Lower Yields and Flatter Municipal Curve in July

The municipal market provided investors another solid month of returns in July as tax-free yields fell modestly and credit spreads narrowed. There was solid demand across the curve, particularly in the 5-year maturity range, where tax-free yields fell 13 bps, twice the decline of comparable maturity Treasuries. Light new supply continued to offer technical support for the market with July’s volume 20% below a year ago and YTD issuance off 13% from the 2016 pace. Demand for municipals remained steady in part due to the ongoing political stalemate in Washington. The Senate failed in its efforts to repeal the Affordable Care Act highlighting the challenges ahead for tax reform. A group of Congressional leaders and senior White House officials (aka the “Big Six”) working behind the scenes released a few key elements of a plan framework, but was short on details. They admitted that the controversial border adjustment tax (BAT) idea was dead, eliminating an estimated $1 trillion of potential new tax revenue. Also, the budget resolution passed by the House Budget Committee only allows for revenue neutral tax reform, which implies less meaningful changes to the tax code than many believed following last November’s election.

Three Credit Updates

First, the drama in Illinois over the budget deadline stretched into early July but was ultimately resolved when the legislature passed a budget, over Gov. Rauner’s veto. Both personal and corporate income tax rates were raised and spending cuts were enacted for state agencies and universities. The state’s credit rating was affirmed as investment grade by the major rating agencies. Investors reacted positively by making Illinois the best performing state GO for the month. There remains an ongoing battle between the governor and legislature over funding for the Chicago Public School system, the debate over which could impact funding for other school districts also, just as the new school year is set to begin. Second, the rating for National Public Finance Guaranty (NPFG), the municipal bond insurance unit of MBIA, was lowered last month by S&P to A from AA-. S&P cited the “very low volume” of debt that NPFG had insured in recent years and questioned its long-term viability. NPFG’s two main insurance competitors, Assured Guaranty (AGM) and Build America Mutual (BAM) each still carry AA ratings by S&P, making it very difficult for NPFG to compete. NPFG will now essentially go into run-off mode, no longer looking to underwrite new business. They appear to have sufficient reserves to honor municipal obligations guaranteed, pending the resolution on outstanding Puerto Rico debt obligations. Finally, construction on two nuclear reactors in South Carolina was halted due to significant cost overruns and delays, as well as the bankruptcy filing of the reactor builder, Westinghouse. Santee Cooper, the state-owned electric utility which has a 45% stake in the reactors (South Carolina Electric & Gas owns 55%), had already raised rates five times since 2009 to help pay for the project and feared excessive increases going forward. Outstanding South Carolina Public Service debt for Santee Cooper will continue to be paid by the electric customers.

Best July Performance Since 2012

Lower tax-free yields and a modest narrowing of credit spreads led to the best July performance for the municipal market since 2012. General Obligation issues outperformed other sectors of the market and longer maturities outpaced returns across shorter segments of the yield curve. Moderate credit risk was rewarded as BBB rated issues outperformed both higher quality and lower quality (below investment grade) municipal debt last month.
Disclosures

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For more information about the Bloomberg Barclays Municipal Bond Index or Bloomberg Barclays High Yield Municipal Index, please visit https://index.barcap.com/Home/Guides_and_Factsheets.

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Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest). Investment grade investments are those rated from highest down to BBB- or Baa3.