RIVERBEND
Capital Advisors

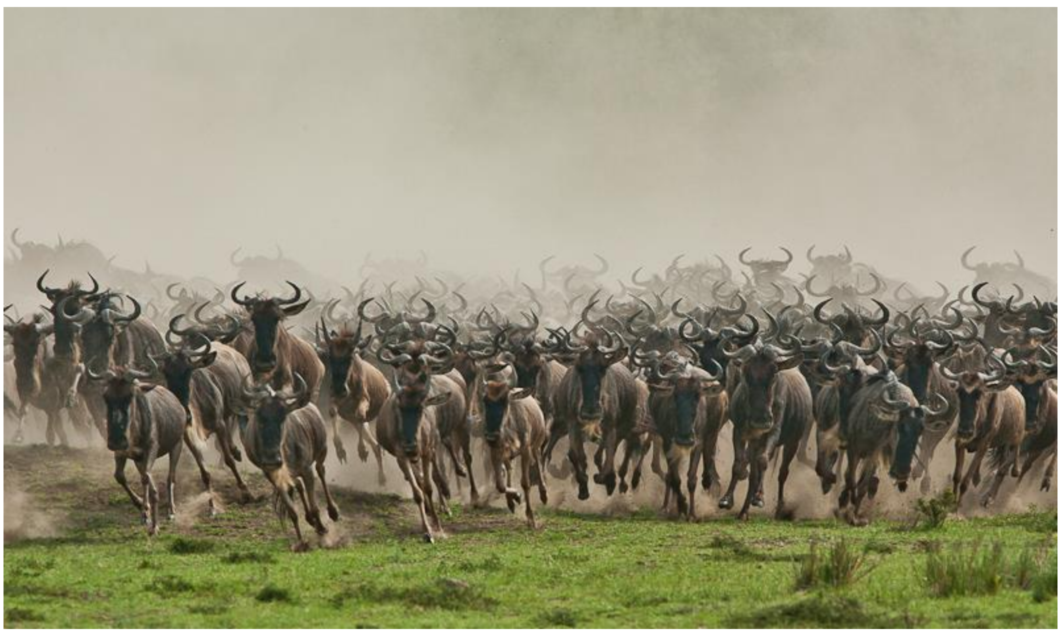
Municipal Rundown 12/1/16

Surprise!

Investors are piling into the reflation trade (and out of bonds) since being caught off guard by Donald Trump's election victory on November 8th. At a macro level, we've entered a high-risk, high-reward market environment. The reaction to this changed dynamic has been swift and somewhat extreme. Adjustment to potential new policies has manifested itself through much higher U.S. Treasury rates. Muni performance has followed suit, and then some. The BofA Merrill Lynch US Municipal Securities Index is off more than 3.3% in November.

One might consider this dramatic move to be an emotional overreaction, pricing in a high probability of significantly increased infrastructure spending and economic stimulus, material levels of deregulation, corporate and individual federal income tax reductions. While signs of a slow U.S. economic recovery continue to appear, the speed of the equity and fixed income market reaction seems aggressive given the possibility that these and other new initiatives (retaliatory trade policies and new tariffs, immigration crackdowns, deficit spending on infrastructure) may also produce an eventual drag on growth.

That being said, the muni market has a general tendency to overshoot to both the upside and downside in times of volatility. Think back to the Meredith Whitney chain-pull in 2010 and the “taper tantrum” of 2013. In those cases, a fairly orderly trend of rising rates was exacerbated by elevated levels of muni bond mutual fund redemptions. As managers were forced to sell into a soft market, bond prices were driven lower for months. While the degree of selling that the market experienced in those two situations (see page 3) has not been reached yet, it is rapidly approaching similar levels.



Individual investors comprise about 70% of municipal bond holders, either through direct ownership or bond funds. Muni bond mutual fund inflows and outflows can push momentum in the market. This occurred in the summer of 2013, as Fed Chairman Bernanke’s comments about the Fed possibly pulling back on its market accommodative policies initially roiled the market, only to have the situation exacerbated by Detroit’s bankruptcy and sudden media attention to Puerto Rico’s dire fiscal condition. If the current selloff is sustained for the next few weeks, funds are likely to experience more redemptions and munis will be cheapened further.

Tax Reform

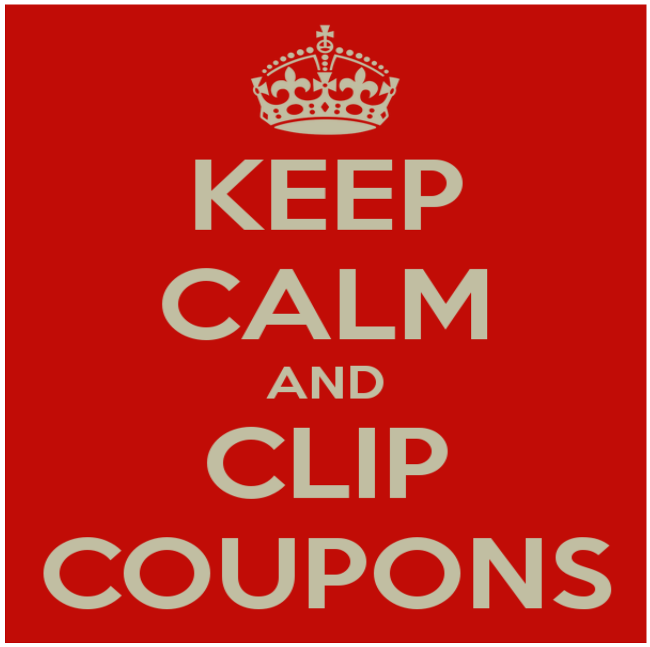
In theory, lower federal income tax rates should result in diminished demand for tax-exempt securities. Muni yields need to be higher in order to maintain taxable-equivalent, right? Interestingly, there has been virtually **no correlation** between muni yields and top tax rates historically. Since 1980, the highest marginal federal income tax rate has ranged from 28% to 70%. However, the muni market has significant participation from investors in the middle tax brackets. In fact, the average federal income tax rate for an individual muni investor has been fairly steady at 25% over this period.

Corporate income tax cuts may impact the longer end of the muni yield curve if enacted. Banks and insurance companies are holders of approximately 25% of outstanding municipal bonds. They tend to be buyers in the 15-30 year range. A reduction in the corporate tax rate from the current 35% to the 15% rate suggested by President-elect Trump during his campaign would likely diminish some of the institutional demand for munis on the long end of the curve, causing a steepening in that range.

Technicals

Muni underperformance during the November selloff has resulted in yields higher than comparable maturity UST's for the first time since early this year. Muni yields are more than 100% of Treasury's across the curve. New issue supply for 2016 is expected to end up at $333 billion, down 16% from last year. Much of this is attributable to fewer refundings, where volume was down 27% as rates drifted higher and the muni curve steepened. As typically happens in the 4th quarter, we are experiencing a surge in supply at the moment (bad timing). Issuers are attempting to price deals before the market "shuts down" in mid-December.

There are approximately $38 billion in coupon payments and principal maturities coming due between December and February. If most of those proceeds are reinvested in munis during a period of light issuance, it will create an element of support for the market.



Nearly $60 billion in bond issuance for municipal projects was approved by voters on November 8th, the highest level since 2008. While it could vary depending on infrastructure-related spending initiatives, expectation for 2017 is $350 billion in new issue. Factoring in the number of bonds maturing next year, this would mean an overall shrinkage of $80 billion outstanding as refunding opportunities continue to decline with higher rates.

Credit

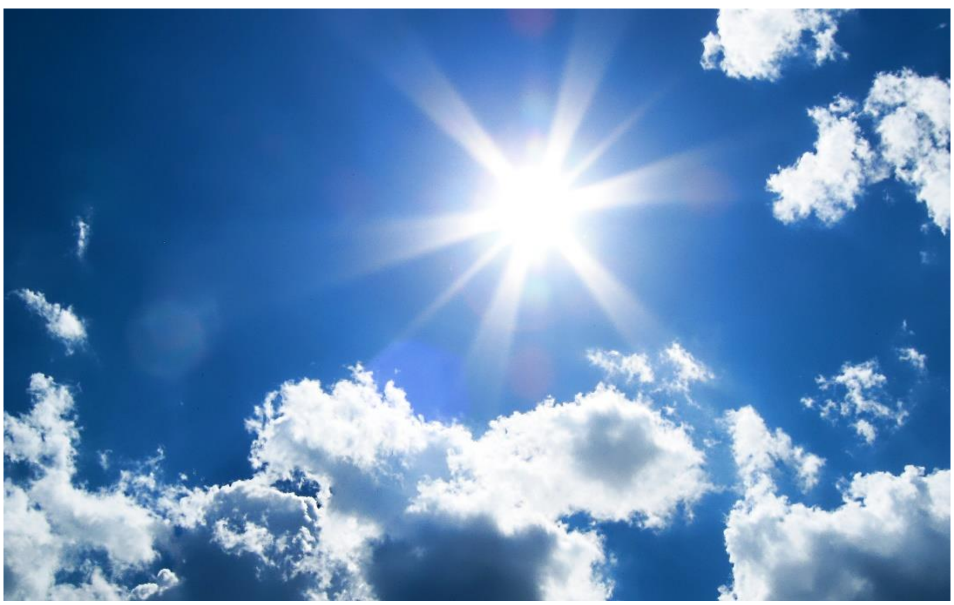
Total state and local tax revenue has increased for 17 consecutive quarters, although growth has slowed this year. In thirteen states, revenue has surpassed 2007 levels. Credit quality has been fundamentally stable and systemic risk has remained low in 2016. Although a lagging data point, Moody's upgrade / downgrade ratio is 77% this year – it's highest since 3rd quarter 2008.

Revenue sectors such as water and sewer utilities, public power, airports, toll roads, health care and higher education have experienced steady operating revenue and debt service coverage. Puerto Rico excluded, muni default rates this year are near all-time lows.

With regard to tax reform and potential impact on municipalities, the National Association of Counties has calculated that had municipal bonds been taxable during 2003-2012, interest expense to state and local governments would have been roughly $500 billion higher for the top 21 infrastructure projects in the United States undertaken during that period. If there had been a 28% cap on tax-exempt interest, the additional borrowing cost would have been $173 billion over this period.

Portfolio Positioning and Riverbend Capital:

Among the new muni market consensus investment recommendations being made in this changing rate environment is a shift to higher coupon (5%+) bonds in the intermediate and long end, given the defensive characteristics of this premium structure. For years we have consistently favored this strategy in our market duration portfolios, in anticipation of an eventual rise in rates. Given the recent selloff, a barbell approach combining short and longer maturities should be considered. Shorter bonds can provide stability while exposure to longer bonds takes advantage of the steeper yield curve and higher rates.



We expect volatility to continue over the coming weeks, at least through the Federal Reserve meeting in mid-December. At that point the market may experience more clarity about Fed plans for 2017 and Trump administration priorities. New issue muni supply for the year should be wrapped up around that time as well.

Keep in mind that ten year muni yields are more than 100 basis points higher than they were in June, much of that increase coming since election day. Significant uncertainly and risk have been priced in during a very short period of time. As we head into 2017, expect the market to continue to react to developments that materialize for fiscal stimulus, tax reform and deregulation and other policy shifts.

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.

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