Municipal Curve Steepens on Light Supply
Yields in the municipal market remained remarkably stable last quarter despite a 25 bps Fed rate hike in mid-March and significant uncertainty on the political front. Ten-year tax-free yields traded in just a 20 bps range, from 2.35% - 2.15%, during the quarter on below average trading volume and light new issuance. New municipal supply fell 30% in March from year ago levels contributing to a 12% year-over-year quarterly decline. With intermediate tax-free yields 50 bps higher, on average, from a year ago, less refunding volume was the primary culprit for the light new supply. The municipal market was, understandably, quite sensitive at the start of the year to the potential for tax reform. Tax concerns eased somewhat as the Trump administration and House GOP leaders focused their efforts instead on healthcare reform. The inability to reach a consensus on healthcare was not lost on municipal investors, which now more fully realize the challenges and complications in changing the tax code. Passage of a tax reform bill by the end of summer, therefore, now seems optimistic. Favorably, demand for municipal debt was relatively steady throughout the quarter, with tax-free funds experiencing inflows in 9 of 13 weeks. Total net inflows were $1.4B during what has historically been a weaker seasonal period leading up to investor tax payments in April. While yields fell across the curve, yields of issues maturing in 5-years or less declined the most, leading to a steeper curve for the quarter.

Credit Updates
The failure to “repeal and replace” the Affordable Care Act is a short-term positive for the nonprofit healthcare sector. Hospitals benefited over the last few years by having a higher level of insured patients and less uncompensated care. The status quo does not, however, mean all is fine going forward. There are healthcare challenges that will, hopefully, be addressed eventually in Congress. If there are fewer enrollees in the healthcare exchanges next year, which seems likely as premiums continue to rise and individuals face fewer insurance options, the revenue gains to hospitals in recent years may begin to reverse. There is also the possibility that further delays in healthcare reform could cause more states to expand their Medicaid program, as 31 states have already done. In other credit news, while the fiscal backdrop for municipalities remains solid, select troubled credits continue to struggle. Illinois, for example, risks further ratings downgrades if they cannot reach agreement on a budget by the end of their fiscal year in June. Moody’s recently stated that Illinois’ problems are political, not economic. There are fiscal solutions, but the political stalemate continues to prevent a resolution. New Jersey is another troubled state, as its rating was cut one notch to A3 by Moody’s last month, the eleventh ratings downgrade since Gov. Christie took office in 2010. The growing unfunded status of the state’s pension is the primary cause for the ongoing ratings deterioration. Finally, Puerto Rico bonds suffered this quarter as the PROMESA board accepted the Governor’s 10-year fiscal plan, which calls for as much as an 80% reduction in scheduled debt service payments over the next ten years. Expect contentious debate with creditors in Puerto Rico.

Strong 1Q Municipal Returns
The municipal market provided strong returns for investors this quarter across the curve and credit spectrum. Longer maturities outperformed shorter and intermediate maturities, despite a steepening yield curve. The decline in short tax-free yields was insufficient, however, to overcome the modest declines among longer duration debt. Credit spreads narrowed leading to outperformance among lower rated and high yield municipal issues.
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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