

Municipal Commentary Third Quarter 2018

Higher Supply Levels Mutes Expected Favorable Market Technicals

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Entering the third quarter, the tax-exempt market was poised to see stronger relative performance versus taxable alternatives. Very favorable market technicals tied to both an expected quarter-over-quarter 22% drop in new issuance and a significant increase in reinvestment flows, were expected to provide a significant boost in muni performance for the quarter. However, although flows from coupon/calls/maturities were a significant source of demand for the quarter, new issue supply came in higher than expected, resulting in a softening of the expected favorable technical environment. For the quarter, 10 year muni yields increased by 12 basis points (bps), which resulted in nominal yield spreads tightening by 8bps versus 10yr Treasury yields.

In taking a closer look at the market technicals for the quarter, new issue supply was expected to total ~\$75 billion. However, the market actually saw a substantial surge in refinancing-related supply that resulted in a 76% increase in this segment versus the average over the levels exhibited during the first two quarters of the year. That surge resulted in total supply for the quarter to come in 12% higher than expected at \$84 billion.

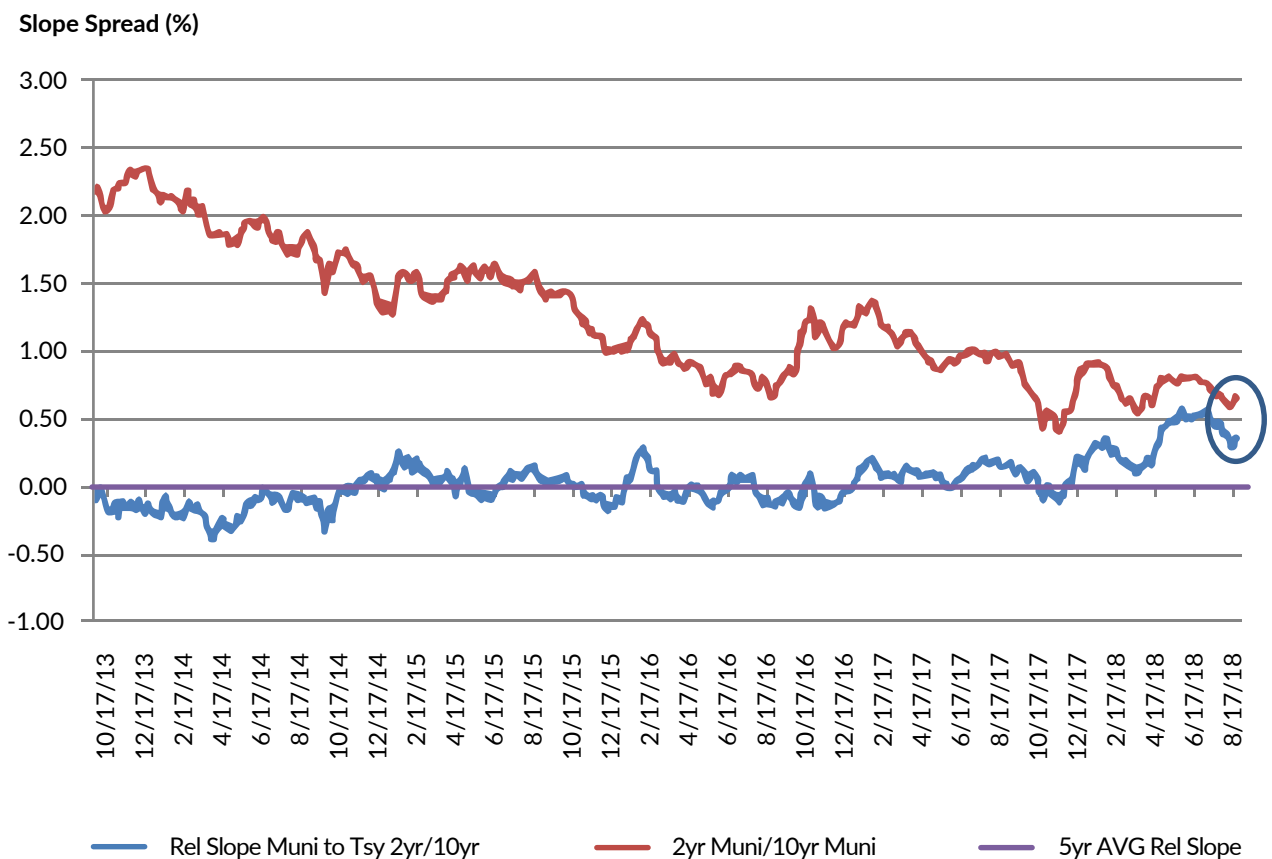
Market technicals during the quarter were also encumbered by a continuation of the selling pressure that's been in place all year. The aggregate amount of daily bid list activity reported by Bloomberg for the quarter totaled \$47.7 billion. Although that was down 10% relative to the average quarterly totals over the first two quarters, it was up an astounding 62% versus the totals for the third quarter of 2017. Most of the selling pressure can be attributed to banks and insurance companies as they continued to sector rotate out of tax-exempts and into taxable alternatives with much higher after-tax yield projections. In comparing muni tax-adjusted 'AAA' yields to 'A'-rated corporate yields, munis are at a substantial yield disadvantage of 80, 87, 71 and 42bps in 3, 5, 10 and 30yrs, respectively, on a maturity-matched basis.

Unless the tax-exempt sector experiences dramatic relative underperformance and reduces these unattractive yield spread relationships to taxable alternatives, the market should expect to see this selling pressure carry into the fourth quarter.

As we enter the fourth quarter, selling pressure is also starting to develop in mutual funds, which is a segment of the market that's provided demand stability for most of the year. After averaging inflows of \$220 million per week on a year-to-date basis through the end of September, fund flows have exhibited a dramatic reversal of negative \$511 million per week over the first 3 weeks of October. Municipal fund flows have historically been very sensitive to heightened concerns over volatility in interest rate levels and those concerns came to the forefront during the first two weeks of October with 10yr Treasury rates reaching a 2018 high of 3.23% on October 11th.

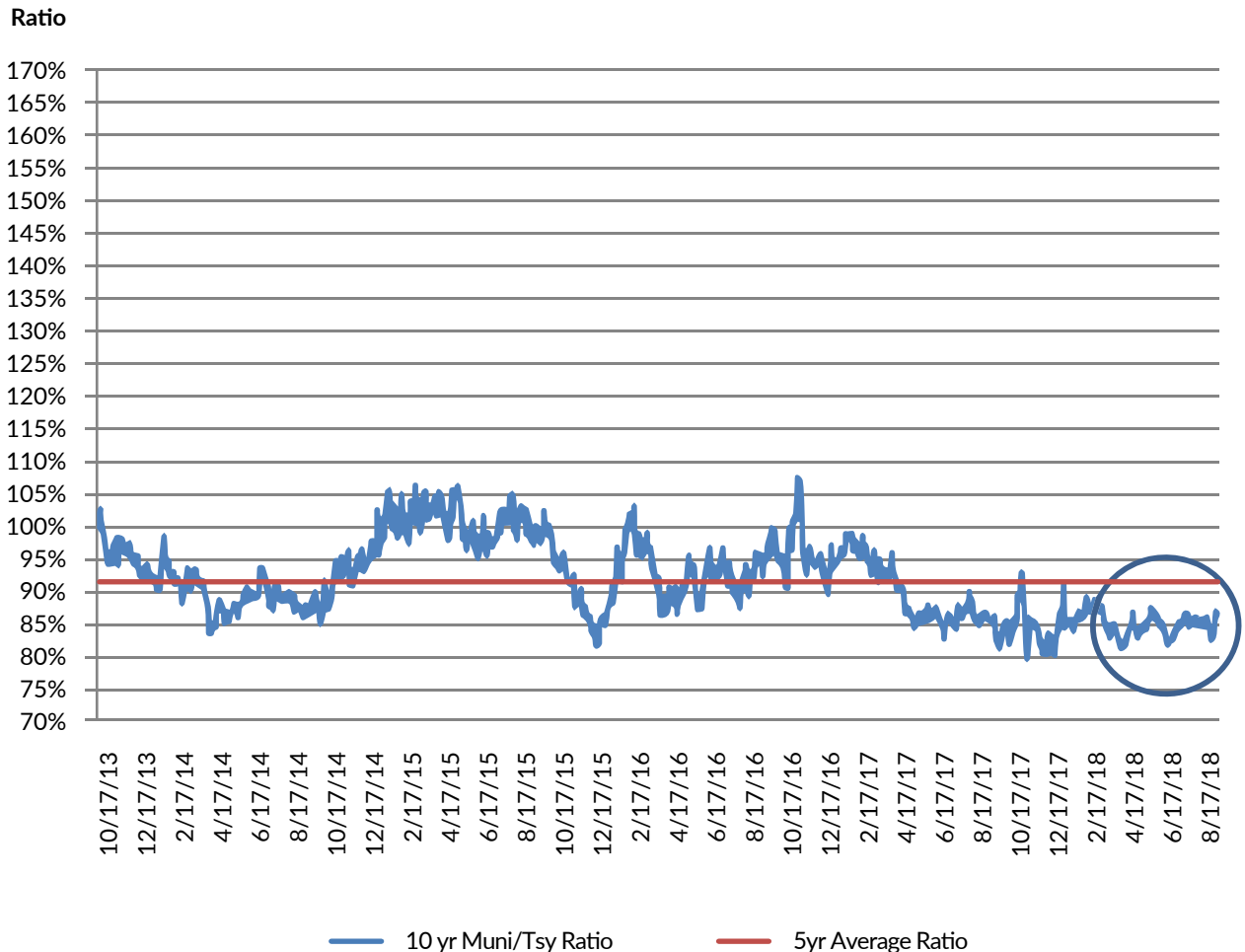
In looking forward to our outlook for the fourth quarter, the selling trends across a number of segments are clearly a risk to market underperformance for the quarter, especially during October and November. However, there are signs that we could see more stability in the market. Net supply levels (gross issuance less reinvestment flows) are expected to total negative \$15 billion for the quarter, which would be the second most favorable fourth quarter technical environment in the last 10 years, behind negative \$19.5 billion in 2015. For our insurance company portfolios, we are currently waiting for the market to stabilize into the stronger technical period that should develop into year-end, at which point we will look to continue to sector rotate out of municipals and sell into stronger relative valuation levels as they materialize.

Yield Curve Slope Comparisons



Source: Bloomberg & Thompson Reuters

10yr Muni/TSY Yield Ratio



Source: Bloomberg & Thompson Reuters

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