August 2019 Muni Market Monthly Review – "Lower Yields, Lower Coupons, Lower Future Prices?"

A strong Treasury rally pulled munis to their lowest yield levels since I have recorded the data (6/31/1991). What is next? We have been bullish on munis all year long, and feel the foundation is solid for the asset class, but we must wonder if the market has come too far, too fast. Technicals will go negative over the next 30 to 90 days and we are expecting some market weakness and the opportunity to make some investments.

Municipal yields are now at record lows throughout the curve, causing many new deals to be priced with lower coupons to minimize the premiums investors have to pay. This is causing investors to coupon down from the long-time market standard of 5%. MainLine also feels it is ok to be couponing down, but not too much or too far down. There is a "creature" hiding in the closet, and its name is ***"Market Discount (Outside De Minimis) Bonds".*** This month's credit review explains what this creature is and how to cage it

bonds.

Muni Market Review

A strong Treasury rally tried hard to pull munis along for the ride. Overseas market weakness, trade wars and Fed Fund rate cuts assumed by the markets led to big price gains in August. Munis underperformed, but did a better than average job of keeping up. August highlights include:

- Muni yields were down 18 to 40 bps, with the curve flattening.
- The muni market has seen 33 straight weeks of inflows showing demand for tax-exempt income remains strong. This is after 2018, which was virtually flat, and outflows in 2017 and 2016. Now that yield levels are at all-time lows, we will see if this demand continues
- Taxable yields were down 50 to 62 bps with the curve slightly flattening. The 30 year reached an all-time low in August and the 10 years got within 10 bps
- Year-to-date, muni issuance is still picking up and it looks like this will continue:
    - 2019 is up 3.9% versus 2018.
    - 2019 is down 17.4% versus the last 5 years' average.

Munis are about to enter a technically weak time of year, this combined with increased supply from lower rates, anticipated slowdown in inflows, could provide an investment opportunity. We will continue to monitor, and keep our investors informed.

MainLine West Tax Advantaged Fund VI remains on hold until we do get some good weakness in the muni market. ***Three of the five Funds have been executed in the months of December and January. SO maybe we are not far off.***

Market News and Credit Update

- Not the first of its kind (MIT, USC, Cal Tech, all in 2011, & UVA 2017), but with yields being at all-time lows the ***University of Virginia is planning to issue more 100 year bonds.*** An estimate on the taxable yield for these bonds is 3.00% to 3.15%. I guess if the US Treasury can consider it, why not one of the oldest and most reputable Universities founded by a Founding Father?
- The potential impact discussed in July's Monthly Credit Report ***"Illinois Agenda", has been muted*** for the time being. The judge denied allowing a lawsuit challenging that the state issued bonds that did not meet with constitutional requirements. The Court cited it did not want to interfere "with the application of public funds". Will this be enough to stop other copycats from trying to make a political statement at the expense of bondholders?
- To further, expand on the ***"Illinois Agenda" theme***: According to MMA, the number of issuers reporting "so-called" impairments such as breach of financial terms in securities contracts is up 41% year-to-date. It just shows that municipalities are issuing more bonds these days that are weak on meeting good issuance protocol, and the buyers are being more accommodating.

Lower Yields, Lower Coupons, Lower Future Prices?

Introduction:

Municipal yields have fallen and are now at record lows, causing many new deals to be priced with lower coupons to minimize the premium investors have to pay. This is causing investors to coupon down from the long-time market standard of 5%. MainLine feels it is ok to be couponing down, but not too much or too far down. We still value the protection a premium bond provides to avoid future tax issues. This seems like a good time to remind muni investors about ***Market Discount and bonds within and outside De Minimis as many of today's "par bonds",*** as purchases made today (that do not take into account this risk) could have their prices adversely influenced tomorrow.

Market Discount (Within De Minimis) Bonds

Market discount exists when a bond price falls in value after its issuance. This is defined as the difference between the purchase price of a bond and its stated redemption price at maturity. In the case of a bond sold with original issue discount (OID), market discount is defined as the difference between the purchase price and the issue price of the bond, and accreted OID. ***Unlike OID bonds, market discount is not treated as tax-exempt interest because it does not represent the interest expense of the issuer.*** The market discount is taxed as ordinary interest income in the year a bond is sold, redeemed or transferred. The yield on the bond will need to be adjusted for the tax owed on the accredited portion of the price return.

Market Discount (Outside De Minimis) Bonds

A bond bought ***outside De Minimis*** is at a significant market price discount below that of its OID price. To qualify as an outside of De Minimis bond, the market discount price must be below 0.25 percent of the face value of a bond times the number of years between the bond's purchase date and maturity. The amount of market discount related to the .25 percent of the face per year is taxed at the capital gains tax rate. However, the market price discount that exceeds this amount becomes taxable at the investors ordinary income tax rate. This can significantly lower the after tax return for a bond outside of De Minimis, com-pared to one that is still within it.

Below is a simple example of three different types of discount bonds and how differences in tax treatment effect the after-tax return of the bonds. The only difference between each example is the coupon, which affects the price (market discount) on the bonds.

Discount Type	OID Bond	Market Discount (within De Minimis)	Market Discount (outside De Minimis)
Coupon	3.75%	3.50%	2.75%
Market Price	$100	$95.57	$82.30
Yield to Maturity	3.75%	3.75%	3.75%
After Tax Yield	3.75%	3.74%	3.59%

To make up for the loss in yield from the tax on the market discount, the seller, on a 30-year bond will receive proceeds roughly 3% less than if the coupon was higher like 3.50%.

Conclusion:

We are not recommending everyone exclusively buy 5% coupon bonds. Lower coupon bonds can have better performance and pay higher yields. We are highlighting that, if you are looking to sell munis in the future for the proceeds, you should seek coupon diversification. MainLine recommends diversifying portfolio risks such as: use of proceeds, reinvestment risk, and geographic risk. ***An investor, in this low rate environment, should limit the purchase of 2.50% to 3.50% coupon bonds as, when rates go back up, a diversified coupon structure will insulate the portfolio from drastic price swings.***