MONTHLY REVIEW

March 2018

MAINLINE WEST

March 2018 Monthly Review – Muni GOs – A Gold Standard No Longer?

Munis finally showed some life the final weeks of the quarter, but not after having their worst first quarter performance in 20 years (Bloomberg Barclays Muni index down 1.1%). We are in a technically weak time of year for munis, which is reflected in a high 7-day floating rate of 1.57%. We feel, if the market can get a pick-up in activity, and fund flows remain positive, there could be some good investment opportunities over the next 30 to 60 days. Yes, we still remain optimistic on munis in 2018, but our patience is being tested.

It has been over four months since the Tax Cut and Jobs Act bill was passed, creating a change in the municipal pond. This month, we provide you S&P's opinion on what these changes will be and their potential impact on credit quality. After reading it and then learning about other changes S&P is making, the biggest credit impact in 2018 (and going forward) has nothing to do with the Act. It has more to do with S&P finally admitting that bonds related to **General Obligation pledges may no longer be the "gold standard".**

Muni Market Review

The markets finally ended the month at lower yields than where they began. Munis did a pretty good job rallying at month-end versus taxable rates, but did show slight underperformance. Munis may finally be getting their game on after a lethargic first quarter. Issuance is still light, fund flows remain positive, and ratios are a bit richer but still show some value. Other March market highlights are as follows:

- Muni did suffer their biggest first quarter loss in over 20 years. The Bloomberg Barclays Index was down 1.1% for the first three months, US Treasuries were down 1.2%.
- Muni curve flattened with 5 year rates up 7bps, and 25 year rates down 11 bps.
- Taxable curve flattened with 5 year rates down 4 bps, and 20 year rates down 12 bps. There was a bit of an "out of sync" change in the 25 year rates, only going down 1 bps.
- Issuance remains down 31% versus year-to-date 2017. The 30-day outlook does not have this changing anytime soon.

The technicals for munis over the next 30 to 60 days are seasonally week and 7-day floating rates notes are seasonally high at 1.57%. We think things may be getting interesting in muni land again for investing. We would just like to see a few more signs of the market becoming more active.

Market News and Credit Update

Already considered the **drama queen of politics in the USA, Illinois is just about to set the bar even higher** (or is that lower)? After the March primaries, it appears the two candidates chosen to run for Governor will most likely set a record for the most expensive race in history with estimates of up to $300 million. Both candidates (Republican Governor Bruce Rauner and Democrat J.B Pritzker) are both considered billionaires, and are willing to spend to win. Let's just hope they pay more attention to the challenges that face the State than buying votes.

An interesting **lawsuit has been filed against the Pennsylvania Turnpike** that could impact municipal issuers across the country. Traffic growth has been flat year over year, but the demand for funds continues to grow. To meet these increased costs, toll increases are planned at an average of 3.7% for the next 27 years (already up 200% since 2006). Numerous transportation companies have filed a suit saying an undue burden has been placed on them to pay these increases. This looks like a case of a monopoly providing an important service (Pennsy Turnpike) having its ability to do what it wants challenged by a group of consumers with no other choice.

Louisiana is still trying to stabilize its credit rating after the fiscal impact of cutting taxes, hurricane damage, and a decline in revenue due to low energy prices. The State has been unwilling to raise revenue through tax increases and, therefore, it is approaching a $692 million budget deficit which would lead to credit rating downgrades from the current AA-/Aa3 by both agencies.

Review of S&P Credit Trends "US Municipal Bonds Enter a New Era in 2018":

The Tax Cuts and Jobs Acts bill passed in late 2017, according to S&P, will have some impacts on the credit trends in the municipal market going forward. Below is a brief overview of this study, highlights from its 2017 credit trends and, most importantly, our thoughts on the matters.

Impact of Tax Cuts & Jobs Act on the Municipal Market:

The loss of advance refunding will lower issuance and provides less financial flexibility for issuers going forward. Due to the low current level of interest rates, S&P does not feel there to be an adverse impact on credit quality, due to the inability to refinance at this time.

The cap of $10,000 on the deduction of state and local taxes on federal tax returns will impede high tax states from raising taxes more and using the proceeds to make debt service payments. S&P does not discuss the potential impact on population migration away from these states over time.

The limiting of interest deduction on mortgage loans could also impact some of these same high tax states. S&P does discuss the potential negative long-term impact on the real estate market and tax revenues for states like California due to this change.

2017 S&P Credit Trends:

Credit trends remain positive overall, due to the large amount of upgrades from local government debt, but for other sectors the trend was negative in 2017. Overall, there was 1.25 upgrades for every 1 downgrade in 2017 (almost identical to 2016). State government, utilities, higher education, health care and housing all had more downgrades than upgrades in 2017.

- S&P feels the impact of the Tax Cut & Jobs Act bill will hurt the credit quality of Higher Education issuers going forward.
- S&P predicts credit trends will be a bit lower in 2018 with states, health care, housing and higher education continuing to weaken and improvement in local government ratings slowing.

S&P has proposed some changes to the criteria ratings for electric and gas issuers. If fully implemented, they predict 20% of the ratings to be changed, with most of them being downgrades.

S&P has proposed a criteria change on priority lien backed bonds that will have a pretty big impact on the ratings of the following types of bonds:

- o Limited Tax General Obligation
- o Priority Lien Tax revenue
- o Special Assessment debt

- 40% to 50% of the ratings could be changed up or down one notch, 15-25% by two notches, and 10-20% by three notches.
- The changes will focus more heavily on the recent credit fundamentals of the issuer and how the issuer treats the pledges and promises when they experience fiscal stress. This includes legal provisions, and cross credit risk amongst related issuers.

Texas was home to the most credit rating upgrades in 2017.

14 of the 20 defaults in 2017 occurred in Puerto Rico. They predict this trend will be the same in 2018.

The MainLine View:

We discussed, in our 2018 outlook, the changes we thought the Tax Cuts & Job Acts Bill would cause. Below is a quick review:

- Lower supply for the next three to four years.
- Lower demand for munis, going forward, from banks and insurance companies. Probably not a big drop, but chances are they will hold fewer bonds with lower corporate tax rates.
- A change in the structure of the average municipal bond. We think you will see fewer 5% coupons, and 10-year callable bonds being issued.

The changes in the proposed rating criteria of priority lien backed bonds, other than the lower issuance, could be the biggest factor they discussed for 2018. It appears roughly 15-20% of the issuers will not be impacted, but 15-20% could be impacted three rating levels. We have discussed our views on these types of bonds in the past. To refresh, we have been guarded on our credit outlook for GO and related bonds for years, as we have not liked the trend regarding the priority of the revenues, the willingness, and the interpretation left open for the courts. It appears S&P has finally developed the same concern and is now doing something about it by changing their rating criteria.

This should not impact our investors as we have always favored revenue bonds and have been looking at general obligation and related bonds with a view on the items that S&P is now looking at. We invite any of our investors to allow us to review any holdings they may have to see how they may be impacted with the proposed changes by S&P.

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