Municipal Fixed Income

Quarterly Market Commentary

Third Quarter 2018

Key Themes

- The S&P Municipal Bond Index posted a return of -0.14% for the third quarter and -0.16% for the full year. While the municipal market outperformed the broad U.S. Treasury market index, it underperformed the Bloomberg Barclays U.S. Credit Index for the three-month period.
- The negative price performance resulted from higher interest rates across the municipal yield curve, offset slightly by narrower credit risk premiums.
- While Treasury rates moved higher during the quarter, the slope of the municipal yield curve was nearly unchanged, as both 2-year and 30-year rates rose.
- Municipal market new issue supply was down 8.7% during the quarter and down 14.9% for the year.
- Improvements at the bottom rungs of municipal credit quality helped coax all valuations higher.

Municipal Market Review

The municipal market produced negative returns in the third quarter, in a sharp reversal from second quarter's positive returns. Interest rates resumed their upward trajectory after a brief second-quarter respite, and total returns suffered accordingly. The S&P Municipal Bond Index posted a return of -0.14%, bringing the year-to-date tally to -0.16% (Table 1). Movement across the AAA municipal rate term structure, as measured by the 2- and 30-year rates, occurred in a nearly parallel manner (Table 3). The 2-year rate rose by 33 basis points (bps) and the 30-year rate rose by 25 bps. The belly of the curve proved the most reticent, as 10- and 15-year rates moved higher by 12 and 16 bps, respectively (Table 2). As stated, the curve was essentially unchanged, with the delta between the 2-year rate and 30-year rate at 122 bps, a slight flattening from the slope of 130 bps to end the second quarter.

As the rate movement would suggest, total return differentials were minimal through the intermediate portion of the curve. Therefore, most of the weakness was experienced beyond 15 years. As rates rise, shorter-duration portfolios offer greater insulation to the deleterious impacts of rising interest rates. Relative to U.S. Treasuries, the ratio of the 10-year AAA municipal rate against like-maturity Treasuries declined from 86% to 84%, closing in on its position as of January 1, 2017 (Table 4).

TABLE 1	S&P Municipal Bond Index Returns 3Q18			YTD Total
Index	Total Return	Price Return	Interest Return	Return 2018
Main	-0.14%	-0.80%	0.66%	-0.16%
Intermediate	-0.01%	-0.64%	0.63%	-0.30%
Short-Intermediate	-0.02%	-0.54%	0.52%	0.38%
Short	0.03%	-0.42%	0.45%	0.85%

Source: S&P Dow Jones Indices, LLC

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%
6/30/18	1.51%	1.64%	1.99%	2.46%	2.67%	2.94%
9/28/18	1.56%	1.97%	2.20%	2.58%	2.83%	3.19%
Quarterly change	0.05%	0.33%	0.21%	0.12%	0.16%	0.25%
YTD change	-0.15%	0.41%	0.52%	0.60%	0.57%	0.65%

Source: Thomson Reuters TM3-MMD, Bloomberg

TABLE 3	Municipal Yield Curve Slope			
	12/31/17	3/31/18	6/29/18	9/28/18
2-year rate	1.56%	1.65%	1.64%	1.97%
30-year rate	2.54%	2.95%	2.94%	3.19%
Slope	0.98%	1.30%	1.30%	1.22%

Source: Thomson Reuters TM3-MMD

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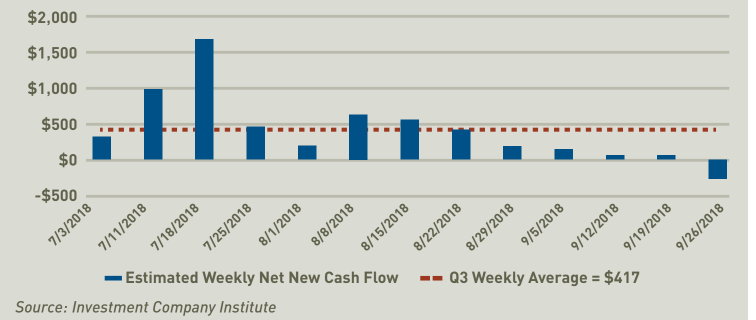
The Federal Open Market Committee met twice during the quarter, resulting in one rate increase following its September meeting. The 9-0 vote increased the lending rate to a target of 2.00% to 2.25%. However, short-term municipal rates continue to ignore the Fed's aims. The SIFMA rate netted a 5 bps rise in the quarter to 1.56%, showing no sympathy for the volatility that occurred 2 years and out. While SIFMA largely diverged in the quarter, it did react to the $7.2 billion, 1-year Texas Tax and Revenue Anticipation Note, priced in late August at 1.79%. Nonetheless, the Fed's desire to push short-term rates to higher bounds remains in place. The consensus anticipates one additional rate action in 2018, for a total of four policy changes for the full year. Also noteworthy in the short-term financing markets, the process of replacing LIBOR with its new alternative, the Secured Overnight Financing Rate, or SOFR, commenced this quarter. Municipal issuers, such as the New York Metropolitan Transit Authority, have begun including SOFR into contemporary financing documents.

TABLE 4	Municipal-to-Treasury Yield Ratios
	10-year Ratios
12/29/17	82%
3/29/18	88%
6/29/18	86%
9/28/18	84%

Source: Thomson Reuters TM3-MMD

The municipal bond market is generally a closed market whose investor base, due to its tax advantages, is heavily reliant on the investment priorities of one particular subset: wealthy Americans. How this group decides to deploy its capital is therefore meaningful. Recent data show a decidedly negative trend for cash flows into municipal investment vehicles, including outright negative cash flows in recent reports. Changes in the trajectory and velocity of investor capital can have a dampening impact on municipal returns (Chart 1).

CHART 1
Q3 Mutual Fund Net New Cash Flows - Municipals



Source: Investment Company Institute

Issuance activity in the third quarter of the year remained weak, with total volume down 14.9% year-to-date at $249.4 billion versus $293.2 billion in the year prior. Issuance in the third quarter was down 8.7% at $84.2 billion versus $92.2 billion in the year prior, and $99.8 billion in the second quarter. Overall, issuance continued to feel pressure from the passage of the Tax Cuts and Jobs Act in December 2017, which reduced the relative benefit for issuers to use advanced refundings. September saw $23.9 billion in new transactions, which was slightly below July issuance of $27.2 billion and well below August issuance of $33.1 billion. The quarter started with July issuance picking up 8.9% from a year prior, but the gain was erased as August and September volume retreated by 11.9% and 19.4%, respectively, from one year prior. Specifically, issuance from the largest state, California, was down 27.3% at $36.4 billion versus $50.0 billion in the year prior. Also, the proportion of new-money-to-refunding issuance remained elevated relative to 2017; the ratio (including year-to-date issuance through September) was 3.9x versus 1.5x for the same year-to-date period of 2017.

Municipal Credit Review

Credit spreads decreased by 1 bp across all categories, reflecting general improvement in credit pricing year-to-date, which served to slightly offset negative rate performance. Ten-year credit risk premiums for A-rated and BBB-rated bonds ended the quarter at 47 and 82 bps, respectively, above the corresponding 10-year AAA rate (Table 5). The stronger bid for credit risk, particularly in below investment grade categories and weaker investment grade quality categories, continues to drive positive performance across all ratings categories.

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
6/29/18	18 bps	48 bps	83 bps
9/28/18	17 bps	47 bps	82 bps
Quarterly change	-1 bp	-1 bp	-1 bp
YTD change	-1 bp	-1 bp	-1 bp

Source: Thomson Reuters TM3-MMD

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Tobacco bonds benefitted from a spate of refunding transactions this year, which helped coax sector-wide valuations higher. The prospect of additional refunding transactions lifted those bonds priced below par. The State of Illinois agreed to a new fiscal year budget, which was enough to propel it to BBB-rated obligor status. Puerto Rico continued progress toward the resolution of its debt restructuring and appears to be moving in a direction that is more favorable to investors. These instances, among others, supported stronger pricing of credit risk in the quarter.

Notable Credit Events in the Quarter

In July, Moody's revised its outlook on the State of Illinois general obligation debt to stable from negative, primarily reflecting its view that near-term fiscal risks are manageable. Prior to the revision, Moody's had the most negative view of Illinois among credit rating agencies, as measured by its Baa3 rating and negative outlook.

In September, Moody's downgraded Platte County, Missouri eight notches to Ba1 from Aa2. The super downgrade resulted not from any change in the county's financial standing, but because Moody's believes the county has a "lack of willingness to fulfill a contractual obligation" surrounding its current level of support of a local economic development project for which there are bonds outstanding.

Jacksonville Electric Authority (JEA) is looking to exit a 20-year agreement to purchase power from the Municipal Electric Authority of Georgia (MEAG), as unbudgeted nuclear plant construction costs make electricity derived from the project economically disadvantageous to JEA. The outcome of the dispute will likely have repercussions across the entire public power sector. In September, S&P placed JEA's bond ratings on CreditWatch Negative, questioning the "utility's willingness to meet its contractual financial obligations."

Looking Ahead

The municipal market surrendered ground in the third quarter, enhancing the prospects for an unsatisfactory full year of returns. The performance hit has been realized primarily in the back end of the term structure, the portion most susceptible to negative performance from adverse rate movement. The Fed has not demurred from its objectives in 2018, and rates from 2- to 30-years have risen, but with some discord. The market believes the Fed will follow through with its objectives and raise rates once more in 2018. The recent weakening trend of municipal fund flows adds another potential headwind to performance to close out the year.

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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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 **SIFMA Municipal Swap Index** is a 7-day high-grade market index comprised of tax-exempt VRDOs reset rates that are reported to the Municipal Securities Rule Making Board's (MSRB's) SHORT reporting system. The index is calculated on an actual/actual basis and is published every Wednesday.

Indexes are unmanaged and not available for direct investment.

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