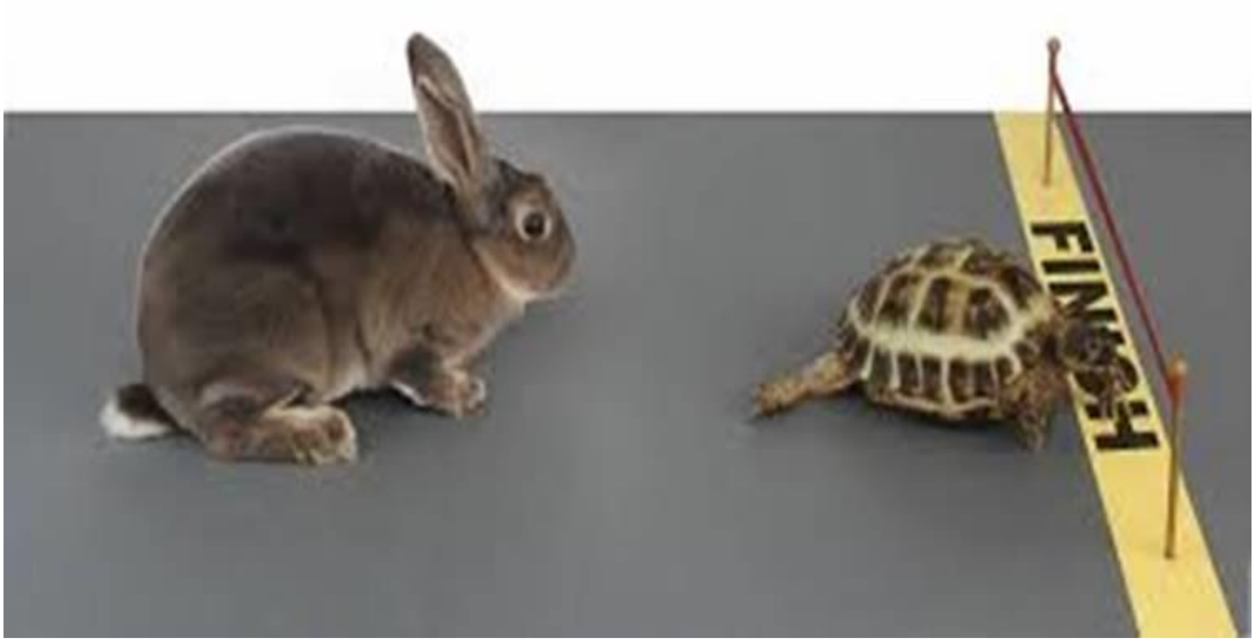
Municipal Comment

January 2019

Slow and Steady

Municipal bond market performance, as measured by the Bloomberg Barclays Municipal Index, ended up 1.28% last year. The broad market benchmark return was positive for the fifth consecutive year. Muni return adjusted for taxes was approximately 4.90% in 2018! The municipal bond market outperformed nearly all other fixed income as well as equity indexes.



Munis tracked the US Treasury market selloff in the first half of last year. Many investors shortened duration, exacerbating weakness in the intermediate and long end of the muni yield curve. By late spring, supply technicals began to take hold and the market experienced a significant mid-year rollover. Additionally, USTs stabilized, leading to a better performance in the summer and early fall. The ride continued into the third quarter with munis again selling off when faced with general bond market volatility, which resulted from trade war and geopolitical stress and concerns surrounding the US mid-term elections. Late in the year, light new issue supply and a market flush with reinvestment cash helped munis close out 2018 with a strong tailwind.

Supply & Fund Flows

Tax reform enacted in late 2017 ended municipal advance refundings. This led to diminished muni new issue supply last year, although not by as much as anticipated due to an increased volume of state and local infrastructure projects being financed. Total new issue supply for 2018 was approximately $340 billion. Net supply, the total amount of new issuance minus the total amount of debt that is called, refunded or reaches maturity, was negative $45 billion last year.

Municipal bond mutual fund flows tend to be a lagging indicator as retail fund investors chase performance after bond rallies or flee the market after experiencing negative returns. Flows were positive in early 2018, but spring bond market losses soured investor interest in funds, leading to outflows. Mid-year supply/demand dynamics lifted performance which attracted money back to muni funds. Fall market weakness turned flows negative once again, and investment grade municipal bond funds ended 2018 with a total outflow of $3 billion.

Munis With Benefits

The most obvious advantage of investing in municipal bonds is the tax exemption. Tax reform has had a negligible impact on the taxable equivalent yield provided by munis. Taxpayers in many states may realize during the next few months that they have actually experienced little, if any, tax cut after the reduced State & Local Tax Deduction (SALT) is taken into account. This will be especially pronounced in high tax states like California, Connecticut, New Jersey, New York, Massachusetts, and Maryland.

The stability of the muni asset class is another part of its appeal. Municipals generally have higher credit quality and generate consistent levels of income over time. Price return can be sensitive to macro trends across fixed income markets, but coupon income has historically provided a stable portion of total returns in the municipal market.

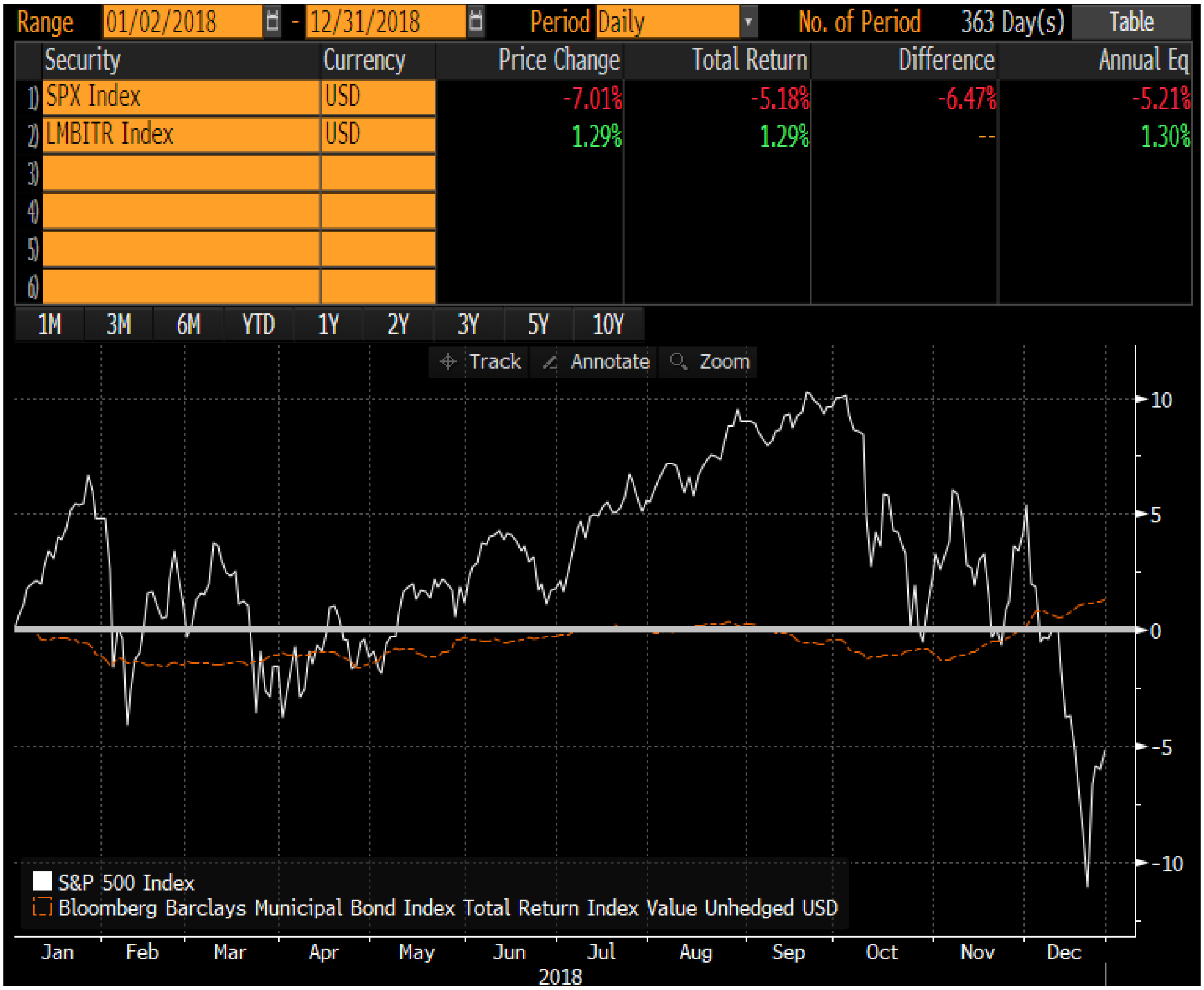
Figure 1: Muni outperformance during equity bear markets

Start date	End date	S&P 500 return	Bloomberg Barclays Municipal Bond Index total return	Bloomberg Barclays IG Corporate Bond Index total return (before taxes)	Bloomberg Barclays IG Corporate Bond Index total return (after taxes*)	Muni outperformance versus equities	Muni outperformance versus IG corporates (before taxes)	Muni outperformance versus IG corporates (after taxes)
7/17/98	10/9/98	-17.05%	2.97%	2.41%	1.86%	20.03%	0.56%	1.11%
7/16/99	10/15/99	-12.08%	-2.17%	-1.19%	-1.80%	9.91%	-0.97%	-0.37%
9/1/00	4/4/01	-27.45%	6.00%	7.98%	6.42%	33.45%	-1.98%	-0.42%
5/21/01	9/21/01	-26.43%	3.65%	3.97%	3.14%	30.09%	-0.32%	0.51%
3/8/02	10/9/02	-33.29%	7.71%	5.05%	3.63%	41.00%	2.66%	4.08%
1/14/03	3/10/03	-13.33%	2.41%	3.42%	3.07%	15.74%	-1.00%	-0.66%
10/9/07	3/10/08	-18.64%	0.97%	2.03%	1.16%	19.62%	-1.05%	-0.18%
8/11/08	3/9/09	-48.17%	0.40%	-6.32%	-7.55%	48.57%	6.71%	7.95%
4/23/10	7/2/10	-15.99%	1.33%	2.33%	1.95%	17.32%	-1.00%	-0.63%
7/7/11	10/3/11	-18.77%	3.86%	3.01%	2.59%	22.63%	0.85%	1.27%
7/20/15	8/25/15	-12.25%	0.77%	0.28%	0.14%	13.02%	0.49%	0.63%
11/3/15	2/11/16	-13.31%	3.15%	0.10%	-0.29%	16.46%	3.05%	3.44%
1/26/18	2/8/18	-10.16%	-0.79%	-1.32%	-1.36%	9.36%	0.52%	0.57%
Average		**-20.53%**	**2.33%**	**1.67%**	**1.00%**	**22.86%**	**0.66%**	**1.33%**

Source: Bloomberg as of July 2018. *Assuming 35% federal rate.

The S&P 500 lost more than 6.00% in 2018, while the S&P Municipal Bond Index posted a 1.36% gain. The negative correlation of municipal bond and equity returns underscores the importance of municipal bonds as a portfolio diversifier. The Bloomberg Barclays Municipal Bond Index has approximately one quarter the correlation to the S&P 500 than that of the Bloomberg Barclays US Credit (corporate) Index.

Figure 2: Bloomberg Barclays Muni Index vs. S&P 500 for 2018



Cautions Optimism on Credit

Standard & Poor's believes states may experience fiscal stress in 2019 if its baseline economic forecast of slower growth for 2019 pans out. S&P expects that credit quality will remain stable for most states but also believes that as the effect of federal fiscal stimulus fades, the pace of economic growth could decelerate this year. S&P indicates there is "some risk to state credit quality" if state governments embark on significant spending after experiencing a surge in revenue for 2018. However, continued fiscal restraint may prevail as state funding for social services and higher education have yet to fully recover recession driven reductions. Pension systems in Illinois, Kentucky, and New Jersey were noted for their abysmal funding ratios, at or below 40%. S&P displayed each state's level of budget reserves. Alaska ranked the highest with FY19 reserve fund at 452% of expenditures. This compares favorably with Illinois' 0.0%, Pennsylvania's 0.1%, and Arkansas' 0.8%.

S&P has a stable outlook for the U.S. non-profit health care sector in 2019, citing "continued balance sheet strength, a long-term trend of improving business profiles from mergers and acquisitions, and a growing array of diversifying joint ventures." Operating margins throughout the sector continue to improve.

2019

We prefer higher quality, liquid bonds in the current environment. Extending somewhat further into the intermediate part of the yield curve is worth consideration. The 10-30 year yield curve slope is steep as banks and insurance companies have retreated from the longer end of the market. Investors might consider lengthening duration and filling this void. We continue to favor bonds with higher coupons and slightly shorter call dates for their defensive characteristics and incremental additional yield.

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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