Municipal Update 5/25/17

Best of Times, Worst of Times…

Illinois Spiral

As the current legislative session draws to a close, Illinois' two year budget impasse shows little sign of being resolved. The worst rated state in the union, already Baa2 Moody's and BBB S&P, remains on negative outlook and on the brink of falling below investment grade. No state has been junk rated in decades, so this will be a dubious distinction should Illinois achieve it.

Illinois has been without a budget for two years and has accumulated more than $14 billion in unpaid bills. Vendors, state agencies, and public universities are among those being impacted. The state has maintained spending via continuing appropriation bills and consent decrees.

As the stalemate drags on and credit rating agencies warn of further downgrades, the current interest rate investors are requiring on ten year Illinois bonds is approximately 2.50% wider than the AAA benchmark where bonds of many other states trade. That yield is more than double where higher rated state general obligations are pricing. As the situation deteriorates, expect spreads to widen further, increasing the state's cost of borrowing.

Compromises have lacked sufficient support in the legislature. Among some of the "Grand Bargain" proposals recently passed by Democrats only in the state senate; raising personal income tax rate from 3.75% to 5.00%, increasing the corporate income tax rate from 5.25% to 7% (really 9.50% when 2.50% replacement tax is included), broadening the sales tax to cover services like dry-cleaning, pest control, tattooing and body piercing. Better get that nose ring soon!

If the proposed individual and corporate increases are enacted, Illinois tax rates in comparison with other states will rank as follows:

Property: **3rd**

Corporate: **5th**

Sales: **7th**

Individual: **9th**

This profile is likely to be a serious consideration for business owners, retirees, young families, corporations, etc. going forward as they make corporate and residential location decisions.

Puerto Rico Eruption

Since the beginning of May, Puerto Rico GO's (general obligation) and COFINA (sales tax) bonds have respectively dropped in value by approximately 5.00% and 9.50%. Compromises with bond holders were not reached after months of negotiation. The PROMESA Oversight Board that was created last year to develop a solution to Puerto Rico's fiscal distress proposed an enormous 73% haircut to creditors, who considered this unrealistic and unacceptable. Lawsuits and a declaration of bankruptcy quickly followed. Resolution of competing claims and untangling of staggering legal disputes are now in the hands of Southern District of New York Judge Laura Swain.

Puerto Rico GDP has declined 13% since 2007 and official unemployment rate is 11%. Population has dropped steadily since 2005. Bankruptcy puts the economic future of the Commonwealth in doubt as capital markets will require a substantial yield premium long after Puerto Rico's financial disaster is sorted out.

Several state-specific municipal bond mutual funds have significant exposure to Puerto Rico credits, as they had long taken advantage of the triple tax-exemption of the Commonwealth's bonds. In some cases, funds held concentrations of more than 30% in Puerto Rico debt. According to Morningstar, more than 40% of muni funds still have exposure. One risk to consider is that redemptions in these funds could accelerate, forcing fund managers to liquidate better quality bonds in order to meet redemptions.

Nutmeg State

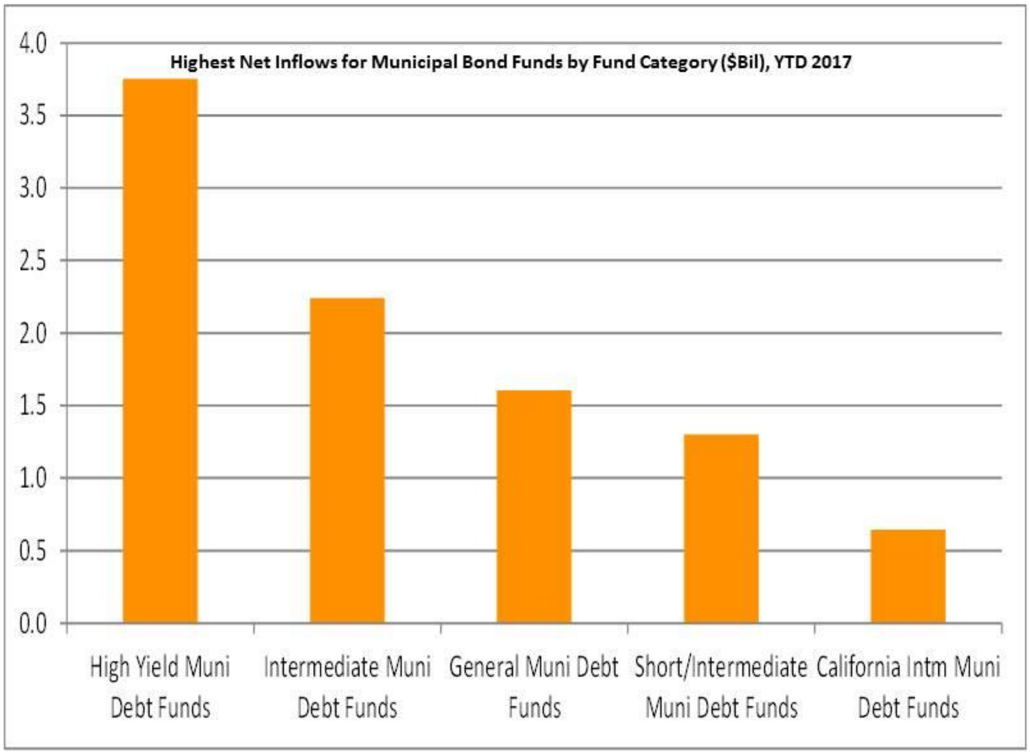
Connecticut state general obligations were downgraded by all three rating agencies last week. Among the concerns cited, reduced revenue projections, high and growing liabilities, and slow economic growth. The state is in the process of tapping its rainy day fund, depleting it's reserves. State employees recently accepted a three year wage freeze and will contribute more of their salaries to fund pensions.

Connecticut's budget deficit is $5 billion. Budget gaps have steadily increased as the state's fiscal condition continues to erode.

Rollover and Fund Flows

Supply and demand technicals in the municipal bond market are about to become much tighter as the upcoming summer redemption season gets underway. As much as $40 billion bonds are expected to mature or be called during the June to August time period. This will be in addition to $44 billion in coupon payments. The resulting $84 billion in potential proceeds to be reinvested in munis amidst light new issuance may support market performance. Year to date new issue supply is down 11% vs. 2016.

Municipal bond funds have experienced six consecutive weeks of inflows. According to Lipper, average weekly inflow to funds in 2017 is $218 million – although this number has spiked more recently. Excluding High Yield, muni funds have taken in $3.6 billion this year.



Lipper U.S. Fund Flows

Foreign investment in the municipal bond market continues to grow. Even without benefit of the tax-exemption, intermediate munis with 2.00% - 2.50% yields look attractive to overseas investors seeking safe havens in comparison with global sovereign debt yielding close to zero.

Tax Reform?

Reducing the corporate income tax rate from 35% to 15% may slow insurance company demand for tax-free munis, but a more likely reduction to 25% would have little impact. A cut in the top individual bracket from 39.6% to 35% would have marginal effect. Consider the taxable equivalent on a muni yielding 2.50%. At 39.6% tax rate, TEY is 4.14% and at 35% tax rate it is 3.84%. Ten year munis historically have traded at approximately 78% of US Treasury yields. Currently they are at 95% - priced as if there is virtually no tax benefit.

Eliminating the deduction for state and local income taxes would encourage demand for tax-exempt bonds from investors in high tax states.

What really matters?

Investors/advisors should be vigilant about the holdings in bond mutual funds, ETF's, and closed-end funds. Consider bond fund exposure to Puerto Rico, Illinois and other fiscally challenged credits. Revenue bonds with dedicated pay sources should be well-represented in a fund or separately-managed account.

From a market perspective, supply and demand dynamics can impact spreads at time of purchase. Steepness of the yield curve may also be an important factor in determining the optimal duration range for a particular investment objective.

For longer term investors, we continue to favor intermediate high coupon, callable bonds for their additional yield and defensive characteristics.

Please feel free to contact us anytime if you'd like to discuss the topics cited in this update, or any others related to the municipal bond market.

Riverbend Capital Advisors, LLC

121 West Wacker Drive

Chicago, IL 60601

312-948-5100