Tax Efficient Fixed Income Market Commentary
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FIERA CAPITAL

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Overview

- Congress passed major overhaul to the federal tax code
- Advanced refunding prohibition leads to spike in Q4 muni supply
- Deductibility of state and local taxes curtailed
- Jerome Powell nominated as the next Federal Reserve Chair

Fourth Quarter Highlights

Tax Reform, record municipal issuance, and continued tightening by the Fed created an eventful 4th quarter in the municipal market for the second year in a row. The Fed's decision to raise interest rates for the third time in 2017 led to a sustained flattening of the yield curve. While yields on 1-year municipal bonds rose by nearly 50 basis points during the quarter, yields beyond 10 years fell. On the year, the flattening was even more dramatic. Yields on bonds as short as 5 years ended the year lower, compared to a rising front end of the yield curve.

During the 4th quarter, the evolving tax reform legislation dominated the municipal market narrative. The initial tax proposals included the elimination of advanced refundings and private activity bonds. Although the private activity bond provision was eventually dropped, the tax developments were enough to cause a rush to market. As a result, new issue supply spiked in the 4th quarter, in what had previously been a year of paltry issuance.

This glut of issuance led to some buying opportunities and we repositioned the portfolios accordingly, often extending slightly. Interestingly, the market was far more orderly than is typically the case in the face of such overwhelming supply. This was likely due to many market participants' belief that issuance would dry up in the first part of 2018.

LOOKING AHEAD

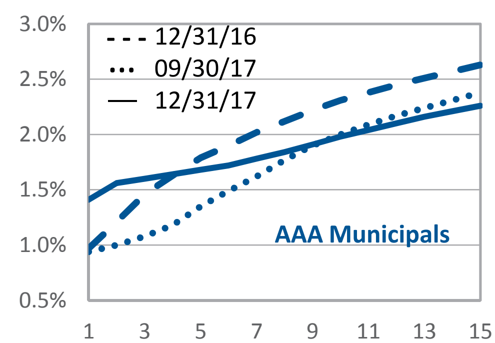
- **Federal Reserve:** Jerome Powell is expected to begin his tenure as Chair of the Federal Reserve in February. Powell's first meeting is anticipated to take place in March, with the market assigning a high probability of a rate hike. We will be watching closely in the coming months for any change in stance relating to the pace of either rate hikes or balance sheet reductions.
- **Deal Pipeline:** A combination of deals that were accelerated into 2017 and a new restriction on advanced refundings may lead to meaningfully reduced issuance in 2018.

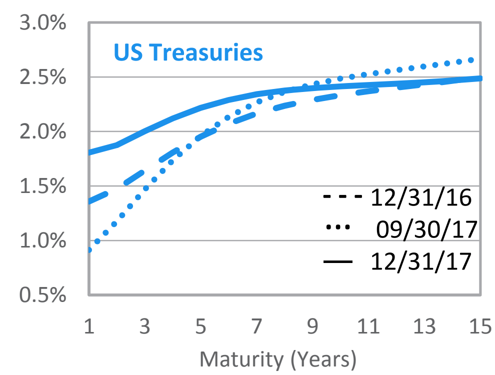
Market Returns

	4Q17	2017
BBC Muni Index	0.75%	5.45%
1 Year	-0.38%	0.92%
3 Year	-0.77%	1.56%
5 Year	-0.70%	3.14%
7 Year	-0.22%	4.49%
10 Year	0.52%	5.83%
20 Year	1.78%	7.47%
1-10 Year	-0.22%	3.49%
Prerefunded	-0.54%	1.37%
AAA	0.51%	4.45%
AA	0.65%	4.96%
A	0.89%	6.16%
US Corp 5-7 Year	0.13%	4.91%
US Treasury 5 Year	-0.71%	0.67%
S&P 500	6.64%	21.83%

Source: Barclays Capital

Yield Curves





Source: Thomson Reuters, Merrill Lynch.

Muni Market Technicals

December was the busiest single month in the history of the municipal primary market. Nearly $63 billion in new issues were priced, compared to average volume of $34 billion for the previous 11 months. Total volume for 2017 came in at $436 billion, just shy of the 2016 record of $445 billion. While supply was the main story, demand, as measured by mutual fund flows, was reported positive in 9 of 13 weeks and totaled $1.1 billion in aggregate.

TAX REFORM

December saw the passage of the most substantial re-write of the federal tax code since 1986. Tax rates were reduced for individuals and corporations, while certain provisions of the tax code were altered in order to keep the ultimate cost of the bill within the limits of the reconciliation process. Some of the most important provisions impacting the municipal market are as follows:

Lower Individual Income Tax Rates: The top marginal tax rate was reduced from 39.6% to 37% and each of the lower tax brackets were adjusted. Notably, the 3.8% Medicare surtax on investment income was retained, keeping the top marginal rate above 40%. While in theory, lower tax rates could pressure municipal yields, the drop in tax rates is likely too small to generate a material change in investor demand.

Lower Corporate Tax Rates: In contrast to a modest reduction in individual income tax rates, the corporate tax rate was reduced from 35% to 21%. {See our recent report on the impact across sectors of the Corporate bond market here}. While retail investors are the largest portion of the municipal market's investor base, insurance companies and banks are meaningful buyers, particularly for longer maturity structures. The significantly lower rate could have a dampening effect on demand for tax exempt securities from banks and insurance companies.

State and Local Tax (SALT) Deduction Capped: In order to reduce the overall cost of the tax reform, the legislation included a cap on the ability of individuals to deduct taxes paid to state and local governments on their federal return. The law will allow up to $10,000 of SALT payments to be deducted annually. From a credit standpoint, a reduced SALT deduction may add budget pressure on those high-tax states that rely extensively on high-income earners for revenues. This is an unwelcome development for those states facing escalating payments to meet underfunded pension commitments.

Creative state tax policy solutions to avoid the cap have emerged in recent weeks, including shifting to a deductible payroll tax, or using charitable deductions to offset state taxes. However, the legal and practical ability to implement these solutions remains to be seen. Last, despite potential for longer term budget pressures, these same high tax states may see an increase in demand for in-state municipal securities, which are typically exempt from state taxes.

Advanced Refundings Eliminated: The law included a prohibition on a common refinancing vehicle used by local governments to save on debt service costs. While the credit impact on most issuers is not likely to be dramatic, refundings have been a significant source of volume in recent years and the loss of this specific type of refunding will likely lead to a smaller new issue calendar. Prerefunded bonds, which are created during an advanced refunding, comprise approximately 9% of the market. These will slowly run off in the next several years as they are retired and the creation of new prerefunded bonds is sharply reduced. Both a smaller calendar and the runoff of prerefunded bonds are likely to be supportive of municipal prices.

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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 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 maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.
  - Subindices include: BBC 1 Year (1-2 year maturities), BBC 3 Year (2-4 year maturities), BBC 5 Year (4-6 year maturities), BBC 7 Year (6-8 year maturities), BBC 10 Year (8-12 year maturities), BBC 15 Year (12-17 year maturities), BBC 20 Year (17-22 year maturities), BBC 1-10 Year (1-12 year maturities).
- The Bloomberg Barclays US Corporate Bond 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 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.