

MONTHLY REVIEW

April 2018



MAINLINE
WEST

April 2018 Muni Market Monthly Report – “Goodbye Libor, Hello SOFR”

Munis spent the month of April showing how they outperform taxables in a rising rate environment. Muni rates increased, but at roughly 2/3 of their equivalent taxable rates. This is the usual long-term performance of munis in a rising rate environment. If we can get a pick-up in issuance over the next 30 days, we think there could be some good buying opportunities before the technically strong summer months.

A mainstay of the investment world is schedule to be terminated by the end of 2021. The \$350 trillion Libor index base market will need to find a new guideline. There is no need to get overly concerned. Even the least desirable option is better than one than the current one, which has been manipulated and is not based on market transactions. The initial replacement looks to be SOFR, a secured overnight rate used for Treasury Repo transactions. We will review the Libor market, SOFR, and the impact on the muni market in this month's credit review.

Muni Market Review

The Treasury market experienced a good sell-off in April. Munis did the same, but proved they will outperform in a rising rate environment.

Highlights from April are as follows:

- Muni yields increased from 7 to 15 bps, curve unchanged.
- Taxable yields increased from up 20 to 7 bps with the long-end flattening.
- Munis remain a good value on the short-end and cheap on the long-end, as compared with taxable rates.
- Issuance is down 23% versus year-to-date 2017, but new money issuance is up 11%. The drop in refunding is over 56%, causing the year-to-date decline.

The market technicals remain negative for the next 15 to 30 days. Any increase in issuance could provide investment opportunities.

Otherwise, it could be the fall before things loosen back up again. If you have any cash you want to get to work, now is the time. We can build a short-term portfolio that will earn 2% to 2.25%, intermediate-term portfolio that will earn 3% to 3.25%, long-term from 3.75% to 4.00%.



Market News and Credit Update

In April a **lawsuit was filed against the “big banks”** accusing them of not managing the rates on the VRDOs (variable rate demand obligations) to the lowest possible and, therefore, costing issuers additional debt service costs. They claim the Banks “group the VRDO’s into buckets”, collecting unrelated bonds and setting their interest rates collectively such that investors will not put them back and require the banks to have to remarket them again. I am not sure how this can be proven to be inefficient for the issuers. Part of the cost of the liquidity agreement that protects the bonds is based on the remarketing ability. My hunch is if they have to remarket them more actively, the fees will go up, and the total cost to the issuers will remain the same. We will continue to monitor this lawsuit, as it could have an impact on the funding costs of our MainLine West Opportunity Funds.

Three month Libor has been rising much higher than other short-term rates. The spread between 3 month Libor and the 3 month overnight index swap rate (OIS) is now at 58 bps. It averaged 19 bps in 2017, and started the year at 25 bps. This increase is due to the repatriation of cash by US firms. They are pulling their money out of foreign dollar funds that are priced with Libor. This higher than average increase in the rates is being enjoyed by the MainLine West Tax Advantaged Opportunity Funds, whose hedges are paid a floating rate payment tied to the 3 month Libor. ***We would estimate that this is adding 15 to 20 bps of additional cash return to the Funds.***

Goodbye Libor, Hello SOFR?

Background:

Libor (Intercontinental Exchange London Interbank Offered Rate) is a benchmark rate set by the world’s leading banks for a \$350 trillion market. The rate is used to charge each other for unsecured short-term loans. Libor is also used for a lot of other costs, such as student loans, mortgages, floating rate corporate and municipal bonds, swap and other derivative payments. In 2012, a criminal investigation revealed that several banks were involved in fraud and collusion when setting Libor. They were setting them higher or lower than they should be to help them increase their profits on trades. Since this scandal, and the decline in the use of unsecured short-term loans being made by banks these days, the various regulators around the world have been looking for a new way to calculate the cost to borrow between banks. Libor rate estimates are scheduled to stop by the end of the year 2021.



The Proposed Answer:

The US, led by the Federal Reserve has put forth **SOFR (Secured Overnight Financing Rate)** as a Libor replacement. It is a broad measure of the cost to borrow cash overnight on loans that are collateralized by Treasury securities. In other words, this is also called the US Treasury REPO market. The rate will be calculated from actual market transactions in what is roughly a \$700 billion a day traded market.

The first official SOFR rate was published on April 3rd, and was set at 1.80%, with the overnight Libor rate that day being 1.70%.

The problems with SOFR:

- It is not stable and is influenced by T-bill issuance. It also has monthly, quarterly and end of year cyclical due to cash movements.
- It is a rate based on US Treasury credit, which will be used by non-treasury counterparties. There will likely be some credit spread added depending on the borrower.
- Once again, the major banks will most likely control the market as they are the big players.
- No historical data available. We don't know what the rate was years ago.

Impact on the Municipal Market:

Libor is used for several different investment products, but we feel its loss to the muni market will be minimal.

- There are floating rate bonds that trade off of the Libor rate. These bonds will need to have a new index to price off of. Not sure how this will be legally changed for all these deals, but the Libor replacement will most likely be used.
- The 7-day VRDO rate is based off of one month Libor. Once again this will change most likely to the new rate.

Conclusions:

There are several other ideas for Libor's replacement other than SOFR:

- Eurodollar Futures trades at the Chicago Mercantile Exchange. This is based off of Libor, but are actual transactions.
- The average rate for borrowing and lending from FHLB's. These are the rates on money activity from 1,000 normal banks, with their credit profiles.



There will be some “noise” over the next three and half years as a replacement for Libor is formalized. ***We think SOFR is not perfect, but it is an improvement over Libor.*** Its use and, therefore, effect on the cost of funds versus their current index is yet to be determined. It will be easier to track going forward, less prone to manipulations, and be actively observed. As we get closer to 2021, we will better access its impact on muni floating rate investments and the possible impact on MainLine West Opportunity Fund’s funding rate.

This document is for informational purposes only and is summary in nature. It does not contain all material information and considerations relevant to an investment in the MainLine West Tax Advantaged Opportunity Funds (“The Funds”). No representations or warranties express or implied, are made as to the accuracy or the completeness of the information contained herein. Any prior investment results presented herein are provided for illustrative purposes only and have not been verified by a third party. Further, any hypothetical or simulated performance results contained herein have inherent limitations and do not represent an actual performance record. Actual future performance will likely vary and may vary sharply from such hypothetical or simulated performance results. This document does not constitute an offer to invest in securities in the Funds. No offer of securities in the Funds can be made without delivery of The Funds’ confidential private placement memorandum and related offering materials. An investment in securities of The Funds involves risk, including potential risks that could lead to a loss of some, or all, of one’s capital investment. There is no assurance that the Funds will achieve their investment objectives. Past performance does not guarantee future results. There can be no possibility of profit without the risk of loss, including loss of one’s entire investment. There are interest and management fees associated with an investment in The Funds which are disclosed in The Funds’ offering materials.