

Tax Efficient Fixed Income Market Commentary

July 2019



Overview

- Trade tensions escalate amid softening of US economic data
- Communication from Fed has market pricing in rate cuts
- Fund flows into municipal market continue at strong pace
- Smooth budget season for states following solid tax receipts

Second Quarter Highlights

During the second quarter, the Fed took center stage as an easing of monetary policy became a real possibility. Driving this change from the Fed was the breakdown of trade discussions with China and its potential impact on the economy. Despite the market's lofty expectations, Chairman Powell's dovish comments did not disappoint. While we believe the Fed is likely to begin an easing cycle, the length and depth of that easing cycle is likely to be influenced heavily by the economic data in the coming months.

The market's perception that the central bank will be more accommodative had a substantial effect on rates. Yields on Treasury bonds fell 40-50 basis points (bps) and there was a marked steepening in the slope of the curve. Municipal yields also fell during the quarter, but they underperformed in the rally as their yields only fell 20-30 bps. Falling demand for the shortest maturities prevented the steepening seen in Treasuries from being reflected in municipals. This dynamic could subside in the coming months, causing a steeper municipal curve.

The outperformance of Treasury bonds during the quarter enabled our 'crossover', initiated in the first quarter, to outperform. For more information on 'crossover', see [here](#). Although we selectively rotated a portion of the Treasuries back into municipal bonds, the position remains in place.

LOOKING AHEAD

- **Census:** The US Census is critical in determining the allocation of federal dollars to the states. In June, the US Supreme Court blocked, at least temporarily, a question on citizenship from appearing on the 2020 census. This is an important ruling for certain states with high immigrant and undocumented populations. Our Director of Credit Research, Judy Wesalo Temel provides more detail [here](#). As of the date of this publication, the Trump Administration issued an executive order requiring Federal agencies to provide the Department of Commerce with records on citizens and non-citizens.

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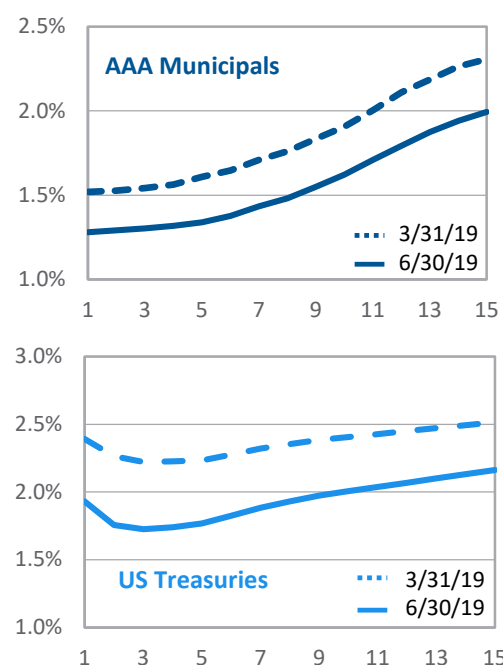
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Market Returns

	2Q19	YTD 2019
BC Muni Index	2.14%	5.09%
1 Year	0.76%	1.58%
3 Year	1.11%	2.46%
5 Year	1.66%	3.80%
7 Year	1.96%	4.70%
10 Year	2.15%	5.36%
20 Year	2.57%	6.16%
1-10 Year	1.64%	3.88%
Prerefunded 5 Year	1.57%	3.61%
AAA	1.83%	4.56%
AA	2.01%	4.80%
A	2.31%	5.52%
US Corp 5-7 Year	3.90%	9.03%
US Treasury 5 Year	2.80%	4.71%
S&P 500	4.30%	18.54%

Source: Bloomberg Barclays Capital

Yield Curves



Source: JP Morgan, Bloomberg, Merrill Lynch.

Municipal Market Technicals

Supply and demand dynamics continued to be supportive of the market in the second quarter. New issue volume was down over 11% compared to the second quarter of 2018. Year-to-date, 2019 is tracking slightly ahead of last year. However, the impacts of subdued Q1 2018 issuance skew this year-over-year comparison to some degree. Overall, supply continues to be underwhelming. Demand, as measured by fund flows into municipal mutual funds was very strong. Average weekly inflows were over \$1.1 billion, showing little sign of slowing from the record pace of fund flows seen in the first quarter.

State Focused Portfolios

We are often asked if we manage “single state” municipal portfolios i.e. one which solely contains bonds from the account holder’s state of residency. Typically, our response is that while we may be able to, doing so may not be the best way to maximize after-tax return.

Most states have a limited number of high-quality issuers and for some, availability in the market can be quite scarce. In these cases, investors can be forced to pay too much in order to get funds invested. Even in states such as California and New York with greater amounts of issuance, demand can push yields to unattractive levels. As a result, we believe “state focused” portfolios make the most sense. In this structure we have the flexibility to buy out of state when it offers greater opportunity, allowing us to tailor the portfolio structure to market opportunities and seek to improve the after-tax yield.

Examples of this can currently be seen in our California portfolios. In the recent past, it was not uncommon for our California portfolio to be fully invested in-state, but this changed following the tax reform which went into effect in 2018. In its wake, the relationship between California-exempt bonds and the rest of the market changed such that California frequently offered 15+ bps less in relative yield than they had previously. Being “state focused,” rather than “single state,” enabled us to sell some bonds in the most impacted areas of the yield curve and replace them with higher yielding bonds from other states. Such a strategy aims to increase the after-tax yield of the portfolio.

Credit Insights: State Budgets

July 1st marks the beginning of the fiscal year for most states, which means that much of the hard work of negotiating taxing levels and prioritizing spending takes place in the second quarter. State budget season in recent years has been characterized by headline-producing budget battles, particularly among the states facing fiscal pressures from underfunded pensions. These budget stalemates have resulted in late budgets or government shutdowns, and have heightened headline risk for certain municipal bonds heading into the summer months.

The 2019 budget season came and went without these intense political conflicts. We noted after last November’s elections that a greater number of states now have single-party rule between the governors office and legislatures. While this increased the likelihood of

reaching compromises, another major contributor to the relatively smooth budget season was a surge in tax receipts. States like California, Illinois, Connecticut among others, reported tax collections that exceeded expectations and allowed for increased projections for the upcoming fiscal year.

The surge in spring tax collections was of particular interest in the wake of the federal tax law changes of 2017. Taxpayers were filing their returns for the first full year under the new tax regime, which included a cap on the State and Local Tax (SALT) deduction. While the changes to the SALT deduction are likely to be a long term drag on high-tax states’ credit profiles, the positive revenue surprises reveal that the short term impacts of tax reform are yet to be determined. As noted above, the SALT changes have increased demand for tax exempt bonds in high-tax states. We will be following this issue closely in the months and quarters ahead.

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

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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 Prerefunded Index is composed of general obligation bonds, revenue bonds, insured bonds (including all insured bonds with a Aaa/AAA rating), and prerefunded bonds.
- 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.