RIVERBEND Capital Advisors

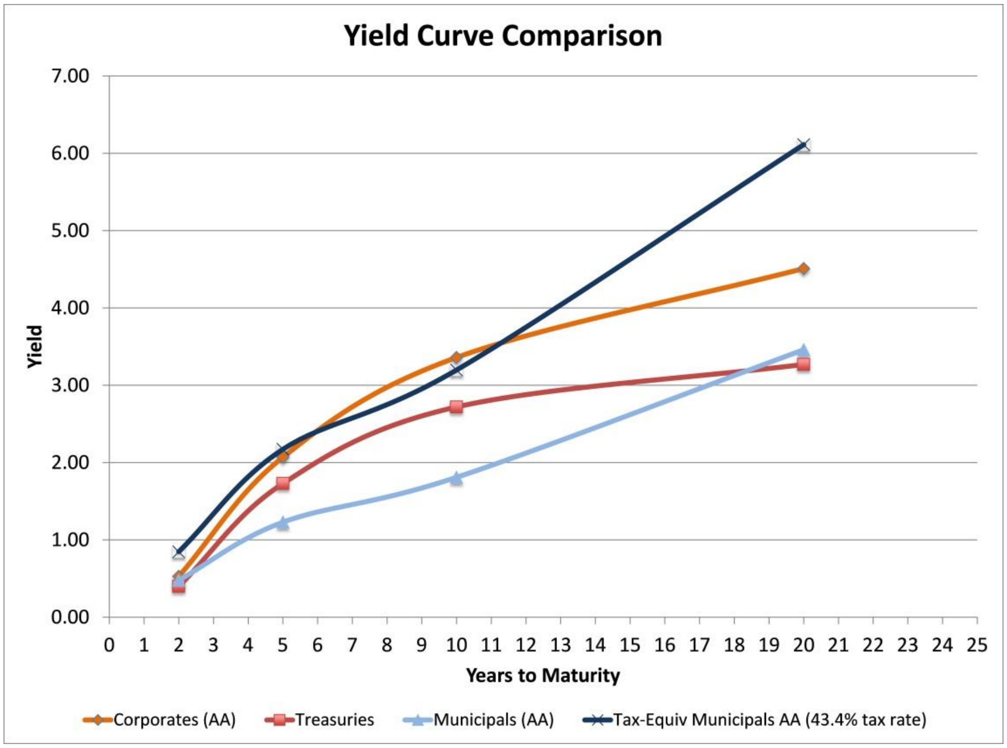
# Market Comment 10/29/14

# Muni Market Retrospective & Perspective

### *How Did We Get Here?*

At the start of 2014 there were few municipal bond market participants expecting much more than mildly positive returns, let alone stellar performance. As has often been the case in recent times, the general consensus was for a mediocre year at best as higher rates were widely anticipated. The negative credit developments in Detroit and Puerto Rico were still weighing on the market. Municipal bond mutual fund outflows, which had tallied more than $70 billion (of the approximately $500 billion total in muni funds) during 2013, were continuing. The outlook was middling at best.

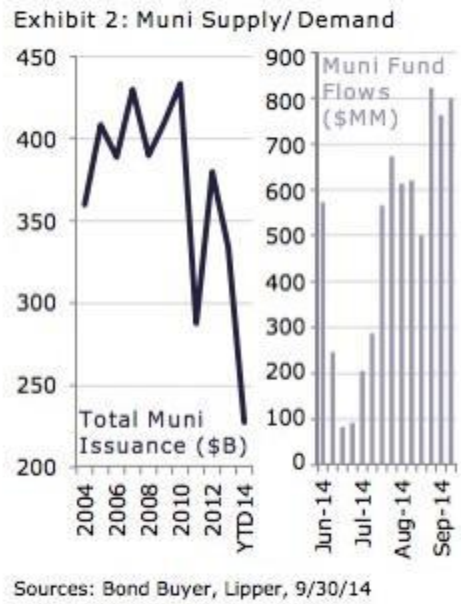
Surprisingly strong muni performance this year has been driven by a couple of key factors. On the demand side, one of those factors has been a realization of the after-tax attractiveness of munis. During the first quarter as many investors prepared their 2013 tax returns, the reality of the new higher 39.6% top tax bracket (up from 35%) settled in. Capital gains tax rates went from 15% to 20%. The 3.8% Medicare surtax took effect in 2013 as well. This new levy applies to investment income such as dividends and taxable bond interest – but not to municipal bond interest. In effect, munis could now be compared on a taxable-equivalent basis using a top rate of 43.4% - which doesn't include state income taxes where applicable. So for example, a 3.00% tax-exempt yield has a 5.30% taxable equivalent yield. See Exhibit One for tax-adjusted comparison:

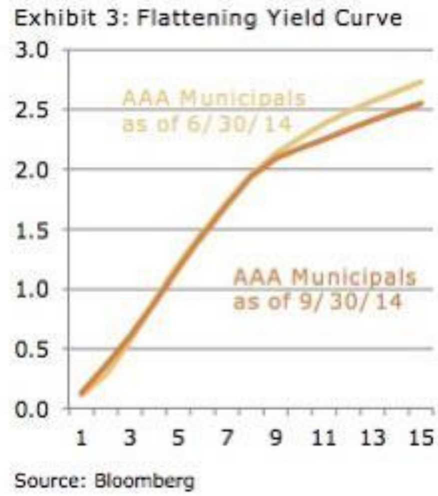



## *Credit Quality Up, Muni Supply Down*

A second and perhaps even more important contributing factor to 2014 muni performance has been the supply dynamic in the market. Muni issuance through the third quarter was $225 billion, down $31 billion vs. the same point in 2013. Diminished new issue supply has been the result of restrained borrowing at the state and local level, as governments have become less likely to add to debt burdens. Additionally, sales, income, and property tax revenues have risen steadily as the U.S. economy improved – further reducing the need for bond issuance.

The trend of broadly improving municipal credit quality continues. While there have been high profile and unique circumstances in Detroit and Puerto Rico, economic conditions continue to be generally positive for states and municipalities. Most have seen tax revenues exceed pre-recession 2008 peak levels. Budgets in 49 of 50 states were completed on time - by the start of the July 1 fiscal year. Rising revenues and fiscal restraint have strengthened balance sheets and enabled municipalities to issue fewer bonds.




Default risk remains low. Bankruptcies are rare and tend to be concentrated in unrated, project specific issues. For some investors it may be appropriate to consider lower-rated, investment grade bonds. To move down in credit rating from AAA to A rated in the same maturity range, the current approximate yield pickups are as follows:

| | |
|---|---|
| 5 year | 0.38% |
| 10 year | 0.63% |
| 20 year | 0.58% |

## *Looking Forward*

Fourth quarter can be an interesting period in the muni market. Thanksgiving and the holiday season cut into time available for transacting. Issuers often attempt to get deals to market before yearend. Liquidity tends to dry up in mid-December as trading desks have locked in their P&L for the year.

Expect total 2014 issuance to come in at $310 billion, down about $40 billion from 2013 and continuing a trend of declining outstanding supply since its peak in 2010. We anticipate a mild 4$^{th}$ quarter surge in supply as municipalities take advantage of lower yields to refund outstanding issues. However, the market should be able to digest whatever is issued given $28 billion in maturities and $29 billion in coupon payments during the 4th quarter.

Of the few substantial bond measures on state ballots this election cycle, California and New York have the most meaningful. Bond initiatives are sparse at the local municipal level as austerity and fiscal discipline continue to be common themes.

Cash still doesn’t pay in this environment. For short-term investors, the 18 month to five year range makes sense. And for those with a longer-term horizon, there is value in the 8-12 year intermediate range. The muni yield curve is steep there with better roll.

Looking out beyond 4Q, let’s consider muni performance in rising rate environments of the last 20 years. In 1994, the ten year US Treasury yield rose 205 basis points. Intermediate munis as represented by the Barclays 7yr Muni Index were down 2.77%. In 1999, UST10 yield was up 178 basis points and the Barclays Muni Index was -0.14%. And in 2013, UST10 yield up 123 basis points, the Index was -0.97%. This certainly doesn’t mean that intermediate munis will always outperform in a rising rate environment, but it’s an interesting look back.

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