Tax Efficient Fixed Income Market Commentary

October 2017

FIERA CAPITAL

Overview

- Fed formally announces plans to slowly reduce balance sheet
- Healthcare reform efforts fizzle out, shifting focus to tax reform
- Major hurricanes make landfall in Texas, Florida and Puerto Rico
- Reduced new issue supply and strong demand continue

Third Quarter Highlights

Municipal bonds opened the third quarter at elevated levels, having shown strong outperformance during the first half of 2017. While this kind of performance could lead us to use more defensive positioning, the technical outlook drove us to maintain a neutral exposure. Specifically, low issuance, in combination with record redemptions of callable bonds created a significant supply-demand mismatch. Our goal throughout the quarter was to remain fully invested. While we preferred to use municipal bonds, there were times when limited availability of municipals compelled us to use Treasuries, rather than be uninvested.

Yields, which had been falling for most of the quarter, rose meaningfully during the closing weeks of September. Key drivers were a tax reform push from the administration and a Fed which appeared to be more hawkish than expected. Although the announced balance sheet reduction plan was anticipated, the Fed communicated that barring a downturn, the tightening cycle will continue. While there is a meaningful chance that tax reform and Fed action will prove less significant than current expectations, it is nevertheless impacting yields at this time.

During the quarter, most credit spreads were stable but two headline names (Illinois and New Jersey) saw their spreads tighten significantly. As such, we did begin to selectively reduce some of these positions. Should these levels continue to hold or improve we will likely look to reduce exposure further.

LOOKING AHEAD

Our focus will likely remain on the municipal supply/demand balance in the fourth quarter as we look for signs of change in a product starved market. We will be monitoring Washington for tax reform developments and a probable December rate hike. Other key developments to watch:

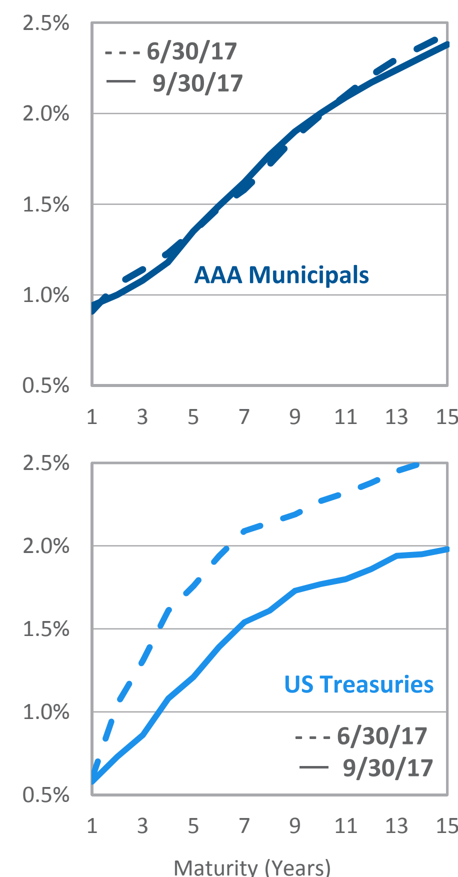
- **Federal Chair:** Fed Chair Janet Yellen's term expires in February 2018 and the Administration is expected to announce its nominee for this important post in the coming weeks.
- **Hartford:** As the State of Connecticut continues through its fiscal year without a budget, an aid package for Hartford hangs in the balance. The aid package will be critical in determining if State's capital city seeks bankruptcy protection. Hartford has commenced restructuring conversations with bondholders.

Market Returns

	3Q17
BC Muni Index	1.06%
1 Year	0.35%
3 Year	0.53%
5 Year	0.68%
7 Year	0.78%
10 Year	1.06%
20 Year	1.51%
1-10 Year	0.73%
Prerefunded	0.38%
AAA	0.71%
AA	0.84%
A	1.23%
US Corp 5-7 Year	1.26%
US Treasury 5 Year	0.26%
S&P 500	4.48%

Source: Bloomberg Barclays 9/30/17

Yield Curves



Source: Bloomberg 9/30/17

Past performance is not a guarantee of future results. Inherent in any investment is the potential for loss.

Tax Reform Efforts Take Center Stage

On September 27th, the Trump administration and members of Congress released a framework to serve as a high level guide for Republican-led tax reform negotiations. Inevitably, questions about the future of the municipal tax exemption emerged. Fortunately, the muni tax exemption did not appear as a target of the framework and the Bond Buyer cited senior administration officials in reporting that the tax exemption would stay in place. Notable aspects of the framework are the creation of new tax brackets, the repeal of the alternative minimum tax, the repeal of the estate tax, as well as the elimination of the state and local tax (SALT) deduction.

While the tax exemption appears safe, the SALT deduction is one of the most prominent 'pay-fors' included in the framework. Its elimination would generate significant budgetary room to allow for a proposed tax break targeted towards low and middle income Americans. The political realities facing the Republican Party provide a significant obstacle to any wholesale elimination of the SALT deduction. Indeed, in the days after the proposal was released there were indications that meaningful opposition had surfaced. Were the deduction eliminated, the impact on municipal bonds would be complex; while many of the effects would be negative it could increase demand for bonds from high tax states.

While we find the framework informative in terms of the forthcoming tax debate, we are skeptical that any broad based individual tax reform is forthcoming in 2017. Should individual tax reform find a path forward, we note that there has been a relatively weak relationship between marginal tax rates and muni/treasury ratios (Q4 2016 Commentary). Agreement on changes to the corporate tax code may find a somewhat less challenging legislative path.

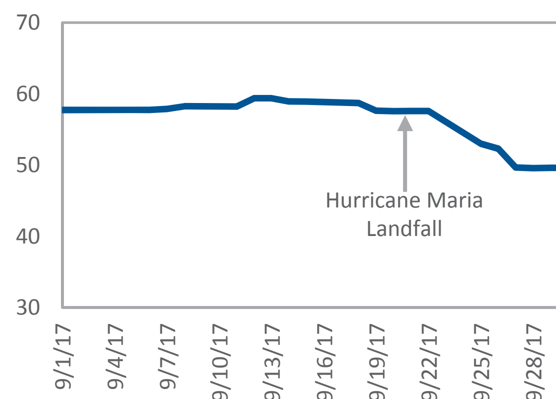
Credit Insight

The credit narrative during the third quarter centered around three powerful hurricanes. First, Hurricane Harvey made a slow and catastrophic landfall in Texas. Hurricane Irma followed. While the resulting impact felt throughout Florida was immense, a last minute change in Irma's path spared the state from even greater damage. After the two storms struck the US mainland, Hurricane Maria made a direct hit on Puerto Rico, devastating the Island.

For high quality municipal issuers, the long term credit implications of natural disasters has been modest historically, standing in sharp contrast to the significant human tragedy of the events. Federal disaster aid can cover a substantial portion of a local government's costs to cleanup and repair after a storm. These reimbursements typically cover 75% or more of overall costs. Another layer of protection for local issuers can come from state governments choosing to supplement FEMA monies. This dynamic was on display in Texas, which recently approved $50 million in aid to the City of Houston.

While high quality issuers are able to leverage FEMA funds to maintain their credit profile, Puerto Rico was hit by Hurricane Maria while in the midst of a severe economic downturn and a debt restructuring. Given the limited precedent for restructurings in the municipal market, practical and political considerations play a critical role. The term 'service delivery insolvency' was invoked by the bankruptcy judge in Detroit. The judge used the term in articulating the need to leave enough resources available, post-bankruptcy, to provide residents with basic services. The judge overseeing Puerto Rico's restructuring process will likely take into account similar considerations. In addition, the Island has seen significant out-migration in recent years and many fear that large scale destruction may accelerate population losses.

Puerto Rico General Obligation Bonds (price)



Puerto Rico bond prices have fallen significantly since the storm.
Source: Bloomberg 9/30/17

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Allocations presented herein are as of the date noted and subject to change.

Index Definitions:

- The Bloomberg Barclays Municipal Bond Index is a rules-based and market value weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody’s, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a double-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.
  - Subindices include: 1 Year (1-2 year maturities), 3 Year (2-4 year maturities), 5 Year (4-6 year maturities), 7 Year (6-8 year maturities), 10 Year (8-12 year maturities), 15 Year (12-17 year maturities), 20 Year (17-22 year maturities), 1-10 Year (1-12 year maturities).
- The Bloomberg Barclays US Corporate Index is composed of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.
  - The Bloomberg Barclays US Corporate Index 5-7 Year Index represents 5-7 year maturities.
- The Bloomberg Barclays US Treasury Index is composed of public obligations of the U.S. Treasury with a remaining maturity of one year or more.
  - The Bloomberg Barclays US Treasury 5 Year Index represents 5 year maturities.
- The S&P 500, or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.
- **It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns and will bear the cost of fees and expenses that will reduce returns.**