Municipal Fixed Income

Quarterly Market Commentary

First Quarter 2018

Key Themes

- The S&P Municipal Bond Index returned -0.92% for the first quarter of 2018. The Index nonetheless easily outperformed the broader Bloomberg Barclays U.S. Treasury Index, which returned -1.18% for the quarter. The 10-year municipal-to-Treasury yield ratio ended at 88%.
- We believe negative price performance is tied to rising 2-year to 10-year interest rates, complemented by slightly wider credit risk premiums.
- The yield curve steepened in the quarter, as 30-year rates rose faster than 2-year rates.
- Municipal credit market spreads widened modestly in all credit categories. However, credit market activity was benign.
- Tax reform greatly impacted supply during the quarter.

Municipal Market Review

The December 2017 passage of the Tax Cuts and Jobs Act (TCJA) prompted a shift in the prevailing sentiment around interest rates that impacted the first quarter of 2018. The most pronounced interest-rate movement occurred on the longer end of the yield curve, with 10-year to 30-year rates rising sharply. Accordingly, the S&P Municipal Bond Index posted a return of –0.92% (Table 1). Short-term rates were affected by a hawkish Federal Reserve, which raised rates in March by 25 basis points (bps). SIFMA rates also reacted to the Fed in addition to dealing with an anomalous end-of-year spike at the close of 2017. Municipal credit markets were quiet throughout the quarter, and credit spreads uniformly widened by two bps. In the first quarter, municipals acted in sympathy with the broader capital markets, namely by exhibiting higher discount rates and greater risk premiums.

TABLE 1	S&P Municipal Bond Index Returns 1Q18			YTD Total
Index	Total Return	Price Return	Interest Return	Return 2018
Main	-0.92%	-1.54%	0.62%	-0.92%
Intermediate	-1.09%	-1.67%	0.58%	-1.09%
Short-Intermediate	-0.33%	-0.81%	0.48%	-0.33%
Short	0.24%	-0.18%	0.42%	0.24%

Source: Standard and Poor's

TABLE 2	AAA Municipal Rates					
Date	SIFMA	2 Yr	5 Yr	10 Yr	15 Yr	30 Yr
12/29/17	1.71%	1.56%	1.68%	1.98%	2.26%	2.54%
3/29/18	1.58%	1.65%	2.04%	2.42%	2.67%	2.95%
Quarterly change	-0.13%	0.09%	0.36%	0.44%	0.41%	0.41%

Source: Thomson Reuters, Bloomberg

The yield curve steepened notably during the first quarter, reversing much of the flattening experienced in 2017. Rates increased across the curve, with 2-year, 10-year, and 30-year rates moving up nine, 44, and 41 bps, respectively (Table 2). Most of the upward pressure on rates occurred during the volatile month of January. Total returns strongly favored shorter-duration portfolios that were less sensitive to interest-rate volatility. The municipal yield curve steepened across maturities, with the slope between 2-year rates and 30-year rates increasing from 98 bps to 130 bps, or a difference of 32 bps (Table 3).

TABLE 3	Municipal Yield Curve Slope	
	12/30/16	3/31/17
2-year rate	1.56%	1.65%
30-year rate	2.54%	2.95%
Slope	0.98%	1.30%

Source: Thomson Reuters

Municipal Fixed Income

During the quarter, 10-year municipal bond yields cheapened relative to comparable U.S. Treasuries. The 10-year municipal-to-Treasury yield ratio moved from 82% to 88% by quarter end. We believe this dynamic creates an enhanced relative value position for crossover buyers into municipals (Table 4). Significant rate movement for both markets contributed to volatility in the ratio during the quarter.

TABLE 4	Municipal-to-Treasury Yield Ratios
	10-year Ratios
12/29/17	82%
3/29/18	88%

Source: Thomson Reuters TM3-MMD

The Federal Open Markets Committee (FOMC) met twice during the quarter, which included its first meeting under new chairman, Jerome Powell. Powell's initial meeting, the second of two occurring in March, resulted in a vote to raise the lending rate target range to 1.50% to 1.75%. The higher Fed target coaxed other short-term rates higher. The 3-month LIBOR ended March at 2.31%, while SIFMA closed out the quarter at 1.58%, or approximately 68% of LIBOR.

Given the Fed's activity, it was notable that SIFMA ended the quarter 13 bps lower than where it began.This was due to an anomalous spike at year end. As of the late March meeting, the FOMC broadly favors a total of three rate actions for the full year 2018.

The municipal market's reaction to the TCJA has been fairly muted thus far, other than to follow Treasury yields higher in the quarter, which can be partly attributed to the bill's overall disdain for federal fiscal balance. Only very recently have issuers begun to offer new structures in the primary market to reflect changes introduced by the tax law. Most notably, issuers' chronic predilection for 10-year call options is showing signs of weakening. We believe this is tied to the TCJA provision that eliminated the tax-exempt option for refundings in advance of the first call date. Sophisticated issuers in California and New York are beginning to experiment with shorter call provisions, which is the natural and predictable reaction.

Municipal bond issuance in the first quarter was very quiet, with total volume down 31.9% at $62.8 billion versus $92.3 billion the year prior. The passage of the TCJA drove an accelerated schedule of issuance, pulling forward a considerable portion of would-be supply from 2018 to late 2017, as we discussed in our recent commentary, Tax Cuts and Jobs Act: What Does It Mean for the Municipal Bond Market? March saw $25.1 billion in new transactions, a slight improvement from February and January, but still below levels seen in years prior. Additionally, the proportion of new money to refunding issuance moved dramatically to 6.1x from 1.8x in March of 2017. We believe the dearth of refundings relative to new financings can be attributed to rising rates, refinancing burnout, and specific provisions in the TCJA that hinder traditional refunding activity.

Municipal Credit Review

During the first quarter, credit spreads increased modestly, conspiring with rising rates to weigh on index total returns. An overall benign credit environment was betrayed slightly by widening spreads. For A-rated and BBB-rated bonds, 10-year credit risk premiums each increased by 2 bps during the quarter, settling at 50 and 85 bps, respectively, above the corresponding 10-year AAA rate (Table 5).

TABLE 5	10-Year Municipal Credit Spreads		
Date	AA	A	BBB
12/29/17	18 bps	48 bps	83 bps
3/29/18	20 bps	50 bps	85 bps
Quarterly change	+2	+2	+2
Annual change	+2	+2	+2

Source: Thomson Reuters

Notable Credit Events in the Quarter

In late January, a ruling by the judge presiding over the Puerto Rico debt restructuring case introduced doubt to the widely believed tenet that special revenue obligations enjoy certain protections under a municipal bankruptcy proceeding. The judge's decision is currently being appealed. Revenue-backed debt in general could face pressure from changing market sentiment and possible revisions to rating agency methodologies if the ruling is upheld.

In March, the city of Hartford, Connecticut inked a deal with the state allowing it to effectively transfer a debt burden of $550 million to state taxpayers in order to avoid a city bankruptcy filing. The agreement calls on the state to cover essentially all of the city's debt in exchange for the imposition of state fiscal oversight. Standard & Poor's quickly announced that the deal may result in multi-notch upgrades of Hartford's CCC debt rating.

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Looking Ahead

While performance in the first quarter underwhelmed, very little has changed in the fundamental or technical environment surrounding the municipal market. The full impact of the TCJA has not yet been realized, as the market has yet to show meaningful signs that it is adapting to the new rules. Nonetheless, those new rules are still not expected to have a dramatic impact on the market overall. Infrastructure will be a major policy focus, but may prove more difficult to navigate after the passage of the deficit-expanding tax reform bill. With two meetings planned in the second quarter, we believe a strident Fed will endeavor to push forward on its rate-raising campaign. Rating agencies stand to play a role in the market's perceptions of credit quality, as they respectively react to prominent events emanating from Puerto Rico, Hartford, and other distressed situations. Updated methodologies and wholesale ratings changes are to be expected. Likewise, investors will add focus to the budget processes for several distressed states, including New Jersey, which has a new governor, and Illinois, which is in a gubernatorial election year.

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Municipal Fixed Income

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Indexes

The **S&P Municipal Bond Index** is a broad, market value-weighted index that seeks to measure the performance of the U.S. municipal bond market. The index includes bonds of all quality—from “AAA” to non-rated, including defaulted bonds — from all sectors of the municipal bond market.

The **Bloomberg Barclay’s U.S. Treasury Index** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

Indexes are unmanaged and not available for direct investment.

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