

## Muni Fortnightly

Treasury yields remain surprisingly stable amidst highly volatile equity markets. Muni yields remain consistent with Treasuries.

David N Violette, CFA  
Senior Fixed Income Analyst

April 9, 2018

### Bottom Line:

- Treasury yields were stubbornly stable during a week of wild swings in the equity market.
- Munis were also relatively stable and were mixed: 10yr AAA GO Ratio at 88.6.
- Supply is expected by market participants (PNC survey) to be down ~22% in 2018 from 2017.
- Moody's highlights:
  - 'Stable' Local Government sector
  - 'Stable' Water and Sewer sector.
  - Aging populations on state and local economic dynamics and strains on tax revenues.
- High-yield muni sector spreads at tightest level in five years.
- S&P Puerto Rico Total Return Index was 0.4% last week; 9.5% YTD.

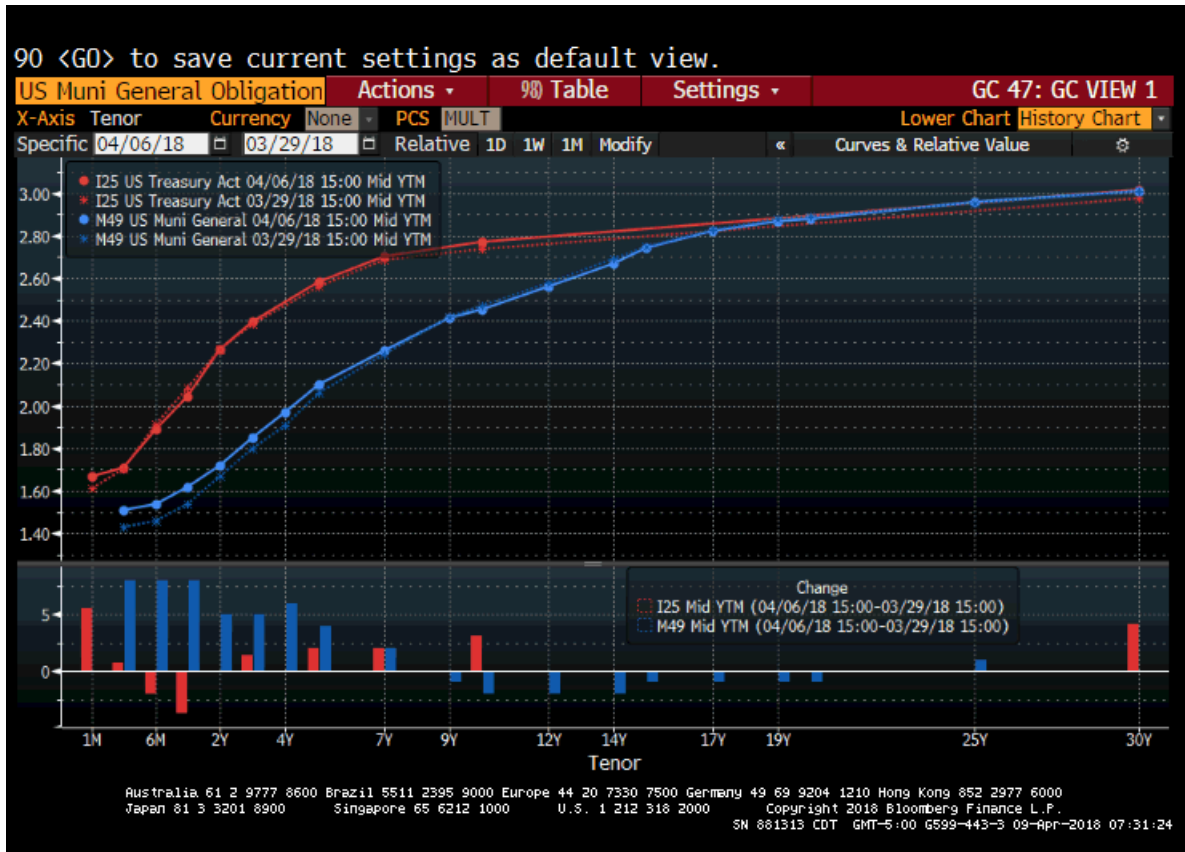
### What Happened in the Bond Markets Last Week?

- Treasury yields, despite the heightened volatility in the equity market remained relatively unfazed. There were periods, such as Friday's equity market meltdown that Treasuries proved their worth as a risk hedge when they rallied strongly. There has been somewhat of a remarkable calm exhibited by the Treasury market in face of a daily whipsaws in risky asset markets from changing perceptions of trade wars. While it is well established that Euro area economic data has been disappointing since mid-January, domestic data, while more subtle has shown some weakness to expectations. Nonetheless, Fed rate hike market implied probabilities remain relatively stable; now at ~80% for the June meeting.
- Municipal bond yields were mixed during the past week. With the 10yr AAA GO Ratio now at 88.6 down from 90.5, it is still well off the most expensive levels (~80-81 that began the year).

### Yields (Figure 1):

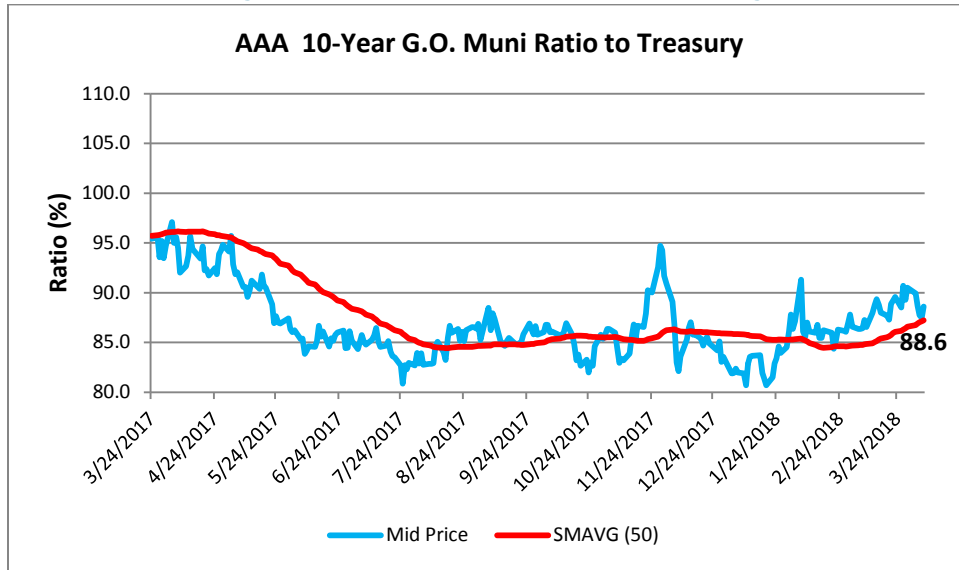
- For the week ending 4/6/18 Treasury yields traded higher; 2-year Treasury Note yields were flat bps at 2.27%, 5-year Notes yields were +2 bps to 2.58%, 10-year Notes yields were +3.1 bps to 2.77% and 30-year bonds yields were +4.1 bps at 3.02%.
- Bloomberg Municipal Index curve yields were mixed; AAA-rated GO yields; 2-year bonds were +5 bps to 1.72%, 5-year bond yields were +4 bps to 2.10%, 10-year bond yields were -2 bps to 2.45% and 30-year bonds were flat bps at 3.01%.
- The Ratio of 10-year AAA GO debt to 10-year Treasury yields fell from week-ago levels to 88.6 from 90.5 last week. The year-to-date average is 85.6 and the 12-month average is 86.7.

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.

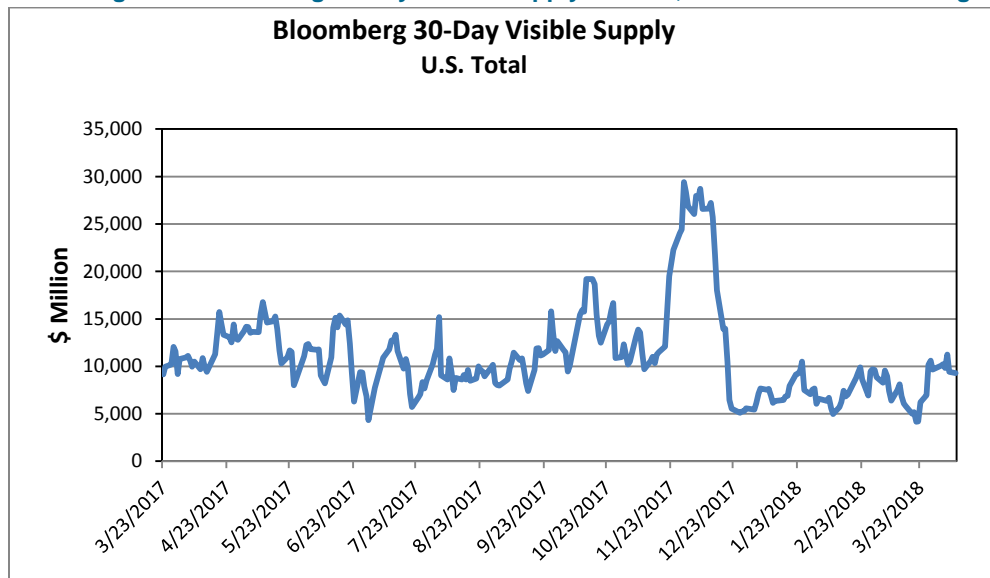
Figure 2 - Muni Ratio – Data Source: Bloomberg



**Supply (Figure 3)** – Bloomberg 30-Day Visible Supply currently stands at \$9.3 billion down from \$10.1 billion this time last week. The YTD average visible supply is \$7.6 billion and the 12-mo average is \$11.2 billion.

- A survey conducted by PNC of 168 analysts forecasts of municipal issuance in 2018 is below \$350 billion after \$446 billion of issuance in 2017 citing the federal tax changes as the reason including the elimination of advanced refundings.
- 

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 outflows of \$247.1 million after \$36.8 million of net inflows during the previous week. The four-week moving average is \$144 million outflows. High-yield funds had net inflows.

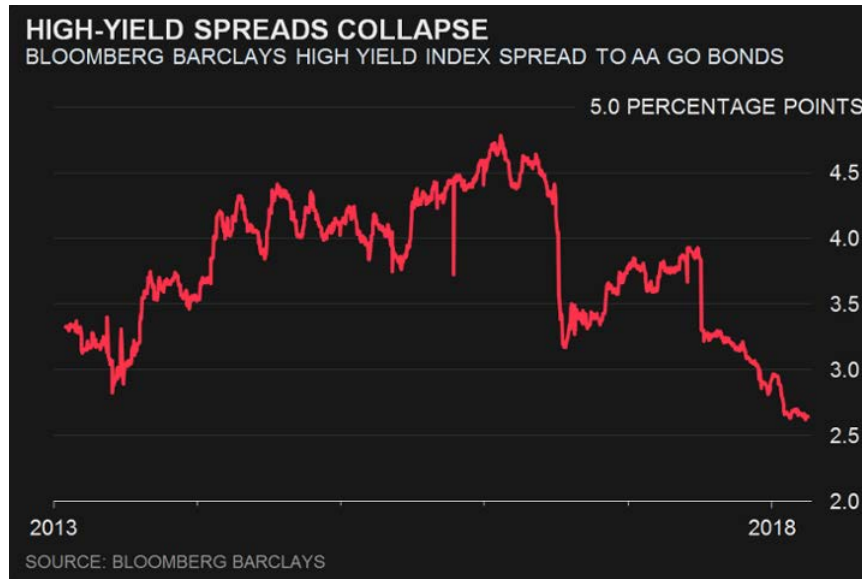
***Local Governments Stabilized by Property Values while Pensions are Challenging (Moody's):*** Moody's issued a Sector In-Depth report on the Local Government sector. Some highlights of their report include: a) the recovery in property values (full value growth of 6% for cities) gives rise to stability within the sector, b) reserves have increased across all subsectors (by 1.45 for cities and 0.8% for school districts), c) liquidity (cash balances as a percent of operating revenue) is healthy, d) net direct debt as a percent of full value is unchanged and e) pensions remain a challenging issue for all subsector (adjusted net pension liabilities have risen by 66% for counties, 41% for school districts and 67% for cities since 2012) and will continue to be a strain.

***Water and Sewer Sector Stable (Moody's):*** Moody's issued a Sector In-Depth report on the Water and Sewer sector. They rate the sector 'Stable'. Some highlights of their report include: a) debt service coverage at 2x remains "strong and stable", b) liquidity is strong and offers flexibility and a cushion, c) leverage is declining with capacity to add to capital projects, d) larger systems have economic scale and more operating flexibility e) areas with better socioeconomic conditions have greater rate-raising flexibility f) there has been deterioration of assets conditions due to underinvestment.

***Aging Populations in Some States Lead to Lower Revenue (Moody's):*** States and local governments with aging populations including NH, ME, VT, WV (the four most aging populations) have below average employment growth and have slower revenue growth. Florida, the fifth older state is different; it has strong employment growth. Some of the highlights of the Moody's report include: a) aging state economies leads to less dynamic economies with less desirable business environments and slower economic growth, b) aging populations can result in strains to state and local government finances as personal spending is lower resulting in lower sales tax revenues, c) while straining, governments can make changes to mitigate the effects of aging populations.

***Bond Insurance Penetration Remains Low (Bloomberg):*** 5.2 % of municipal bonds sold in Q1 were insured marking the weakest Q1 penetration level since 2015 according to Bloomberg data. This compares to approximately 57% penetration in the pre-financial crisis period.

***High-yield Muni Spreads Lowest in 5 years (Bloomberg Brief):*** According to Bloomberg data, high-yield municipal bond spreads, at 261 bps over AA munis, are at the tightest level in five years. They are 118 bps tighter than they were in March 2017 largely attributable to defaulted Puerto Rico bonds dropping from the index. The Bloomberg article notes that on a tax-adjusted basis (assuming a 35% tax bracket) high-yield munis are 99 bps wider than high-yield corporate bonds.



**Puerto Rico:**

- **Puerto Rico Boosts Financial Projections Again:** PR boosted its financial expectations for budget surpluses over the next six years. This is the third boost to expectations over the past three months and is a key reason for the recent rally in PR bonds.
- **The S&P Municipal Bond Puerto Rico Index** finished at 157.8 on Friday vs. 157.6 at the end of the previous week, +0.4%. Year-to-date the index is +9.5%.

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

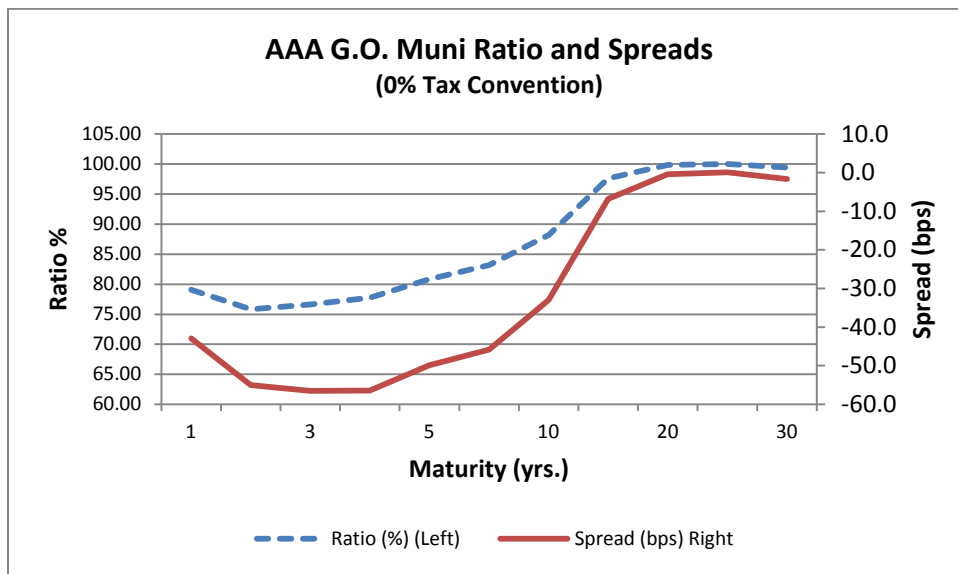


**Relative Value by Maturity**

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

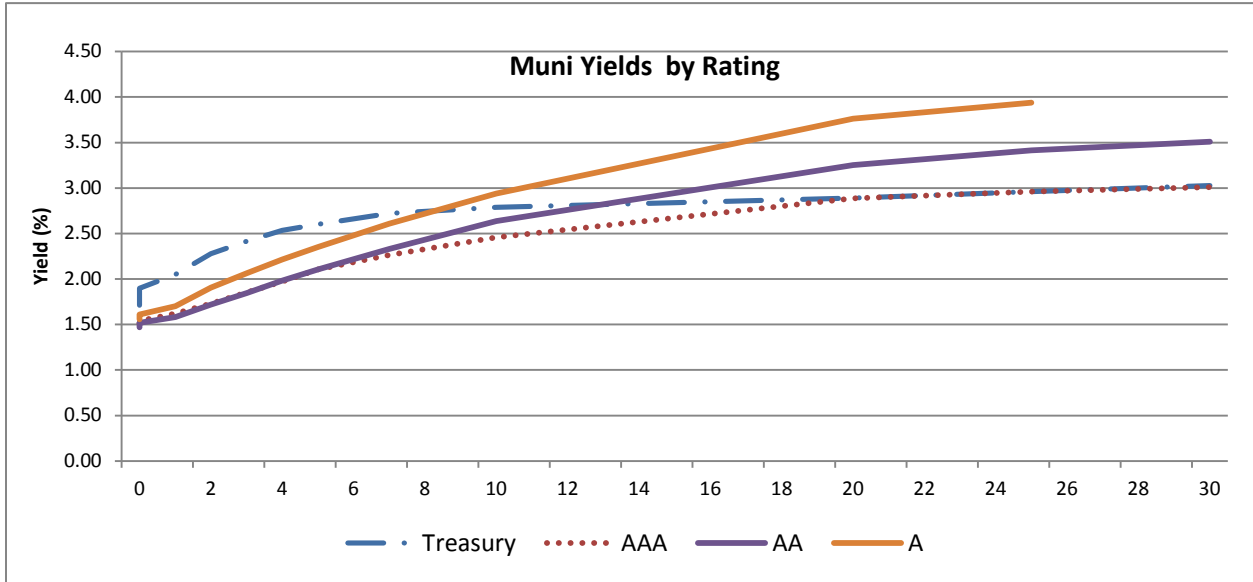
4/9/2018	Yield-to-worst (%)		0% Tax Rate		35% Tax Equivalent	
Maturity (yrs.)	AAA Gen. Oblig.	Treasury	Spread (bps)	Ratio (%)	Spread (bps)	Ratio (%)
1	1.62	2.05	-42.9	79.1	44.4	121.6
2	1.73	2.28	-55.0	75.8	38.0	116.7
3	1.85	2.42	-56.5	76.6	43.1	117.8
4	1.97	2.54	-56.4	77.8	49.8	119.6
5	2.10	2.60	-49.9	80.8	63.4	124.4
7	2.26	2.72	-45.8	83.2	76.0	127.9
10	2.46	2.79	-33.0	88.2	99.3	135.6
15	2.74	2.81	-6.8	97.6	140.8	150.1
20	2.89	2.89	-0.4	99.9	155.1	153.6
25	2.96	2.96	0.1	100.0	159.5	153.9
30	3.01	3.03	-1.7	99.4	160.4	153.0

**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**



For more information please contact your Financial Advisor.

## 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.

This is not a complete analysis of every material fact regarding any sector, municipality or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. Municipal securities investments are not appropriate for all investors, especially those taxed at lower rates. The alternative minimum tax (AMT) may be applicable, even for securities identified as tax-exempt. It is strongly recommended that an investor discuss with their financial professional all materially important information such as risks, ratings and tax implications prior to making an investment. Past performance is not a guarantee of future results.

This report does not provide recipients with information or advice that is sufficient on which to base an investment decision. This report does not take into account the specific investment objectives, financial situation, or need of any particular client and may not be suitable for all types of investors. Recipients should consider the contents of this report as a single factor in making an investment decision. Additional fundamental and other analyses would be required to make an investment decision about any individual security identified in this report.

ADDITIONAL INFORMATION ON SECURITIES MENTIONED HEREIN IS AVAILABLE UPON REQUEST BY CONTACTING YOUR BAIRD INVESTMENT PROFESSIONAL.

Copyright 2018 Robert W. Baird & Co. Incorporated.