Municipal Fixed Income

Quarterly Market Commentary

First Quarter 2017

Key Themes

- Following a weak fourth quarter, the S&P Municipal Bond Index returned 1.41% for the first quarter, outperforming the broad U.S. Treasury market index.
- Declining interest rates from 2 to 10 years drove positive price performance, complemented by slightly narrower credit risk premiums.
- The yield curve steepened in the quarter as 2-year rates declined and 30-year rates remained stable.
- Municipal credit market spreads narrowed in all credit categories. Negative credit news proliferated, but was unable to derail performance.

Municipal Market Review

The first leg of 2017 marked a reversal of volatility and a welcome return to the more serene environs that preceded the presidential election. For the first quarter, municipal bond performance was positive, as the S&P Municipal Bond Index returned 1.41% (Table 1). Pronounced weakness in the fourth quarter set the stage for the retracement of a portion of those losses. Declining interest rates from 2 to 10 years drove positive price performance, while yields rose moderately 15 years and out. Short-term rates were impacted by a hawkish Federal Reserve that raised the policy rate once during the quarter by 25 basis points (bps). Serenity also embraced municipal credit as spreads narrowed slightly, in contrast to the late 2016 widening. Consistent with the broader markets, municipal investors generally favored a return to riskier assets in early 2017.

TABLE 1	S&P Municipal Bond Index Returns 1Q17			YTD Total
Index	Total Return	Price Return	Interest Return	Return 2017
Main	1.41%	0.77%	0.64%	1.41%
Intermediate	1.61%	1.00%	0.61%	1.61%
Short-Intermediate	1.36%	0.92%	0.44%	1.36%
Short	0.87%	0.53%	0.34%	0.87%

Source: Standard and Poor's

TABLE 2	AAA Municipal Rates					
Date	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%
Quarterly change	19bps	-19 bps	-24 bps	-6 bps	6 bps	1 bps
Annual change	19bps	-19 bps	-24 bps	-6 bps	6 bps	1 bps

Source: Thomson Reuters, Bloomberg

The yield curve steepened modestly through the first quarter, driven by declining yields on the short end. The 2- and 10-year rates declined by 19 and 6 bps, respectively and the 30-year rate increased by 1 bp. Rates in the 3- to 5-year range experienced the greatest decline ranging from 24 to 27 bps in movement (Table 2). Total return performance favored portfolios focused in the final segment of the curve. Cumulatively, the slope steepened from the 2-year rate to the 30-year rate from 183 bps to 203 bps or 20 bps (Table 3). Over the first 90 days of 2017, 10-year municipal bonds finished in virtually the same yield relationship to Treasuries as they had commenced, moving from 95% to 94% (Table 4).

TABLE 3	Municipal Yield Curve Slope	
	12/31/16	3/31/17
2-year rate	1.21%	1.02%
30-year rate	3.04%	3.05%
Slope	1.83%	2.03%

Source: Thomson Reuters

The Federal Open Market Committee met twice during the quarter and voted to raise short-term interest rates by 0.25%, resulting in a target range of 0.75% to 1.00%. The higher Fed target coaxed other short-term rates higher. The 3-month LIBOR ended March at 1.15%, while SIFMA closed out the quarter at 0.91% or approximately 79% of LIBOR. Federal funds futures imply a baseline of one or two additional rate increases in 2017, which would place additional upward pressure on other short-term rates throughout the year.

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On the policy front, health care reform took center stage in March. The U.S. House of Representatives failed to pass the American Health Care Act (AHCA) after the bill was pulled from the floor due to lack of support. The Congressional Budget Office's scoring of the AHCA forecasted a shrinking of the federal budget by $150 billion between 2017 and 2026. However, it also predicted that, compared to the Affordable Care Act, the act would result in an additional 24 million uninsured individuals by 2026. For now, hospitals and states continue to operate under the Affordable Care Act's provisions, which preserve increased federal funding for Medicaid expansion enrollees.

TABLE 4	Municipal to Treasury Yield Ratios
	10-year Ratios
12/31/16	0.95
3/31/17	0.94

Source: Thomson Reuters

Municipal bond issuance began the quarter on a noticeable uptick as the late-2016 volatility resulted in several deals being pushed forward into January. February and March both fell below the long-term trend. Total volume was $87.9 billion, a decrease of 12% from the $99.9 billion issued in the same period of 2016. New financings constituted a greater share of the total in lieu of refundings, year over year, reflective of growing economic limitations on refunding viability. The largest transactions for the period were $2.8 billion California State general obligation (GO) bonds and $1.8 billion Empire State Development Corporation bonds in March, while January saw a $1.2 billion financing from Triborough Bridge and Tunnel Authority of New York. The second quarter tends to be the most robust period in terms of issuance, with June as historically the most active month of all.

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
Quarterly change	0 bps	-2 bps	-2 bps
Annual change	0 bps	-2 bps	-2 bps

Source: Thomson Reuters

Municipal Credit Review

In the first quarter of 2017, credit spreads declined modestly, supportive of positive overall returns. Consistent with the theme, spread performance retraced some of the lost ground from the volatility experienced in the final quarter of 2016. Specifically, 10-year credit risk premiums for A-rated and BBB-rated bonds declined 2 bps each in the quarter settling at 55 and 90 bps, respectively, above the corresponding 10-year AAA rate (Table 5).

Notable Credit Events in the Quarter

In January, Illinois received its third rating downgrade to BBB from BBB+ by Fitch, matching the existing Moody's and S&P ratings levels. Fitch further intimated that it would downgrade the rating again within six months if certain fiscal measurements are not satisfactorily met.

Moody's downgraded New Jersey's general obligation and appropriation ratings one notch in March to A3 and Baa1, respectively. This rating action follows Governor Christie's fiscal year 2018 budget proposal, which while increasing pension contributions, still reflects below-standard financial management practices. Chronic pension underfunding, use of one-time revenue sources to plug budget gaps, and a large structural imbalance remain in place.

In January, the city of Chicago sold $1.2 billion GO bonds at strikingly penal rates. The tax-exempt portion of the deal performed worse than expected and required prices below par to appease prospective buyers. The transaction signaled that Chicago had yet to revive confidence through its efforts thus far to resolve its myriad financial problems.

On February 28, Puerto Rico's new Governor Ricardo Rossello presented his fiscal recovery plan that implies projected government cash flows can only support 18% to 41% of currently scheduled debt service, significantly below most current market values of defaulted Puerto Rico bonds.

On January 11, the U.S. Virgin Islands failed to access the market with a transaction that would have helped its strained liquidity position. Moody's, S&P, and Fitch all subsequently downgraded the debt. Despite the U.S. Virgin Island's recent efforts to reduce spending and increase revenues, access to the public debt market is expected to remain constrained in the near term.

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Looking Ahead

The view from the end of the quarter varies greatly from where the market found itself three months earlier. Market performance has stabilized and reversed and anticipated volatility-inducing reform measures have not yet materialized. Accordingly, with the aforementioned negotiation process on health care reform having reached an impasse, we expect the administration to pivot to other policy priorities in the second quarter. Tax policy, infrastructure spending, and financial reforms remain on the agenda, all of which hold prospects of profound impacts on the municipal market. However, tax reform efforts could prove more elusive following failure to enact complementary policy through AHCA. Recent downward revisions of state tax revenue expectations may portend some added challenge in fiscal year 2018 budget discussions; some of these expectations are related to federal budget and reform proposals.

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