Municipal Fixed Income

Quarterly Market Commentary

Second Quarter 2017

Key Themes

- The S&P Municipal Bond Index returned 1.82% for the second quarter of 2017, strongly outperforming the broad U.S. Treasury market index.
- Declining interest rates across most spots on the yield curve drove positive price performance over the quarter.
- The yield curve flattened in the quarter as 30-year rates declined, while 2-year rates increased modestly.
- Municipal credit market spreads remained flat in all credit categories, shrugging off certain high-profile, negative credit events.

Municipal Market Review

The S&P Municipal Bond Index continued its positive momentum in the second quarter by posting a gain of 1.82%, following a first-quarter total return of 1.41% (Table 1). The index's two consecutive quarters of positive returns have approximately offset the steep losses experienced in the final quarter of 2016. The low-volatility environment that sustained itself for most of 2016, until the election, has reemerged in familiar form. Interest rates declined across most of the curve, from 3 to 30 years, to push the index pricing level higher. Inside of one year, additional action by the Federal Reserve in June raised the benchmark rate target once during the quarter by 25 basis points (bps). The low-volatility theme extended to municipal credit as spreads remained flat, despite significant credit events among several widely held issuers.

TABLE 1	S&P Municipal Bond Index Returns 2Q17			YTD Total
Index	Total Return	Price Return	Interest Return	Return 2017
Main	1.82%	1.22%	0.60%	3.26%
Intermediate	1.88%	1.33%	0.55%	3.52%
Short-Intermediate	1.01%	0.62%	0.39%	2.38%
Short	0.41%	0.11%	0.30%	1.29%

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%
6/30/17	0.91%	1.06%	1.35%	1.99%	2.44%	2.79%
Quarterly change	0 bps	4 bps	-20 bps	-26 bps	-25 bps	-26 bps
Annual change	19bps	-15 bps	-44 bps	-32 bps	-19 bps	-25 bps

Source: Thomson Reuters, Bloomberg

Declining rates, combined with a Fed rate increase, resulted in a flattening municipal yield curve through the second quarter. The 2-year rate increased by 4 bps, while 10- and 30-year rates each declined by 26 bps. The largest movement occurred in the 7- and 8-year rates which both declined 30 bps (Table 2). Absolute returns favored longer-duration portfolios, which benefitted from both relative yield and price return. Accordingly, the slope of the curve flattened from the 2-year rate to the 30-year rate from 203 bps to 173 bps, or a 30 bps difference (Table 3). The municipal sector outperformed risk-free rates by quarter-end as evidenced by the municipal to U.S. Treasury ratio declining by seven ratios and ending the quarter at 87% (Table 4).

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

Source: Thomson Reuters

The Federal Open Market Committee met twice during the quarter and voted once to raise its policy rate target by 0.25%, resulting in a target range of 1.00% to 1.25%. The Fed also introduced the possibility of reducing the amount of securities held on its balance sheet, which would act to further remove monetary accommodation. The Fed's action impacted other short-term rate markets as 3-month LIBOR rose to 1.30% by the end of June. Accordingly, SIFMA ended the quarter at 0.91%, or approximately 70% of LIBOR. Federal funds futures imply even odds of one additional rate increase in 2017, as the Fed asserts a balanced approach to its policymaking.

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Certain meaningful Federal policy reforms remain in the offing. Congress continued to struggle in its efforts to repeal and replace the Affordable Care Act (ACA). The Congressional Budget Office produced scoring for both the U.S. House and Senate health-care reform bills, predicting that, compared to the ACA, more than 20 million additional Americans would be uninsured by 2026. After failing in its first attempt in March, the U.S. House of Representatives narrowly passed the American Health Care Act (AHCA) in May. The Senate faced an uphill battle as it attempted to pass its own reform bill in June and decided to postpone the vote due to opposition from enough Senate members to block passage.

TABLE 4	Municipal to Treasury Yield Ratios
	10-year Ratios
12/31/16	0.95
3/31/17	0.94
6/30/17	0.87

Source: Thomson Reuters

Total municipal bond issuance in the second quarter was $103.8 billion, a decrease of 17.4% from the $125.6 billion issued in the same period in 2016. Just under half of the quarter's issuance, 48%, was for transactions to finance new projects, accounting for a slightly larger percentage of supply compared to the second quarter of 2016. Only 28% of issuance was for refunding purposes during the most recent quarter, reflective of limited refinancing opportunities. The largest transactions for the period were $2.1 billion from the California Health Facilities Financial Authority in April, $2.1 billion from the Hudson Yards Infrastructure Corporation in May, and $1.75 billion from the Dormitory Authority of the State of New York in June.

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
Quarterly change	1 bps	1 bps	1 bps
Annual change	1 bps	-1 bps	-1 bps

Source: Thomson Reuters

Municipal Credit Review

Credit pricing showed little movement in the second quarter, following a slightly positive performance in the first quarter. Notable headline credit events, including Illinois and Connecticut downgrades, have thus far been unsuccessful at derailing collective risk appetites. For A-rated and BBB-rated bonds, 10-year credit risk premiums remained flat at 55 and 90 bps, respectively, above the corresponding 10-year AAA rate (Table 5). On the surface, credit pricing has shown little volatility. However, it is of note that a dichotomy is developing where the aforementioned investment grade obligors, and others, are experiencing high levels of stress, while the market remains very receptive to riskier and higher-yielding new transactions within the below-investment-grade sector.

Notable Credit Events in the Quarter

On June 9, S&P downgraded Massachusetts' General Obligation rating one notch to AA from AA+. Citing concerns about the commonwealth's dwindling reserves, the rating agency nevertheless assigned a stable outlook, which could prove challenging to maintain in the face of volatile revenues and rising expenditure pressures, including Medicaid costs, should the ACA be successfully repealed by Congress.

On June 2, Illinois received simultaneous downgrades from Moody's and S&P to Baa3 and BBB-, respectively. S&P has threatened to downgrade the state additionally should it not commence the new fiscal year (2018) with a budget in place. S&P's threat implies a move to below investment grade, an unprecedented move for a state general obligation rating.

Connecticut's ongoing fiscal woes translated into a new round of rating downgrades in May – this time by all three rating agencies. For both Moody's and S&P, Connecticut's respective A1 and A+ ratings are only surpassed to the downside by Illinois and New Jersey. The acute fiscal stress is driven by underperforming revenues, dwindling reserves, a weak economy, and rising expenditure pressures.

In April, Moody's upgraded Ochsner Clinic's rating one notch to A3 from BBB+. The system's graduation to the A category is a reflection of Ochsner's stronger operating performance and successful implementation of its multi-year strategy to improve patient experience, revenue cycle efficiency, and brand recognition.

The downgrades of Illinois in June had secondary impacts, engulfing the following issuers and programs in the revisions: Metropolitan Pier and Exposition Authority, Build Illinois sales tax-backed bonds, and Chicago motor fuel tax-backed bonds.

The downgrades to these names underscore our prior warnings about the dangers of placing undue confidence in dedicated-tax bond structures, even those rated AAA, as our published analysis demonstrates (see Illinois Sales Tax bonds, downgraded by S&P from AAA to AA-, concurrent with the GO action).

Looking Ahead

With the continuation of relative stability in the second quarter, the market will look forward to several events in the subsequent three months that could conspire to alter the trajectory. Healthcare reform was resuscitated when the U.S. House revived the AHCA in May and the Senate plans to decide on its bill in July. Tax reform remains on the administration's agenda and is anticipated to follow healthcare though timing is largely in question. Several states have yet to finalize their respective spending plans for the new fiscal year beginning July 1. Accordingly, Illinois is facing the specter of becoming the first ever below-investment-grade state. The Fed has two meetings scheduled for the 3rd quarter but neither is currently anticipated to eventuate in a rate hike.

If you have questions regarding this commentary, please contact Jamie Horn, Portfolio Specialist, at Jamie.Horn@pnc.com or 215-585-5552.

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