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Private Wealth Management

Muni Fortnightly

Treasury curve flattens and 10yr AAA GO Muni Ratio rises. Tax plan proposal has mixed implications.

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Bottom Line:

- The Treasury curve bull flattened despite higher-yield supporting economic data, tax changes and economic upgrade from the FOMC. Despite all of the punditry leading build-up, the newly nominated Fed Chair is seen as producing minimal practical change.
- Muni yields fell but trailed Treasuries; the resulting 10yr AAA GOP ratio rose off low levels experienced during the past several weeks.
- Bloomberg Barclay's Municipal Bond market index total return was 0.24% in October (4.92% YTD).
- The House tax plan proposal contained some surprise elements that may have mixed implications for the municipal bond market.
- S&P Puerto Rico Total Return Index was -0.1% two weeks; -16.8 YTD.

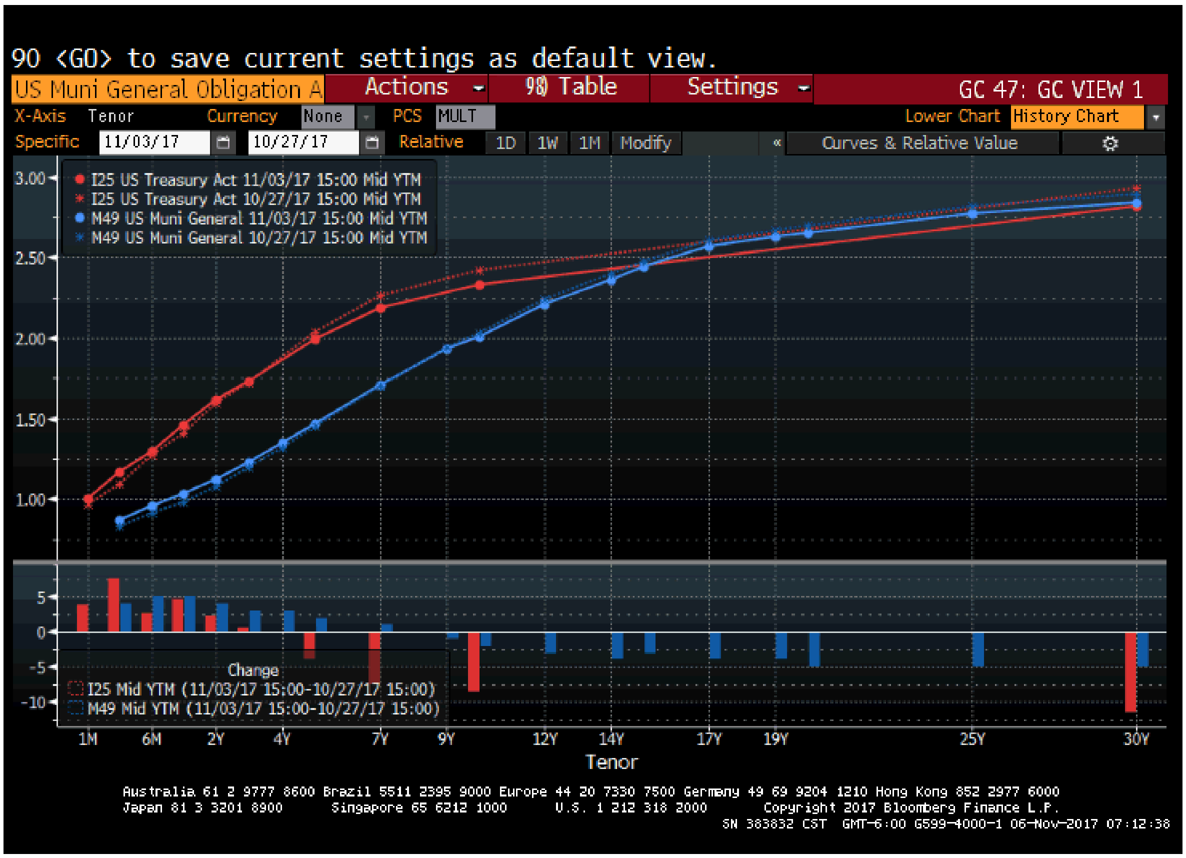
What Happened in the Bond Markets Last Week?

- Treasury yields moved steadily lower during the course of the week. There were a lot of moving parts; many important economic data releases, FOMC meeting, BOE meeting, House tax plan release, the announcement of a new Fed Chair and the arrest and indictment of the administration's campaign chairman (and others). Treasury curve bull-flattening was the predominate feature of the week.
  - Economic data were for the most part supportive of higher yields, while recedingly asterisked by hurricanes; Personal Income/Spending, PCE Deflator, Chicago PMI, Employment Cost Index, Construction Spending, Vehicle Sales, Productivity, ISM Non-Mfg. and Factory Orders were all better than consensus estimates. Only payrolls and ISM Mfg. were weaker. This type of week alone should have driven yields higher.
  - The FOMC meeting delivered nothing much new but acknowledged an economy that was a bit strong then was noted at the last meeting. The market implied probability for a rate hike in December is 92.4%.
  - The announcement of Jerome Powell as the next Fed Chair (livid opposition is unlikely), which after SO much punditry and drama, really amounts to very little expected change in leadership – he is as close to being Janet Yellen without being Janet Yellen. There is some argument that he will be more regulatory-lite. Consensus building amongst other Fed participants during more troubled moments will be watched (he is a non-academic economist as has held the seat over the past several decades).
  - The BOE meeting turned out to be more dovish than expected.
  - The tax plan as released was mostly as expected. The more difficult period of "getting it sold" will come with many gives and takes that are inconclusive relative to what has already been expected.
- Municipal yields followed Treasuries in direction but lagged in magnitude. The municipal market is still trying to digest the probability and magnitude of tax changes on the municipal market.

Yields (Figure 1):

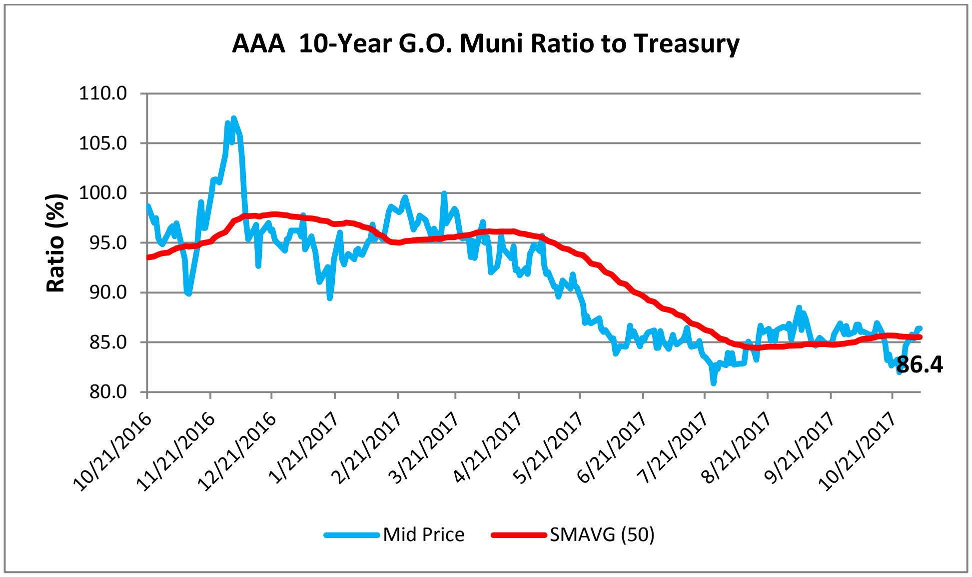
- For the week ending 11/3/17 Treasury yields traded notably lower and flatter; 2-year Treasury Note yields were +2.2 bps to 1.61%, 5-year Notes yields were -4.0 bps to 2.00%, 10-year Notes yields were -8.7 bps to 2.33% and 30-year bonds yields were -11.5 bps to 2.81%.
- Bloomberg Municipal Index curve yields were mixed and the curve flatter, AAA-rated GO yields; 2-year bonds were +4 bps to 1.08%, 5-year bond yields were +2 bps to 1.45%, 10-year bond yields were -2 bps bps to 2.03% and 30-year bonds were -5 bps to 2.89%.
- The Ratio of 10-year AAA GO debt to 10-year Treasury yields rose off lows to 86.4 from 82.7 last week. The year-to-date average is 89.5 and the 12-month average is 90.8.

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



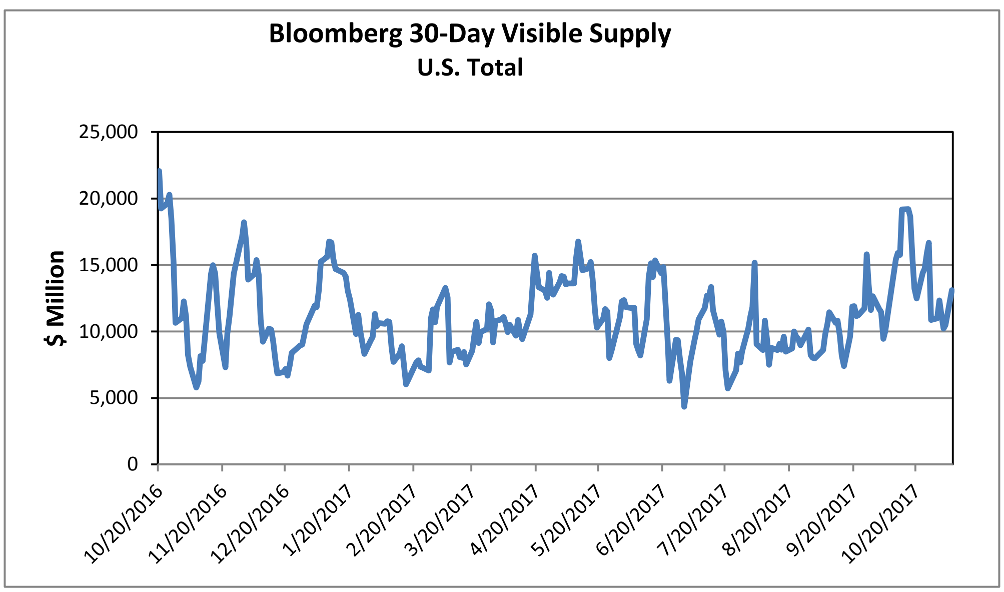
One can observe these changes by looking at how rates have changed along the curve for both the Treasury curve and for the AAA-rated G.O. Index since last week. The top panel shows four yield curves; two for the Treasury curve (in red) - one for the most current date and one from last week and two for 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 $13.1 billion up from $10.9 billion this time last week. The YTD average visible supply is $11.1 billion and the 12-mo average is $11.1 billion.

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



<u>Articles of Interest</u>

Municipal Fund Flows: According to Lipper data muni funds had net outflows of $655.0 million after $262 million of net inflows during the previous week. The four-week moving average was $46.7 million of inflows. High-yield funds had net outflows.

Tax Legislation Possible Impacts on Munis: The new House tax change/cut/reform brought some surprises for the municipal market. Of course, given the early stages of such change, anything could be modified so analysis is preliminary until (and if) it becomes law. Most importantly there was no threat posed to municipal tax exemption. Below is a summary of various analysts' comments:

- *Corporate tax rate cut to 20%:* This alone could be a factor in reducing the appetite for tax-exempt bonds by banks and insurance companies which could raise the cost of capital at the margin for municipalities.
- *Individual tax rate changes:* Potentially small incremental negative (maybe) to tax-exempt demand if tax rate changes are lower at higher income levels.
- *AMT:* The elimination of AMT could be a net positive for existing AMT bonds outstanding as they become more dear. The associated reduction in private activity projects funded by such bonds (think stadiums) would lose an attractive form of financing for those types of projects.
- *SALT:* to the degree that state and local income taxes are no longer deductible at the federal level it may create an incentive by those regions of high-taxes to seek incremental tax-exempt income. This however, may make the financial cost to these local and state governments to rise modestly.
- *Mortgage deduction Limit:* To the extent that the mortgage deduction limit could limit property values, it would be a marginal credit negative to high property value regions.

October Municipal Tax-Exempt Performance:

- Bloomberg Barclay's Municipal Bond Index had a +0.24% total return in October and outperformed the Treasurys' Index return. The negative municipal index return comprised of a price return of -0.10% and a positive coupon return of +0.35%. Through October, the year-to-date total return is +4.92% and the last 12-months' total return is +2.19%.
  - The ending Yield-to-Worst (YTW) for October was 2.25% (+2 bps) with a 5.1 modified duration-to-worst.
- The *General Obligation Index* had a +0.21% total return in October. Through October GOs had a +4.86% total year-to-date and +2.03% during the last 12-months.
  - The YTW at the end of October was 2.13% (+3 bps).
  - The *State General Obligation* sub-index had a +0.18% total return in October, with a +4.53% total return year-to-date and a 12-month total return of +1.89%.
    - Notable geographic indexes' October returns include; *Laggards* – Puerto Rico (-2.96%), ND (-0.08%) and AR (-0.03%); *Leaders* – SC (+0.46%), VT (+0.44%), CO (+0.41%). Other notable jurisdictions; AZ (+0.27%) CA (+0.32%), CT (+0.34%) FL (+0.31%), IL (+0.19%), IA (+0.12%), KS (+0.23%), MI (+0.29%), MN (+0.19%), NJ (+0.34%), NY (+0.24%), OH (+0.13%), OR (+0.21%) PA (+0.33%), Puerto Rico (-2.96%), TX (+0.31%), WA (+0.18%), WI (+0.24%).
    - The ending YTW for the State G.O. sector was 2.04%.
  - The *Local General Obligation* sub-index had a +0.23% total return in October, with a 5.26% total return year-to-date and the 12-month total return of +2.19%.
    - The ending YTW for the Local G.O. sector was 2.24%.
- The *Revenue Bond Index* had a +0.28% total return in October, with a year-to-date total return of +5.29% and a 12-month total return of +2.38%.
  - The best performing revenue sectors in October were industrial revenue (+0.49%), resource recovery (+0.37%) and hospitals (+0.36%).
  - The laggard revenue sectors were water and education (+0.21%), special tax (+0.22%), and electric (+0.25%).
  - The ending YTW for the Revenue sector was 2.39%.

The returns across maturities for the Barclay's Muni indexes were; 3-yr -0.03%, 5-yr -0.03%, 10-yr +0.22% and 20-yr -0.45% reflecting the flattening in the Treasury curve.

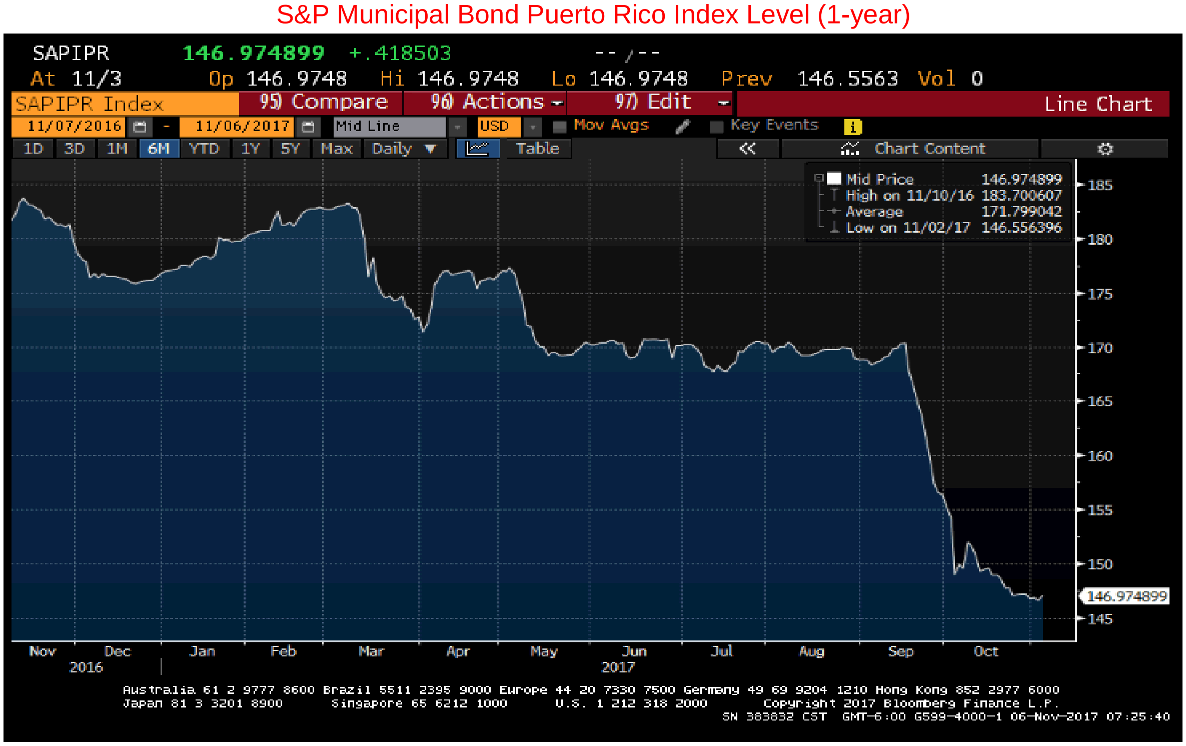
Miscellaneous:

- ***Hartford Rallies (Bloomberg Brief):*** Hartford bonds have rallied approx. 28% since a state legislature budget approval that gives $50 million of aid to the city.
- ***Fitch Upgrades/Downgrades Q3:*** Upgrades outnumbered downgrades, for the first time in 13 consecutive quarters in Q3'17.
- ***Alaska Downgraded to AA by Fitch:*** Fitch downgraded Alaska to AA from AA+ on energy-related revenue weakness.

Puerto Rico:

- ***Misc:***
  - ***PREPA:*** Puerto Rico was reportedly going to cancel a deal made to rebuild the electric grid given to a extremely small company (whitefish Energy Holdings) with ties to a U.S. official. It is reported that 70% of the island remains without power.
  - ***COFINAs (Bloomberg Brief):*** Large bondholders have increased positions on COFINA bonds. These bonds are at the fulcrum of a dispute between GO bondholders about the constitutionality of the sales taxes being an instrumentality of the Commonwealth.
  - ***PROMESA (Bloomberg Brief):*** The oversight board has given the government seven weeks to revise its financial recovery plan to account for hurricane losses. It is expected that this will decrease potential recovery to Puerto Rico bondholders.
- ***The S&P Municipal Bond Puerto Rico Index*** finished at 147.0 on Friday vs. 147.2 at the end of two weeks ago, -0.1%%. Year-to-date the index is -16.8%.

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

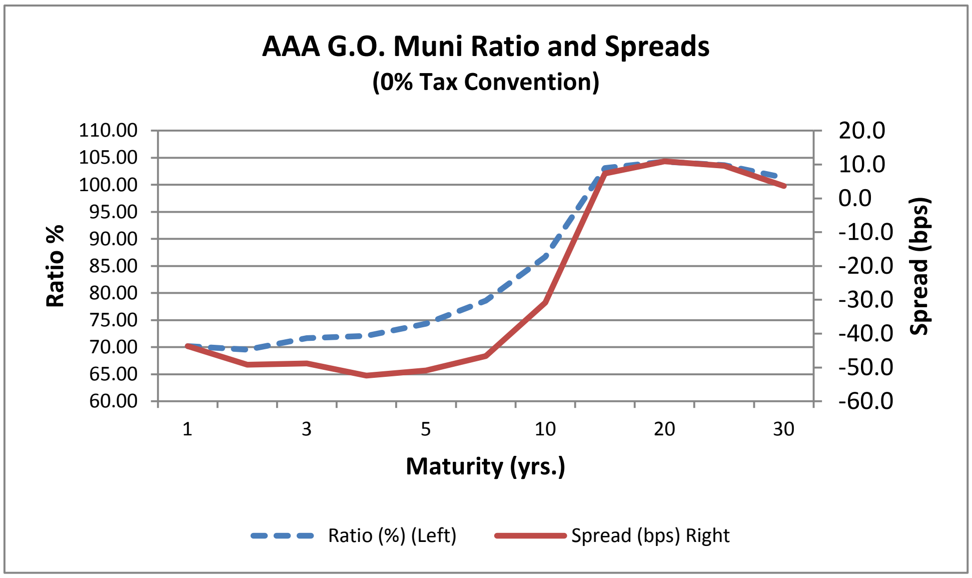


<u>Relative Value by Maturity</u>

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

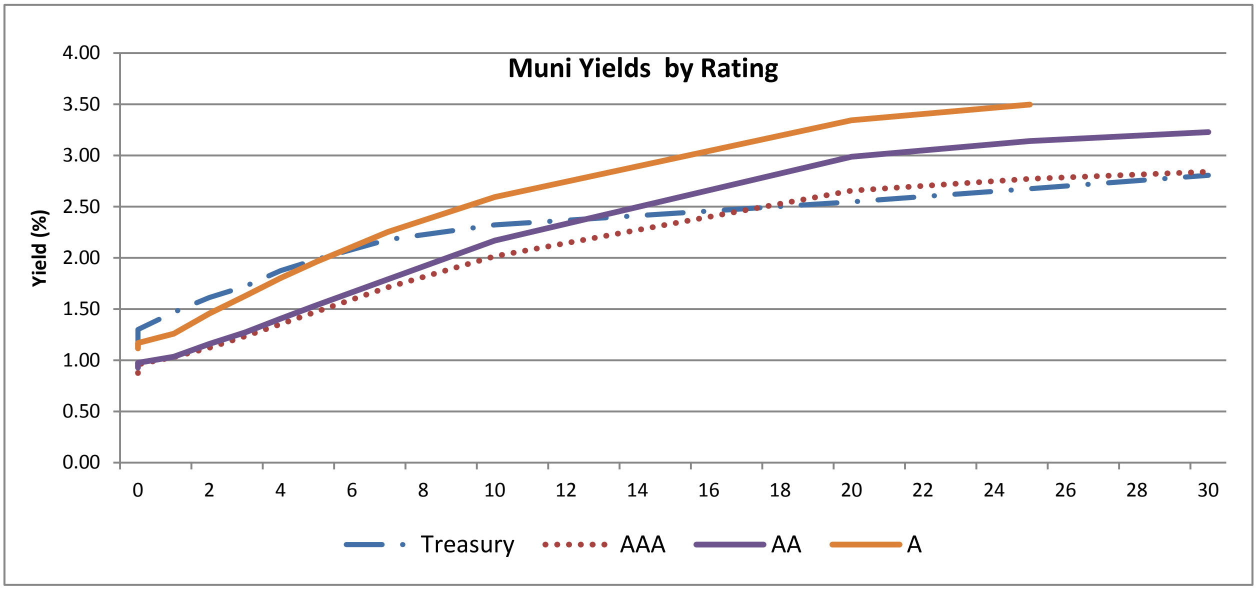
11/6/2017	Yield-to-worst (%)		0% Tax Rate		35% Tax Equivalent	
Maturity (yrs.)	AAA Gen. Oblig.	Treasury	Spread (bps)	Ratio (%)	Spread (bps)	Ratio (%)
1	1.03	1.47	-43.7	70.2	11.7	108.0
2	1.12	1.61	-49.2	69.5	11.2	106.9
3	1.23	1.72	-48.8	71.7	17.6	110.2
4	1.35	1.88	-52.4	72.1	20.4	110.9
5	1.47	1.98	-50.9	74.3	28.4	114.3
7	1.71	2.18	-46.6	78.6	45.5	120.9
10	2.02	2.32	-30.8	86.7	77.7	133.4
15	2.44	2.37	7.4	103.1	138.8	158.6
20	2.66	2.55	10.9	104.3	154.0	160.4
25	2.77	2.68	9.7	103.6	159.0	159.4
30	2.84	2.81	3.7	101.3	156.7	155.9

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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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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