ANNUAL OUTLOOK

2019 – Training Your SWAN

MAINLINE WEST

Outlook 2019 - Training your SWAN:

Munis are a "late-cycle" haven. Their historical performance in a Fed rate hike environment is good and their credit quality is improving. Munis have always been, and will continue to be, a safe haven for "long-term" investors - even late in an economic cycle.

We see value in 2019, as fundamentals and technicals are attractive and, historically, munis are in a good spot to remain a top performing asset class. That being said, we do see some long-term concerns and changes developing that, we feel, should be monitored.

Munis have become an asset class that needs to be individually and professionally managed by a muni expert. We consider it risky and expensive to buy any issuer at the given price. Long-term credit concerns are evolving, the cost to buy munis from secondary firms is too expensive, and relative value of certain types of bonds and investment strategies can make a big difference in a SWAN's performance.

MainLine feels it's time to start training your SWAN to do the following:

- ***Actively look to protect principal and liquidity.*** Own bonds that maintain their high principal repayment ability, and bid side price, through any type of fiscal and operational mishaps in the market. There is a change occurring in the 'gold standard" of muni credit.
- ***Minimize costs and receive bonds allocations.*** Investors should be executing the purchase and sale of bonds at the highest level of efficiency, while not paying high management fees. A study released in 2018 shows muni investors are grossly overpaying for bonds. Investors should insist on institutional access to purchase bonds and a competitive bid process to sell them. This will also ensure investors access to bonds, as we feel supply will be decreasing and demand increasing, impacting the ability to be allocated bonds.
- ***Maximize your after tax income.*** It's about earning the most after-tax income on bonds based on the investor's tax status, investment objectives and horizon. This involves one strategy, unique for the investor, and not one shared by others and/or disguised by a mutual fund.

Highlights from 2018:

- Munis were a top performer in 2018, easily outperforming other composite indices:

Bloomberg/Barclays Index	Coupon Return	Price Return	Total Return
Muni Composite	4.20%	-2.91%	1.28%
US Treasury Composite	2.25%	-1.39%	.86%
US Agency Composite	3.72%	-6.23%	-2.50%
US Corporate Composite	3.07%	-2.79%	.27%
Global Aggregate (*)	2.71%	-2.19%	-1.64%

(*) Invested in a GDP weighted portfolio of Global government and non-government issuers

- Credit default spreads on some of the largest and lowest rated states tightened significantly in 2018, suggesting that investors feel the chance of defaults are much lower and credit quality is getting stronger. For example, CDS spreads tightened as follows:

New Jersey	-37%	Texas	-8%
California	-40%	Illinois	-19%

- Muni issuance dropped significantly in 2018, helping munis perform well in a raising rate environment. 2018 issuance was down as follows:
  - 24% versus record levels in 2017.
  - 14% versus the average over the last 5 years.

- Muni curve flattened, but nothing near that of the US Treasury. It does set up some interesting curve dynamics for 2019 in muniland. Munis versus US Treasury curve changes:
  - 2 to 10 year rates flattened by 8 bps for munis, 32 bps for US Treasuries.
  - 2 to 30 year rates flattened by 24 bps for munis, 32 bps for US Treasuries.

- USD Libor market and its relationship with the 7-day Muni PSA rate is out of whack. USD is in short supply overseas from corporations bringing back dollars after the tax reform of 2017. Recently the muni rate has averaged 68% of the taxable rate. Since 2016 this relationship has averaged 74%. ***We are very happy with this relationship as it is providing the Funds with lower funding costs, while providing them higher floating rate income from the swaps.***

- In August, after five years, ***The Mainline West Tax Advantaged Opportunity Fund III*** was successfully wound down to a ***10.49% IRR (16.36% tax equivalent)***. ***MainLine also finished investing Fund V in December of 2018.***

Munis – Your Late Cycle Safe Haven Floaty in 2019:

In a recent study by Bank of America/Merrill Lynch, municipal returns during rate hike periods are pretty impressive, showing investors how munis outperform when rates go up.

Fed Rate Hike Period	Muni 7-12 Yr(*)	Corp 7-12 Yr	Muni 22+	Corporate 22+
1994-1995	.40%	-1.70%	-1.30%	-1.40%
1999-2000	4.90%	.70%	-.80%	1.50%
2004-2006	6.80%	2.70%	10.70%	2.60%
2016-2018	5.70%	2.40%	7.10%	2.00%

(*) adjusted for Federal tax rate during that time period

As the chart above shows, during a rate hiking period, munis have outperformed 3 out of 4 times for long-term maturities, 4 out of 4 times for intermediate.

Using this as a back drop, we can help explain why the fear of rising interest rates, manageable in scope, does not turn us negative on muni returns.

Muni Yield Curve, the Fed, and Interest Rates – Keeping your Head Above Water:

- ***MainLine believes the muni yield curve cannot invert beyond 10 years for bonds that are callable and shorter in final maturity.*** It is mathematically impossible, as bonds trade to the lowest yield using the call date or the maturity date. A price of $105 will provide a higher yield when calculating it to maturity versus call date since it has more time to work its way to par. That being said, the curve does have room to flatten more if the Fed continues to tighten.
- Historical yield spreads since May 1994 through December 2018 shows the following:

Time / Yield Spread	2 Yr – 10 Yr	2 yr – 30 Yr	10 Yr – 30 Yr
Historical Average	139 bps	229 bps	89 bps
Current 12/31/18	54 bps	130 bps	76 bps
12/31/2006 – Fed Tightening	(5) bps	34 bps	39 bps
8/31/2000 – Fed Tightening	37 bps	110 bps	73 bps
Minimal Spread	(12) bps	28 bps	31 bps

- We feel this round of flattening appears to be nearly over, and any movement up in rates is going to be limited.
  - Since 1/1/2017, the 10-year has increased roughly 60 bps. Yes, we have had bigger inter-year range movements, but the fact remains the move up has not been that large.
  - We feel demographics continue to support demand in fixed income and supports lower inflation; both factors will limit any move up in rates.
  - Considering the performance of munis in 2018 and the history of muni performance in a rate tightening in environment, ***we do not fear an increase in rates that will significantly hurt muni returns for 2019.***

Munis – Your Late Cycle Safe Haven Floaty in 2019 (cont'd)

- Our view of the curve and opportunities going forward are as follows:
  - ***The short-end of the curve represents price performance value versus taxables.*** This is a great place to invest cash right now and, if the Fed is about done, there is a good chance for price appreciation, as the curve is flat versus historical standards.
  - ***The curve has shown a few points in time where the 10-year was inverted to the 2-year yield.*** These were non-callable bonds. This happened for about a month in late 2006 and early 2007.
- ***The increased use of professional management by muni investors, at some point in the future, could weaken demand for munis 10 years or less.*** This is not happening at this moment, as investors still want to stay short in munis. It will take some time for the "Pros" to convince investors that longer is better in muniland!

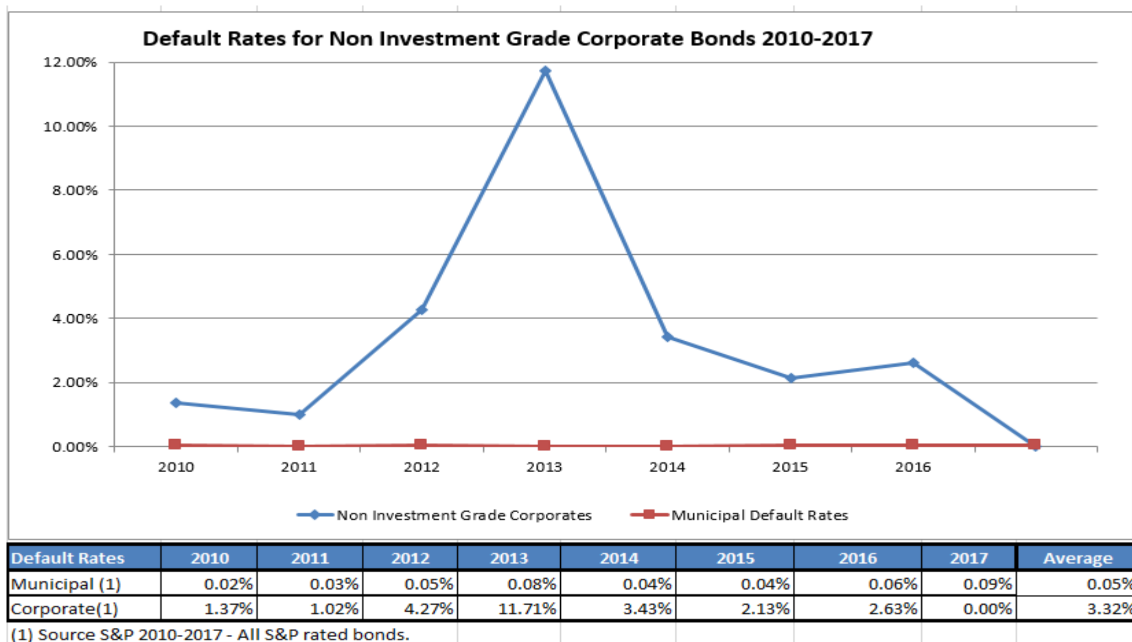
A Change in the Gold Standard of Credit Quality?

If you buy the right type of bond from the right issuer, munis remains the principal protection star of the show. ***That being said, we see a trend slowly developing where the wrong type of bonds, from the wrong issuer could result in the possible principal or liquidity loss in the future.***

- ***In 2018, we saw a continuation of the credit quality decline of the unlimited and limited General Obligation pledge***:
  - Beware of moral and appropriated debt not tied to essential services
    - The recent default of bonds backed by a limited moral pledge by Platte Valley, is a continuation of the trend Detroit, and Puerto Rico have created.
    - Re-evaluate appropriation & limited GO bonds. (Essentiality is more important than the pledge.)
  - There will be a continued segregation of revenue streams to support debt. For example, the issuance of sales tax backed revenue bonds. This takes the first lien away from General Obligation investors, creating a higher rated bond, at the expense of the GO's - another way of weakening the GO pledge.

A Change in the Gold Standard of Credit Quality? (cont'd)

- ***Monoline insurance no longer provides an easy way to buy "high quality" bonds.*** Since the demise of the monolines in 2009 and 2010, credit research in muniland has had to go back to looking at the fundamentals of the issuer. MainLine does support one monoline insurer, due to its formation charter and underwriting procedures.
    - We will not buy a bond based solely backed by BAM, but we do feel it adds value.
        - Why do we support the BAM pledge?
            - It is a Mutual Company, where each issuer puts money into the company and claims paying ability continues to grow with insurance.
            - The only product insured is municipal bonds, unlike the other monolines that insure home loans.
- ***Pension issues, declining demographics in regions of the US, and the inability to manage increasing liability costs will not change.*** The issuers facing these problems will continue to decline in credit quality and, at some point, gain greater headlines.
- ***A special point of focus needs to be rural hospital credit strength***. The rising cost of healthcare, lack of physician/nursing staff, and the lack of inpatient growth has this sector on high alert for credit quality weakening. There could be some assistance at the national level, but investment in these issuers requires good quality research.



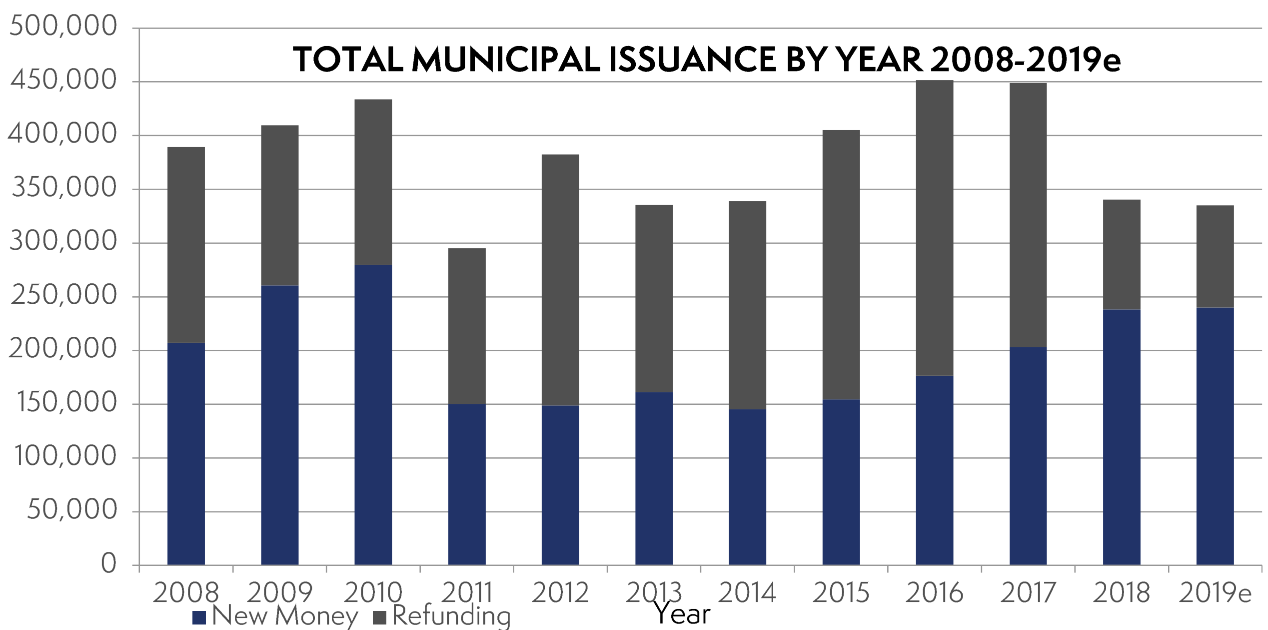
Default Rates	2010	2011	2012	2013	2014	2015	2016	2017	Average
Municipal (1)	0.02%	0.03%	0.05%	0.08%	0.04%	0.04%	0.06%	0.09%	0.05%
Corporate(1)	1.37%	1.02%	4.27%	11.71%	3.43%	2.13%	2.63%	0.00%	3.32%

(1) Source S&P 2010-2017 - All S&P rated bonds.

The growing importance of credit research illustrates the need for professional management. Investors should consider improving credit quality by reviewing the fundamentals of the bond and issuer, and not just looking at the credit rating. That being said, things will never get to the level of corporate defaults.

Muni Issuance for 2019:

- ***Forecast a slight decrease (5 to 10%) to flat***, based on the amount of new projects passed at the mid-term elections and a continue decrease in prerefunding.
    - Muni industry is starting to pick-up the pace for infrastructure improvements, as new money has been picking up.
    - Refunding volume should remain low over the next couple years, as the rush to refinance in 2017 took away the refundings we anticipated for the next 2 to 3 years.
- ***Issuance will still be lower than expected demand***, given coupon and maturity payments providing a bullish outlook for rates.
    - Issuance forecasts from the street are from $340 (no change) to $320 billion forecasted.
    - Forecast for $400 million in cashflow estimated. Net decrease of $60 to $80 billion in cash versus muni bonds.
- Lower issuance and increased demand leads to a tougher time receiving allocations on bonds that fit your investment profile. ***It's important to have an investment professional who has the relationships to get you the bonds you need.*** It's called institutional access, the top line in the allocation process.



- ***Continued decline in demand from Banks and P&C Insurers,*** but we feel the increase in overseas investors and growth in SMA's will offset this decrease.
- ***A potential game changer is if Congress can finally get an infrastructure plan in place,*** and how it could impact tax-exempt issuance, and/or demand.

Fundamentals lean a bit bullish, but there is a risk that this could change.

Finally, an Infrastructure Plan? Which one? What is the potential impact on munis?

The Need for an Infrastructure Plan: ***Why all the fuss?***

The ASCE (American Society of Civil Engineers) has identified an infrastructure gap of $1.5 trillion today and a need for $4.6 trillion by 2025. This includes maintenance of current projects and the demand for new ones. A quick review of the issues looks like this:

- One in four bridges is structurally deficient.
- Water and energy systems require $632 billion for safety and usage needs.
- One out of every five miles of highway pavement is in poor condition.
- A broadband gap: believe it or not, the USA trails a lot of other countries in providing internet service. Roughly 25% of Americans live in "low subscription" neighborhoods.

Once a nation known for its good infrastructure, the USA has lost pace with the rest of the world and now needs to change its ways. The USA spends much too little on infrastructure.

- European countries spend roughly 5% of GDP, USA spends 2.4%.
- Most states have been concerned with cutting taxes and offering corporate subsidies to promote economic growth, and have not invested in their infrastructure.
    - State and local spending on infrastructure is now at a 30-year low.
    - Most states are in solid fiscal shape and could afford an increase in spending or taxes.

Current plans floating around DC:

1. "National Infrastructure Development Act of 2018", now 2019.
    - Rebuild America Bonds
        - Starts with $75 billion (up to $300) to be sold to Pension Funds. Bonds would mature in 40 years and pay taxable interest of +200 bps versus the 30 year Treasury.
        - Guaranteed and paid by the US Government
        - Priority of projects will be based on economic, environmental, energy, and telecommunications projects which will spur economic growth, create jobs, or have regional/national importance.

Current plans floating around DC (cont'd):

- What the plan is missing:
  - The "little" municipality will be left out.
  - No responsibility for the muni issuer to manage projects efficiently (they are not paying for it).
- Takes away supply from the muni tax-exempt market.

2. Build America Bond Program revived:
   - Taxable munis that receive a subsidy from the US Government:
     - This subsidy will need extra protection so as not to be cut like it was under the old program.
     - Will encourage the further growth of overseas investors, and provide an investment for pension funds.
     - Promotes accountability and responsibility by the issuers as they have some "skin" in the game, and are in control of the project.
     - Takes away supply from the muni tax-exempt market.

Munis will participate, but a national program and a BAB program that will compete for tax-exempt investors does not look likely.

Pension Bonds (POB's), Politics & Reforms: Seven Letter Words, with Four Letter Meanings.

Pension Bonds (POB's):

- 2019 is the first year for GASB 74 & 75 and the reporting of future retiree healthcare plans costs on the balance sheet. It is anticipated to have a negative impact on the balance sheet, as most plans are pay-as-you-go. This change requires municipalities to report the future liability of their plans now. It is anticipated to add $900 billion in liabilities to their balance sheets.
- Bonding out the pension liability with bonds; Investment arbitrage - borrow and invest.
  - The issuers with the large unfunded pension balances are looking at borrowing the difference, then investing it hoping to make enough money to repay the loan and rebuild the pension account balance.
    - Chicago is floating the ridiculous idea of issuing $10 billion POB's.

Pension Bonds (POB's), Politics & Reforms: Seven Letter Words, with Four Letter Meanings (cont'd).

- Seeing how most pension funds assume a 7% or higher rate of return, and the cost to borrow is from 4% to 5%, it appears to me that hoping for a 11% to 12% return on investments is a little out of touch with reality.
- MainLine does not like this form of financing, from both an investment point of view and as a general credit statement about the municipality. We would rather see the municipality find a new source of revenue and slowly started paying down the difference over the next 30 years.
- We can't help but think these issuers may have a better chance going to Vegas.

Politics, Tweets, and Reforms:

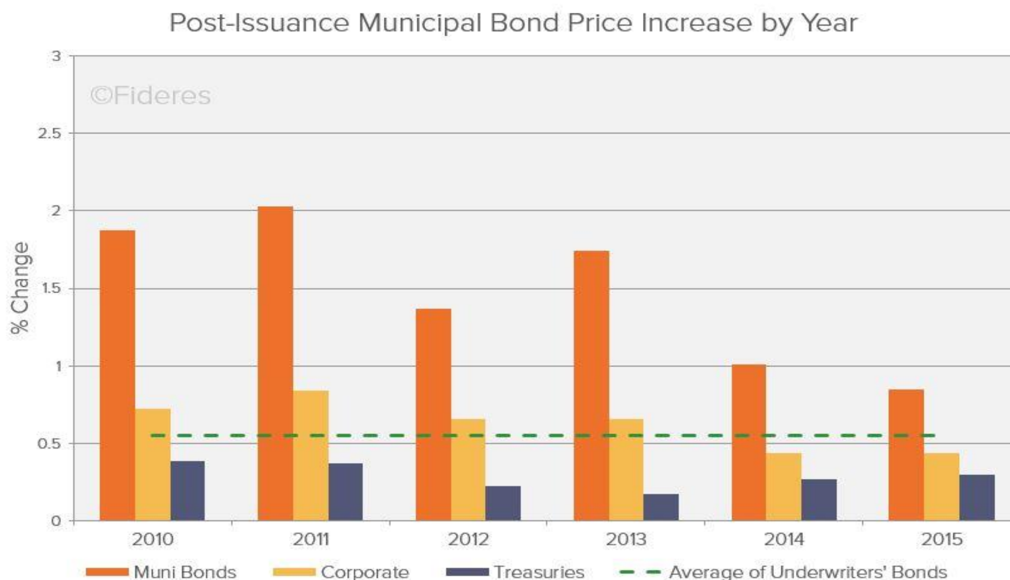
- It just keeps getting louder regarding news and opinions from DC. We do not feel like any of this is a threat to the muni market. ***Having just been through tax reform, and munis not being greatly impacted, the need for infrastructure and a general level of higher comfort with the muni market in DC gives us confidence.***
- Local politics are beginning to pollute the muni industry. It's not enough for politicians to look out for themselves and their constituents; it is becoming easier for them to do it at the expense of everyone else, including the municipality. ***This is leading to a clouding of credit quality for general and moral obligation debt.***
- If there is negative news on munis at some point, we would view this as an opportunity to purchase the right type of munis.

Other items in 2019:

- Failed Brexit? Flight to quality?
  - The markets seem to have this event isolated away from US Treasuries and other fixed income markets. We feel things could get a little chaotic if there is a bad ending to the Brexit. We feel this is just the beginning of Euro issues, but the market does not seem to be thinking that far in advance at this time.
- Economy starts to pick back up and rate hikes are back on from 1 to 4 times.
  - The economy has been impressive, but we still feel the demographics outweigh any significant increase in rates. ***We could get another run back up in rates if the economy picks up, but lack of true inflation, and continued demand for fixed income, will keep a ceiling on the increase in interest rates.***

The Need to train your SWAN:

- The change in mutual holdings Q2 2008 to Q2 2018 shows that the use of separately managed account is increasing:
    - SMA's increased from 2.7% to 14.9%.
    - Mutual Fund increased from 10.7% to 18.1%.
    - Household managed decreased from 47.3% to 27.3%.
- **Credit research is becoming more complicated** in the absence of monoline insurers and current muni defaults and court rulings.
- ***Fees are dropping,*** making it much cheaper to have professional management.
- ***SMA's are offering more individual strategies that mutual funds do not,*** easing the need for individuals to do things themselves.
- Long-term, this trend could finally influence the relatively rich ratios munis trade at versus the long-end and professional management encourages investors to move out the curve for better value.
- ***The need for full price and fee disclosure.*** In the study, Fideres analyzed a Bloomberg sample of price increases from new bond deals from 2006 to 2015 for Municipal, Corporate and US Treasuries. The graph below shows the average percent change in price for each bond from it's selling date to it's settlement date.



The graph shows us the following:

- Muni bond prices on average increased 163 bps.
- Corporate bond prices on average increased 64 bps.
- Treasury bond prices on average increased 33 bps.

Fideres goes on to conclude that these increases in bond prices after issuance shows that underwriters have underpriced the bonds by the increase in bps reflected. For munis, they calculate this to be $28 billion from 2006 to 2015 (rough average of$2.8 billion a year). They then imply that this is the additional cost that the issuers are paying on their debt and, therefore, costing the taxpayers money. This makes the muni market look very inefficient versus the other asset classes in the study.

A good professional muni manager should avoid this food chain of market ups, and provide investors muni bonds at their offering price. Mainline charges 15 bps a year and provides investors the initial offering price, saving clients an additional 163 bps in price mark-ups.

Welcome to the MainLine Advantage!

Munis 2019 Outlook & Conclusions:

In 2019, we are going for the coupon, but we feel good that if rates rise again, munis will hang in there versus other fixed income classes.

The muni curve is flat, but still looks cheap versus taxables on the short-end, especially if the Fed is near finished raising rates. That being said, we feel long munis seem like the safest bet for top performer.

Defaults will not rise substantially, but political risk is increasing and what were once considered good principal protection standards are changing. We feel this is a trend that is just beginning and will lead to increases in default rates years from now. ***Time is now to avoid this if you want to maintain that SWAN portfolio***

The word is now out on the muni market and its dirty secret of marking up bonds and costing investors yield. Investors are getting educated and efficient and proper professional management is growing. This is reflected in the large increase in the muni SMA business over the last ten years.

Investors can still trust the muni market to provide good after tax income and high quality principal protection. It just needs to be managed by a muni professional who will work for you and who can train your SWAN!

MainLine is that professional muni expert with a ten year track record, $1 billion in assets, and certified to train your SWAN!

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