Municipal Market Commentary
Q1-2018

As expected, new issue municipal supply in the first quarter dropped dramatically from the same period last year, falling nearly 30%. However, the lack of supply was only able to serve as a buffer to the large secondary market activity that led to underperformance of the high grade municipal sector relative to the US Treasury market, in absolute yield terms (Figure 1). Once again, the bright spot within the municipal market remained the high yield market, where supply was nearly non-existent, fund flows were largely benign and credit spreads continued to tighten. With the Federal Reserve on pace for several more interest rate increases in 2018 and continued volatility in the equity markets, the remainder of 2018 should provide a very interesting market environment.

The deluge of new issue supply in December ($60+ billion) led most municipal market participants to expect a light calendar through Q1-2018 and possibly beyond. For the first 3 months of 2018, long-term issuance totaled $60.5 billion, roughly the same volume experienced in December 2017, alone. The expectation with substantially lower supply was for general market outperformance relative to US Treasuries, particularly given the strong supply-demand correlation to overall municipal rate movements. While primary market supply was anemic, secondary activity was robust. The combination of the dealer inventory hangover from December and secondary market sellers led to fairly dramatic underperformance within the high-grade sector. It has been reported that banks and property and casualty companies were consistently selling into the secondary market throughout the quarter. This is likely the result of the tax-reform bill passed late last year, lowering the corporate tax rate from 35% to 21%, dramatically altering the taxable equivalent relationship to other markets. The lone bright spot within the municipal market was, once again, the high yield sector.

Figure 1.	Aaa Yields			
Maturity	1-Jan	1-Feb	1-Mar	1-Apr
2023	1.68	1.86	1.96	2.04
2028	1.98	2.38	2.44	2.42
2048	2.55	2.93	3.02	2.95
2048 UST	2.74	2.94	3.12	2.97

While the high-grade market experienced a heavy secondary market leading to under performance (-1.13%), the high yield market experienced the opposite (+0.27%) [Source: Bloomberg Barclays Municipal Indices]. New issue supply of high yield municipal bonds was non-existent in the first quarter, due to the extremely heavy issuance in December. Any non-profit 501(c)3 borrower with a future financing scheduled, rushed their issue to market in December to beat the proposed year-end date eliminating tax-exempt borrowing as a financing option. Ultimately, the tax reform legislation preserved the financing mechanism, though the outcome was uncertain through much of December. As a result, there were no major high yield issues during the first quarter and secondary market selling was manageable. High yield fund flows were down considerably from the same period last year, totaling $98 million vs. $2.6 billion for the quarter. However, the overall positive nature of the flows kept high yield mutual fund managers from having to liquidate positions in an otherwise treacherous secondary market. The tobacco sub-sector (20%+ of the high yield municipal index) continued to perform well with participants banking on additional refinancing of outstanding debt. Pennsylvania issued their first tobacco securitization issue in the quarter, but it was additionally secured by an appropriation pledge by the state assembly.

Clearly, the best performing *sector* of the municipal market for the quarter was Puerto Rico. Yes, Puerto Rico. Much has been reported on the devastation following Hurricane Maria last fall, on top of the bankruptcy/financial restructuring. Large mutual fund selling following the hurricane drove prices of Puerto Rico debt to all-time lows at year-end. Reports of the Governor's Fiscal Plans, which will serve as the blueprint for the financial restructuring, have gotten progressively better, over time. The Governor has revised the plan several times since the devastating hurricane last fall. Each revision has incorporated more optimistic economic and financial projections with increasing monies available for debt service. The worst fears, as regularly reported in the press, regarding economic devastation and out-migration following the hurricanes have not, to date, materialized.

Once again, the municipal high yield market proved to be a shelter from the rising rate storm. The combination of higher coupon income, diminished market supply and ongoing customer, albeit muted, demand drove the sector to positive performance despite a 40-basis point upward move in municipal rates. While rates have risen, generally, they remain low by historical standards. The high yield sector continues to offer enticing yields and some insulation from the impact of rising rates. Additionally, compared to corporate counterparts, the sector offers lower default rates, higher recovery rates and lower volatility. Although spreads are tighter today than they have been in recent years, the sector retains many attractive characteristics.