Municipal Market Commentary
Q3-2018

The municipal market dynamics of the first six months of 2018 continued into the third quarter; diminished new issue supply, strong customer demand and high volume of bonds being redeemed leading to negative net new issuance. This market environment provided market participants with low volatility, steady rates and stable, albeit low, returns. However, as summer turned to fall, municipal issuance began to rebound, and volatility returned to the US Treasury market. As a result, municipal fund flows turned negative and municipal rates began to rise. This trend is likely to continue through the fourth quarter, as new issue supply continues to build and retail investor demand wanes in the face of rising rates and falling mutual fund values.

The impact of the tax-reform bill passed in December 2017 was certainly discussed at the time of passage, but the true impact was probably not fully comprehended at the time. The elimination of advance refunding issues has had a dramatic impact on new issue supply throughout 2018. Through September 30, total new issue volume was $247 billion, a 23% decline from the same period in 2017. Additionally, bond redemptions, via maturity or call, has resulted in a negative net new issuance of -$41 billion, which has resulted in municipal investors chasing fewer and fewer bonds. This has been particularly evident in the high yield sector of the municipal market, where new issue supply has been down more dramatically due to the heavy issuance in November-December of last year, when tax-exempt issuing ability was in jeopardy for 501(c)3 not for profit borrowers.

Figure 1.	Aaa Yields			
Maturity	1-Jul	1-Aug	1-Sep	1-Oct
2023	2.00	1.99	2.04	2.21
2028	2.46	2.48	2.46	2.58
2048	2.94	3.05	3.03	3.21
2048 UST	2.99	3.13	3.02	3.23

The impact of the supply-demand imbalance has been the outperformance by the municipal market of the US Treasury market by both the high grade and high yield sectors. Year to date performance for the Bloomberg Barclays US Treasury Index (LUATTRUU) was -1.67% compared to -.40% and 4.45% for the Bloomberg Barclays US Municipal (LMBITR) and Bloomberg Barclays Municipal High Yield Index (LMHYTR), respectively. The dearth of high yield municipal supply has created an environment of investors "chasing yield" where previously unfinanceable projects are able to receive a ready audience of investors and otherwise high yield borrowers are able to borrow at incredibly low yields. This environment has created something of a bubble, waiting to "pop".

An example of the frothiness of the high yield municipal market was the August pricing of $400 million California Statewide Community Development Authority Hospital Revenue Bonds for Loma Linda University Medical Center (NR/BB-/BB). Loma Linda University Health is an academic medical center operating six hospitals, a physician practice and remote clinics in the western United States. The term bonds (2058) were priced on August 9th with 5.50% coupons to yield 4.50%. The next day, bonds were trading to yield 4.17%, or 33 basis points lower yield than the original pricing a day earlier. Bonds continued trading around 4.20% for weeks, until the strong fund flows began to abate in mid to late-September. By the end of the quarter, the bonds had risen to a yield 4.63%, a selloff of nearly 50 basis points while the high-grade municipal market rose 18 basis points over the same time frame. It is indicative of how fund flows impact the municipal market, particularly the high yield sector.

Throughout 2018, the municipal market has benefited from strong demand and diminished supply. The demand component of the market began to show weakness towards the middle of September, which has continued through the end of the quarter. This resulted in a 20-basis point rise in high grade rates at the end of the month. Going forward, should fund flows continue to be negative, we could see a welcome return of volatility in the municipal market, which has been absent for years. When faced with investor redemptions, mutual fund managers often find themselves scrambling for liquidity and are forced to sell assets they prefer not to sell at prices they prefer not to accept. In the past, these have been the best times to deploy capital as otherwise unattainable assets are suddenly available at very attractive prices. Historically, when retail (mutual fund) investors have been exiting the municipal market, sophisticated (SMA) investors have filled the void. It has been almost three years since we were in a similar environment, albeit briefly. It is an environment we have been waiting for, very patiently.

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