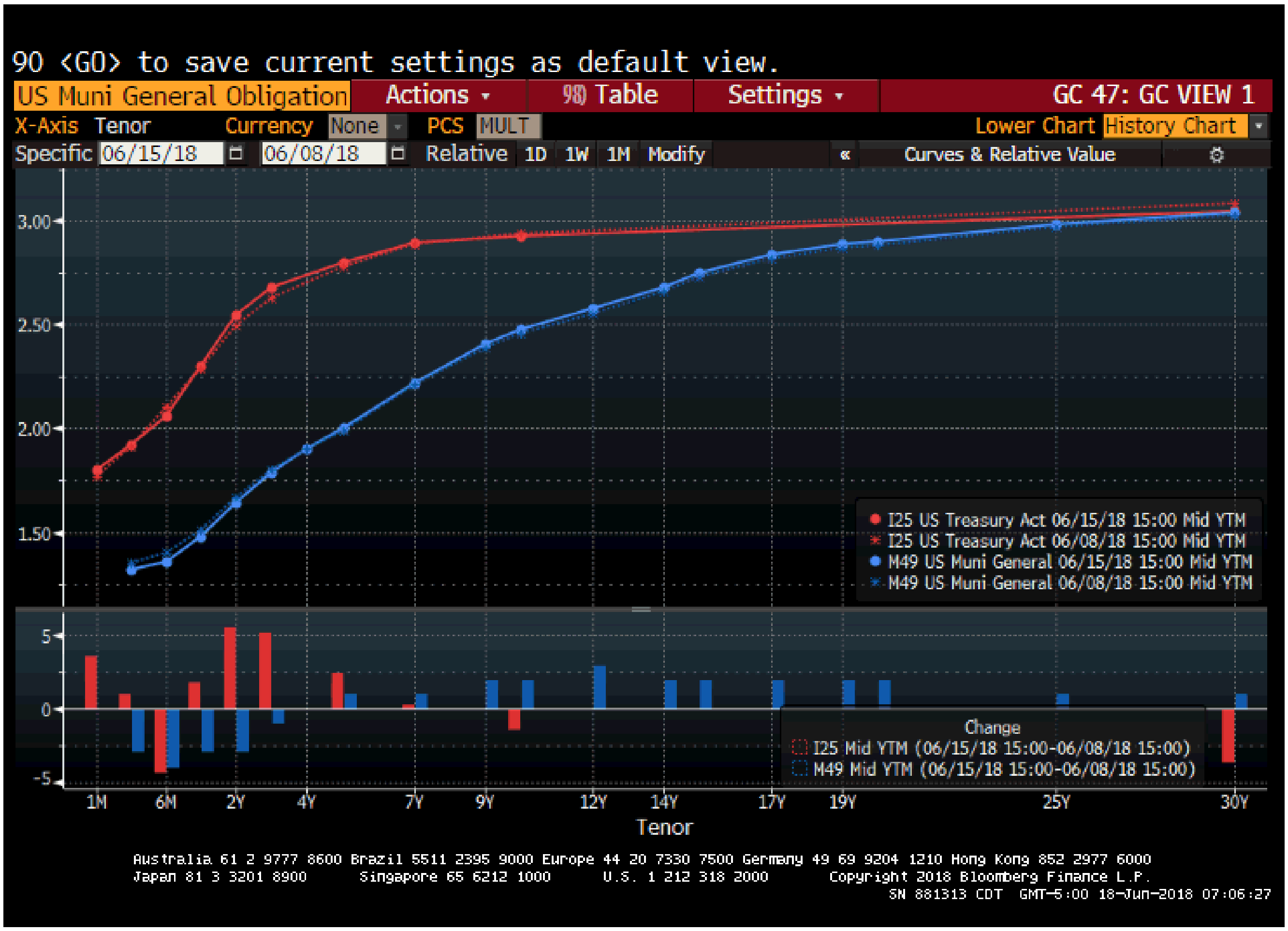
Figure 1 - Yield Curve and Muni Curve Changes – Data Source: Bloomberg



One can observe these changes by looking at how rates have changed along the curve for both the Treasury curve and for the AAA-rated G.O. Index since last week. The top panel shows four yield curves; two for the Treasury curve (in red) - one for the most current date and one from last week and two for the AAA-rated G.O. (in blue) - current and last week. The bottom panel of the graph shows changes in the rates along both curves for the week for both Treasuries and the AAA G.O. Index.

Figure 2a - Muni Ratio – Data Source: Bloomberg

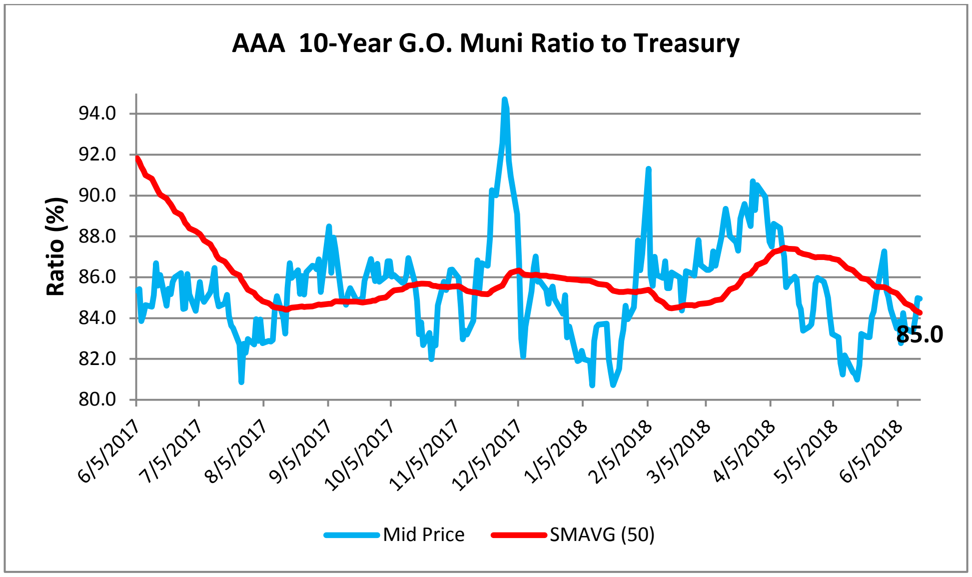
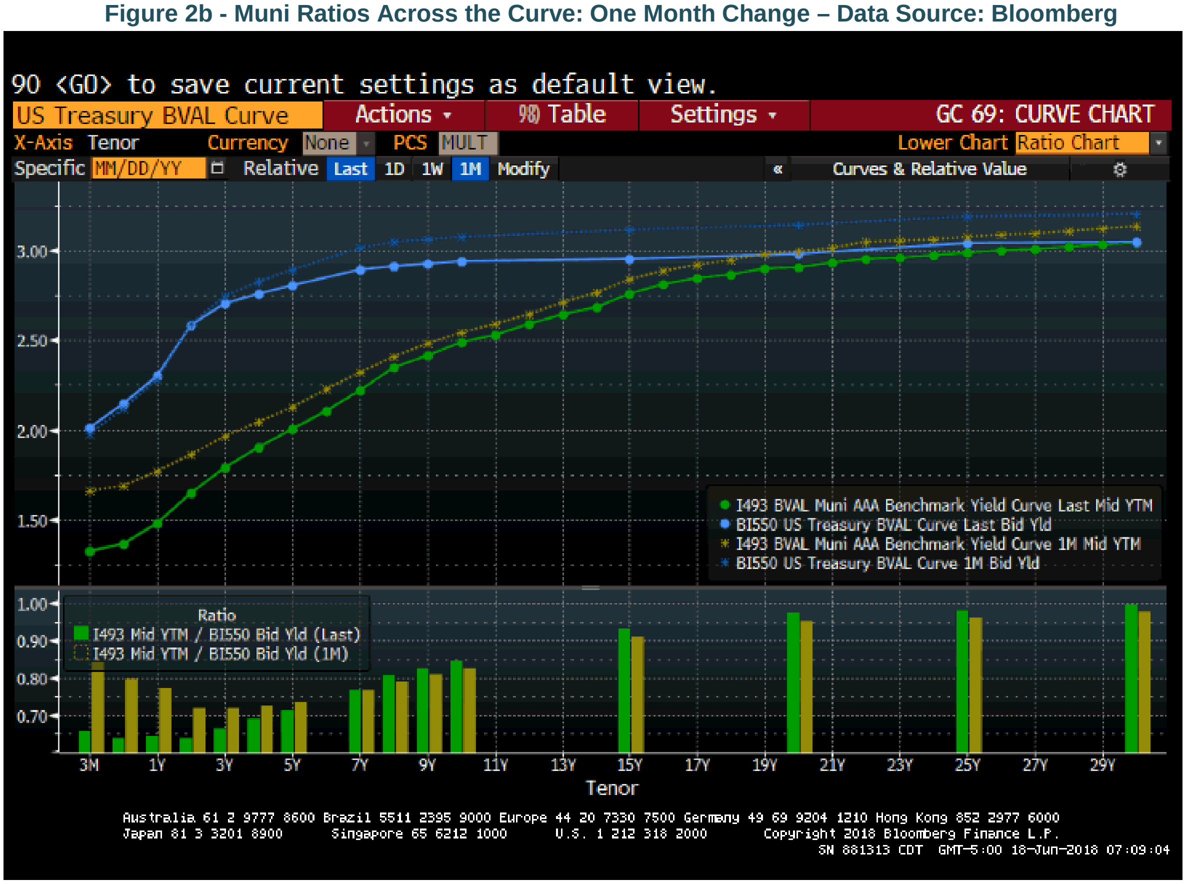
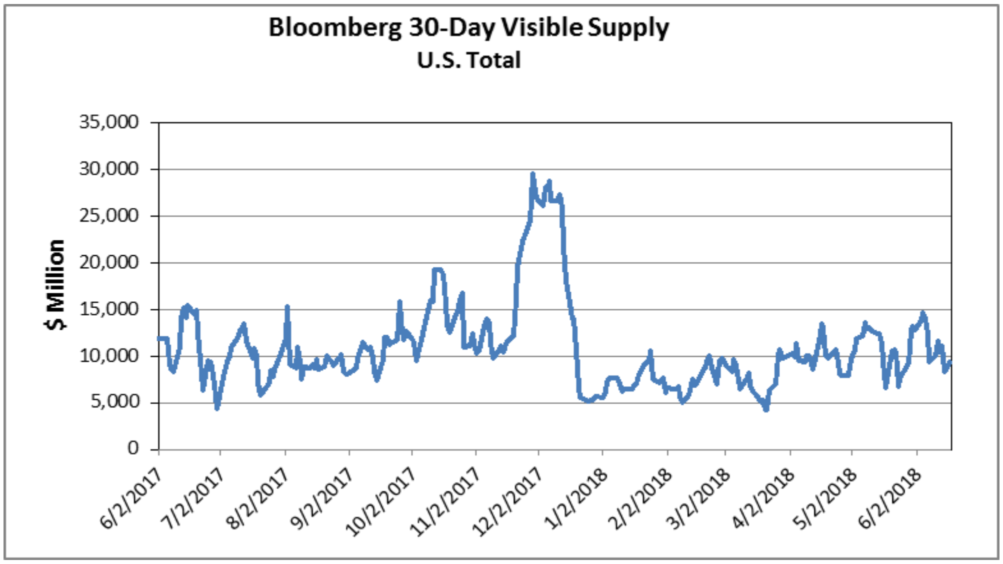


Figure 2b - Muni Ratios Across the Curve: One Month Change – Data Source: Bloomberg



Supply (Figure 3) – Bloomberg 30-Day Visible Supply currently stands at $9.3 billion down from $10.0 billion this time last week. The YTD average visible supply is $8.9 billion and the 12-mo average is $10.9 billion.

Figure 3- Bloomberg 30-Day Visible Supply - 1 Year; Data Source: Bloomberg



Articles of Interest

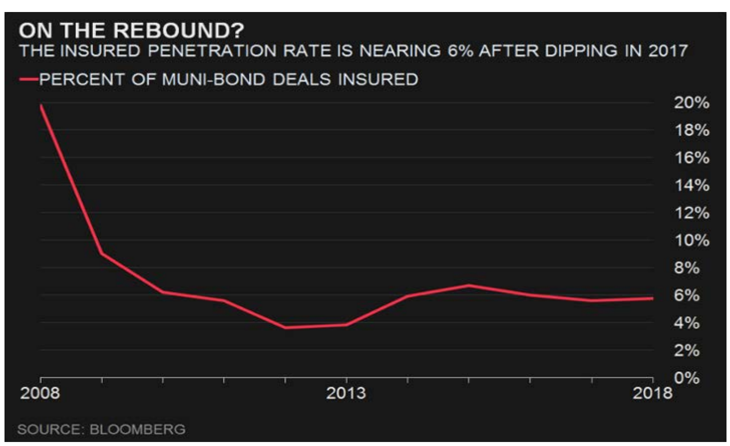
Municipal Fund Flows: According to Lipper data muni funds had net inflows of $449.6 million after $189.5 million of net outflows during the previous week. The four-week moving average is $237 million outflows. High-yield funds had net inflows.

Illinois Pension Legislation Credit Positive but Still Remains Challenging (Moody's): The State of Illinois passed legislation offering pension benefit buyouts to plan participants. This will decrease pension contributions by about 5.2% in current fiscal year. However, the pension plan, with a $201 billion adjusted net pension liability and highest of any U.S. state, will remain a "credit challenge".

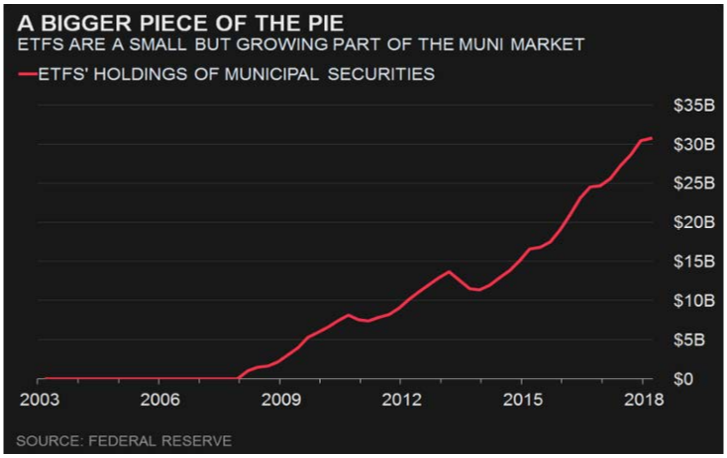
State Finances Improving: According to the National Association of State Budget Offices, fewer state budgets are facing deficits. Thirteen states face projected shortfalls compared to 19 last year.

Wayne County, MI Back to Investment-grade: Wayne County, which emerged two years ago from state oversight has received an investment-grade rating by Moody's.

Municipal Bond Insurance (Bloomberg Brief): *Bloomberg Brief* notes that he municipal bond insurance penetration rate has increased slightly to 5.8%, up from 5.6% in 2017 but lower than 6% in 2016 (graph below).



Muni ETFs (Bloomberg Brief): *Bloomberg Brief* wrote about the growing presence of municipal bond ETFs (see graph below). According to Federal Reserve data muni ETFs account for approximately 0.8% of all municipal bond holdings ($31 billion) – this compares to corporate bond ETF holdings of about 2.6%.

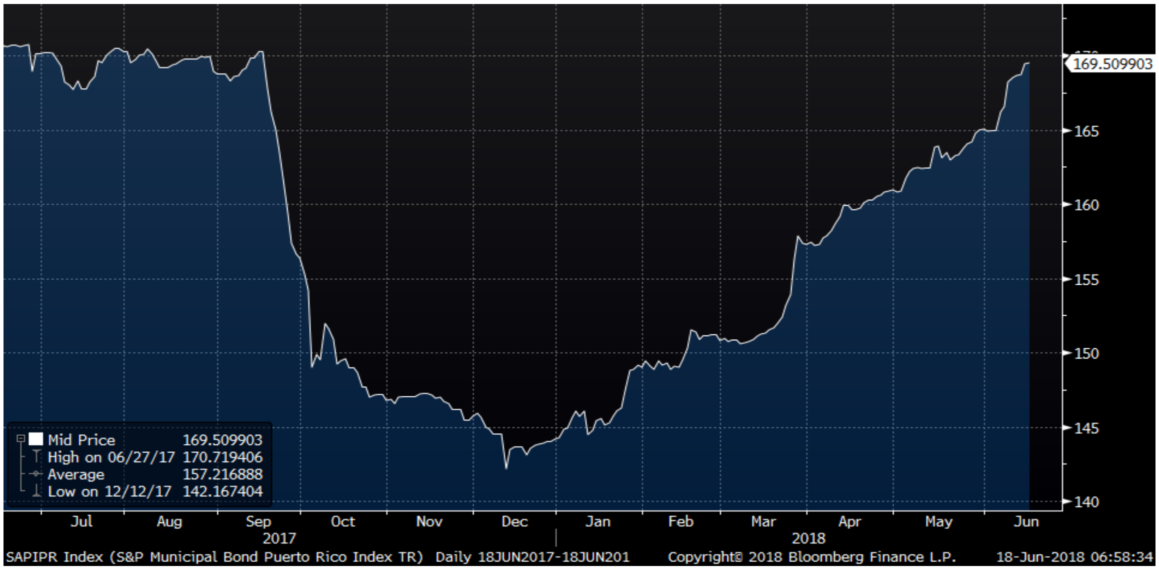


Puerto Rico:

- ***Moody's Puerto Rico In-Depth Comment:*** Moody's issued an *In-Depth* sector report on Puerto Rico's economy and financial conditions. Generally, they comment that the post-hurricane season economic recovery is "tenuous" and recovery prospects vary by sector. Some the highlights of the report include: 1) the economic recovery is challenging particularly so given the slow and leveling disbursement of fiscal help from the federal government and general fragile infrastructure. 2) Debt recovery levels will be dependent on the island's economy (which is expected to shrink 5% in 2019 from 2017 levels.) and the judicial restructuring. 3) Infrastructure credits are still challenged by damage and low utilization.
- ***COFINA Bonds Rally*** after a tentative agreement that would direct revenues to the agency. This would mitigate losses previously believed possible. The bonds could get approximately half of the revenue that has been in a reserve account. This tentative agreement is being met by resistance from holders of general obligation bonds. An example (graph shown on following page) is the 6.05% 2036 Puerto Rico Sales Tax Revenue bonds.

- ***The S&P Municipal Bond Puerto Rico Index*** finished at 169.5 on Friday vs. 168.2 at the end of the previous week, +0.78%. Year-to-date the index is +17.6%.

S&P Municipal Bond Puerto Rico Index Level (1-year)

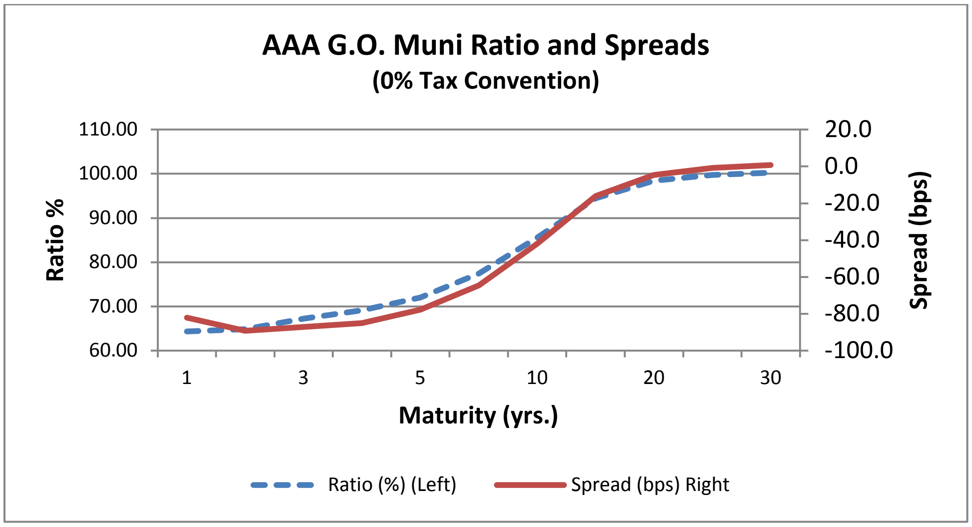


Relative Value by Maturity

Table 1 - AAA Muni Ratios and Spreads by Maturity - Data Source: Bloomberg

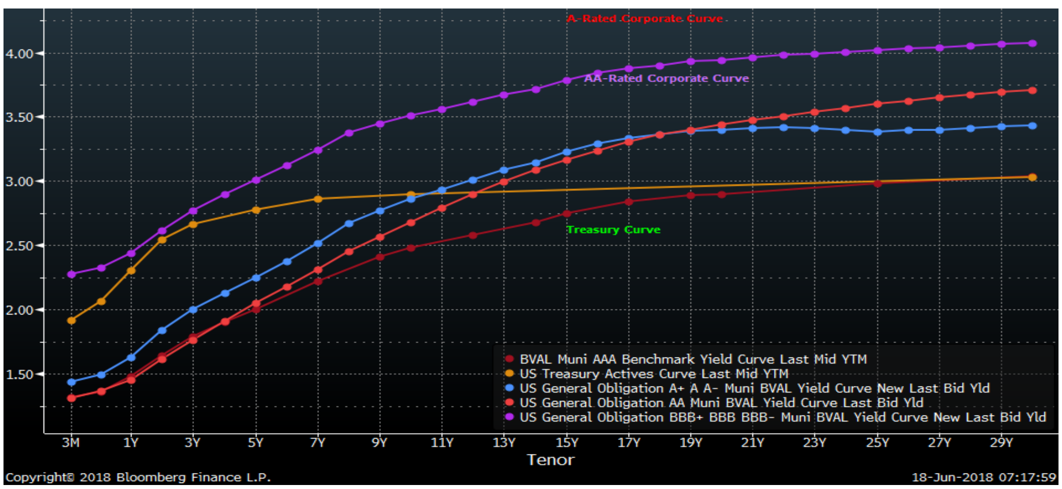
6/18/2018	Yield-to-worst (%)		0% Tax Rate		35% Tax Equivalent	
Maturity (yrs.)	AAA Gen. Oblig.	Treasury	Spread (bps)	Ratio (%)	Spread (bps)	Ratio (%)
1	1.48	2.30	-82.1	64.3	-2.4	99.0
2	1.65	2.54	-89.3	64.9	-0.6	99.8
3	1.79	2.66	-87.2	67.2	9.2	103.5
4	1.90	2.75	-85.0	69.1	17.3	106.3
5	2.00	2.78	-77.8	72.0	30.0	110.8
7	2.22	2.87	-64.6	77.5	55.0	119.2
10	2.49	2.90	-41.9	85.6	91.9	131.6
15	2.76	2.92	-16.1	94.5	132.3	145.4
20	2.91	2.95	-4.6	98.4	152.0	151.5
25	2.99	2.99	-0.8	99.7	160.0	153.4
30	3.04	3.03	0.7	100.2	164.5	154.2

Figure 4 – AAA General Obligation Ratios and Spreads – Data Source: Bloomberg



Relative Value by Rating

Figure 5 – Muni Index Yield Curve by Credit Rating – Data Source: Bloomberg



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Appendix – Important Disclosures

Some of the potential risks associated with fixed income investments include call risk, reinvestment risk, default risk and inflation risk. Additionally, it is important that an investor is familiar with the inverse relationship between a bond's price and its yield. Bond prices will fall as interest rates rise and vice versa.

When considering a potential investment, investors should compare the credit qualities of available bond issues before they invest. The two most recognized rating agencies that assign credit ratings to bond issuers are Moody's Investors Service ("Moody's") and Standard & Poor's Corporation ("S&P"). Moody's lowest investment-grade rating for a bond is Baa3 and S&P's lowest investment-grade rating for a bond is BBB-. Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest).

The Bond Buyer 20-Bond Index consists of 20 general obligation bonds that mature in 20 years. The average rating of the 20 bonds is roughly equivalent to Moody's Investors Service's Aa2 rating and Standard & Poor's Corp.'s AA. The Bond Buyer 11-Bond Index uses a select group of 11 bonds in the 20-Bond Index. The average rating of the 11 bonds is roughly equivalent to Moody's Aa1 and S&P's AA-plus. The Bond Buyer Revenue Bond Index consists of 25 various revenue bonds that mature in 30 years. The average rating is roughly equivalent to Moody's A1 and S&P's A-plus. The indexes represent theoretical yields rather than actual price or yield quotations. Municipal bond traders are asked to estimate what a current-coupon bond for each issuer in the indexes would yield if the bond was sold at par value. The indexes are simple averages of the average estimated yields of the bonds, are unmanaged and a direct investment cannot be made in them.

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