# Municipal Fixed Income Market Outlook 2017

While the year began with much promise, municipal bond investors will be happy to see 2016 come to an end as the sector greatly underperformed other fixed-income sectors through November. For 2016, we expect returns will be flat to modestly negative for investment-grade indexes while high-yield municipal and taxable municipal-sector indexes are tracking to have respectable positive returns. Municipal investors describe the year as experiencing a tremendous amount of interest-rate volatility as markets contended with the impact and valuation of political risk, the ebb and flow of domestic and global economies, and corresponding central bank policy. With the wide range of interest rates experienced over the year, investors who entered the sector during mid-summer with rates at all-time lows will have markedly different performance from investors who held municipal bonds for the entire year.

Moving into 2017, the municipal sector appears to be in a favorable position as compared to its fixed-income sector counterparts and to its absolute total return potential relative to 2016. Our market outlook highlights macro issues that we believe will impact municipal performance in the coming year. We provide guidance on how we have positioned our municipal strategies to generate favorable returns. Our investment philosophy is anchored by a resolute belief that the future path of interest rates is uncertain. We continue to implement our portfolio strategies so they will mirror the interest-rate risk profile of their respective indexes, and therefore we expect our interest-rate driven return differentials to be negligible again in 2017. As always, we will emphasize sector allocation and security selection through fundamental credit work, strategy execution, diligent interest-rate risk calibration, and a dogged commitment to our investment process.

## President-Elect Trump and the 115th United States Congress

The election of Donald Trump has undoubtedly had an impact on interest-rate markets and specifically the municipal sector. The fixed-income markets expect higher budget deficits and rising inflation as a consequence of tax reform coupled with greater spending on defense and infrastructure. Many of Trump's policy initiatives could have an adverse effect on the municipal yield curve and risk premiums, which will flow through to municipal bond valuation during 2017 and beyond. Below, we list elements of the president-elect's agenda and our view of the potential impact on municipal bond valuation.

| Policy | Policy Summary | Municipal Valuation Impact |
|---|---|---|
| Tax Reform (Corporate and Individual) | Lower, simpler, and pro-growth. | Negative |
| Health-Care Reform | Repeal and replace the Affordable Care Act. Maximize choice and create a dynamic health-insurance market. | Negative |
| Regulatory Reform | Review to identify and eliminate unnecessary regulations. | Positive |
| Transportation and Infrastructure | Invest $550 billion. | Neutral |
| Border Security | Reform legal immigration, enhance border security. | Neutral |

*Source: www.greatagain.gov, PNC Capital Advisors*

## The Federal Reserve and Interest Rates

The Federal Reserve Open Market Committee increased the fed funds rate by a total of 25 basis points (bps) in 2016. Domestic interest-rate sentiment has shifted post-presidential election to higher interest rates in 2017 as many of the new administration's policy positions are deemed to be pro-growth and inflationary. Most economists forecast the policy rate moving higher by 50 to 75 bps in 2017 at a measured pace, but we continue to be skeptical that longer-term rates will move considerably higher. If real interest rates increase, financial conditions should eventually tighten and act to temper economic enthusiasm. As always, the Fed will be data dependent in its decision making and will need to see economic policies take hold before rates change materially from current levels.

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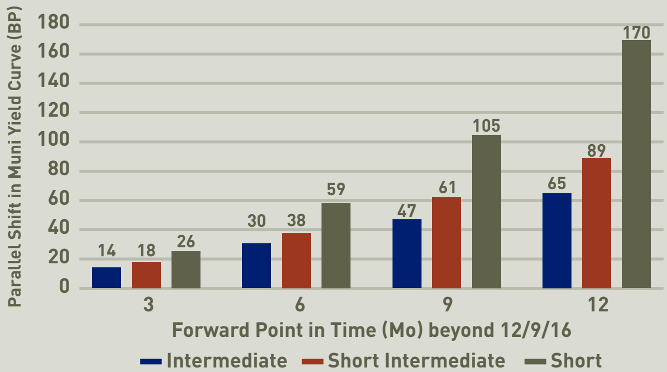
**Table 1a: PNC Capital Advisors Municipal Composite – Breakeven Analysis by Time Period**




Source: Investortools Perform

**Table 1b: S&P Municipal Bond Index Breakeven Analysis**

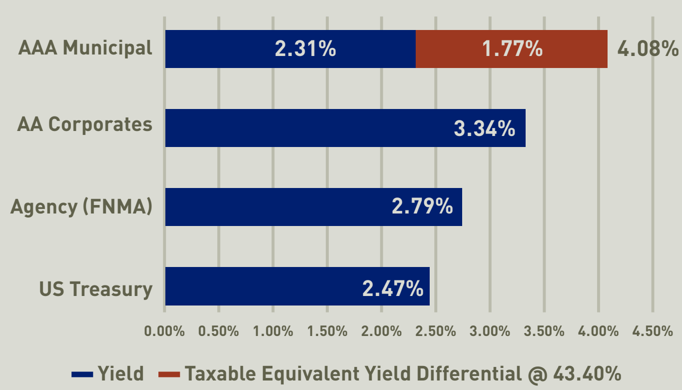
| Index | 12 Month Horizon | | | |
|---|---|---|---|---|
| | Scenario* | Total Return** | Yield Return | Price Return |
| Short | +186 | 0% | 1.75% | -1.75% |
| Short-Intermediate | +98 | 0% | 2.27% | -2.27% |
| Intermediate | +71 | 0% | 3.19% | -3.19% |

* A parallel shift of the benchmark yield curve.

** Total Return = Yield Return + Price Return.

*Source: S&P and Investortools Perform*

**Table 2: 10 Year Bond Cross Sector Relative Value 12/09/2016**




Source: Bloomberg, Thomson Reuters

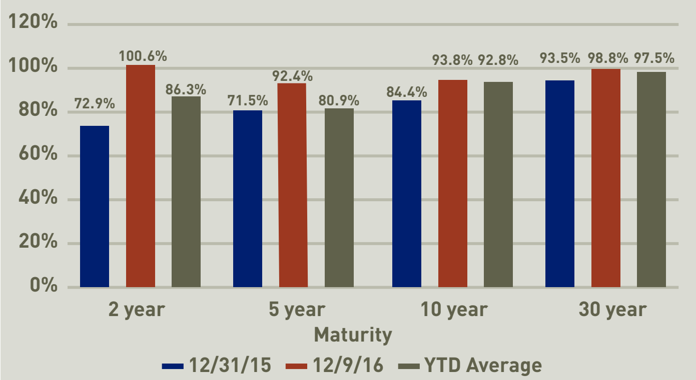
## Municipal Bond Market Liquidity

Bond-market liquidity continues to be a primary focus of investors going into 2017. Liquidity was tested in 2016, as interest rates demonstrated noteworthy volatility prompting investors to review asset-allocation decisions to fixed-income sectors. While most fixed-income sectors experienced steady demand and functioned well during minor periods of stress throughout the year, we believe market liquidity could improve further in 2017. Regulatory reform based on Trump administration initiatives could directly benefit fixed-income trading and market depth. Reforming elements of the Dodd Frank legislation, particularly allowing banks greater ability to hold inventory for market making, would be additive to the liquidity profile of debt markets. Nevertheless, our unique investment process utilizes a significant liquidity buffer in all of our municipal strategies through our proprietary portfolio construction process, which evolved out of the 2008 liquidity crisis. This process also enables us to opportunistically add exposure when a liquidity event takes place and is an important aspect of what we believe is our competitive advantage.

## Municipal Interest Rates and Sector Relative Value

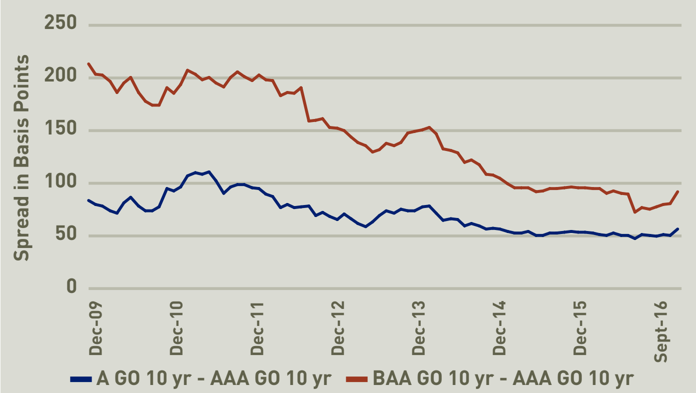
Municipal interest rates have moved substantially higher than corresponding Treasuries during 2016 and in our view could outperform Treasury rates in 2017 as the market regains clarity on pertinent issues. If investors expect interest rates to move higher during 2017 and continue to require fixed-income exposure, there is little doubt in our view that the Municipal sector will outperform most other fixed-income sectors in a rising interest-rate environment. We also recognize that at the current nominal level of interest rates, fixed-income mandates can move into negative total-return[1] territory with minor increases in rates. Whether total index returns approach zero is dependent on the timing and magnitude of interest-rate increases. While we disagree with the assertion that rates must move materially higher from where they stand today, Table 1a provides an illustration of the magnitude that municipal interest rates need to move and over what time horizon we expect before PNC Capital Advisors' municipal strategies are projected to generate zero total return. We believe the aforementioned municipal interest-rate underperformance relative to U.S. Treasury rates presents municipal investors with an attractive entry point (Table 2). Higher AAA-municipal-yield to Treasury-yield ratios at most points on the curve provide evidence of municipal underperformance in 2016 (Table 3).

**Table 3: Municipal to Treasury Yield Ratio Comparison**




Source: Thomson Reuters

**Table 4: A and BBB Municipal Credit Spreads 2009 - 2016**




Source: Thomson Reuters

## Municipal Credit

Municipal credit had performed above expectations in 2016, only to reverse its progress after the general election. Investors' 2017 docket sheet will begin with assessing the potential outcomes of the market post-election. The sharp movement in pricing thus far will impact relative positioning as 2017 commences, but the jury is still out. Much of the recent volatility does not necessarily indicate fundamental credit risk. Consequently, the additional return potential implied through current pricing can be viewed as an emerging opportunity. Fundamentally, our view is municipal credit remains intact and contagion risk suppressed. The same remains true within all levels of corporate credit as corporate default rates are flattening following the commodity-decline-induced losses of 2016. Municipal spreads tend to lag signals from the corporate-credit market. Signs of improved vitality provide one signal of support for municipals in the new year. As investors continue to deliberate on proper levels of risk pricing, we expect the market will ultimately find direction in 2017 as it gains conviction on risk.

Credit quality will remain stable amid tepid economic growth in 2017. Underneath the stability, nascent credit stress will inevitably surface throughout the year. For example, February will be an important time for Puerto Rico as it marks the end of the automatic stay on litigation against the Commonwealth, though the option for extensions could push the timing later into 2017. The Chicago Board of Education is on course to face potential liquidity shortfalls by mid-year. Likewise, the travails of the troubled pension states, including New Jersey, Illinois, and Pennsylvania, are well documented. It remains to be seen if 2017 will mark the year when these states, including potentially Louisiana and Connecticut, approach attractive relative valuations. While this basket of troubled states garners the attention of the market, a second tier of troubled states is exhibiting similar risks that are not as evident through pricing signals. These states include Hawaii, Kentucky, Massachusetts, Michigan, and New York, among others. As conviction wanes among market participants over the ability to navigate pension risk, these states and some others could find themselves increasingly vulnerable to credit repricing.

As pockets of credit risk emerge, noteworthy is the growing list of obligors that have migrated to the reaches of ratings below the investment-grade (BIG) boundary. This continued devolution could be viewed as a positive because it may act to invigorate the process of more deft discrimination of credit quality in the market. However, it also requires recognition of the increasing divergence that results. Municipal fixed-income portfolios reside primarily within the investment-grade space and while the market value of BIG debt expands, it aggravates the potential for performance mismatch. The growing list of obligors contributing to that mismatch includes the usual suspects in Puerto Rico, as well as Chicago and the Chicago Board of Education.

# Municipal Fixed Income Market Outlook 2017

## 2017 PNC Capital Advisors Municipal Composite Strategy

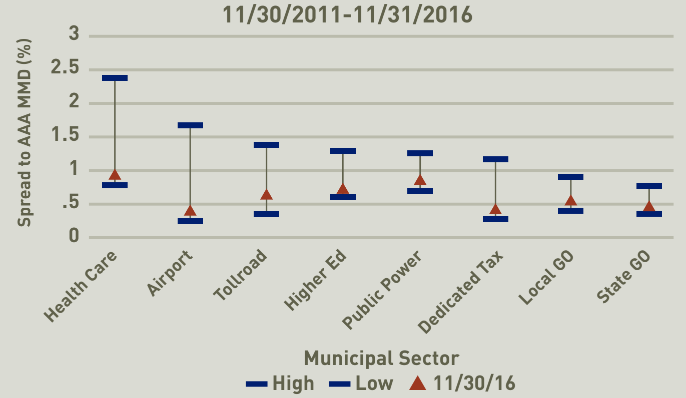
### Interest Rate Exposure

The path of interest rates in 2017 remains unpredictable and we expect our municipal composites will remain key rate duration neutral to their respective S&P benchmarks. Our investment philosophy, coupled with our portfolio construction process, is designed to ensure that we are interest-rate agnostic where we expect most excess return will be generated from tactical and strategic views unrelated to interest rates.

### Credit Quality

The portfolio stance on overall credit at the start of 2017 will largely mirror our position in 2016. That is, we see the risk-reward tradeoff as most favorable for mid-grade credit over the high-grade or BBB alternatives. The overall economic environment in 2017 should remain supportive for lower-quality credit, but some concerns loom for the lowest rungs of the investment-grade ladder. While we will favor a credit bias away from BBB generally, we expect to add or retain a complement of lower-grade credits that we see as idiosyncratic contributors to portfolio excess return. Under a mild economic growth expectation, enterprise credits offer insulation from many of the specific risks borne by local governments. From a weighting perspective, the year begins with a positive focus broadly on the Housing, and Public Power sectors and selectively on the Higher Education sector. Absent wholesale moves in spreads, credit selectivity will be the primary driver of non-interest-rate-driven performance. While we constantly seek ideas to add excess return through credit, we require that those ideas provide a large enough portfolio impact to move the dial on performance. Therefore, there is a large swath of obligors in the municipal market that naturally remain outside of our opportunity set simply due to a lack of debt, true to our process. Additionally, among the tax-backed sectors we prefer to rely on our experience as credit evaluators, and therefore our process largely excludes reliance on structural features designed to enhance credit quality. Examples of such structural features include state-level statutory liens, tax carve-outs, and cognizance of bankruptcy authorization. Attaching a temporary outboard motor to a rowboat does not change the intrinsic value of the rowboat. The same holds true for obligors who attempt to enhance their credit quality through legal features. We will remain committed in this approach in 2017 and going forward.

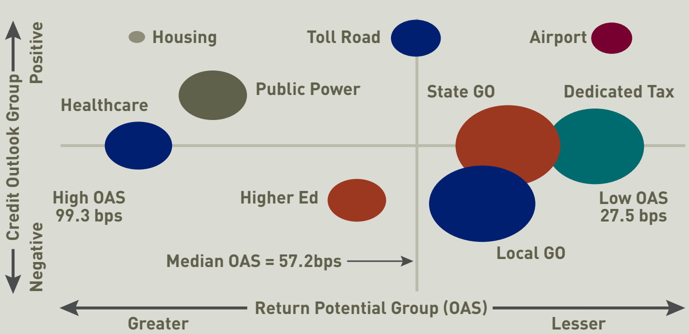
**Table 5: Intermediate Index OAS by Sector 11/30/2011-11/31/2016**




Data Sources: MMD, JJ Kenney, Axiom, S&P Index, PNC Capital Advisors Sectors

### Select Sector Opinions

**Table 6: Sector OAS 11/30/2016 Intermediate Index**




*Horizontal Axis represents weighted average Option Adjusted Spread for the sector in the JJK Intermediate Index for Non-AMT bonds*

OAS data was obtained from Wilshire Axiom

### State Government

We expect the state General Obligation (GO) sector to come under some pressure as tax revenue growth slows amid continued pressure on pension and other post-employment benefits liabilities. While states like

New Jersey, Pennsylvania, and Connecticut have comparatively wider spreads, we do not yet advocate increasing exposure to those states as they continue to have persistent structural imbalances and have made only limited progress in addressing their debt burdens.

### Local Government

Local government credit quality is generally expected to remain stable in 2017, though we believe other sectors are better positioned to provide excess returns. While mild economic expansion and growing real-estate values fundamentally support the sector, we believe that downward pressure on state support could materialize and stress certain credits. We continue to expect that most of our local GO exposure in the coming year will be limited to high-grade credit where stability is expected.

### Health Care

We expect the Health Care sector will be susceptible to uncertainty as the Trump administration appears determined to repeal many provisions of the Affordable Care Act quickly. While Congress is likely to pass a repeal bill early in 2017, there will be a transition period while details of a new reform bill are developed. As a result, we expect much of the infrastructure of the Affordable Care Act to remain in place during the year with the effective date of the repeal occurring in 2018 or later, providing some credit stability. However, there will be some pressure on operating performance as bad-debt expense is beginning to rise and the boost in patient volumes from exchange enrollees and Medicaid expansion is waning. We continue to see opportunities across rating categories, especially among A-rated hospitals.

### Power

For the year, we anticipate the sector will exhibit a favorable credit profile, given a steady demand for electricity and a likely regulatory respite. Utilities' expected low purchased power costs coupled with rate-setting flexibility will buttress the sector's creditworthiness. Meanwhile, a new Environmental Protection Agency administrator starting in 2017 is expected to refocus the agency's efforts away from stringent carbon emission standards to a softer regulatory touch. As such, our team will favor plants fired by a wide mix of fuel sources.

### Housing

The Housing sector continues to offer a very favorable risk-reward profile entering 2017. Smaller balance sheets since the financial crisis are poised to expand with high-quality collateral and improving margins. Somewhat counterintuitively, incrementally rising mortgage rates will favor tax-exempt loan providers and increase relative demand for the product. Single-family programs with growing mortgage-backed securities compositions are favored, but we see no value in names subject to funding risks, should short-term markets display more volatility than currently contemplated.

### Higher Education

The credit outlook for the Higher Education sector is generally negative going into 2017. However, we believe the sector offers strong opportunities in a specific subset of obligors, which we will add aggressively to the portfolios in order to achieve the desired weighting. As was true in 2016, we expect to witness a growing divergence in credit performance based on inherent characteristics found within particular subsets within the broader sector.

### CONCLUSION

Contrary to consensus views, we expect the municipal sector to generate modestly positive total returns in 2017. As of this writing, we believe the municipal sector is poised to enter 2017 in a strong technical position, pricing in worst-case scenarios on most threats to valuation. Economic growth and inflation expectations have clearly moved higher. However, fixed-income markets could benefit from any failure to fully realize these new and loftier expectations. We will focus on credit selectivity. Municipal credit will likely exhibit divergence, and risk premiums will likely be guided by idiosyncratic movements. For 2017 we will position portfolios with a mix of credit quality and maintain a neutral-duration profile relative to our benchmarks.

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[1] Total return = price return + coupon return