Municipal Update 3/27/17

Munis 2017: What are the Concerns?

Limit the Tax Exemption? Not A Good Idea…

Could tax reform reduce the attractiveness of municipal bonds by capping or reducing the benefits of the tax exemption? In terms of the exemption's cost to the federal government, at $14.9 billion in 2016, it doesn't even fall into the top ten tax expenditures for individuals (see below). Reducing the exemption would disrupt a smoothly functioning, liquid market and would raise the cost of financing for state and local government entities. These costs would then be passed along to taxpayers. Two thirds of U.S. core infrastructure investments are financed in the muni market. It is an efficient mode of funding, which maintains local responsibility and control.

Estimated Cost of Major Individual Tax Expenditures
Billions of Dollars

Tax Expenditure	FY 2014	FY 2015	FY 2016	FY 2017
Exclusion of Employer-Sponsored Health Insurance	143	153	162	171
Exclusion of Net Pension Contributions and Earnings	109	120	135	147
Preferential Tax Rates on Capital Gains and Dividends	91	115	121	129
Deduction of Mortgage Interest	72	75	79	83
Earned Income Tax Credit (EITC)	67	67	66	65
Child Tax Credit	58	58	59	59
Deduction of State and Local Taxes	52	55	59	62
Exclusion of Capital Gains on Assets Transferred at Death	48	52	56	60
Deduction of Charitable Contributions (other than education and health)	35	36	37	39
Exclusion of Untaxed Social Security Benefits	34	36	37	39

Source: Joint Committee on Taxation, February 2013

Let's Cut Taxes!

If the top marginal income tax bracket is reduced from 39.6% to 33%, won't that diminish the appeal of tax-exempt munis? That seems like a reasonable assumption, but historically there has been virtually no correlation between tax rates and muni/UST ratios. Consider the relationship in recent decades:

	Top Tax Rate	**10 Year Muni/UST Ratio**
1982	50.0%	87.7%
1987	38.5%	91.0%
1990	33.0%	85.7%
1993	39.6%	93.5%
2009	39.6%	100.0%+

Data Source: Bloomberg

During Reagan and George W. Bush eras, taxes were reduced yet muni returns were positive. During Clinton and Obama presidencies, taxes were raised but muni/UST ratios increased.

Other notable considerations: Tax bracket for the average municipal bond investor is 25%. Taxable income for 75% of muni investors is under $200k per year. At muni/UST ratios of 100%+, the muni market is priced as though there were little to no tax benefit whatsoever.

Bring on the Rate Hikes

Is the FOMC rate hike cycle that we have seemingly embarked on going to decimate muni returns? Naturally there is concern about a bond selloff, given that it's been ten years since the last period of increasing federal funds rates. The market prices in expectations, and at this point a slow and steady approach likely resulting in three additional 25 basis point moves in 2017 is what's expected.

History doesn't guarantee future performance, but consider that muni returns have been better and volatility lower than US Treasury bonds during the last three Fed tightening cycles.

See below for 10 year muni performance during the tightening cycle *and* six months after end of cycle:

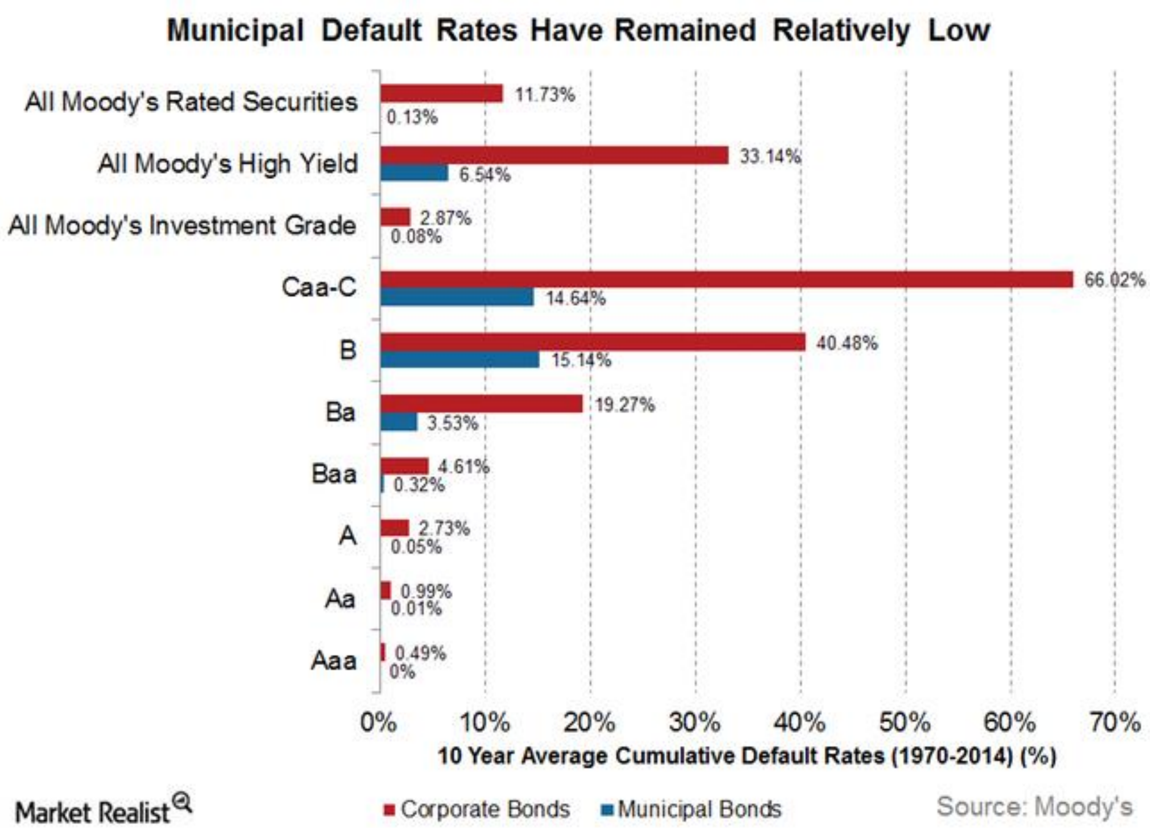
Period	**Magnitude of Rate Hikes**	**During Cycle**	**Six Months After**
2/94 – 2/95	+ 300 basis points	-3.49%	+8.55%
6/99 – 5/00	+175 basis points	+1.71%	+6.92%
6/04 - 6/06	+425 basis points	+7.81%	+4.77%

Bloomberg Barclays 10-Year Municipal Bond Index

Credit

How is muni credit faring in this environment? There are a broad range of sectors and many thousands of municipal bond issuers to consider, but credit quality is generally good and improving. Muni defaults in 2016 were the lowest since 2008, Puerto Rico excluded. Default rate on investment grade (Moody's) munis during 1970-2015 was 0.15%. Compare with global corporate bond default rate of 10.16%

The rate of state and local tax revenue growth moderated last year, and the Trump administration's budget proposal may inflict stress in the form of cuts to transportation grants, public housing funding, and other supports. However, credit rating (S&P) upgrades outpaced downgrades in 2016 as state tax revenue continued to recover and surpassed pre-financial crisis levels.



PR

As a firm, we are pleased to have avoided Puerto Rico (as well as Detroit and Illinois) in client portfolios since Day One. However, Puerto Rico remains in the headlines and is always a topic of interest. Last year Congress created a Puerto Rico fiscal oversight committee to try and put the Commonwealth's finances in order. Some market participants viewed this favorably and bond prices rose approximately 5% in the subsequent months.

Recently the oversight committee approved a budget that dedicated far less to debt payments than the market expected, and bond prices dropped to reflect this unanticipated development. An out of court settlement with bondholders seems remote and reaching a resolution is likely to be a long, drawn-out process.

Municipal bond mutual funds with significant Puerto Rico holdings have lagged market returns. Morningstar data shows that nearly half of muni funds have exposure to Puerto Rico debt. Funds managed by two fund firms together own approximately $14 billion of Puerto Rico's $72 billion outstanding.

Fortunately, the broader market continues to treat the Puerto Rico debt crisis as the unique and idiosyncratic situation that it is, and not as a representation of general muni credit.

Munis Look Good From Abroad

Foreign holdings of municipal bonds rose 16% in 4Q16 to a new record $106 billion. Foreign ownership has increased 32% in the last two years. Non-U.S. investors don't benefit from the tax-exemption, but seek out better yields in what they consider to be a low risk, safe haven asset class. Compare muni yields with Japanese bonds at negative yields inside ten years and zero out longer.

Market Technicals

With interest rates higher in 2017, the refinancing of muni issues has become less attractive and the volume of muni refundings this year will be diminished. This dynamic has resulted in consensus new issue supply forecasts of under $400 billion for the year. Expect more than $430 billion in maturities and called bonds over the same period.

Fix Those Bridges

Will massive stimulus in the form of $1 trillion in infrastructure spending flood the market with bond issuance and cause spreads to widen? The "plan" is for that $1 trillion to be spent over ten years, but at this point not many details are available. Probably too early to consider this an imminent or longer term threat to market performance.

Investor Behavior

There have been three 100+ basis points selloffs in the muni market over the last ten years, including Sep/Oct 2008 (Lehman Brothers collapse), Dec 2010/Jan 2011 (Meredith Whitney default prediction false alarm), and summer 2013 (Fed taper comments / Detroit bankruptcy / realization of Puerto Rico fiscal stress). In all three cases, principal was fully recovered within 3-12 months for investors owning bonds directly who did not sell.

Looking Ahead 2017

- Muni/UST ratios have risen to 100% in 10 years from 85% one year ago, so relatively inexpensive vs. other sovereign debt.
- Recent muni mutual fund flows have turned positive after three months of post-election outflows and redemptions.
- Higher rates will reduce new issue supply, adding to a favorable technical backdrop for the market.
- Muni credit remains fundamentally strong, and should continue to improve with the economy in general.
- Munis offer low risk diversification, given negative correlation to equity markets.
- 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.

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