Municipal Comment June 2018

Roll Over

Summer is historically a time of positive muni performance. Due to a significant concentration of maturity, call and coupon payment dates in June, July and August, mid-year in the municipal bond market is characterized by heavy reinvestment of those proceeds. New issuance is 21% lower this year compared with 2017 and should have been a positive for bond prices in 2018, but the reduction in supply has been offset by significant retrenchment in demand from banks and insurance companies following last December's tax reform. The negative net supply for this seasonal rollover is expected to be $75-$80 billion, potentially supportive of market returns. That negative supply estimate is approximately 45% larger than 2017.

Municipal bond yields across the curve are considerably higher than last year's summer rollover period and taxable equivalent yields are exceeding 5.00% for high quality intermediate bonds. Munis could be positioned for a spike in demand.

Bottoming Out?

The Illinois' General Assembly passed its $38.5 billion budget on time. The bipartisan plan sailed through the legislature with votes of 58-2 in the Senate and 97-18 in the House. Education spending increased by $407 million but there are spending cuts to the Department of Corrections and a broad array of services. The budget includes approximately $444 million in pension savings through buyouts and other changes as well. It is now awaiting the governor's signature. While being characterized as a credit positive for a state that flirted with sub-investment grade credit ratings last year, this budget is predicated on numerous optimistic assumptions about tax revenue growth and asset sales. Should they materialize, this would potentially represent a turning point / glimmer of hope in a state that has experienced years of fiscal deterioration

Connecticut's April net revenues of $2.6 billion were up $537 million or 26.0% on a year-over-year basis. This was primarily due to significant increases in income tax, sales and use tax and healthcare tax receipts. For the fiscal year-to-date, collections of $13.7 billion are up $1.8 billion, or 15.1% compared to the same period last year.

Drops in the Bucket

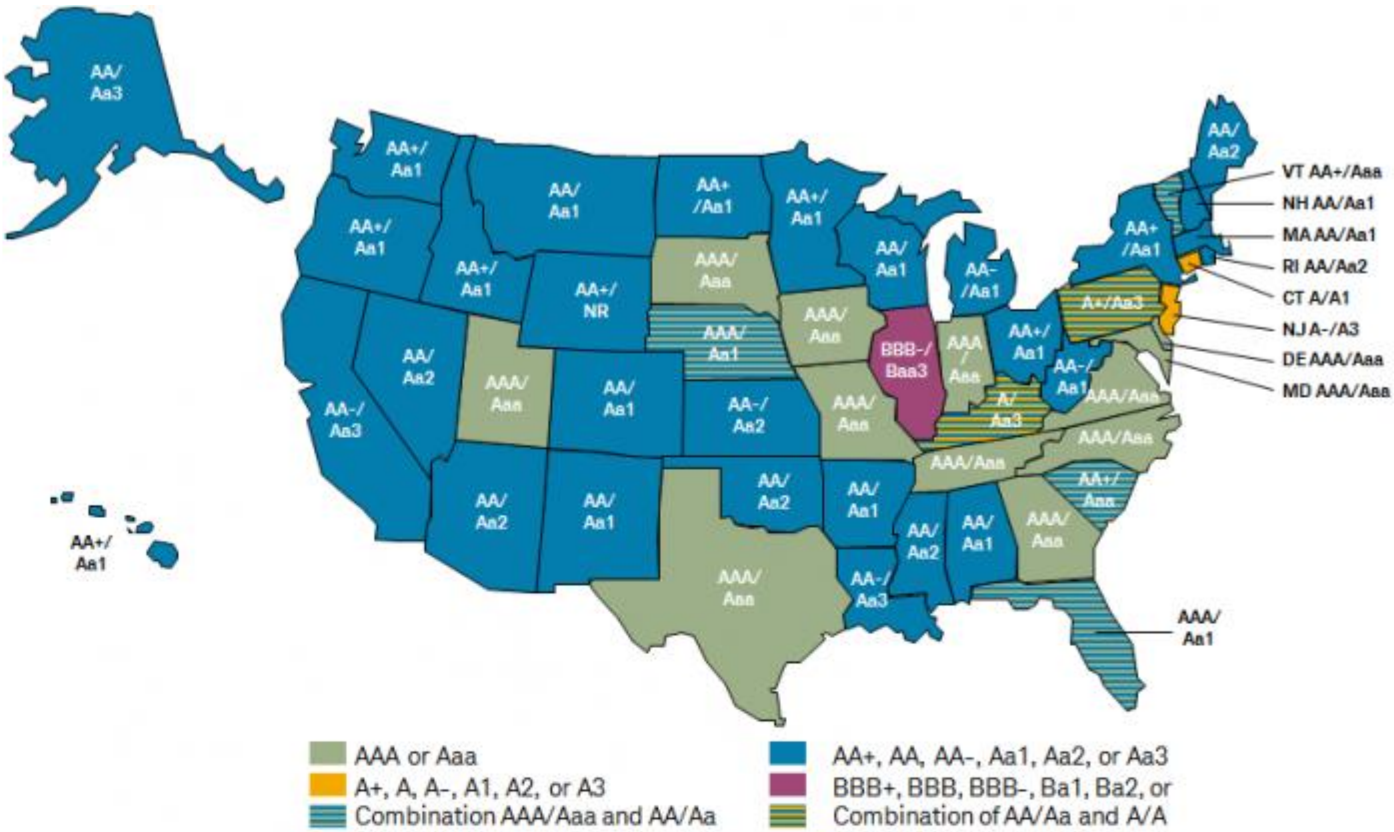
Recent developments in some states have been perceived as beneficial to state tax revenues, however actual impact is likely to be small. Crude oil prices are up about 70% since this time last year. While the increase is a positive development for states with large oil and gas industries, the incremental benefit to an economically diverse state such as Texas will not be overly significant. States with smaller economies like North Dakota will experience more of a credit boost.

Recreational marijuana sales became legal in California on January 1st. Currently 30 states have approved some form of marijuana use. Colorado was the first state to legalize, and it taxes sales at a rate of 30%. However only about 5% of this tax revenue ends up in the state's general fund.

A U.S. Supreme Court decision announced on May 14th ended the prohibition on sports gambling. New Jersey had brought the suit and is likely to join Nevada as the second state to allow sports betting. State tax revenues from sports gambling aren't expected to contribute more than a fraction of a percent.

State of the States

As baby boomers retire, state budgets are likely to feel a financial pinch as they face growing pension obligations and related unfunded liabilities. The shrinking proportion of working-age adults-to-retirees may not generate enough revenue to support the generous pensions that many states' defined benefit plans have promised. This could necessitate reduction in services, increases in taxes, additional pension reforms, or some combination of the three in coming years.



Source: Standard and Poor's as of 5/18/2018 and Moody's as of 5/22/2018

Most state economies are not overly reliant on one type of revenue source and their credit quality is strong. States are required to balance their budgets every year, unlike the U.S. government. If they face shortfalls, they must cut expenses and/or raise taxes. A recent Moody's study of the top 15 state issuers of municipal bonds ranked their financial preparedness for a potential moderate economic recession. They concluded that Texas was the strongest given large cash reserves as a percentage of annual revenue. Not surprisingly, Illinois ranked last. Most states are well-positioned to pay debts and their credit quality has improved significantly since the Great Recession ten years ago.

Cities in Motion

The U.S. Census Bureau recently released a report on city population change and ranked Frisco, Texas as fastest growing. Three of the top five cities were in Texas and eight of the top 15 were in the south.

Casper, Wyoming felt the largest percentage decline while Baltimore, Maryland experienced the largest numerical decline. San Antonio, Texas saw the largest numerical increase. Only three of the nation's top 25 most populated cities saw population declines year-to-year: Chicago, Detroit and Memphis. For Chicago, 2017 represented the third consecutive year of population loss.

Midland, Texas led the nation in employment with an 11.5% year-over-year increase as its economy benefitted from natural resource industries. San Mateo, California and Ada, Idaho led in wage growth. Shawnee, Kansas and Caddo, Louisiana saw the largest employment declines. Clayton, Georgia wages experienced the largest decline in the country as a result of shrinking trade and transportation sectors in that region.

Generally Speaking

With regard to proactive ongoing muni portfolio management, investor considerations should include:

- Is the portfolio customized according to risk profile and investment objectives?
- Has anything changed with the investor situation?
- Have there been material events affecting any of the credits held in a portfolio? (Municipal issuers may become stronger or weaker over time)
- Has the yield curve changed? Bonds maturing two years and less are offering roughly 60% of the yield in the market, compared to a five-year average of 21%.
- Is the portfolio sufficiently diversified geographically and in terms of sectors? (general obligation, utility, health care, higher ed, etc)

Income is generally the largest driver of total return for fixed income investors. An actively managed, laddered strategy that methodically reinvests the consistent cash generated by coupon payments and maturities can be an effective mechanism to manage a fixed income portfolio in a rising rate environment. This structure also allows investors to capture yields as rates rise, increasing the cash flow of a muni portfolio.

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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