RIVERBEND
Capital Advisors

Municipal Comment November 2018

Why Munis?

Performance: Municipal bonds outperformed corporate bonds in three of the last four Federal Reserve rate tightening cycles as measured by the Bloomberg Barclays Municipal Bond Index and the Bloomberg Barclays Investment Grade Corporate Bond index. On an after-tax basis, munis actually outperformed during all four rate tightening cycles that have taken place since 1987.

Diversification: Over the last ten years, investment grade munis have demonstrated approximately one third of the correlation that taxable corporate bonds have experienced relative to the S&P 500.

Manageable Supply: Total outstanding municipal market size has increased less than $200 billion since 2008, while the supply of taxable corporate debt has increased more than $9 trillion. Muni issuance is down 11% YTD.

Municipal Issuance ($billions)	2018 YTD	2017 YTD	YoY % Change
Tax-exempt	$237.79	$274.71	-13%
Taxable	$32.94	$35.25	-8%
AMT	$13.71	$11.19	26%
Total	$284.44	$321.15	-11%

Muni Yield Curve

Even when the UST yield curve has inverted, the muni curve has not followed suit and in fact has never experienced an inversion. Consider that municipal bonds are generally issued to fund long-term projects, so the structure of new deals tends to be more heavily weighted with bonds maturing in the intermediate and longer term. This combined with the consistent demand for shorter-term bonds by retail investors has long served to keep the muni curve steeper.

Backflow

Last week municipal bond mutual funds experienced a significant $1.3 billion outflow, more than double the previous week's outflow of $495 million. This was the sixth consecutive week of outflows. Muni fund redemptions are often the result of individual investors reacting to selloffs in the UST market. Flows are likely to remain choppy over the next several weeks as investors digest the election outcome and come to terms with declining fund valuations, and the market braces for the upcoming holiday periods with their diminished liquidity and dampened trading volumes.

Rising Tide

The muni market has come a long way since the late 2010 hysteria caused by banking analyst Meredith Whitney's bold but errant prediction of an imminent and unprecedented wave of muni defaults which never materialized. At that time, the market reacted with massive panic selling for several weeks before stabilizing when hedge funds and institutional buyers stepped in to take advantage of the disorder.

The current reality is that state and local credit fundamentals continue to improve. While there have been a handful of high-profile downgrades, the investment grade default rate for munis is extremely low. For fiscal year 2017, the average state pension funding level stabilized around 70%. Standard & Poors recently named states with the best funded pensions (91% - 100%) SD, WI, NC, NY ID and worst funded ((34% - 46%) IL, CT, NJ, KY, CO.

S&P also indicated that state and local credit conditions continue to trend positive. Tax cuts and higher federal spending have provided stimulus to fuel expansion.

The Old Dominion

Moody's comment on Virginia specifically. The state ranks first in terms of percentage of gross state product comprised of U.S. military spending. The world's largest naval base is in Norfolk, and the state is home to the Pentagon and numerous additional operations.

Virginia has a highly educated workforce and weak union protection. It has experienced vibrant population growth and a steady expansion of private sector. Local governments have flexibility to cut personnel costs and raise property taxes without voter approval.

Credit

We remain concerned about the credit profiles of states and municipalities with high levels of public employee pension and benefit liabilities, liberal arts colleges with low enrollment and small endowments, and small, non-profit hospitals with weak financials in competitive markets. We continue to favor essential service revenue bonds with secure income streams, general obligations of fiscally responsible state and local governments in growing areas of the country, larger colleges and universities with robust application and enrollment trends and ample endowments, and healthcare issuers that are part of larger systems whose debt includes strong security provisions.

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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