Municipal Comment

March 2019

Muni Trifecta

The municipal bond market is experiencing its best first quarter performance in five years, returning approximately 1.90% year-to-date, according to Bloomberg Barclays muni indexes, outperforming other U.S. fixed income over the same period. Muni funds have seen inflows of nearly $15 billion. Not exactly what investors expected six months and many basis points ago.

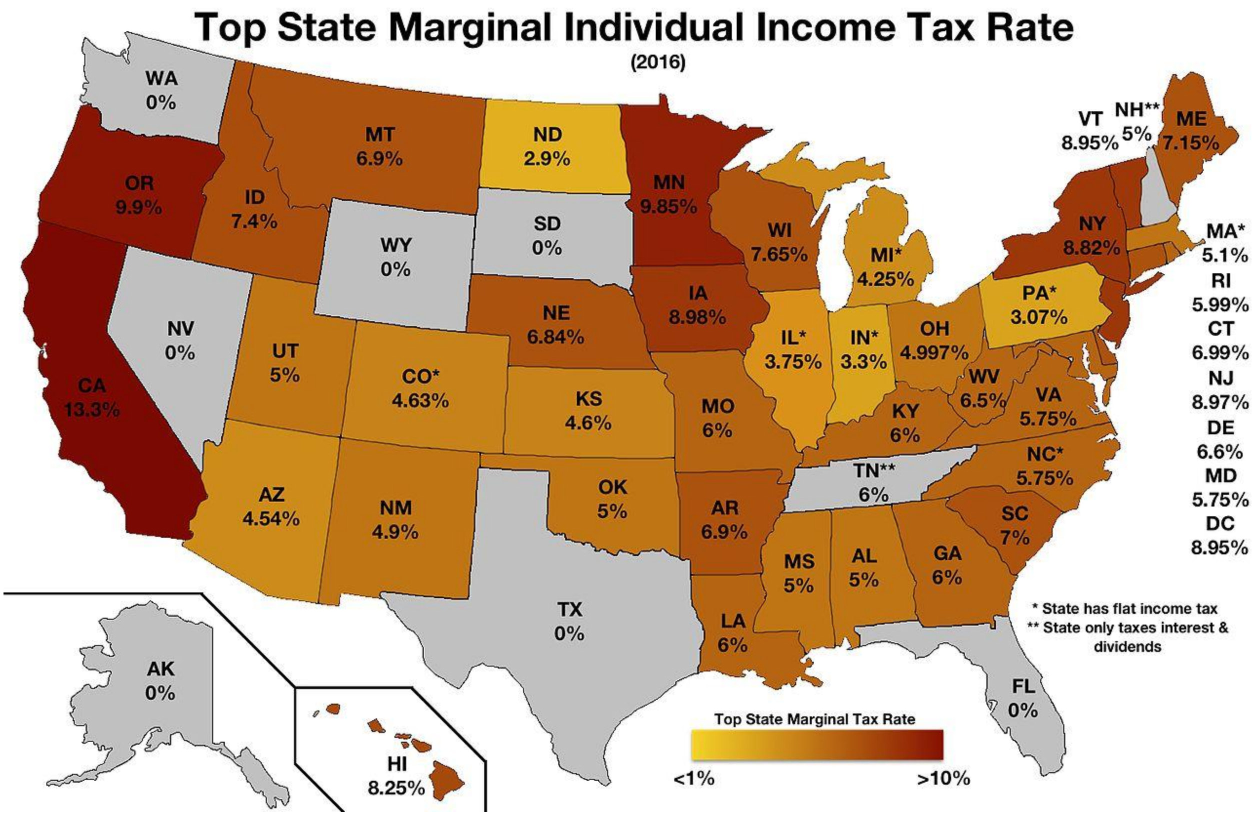
Timeframe	Municipal Bonds	Total U.S. Fixed Income	U.S. Government Bonds
YTD (3/1/19)	1.22%	-0.04%	-0.23%
1-Year	3.92%	2.68%	2.60%
3-Year	2.31%	1.75%	0.59%
5-Year	3.43%	2.28%	1.66%

*Total Return Comparison (Source: Morningstar)

What's driving this remarkable run? Obviously, the Fed's decision to put it's tightening of monetary policy on hold is part of it. Other factors include slowing global economic growth, falling bond yields in Europe, U.S. stock market volatility and uncertainty in Washington about issues such as U.S./China negotiations and immigration policy.

Tax Reform Blues

In addition to the general direction of interest rates, muni performance has been propelled by elements of the Tax Cuts and Job Act enacted at the end of 2017. In theory, lowering the top federal income tax bracket from 39.6% to 37% should have reduced investor appetite for tax-exempt bonds. However, the tax reform law capped state and local tax deductions (SALT) at $10,000 This hit taxpayers in high tax states like California, New York and New Jersey particularly hard. In February a report from the Treasury Inspector General for Tax Administration estimated that 11 million taxpayers would be negatively affected by the cap on this deduction.



Munis should experience a continuation of strong demand from individuals as the April 15 federal income tax deadline passes and investors come to the realization that their tax liabilities exceed prior years due to lost deductions.

With the 2020 presidential election on the horizon, Democratic candidates and politicians increasingly advocate higher taxes on wealthy Americans. This phenomenon may result in increasing interest in remaining tax-advantaged investments such as municipal bonds.

Credit

Moody's recently reported continued improvement in muni credit quality, with rating upgrades outpacing downgrades in 2018. Sector improvements in state and local debt, infrastructure, utilities and housing offset downgrades in higher education and healthcare.

Municipal credit quality in 2019 is likely to remain stable given strong fundamentals. Recent state and local government economic and fiscal statistics showed positive trends in revenue growth. Most municipalities are adding to rainy day reserve funds and limiting their debt burdens.

That being said, we continue to favor issuers and sectors that are likely to be more insulated from an economic downturn. These include essential service revenue-backed bonds issued by municipal enterprises that maintain pricing power and credits less vulnerable to contractions in consumer spending.

Yield Curve Positioning

Institutional investors have traditionally supported the long end of the muni curve, purchasing long bonds while individual investors gravitate to shorter- and intermediate-term maturities. According to Fed data, bank muni holdings dropped 13% in 2018, while insurance company holdings increased slightly by 4%. Individual investors increased their direct muni holdings by 8% and mutual fund holdings were up 2%. Diminished interest in munis from banks and insurance companies in the aftermath of tax reform has resulted in a steepening in the muni yield curve just beyond ten years.

For individuals with longer term investment horizons, a steeper municipal yield curve can create opportunity. Muni investors may benefit from extending duration to reach higher levels of roll down and carry. It's been a while since we advocated a barbell approach, but in the current environment we believe it is worth serious consideration. Given that lower duration muni yields are "anchored" by short-term rates, a combination of longer-intermediate and short-term munis can generate reasonable yield while maintaining the intermediate duration that we typically target in market duration portfolios.

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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