Municipal Market Commentary
Q2-2018

With the Federal Reserve intent on raising rates and a generally strong economy, most market participants expected a steady rise in general interest rate levels in the second quarter. However, external factors including the prospect of a global trade war and uncertainty regarding Italy's continued participation in the eurozone kept the equity markets on edge and US Treasury rates relatively steady over the quarter, albeit with substantial day-to-day volatility. The municipal market continued to benefit from restrained new issue supply and generally positive fund flows. Additionally, the extraordinary volume of bond redemptions via maturity or call enhanced the performance of the municipal market. Finally, Puerto Rico debt continued to outperform the municipal market as additional clarity surrounding potential settlements and agreements between different factions began to emerge.

As expected, new issue volume continued to trail 2017 issuance, mostly due to the elimination of the ability of issuers to advance refund outstanding debt. New issue volume for new projects is ahead of 2017 levels, but total volume is down 21% year to date. Municipal fund flows have generally been positive throughout the year, with all funds reporting positive fund flows of $7.1 billion or $570 million per week. High yield funds have experienced even greater fund flows, from a relative perspective, totaling $2.4 billion or $209 million per week (Lind Capital estimates the municipal high yield market constitutes roughly 15% of the overall municipal market). Finally, new issue volume through the first six months totaled $157 billion, outstanding bonds that were redeemed via traditional maturity or call totaled $168 billion yielding a net issuance of -$11 billion. Combined, a decline in new issue volume, steady and positive fund flows and an extraordinary volume of municipal bonds being retired from the market led to solid market performance through the quarter in a generally flat interest rate environment. Bloomberg Barclays Municipal Index posted a .88% return for the quarter, raising year-to-date performance to -.25%. The Bloomberg Barclays Municipal High Yield Index generated positive returns 3.39% over the quarter, bringing year-to-date performance to 3.66%. The lack of new issue high yield supply and strong investor demand led to tightening credit spreads and general outperformance for the municipal high yield sector.

Figure 1. Aaa Yields

Maturity	1-Apr	1-May	1-Jun	1-Jul
2023	2.04	2.19	1.99	1.99
2028	2.41	2.50	2.44	2.46
2048	2.94	3.09	2.92	2.94
2048 UST	2.97	3.12	3.03	2.99

The best performing sub-sector of the municipal high yield market through the first three months of the year was Puerto Rico. Throughout the second quarter, the market really began to differentiate among different issuers and collateral packages. This was most notable in the General Obligation debt (GO) and bonds backed by sales tax revenue (COFINA). Combined, GO and COFINA constitutes roughly 50% of outstanding Puerto Rico debt. Prior to the "bankruptcy" filing on May 1, 2017, GO and COFINA were trading at $65 and $60, respectively. The GO holders made several claims regarding the constitutionality of the COFINA debt and their right to the pledged sales tax revenue. However, the market maintained a fundamental belief in the underlying structure and collateral of the COFINA issuance. Following Hurricane Maria and the ensuing political turmoil, bond prices on COFINA and GO debt had fallen to $38 and $24, respectively at year end.

In Q2-18, three reported agreements among related parties in the debt negotiations provided the market with further clarification of potential settlement outcomes between the different debt classes. In late May, it was announced the GO and COFINA representatives agreed in principal to split the sales tax revenue, an agreement the Commonwealth deemed unaffordable. In early June, it was reported the PROMESA Board, as representative of the Commonwealth and COFINA representatives agreed in principal to provide 53.65% of sales tax revenue to COFINA bondholders, plus accrued but not paid, interest (senior and subordinate). Finally, in late June it was announced representatives COFINA senior and subordinate holders were nearing an agreement that would provide senior holders between 90% - 100% of their par value. The impact of these proposed agreements was clear in the market, senior COFINA bonds were trading around $85 at quarter end, while GO bonds were trading in the upper-$30s.

Clearly, higher rates are on the horizon. Whether or not the recent supply-demand dynamics will continue to provide support to the municipal market remains to be seen. Historically, a rising rate environment leads to outflows from the municipal market, which in turn, leads to higher rates. High grade municipal rates have risen nearly 100 bps since the lows were recorded in July 2016; the market has been able to generate positive, albeit small, returns over the 2 years. With the prospect of 5 additional rate hikes by the Federal Reserve over the next 18 months, the municipal market might provide some interesting surprises.

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