

# Municipal Fixed Income

## Quarterly Market Commentary

Third Quarter 2017

### Key Themes

- The S&P Municipal Bond Index returned 0.99% for the third quarter of 2017, strongly outperforming the broad U.S. Treasury market index.
- The persistence of steady-to-declining interest rates across most of the yield curve added to performance over the quarter.
- The yield curve steepened in the quarter, as 30-year rates increased while 2-year rates declined.
- Municipal credit market spreads declined moderately, reaching new lows for the year and adding to overall performance.

### Municipal Market Review

Conditions remained conducive to ongoing positive total returns during the third quarter. The S&P Municipal Bond Index gained 0.99% over the third quarter adding to a total year-to-date return of 4.28% (Table 1). Throughout 2017, the environment has reflected a benign economic outlook, positive technical factors, and an otherwise absence of potential negative catalysts. Indicative in the total return performance, AAA municipal rates remained steady or declined at almost every point excluding a 5 basis point uptick in the 30-year rate. Short-term rates moderated in harmony with a quiet Federal Reserve, which paused its rate-raising campaign in the quarter. Municipal credit benefited as risk premiums among investment-grade securities declined to new lows for the year.

While rates have declined overall in 2017, the yield curve has oscillated in each successive quarter and the third quarter saw a steepening. The 2-year rate dropped by 6 basis points (bps), while the 10-year rate rose by a single basis point. The 30-year rate made its own contribution to the steeper curve by increasing 5 bps (Table 2). Absolute returns favored longer-duration portfolios, as the price sensitivity and coupon accrual overcame otherwise similar movements on the shorter end of the term structure. The steepening curve ended with a slope of 183 bps from the 2-year rate to 30-year rate as compared to a 173 bps slope in the prior quarter or an 11 bps change (Table 3). The municipal sector significantly outperformed risk-free rates as the broad U.S. Treasury market index generated 0.38% total return as compared to 0.99% for the municipal

TABLE 1 Index	S&P Municipal Bond Index Returns 3Q17			YTD Total Return 2017
	Total Return	Price Return	Interest Return	
Main	0.99%	0.43%	0.56%	4.28%
Intermediate	1.07%	0.57%	0.50%	4.63%
Short-Intermediate	0.62%	0.26%	0.36%	3.02%
Short	0.46%	0.17%	0.29%	1.76%

Source: Standard and Poor's

TABLE 2 Date	AAA Municipal Rates					
	SIFMA	2 Yr	5 Yr	10 Yr	15 Yr	30 Yr
12/31/16	0.72%	1.21%	1.79%	2.31%	2.63%	3.04%
3/31/17	0.91%	1.02%	1.55%	2.25%	2.69%	3.05%
6/30/17	0.91%	1.06%	1.35%	1.99%	2.44%	2.79%
9/30/17	0.94%	1.00%	1.35%	2.00%	2.38%	2.84%
Quarterly change	0.03%	-0.06%	0.00%	0.01%	-0.06%	0.05%
YTD change	0.22%	-0.21%	-0.44%	-0.31%	-0.25%	-0.20%

Source: Thomson Reuters, Bloomberg

TABLE 3	Municipal Yield Curve Slope			
	12/31/16	3/31/17	6/30/17	9/30/17
2-year rate	1.21%	1.02%	1.06%	1.00%
30-year rate	3.04%	3.05%	2.79%	2.84%
Slope	1.83%	2.03%	1.73%	1.84%

Source: Thomson Reuters

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main index. The municipal to U.S. Treasury ratio declined by 2 points ending the quarter at 85%, the richest relative evaluation for municipals since 2016 (Table 4).

The Federal Open Market Committee met twice during the quarter and left policy rates unchanged, reaffirming a federal funds rate target range of 1.00% to 1.25%. The Fed asserted that inflation could remain below the 2% target over the next 12 months, but also declared that the balance-sheet normalization program would commence in October 2017. Short-term rate markets were relatively unchanged as 3-month LIBOR moved just 3 basis points higher quarter over quarter, ending September at 1.33%. Accordingly, SIFMA ended the quarter at 0.94%, or approximately 71% of LIBOR. Federal funds futures imply a 66% probability of one additional rate increase in 2017, as the Fed maintains a balanced approach to its policymaking.

The third quarter ended without significant Federal policy changes. An effort to repeal and replace the Affordable Care Act (ACA) materialized late in the quarter, though the Senate was unable to get the 51 votes necessary to accomplish this through its reconciliation process. Inaction on health-care reform has benefited the not-for-profit health-care sector, though the debate is not finalized. Congress will keep health-care reform as a back-burner political narrative as tax reform efforts take center stage.

Just prior to the close of the quarter, Republican leadership released an outline for tax reform,<sup>1</sup> which called for lower individual and corporate tax rates and the elimination of many itemized deductions including those for state and local taxes paid. Pertinent to the municipal market, the outline did not specifically address tax-exempt interest, but it did include mention of elimination of the individual Alternative Minimum Tax. Effecting large-scale tax reform will require significant dialogue and final legislation is unlikely to resemble the initial framework. As such, any impact on the municipal market would likely be felt beyond 2017. We will continue to monitor Federal policy initiatives to determine which municipal sectors and security structures will outperform or underperform given legislation.

Bond issuance in the third quarter was \$86.6 billion, a decrease of 24.8% from the \$115.3 billion issued in the third quarter of 2016. Financing for new projects, versus refinancing transactions, constituted a larger portion of the supply compared to 2016, albeit on a lower total volume. The largest issues for the quarter were \$2.5 billion California state general obligations, \$1.95 billion Bay Area Toll Authority bonds, and \$1.35 billion New York City Transitional Finance Authority bonds, each occurring in August. Year-to-date supply was \$285.7 billion, a decrease of 16.2% from the \$340.8 billion issued year to date in 2016.

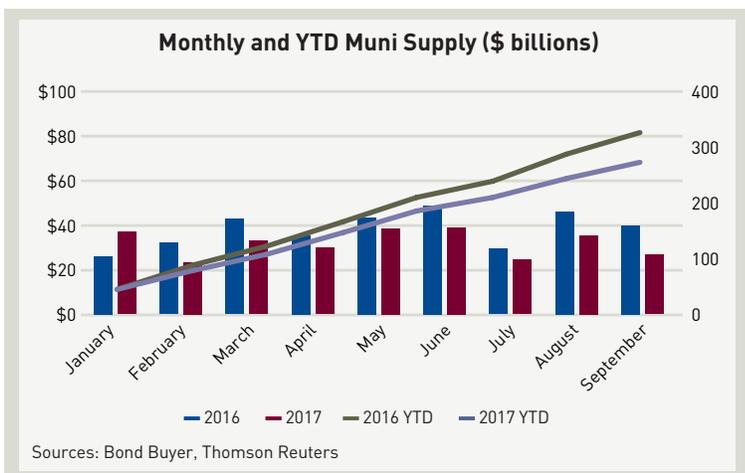
**TABLE 4** Municipal to Treasury Yield Ratios  
10-year Ratios

Date	Ratio
12/31/16	0.95
3/31/17	0.94
6/30/17	0.87
9/30/17	0.85

Source: Thomson Reuters

Supply (\$000s)	2016	2017	% YOY
QTD	\$115,284	\$86,641	-25%
YTD	\$340,807	\$285,720	-16%

Sources: Bond Buyer, Thomson Reuters



Sources: Bond Buyer, Thomson Reuters

**TABLE 5** 10-Year Municipal Credit Spreads

Date	AA	A	BBB
12/31/16	20 bps	57 bps	92 bps
3/31/17	20 bps	55 bps	90 bps
6/30/17	21 bps	56 bps	91 bps
9/30/17	20 bps	53 bps	88 bps
Quarterly change	-1	-3	-3
YTD change	0	-4	-4

Source: Thomson Reuters

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## Municipal Credit Review

The market signaled greater acceptance of credit risk as spreads reached new lows for the year, particularly among A- and BBB-rated securities. Notable states including New Jersey, Illinois, and California showed new or renewed strength and helped lead some of the market. For A-rated bonds, 10-year credit risk premiums tightened 3 bps to 53 bps and BBB-rated also tightened 3 bps to end at 88 bps above the corresponding 10-year AAA rate (Table 5 on page 2). A strong technical backdrop continues to provide accommodation for collective risk taking and the further stretching of valuations.

## Credit Events in the Quarter

Notable state rating and outlook changes:

State	Rating Agency Action				
	Moody's	Date	S&P	Date	Rationale
Kentucky	Aa3 to A1	17-Jul	None		Unfunded pensions
Illinois	None		CreditWatch Negative to Stable	17-Jul	Budget enactment
Pennsylvania	None		AA- to A+	17-Sep	Structural imbalance; liquidity concerns
New Jersey	None		Negative to Stable outlook	17-Aug	Expects improved pension funding ratio

Sources: Moody's and Standard and Poor's

- Weighed by the bankruptcy of its project contractor, Westinghouse Electric Company, and numerous rating downgrades, power utility Santee Cooper decided on July 31, 2017 to suspend construction of the Summer Nuclear Units 2 and 3 in South Carolina. For years, the overall project had experienced budgetary delays and cost overruns. As the industry moves away from fossil fuels for electricity generation, new utility-scale nuclear projects remain challenged given construction difficulties and cheaper alternatives powered by wind, solar, or natural gas.
- The U.S. Senate failed in its attempt to pass the Graham-Cassidy bill, which was created to repeal the Affordable Care Act. We expect future ACA repeal attempts, leaving non-profit hospital and state general obligation credits exposed to lower federal funding for Medicaid and a higher number of uninsured patients. For more detail on the lingering credit risks, see [Congressional Action Poses Risks for States and Hospitals](#).

## Looking Ahead

Risks are biased to the downside in the fourth quarter. Following healthy returns to this point in 2017, the municipal market is positioned to reward a more cautious stance. Both monetary and fiscal policy changes could put upward pressure on U.S. Treasury and municipal interest rates. On the monetary policy front, it is expected that the Fed will continue tightening monetary conditions by increasing the policy rate and embarking on balance-sheet contraction. As tax reform ideas percolate, the municipal market must remain on guard for legislative surprises and enhanced volatility, despite the low likelihood of policy resolution within the next three months. Current municipal credit valuation leaves little margin for error, and in the fourth quarter, Illinois and Chicago have designs to issue a significant supply of lower-quality bonds that credit-focused investors will need to digest. Year end is also marked by typical tax-loss harvesting activity, but it is not expected to impact the market in an outsized manner. Nonetheless, investors should remain aware of the rich relative value of the municipal sector, which would favor Treasuries and corporates more so than at any other point in the year.

*If you have questions regarding this commentary, please contact Jamie Horn, Portfolio Specialist, at [Jamie.Horn@pnc.com](mailto:Jamie.Horn@pnc.com) or 215-585-5552.*

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<sup>1</sup>[Unified Framework For Fixing Our Broken Tax Code](#). September 27, 2017

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