MONTHLY REVIEW

May 2018

MAINLINE WEST

May 2018 Muni Market Monthly Report – "Summertime in MuniLand"

In May, we experienced the strong muni market performance that was expected earlier in the year. We think this is just the beginning and feel munis will be the "summer place" for investors. Munis outperformed taxable rates by declining twice as much as taxables during the month of May. Lack of supply, strong technicals, and improving credit quality perceptions have munis in a nice spot for the near-term.

As you make plans for the summer, we would recommend booking a visit to MuniLand. ***We feel munis are technically set up well and have a solid foundation for good performance in the next 60 to 90 days.*** It's all about a cool summer demand breeze, sun rising on the rollback of regulations, no credit hurricanes on the horizon, and low cost to finance the journey. As a muni investor, we recommend being all-in for at least the next 60 to 90 days and then enjoying a little more summertime.

Muni Market Review

The muni market is finally starting to show the strong performance we expected a little earlier in the year. Munis outperformed taxables by close to 2 times. Highlights of May are as follows:

- Muni yields decreased from 8 to 22 bps, with the curve moving at the ends. Ten-year was the biggest underperformer, with five and thirty year maturities the big outperformers.
- Taxable yields decreased from 7 to 9 bps, with the curve staying the same.
- Munis are starting to look rich versus current ratios, but still remain a good value versus longer term comparisons.
- Issuance is down 22% versus year-to-date 2017. This does not look like it will be changing and we feel will be a big reason for outperformance, given anticipated strong demand over the next 60 to 90 days.
- There have been big decreases in credit default swaps spreads over the last year for some states, signaling there is an improved perception of their credit quality:
    - California from 53 to 32 bps.
    - New Jersey from 175 to 77 bps.
    - Illinois from 408 to 230 bps.

Muni Market Review (cont'd)

As we look at the muni market risks and the opportunities, munis look fundamentally and technically strong for the near-term. We will discuss why we feel this way in this month's credit review. We advise clients to stay fully invested and, at some point if they need to raise cash, the opportunity should present itself by summer's end.

Market News and Credit Update

Cyber insecurity has hit the muni market in the form of "ransomware". Malware that permits a hacker to take control of a computer system has recently impacted municipal operations in Atlanta, Colorado Department of Transportation and Michigan's Board of Water & Light. In some cases, there was an extortion ransom paid in bitcoin, but the real costs have come from the computer systems' need to be updated and secured. At this point, the attacks have been more of a nuisance than causing any real damage.

Water bills have been rising fast over the last 20 years, as authorities are stepping up repairs on aging water and sewer infrastructures. According to the American Water Works Association, water bills have increased 75% since 2006. Unfortunately, these upgrades have not been near enough and it is estimated another $655 billion will be needed over the next 20 years. This means the increase in water bills is far from over.

As of April 2018, the states with the **lowest unemployment rates** are: Hawaii, New Hampshire, North Dakota, Maine and Iowa. The states with the highest are Alaska, New Mexico, District of Columbia, West Virginia, and Nevada.

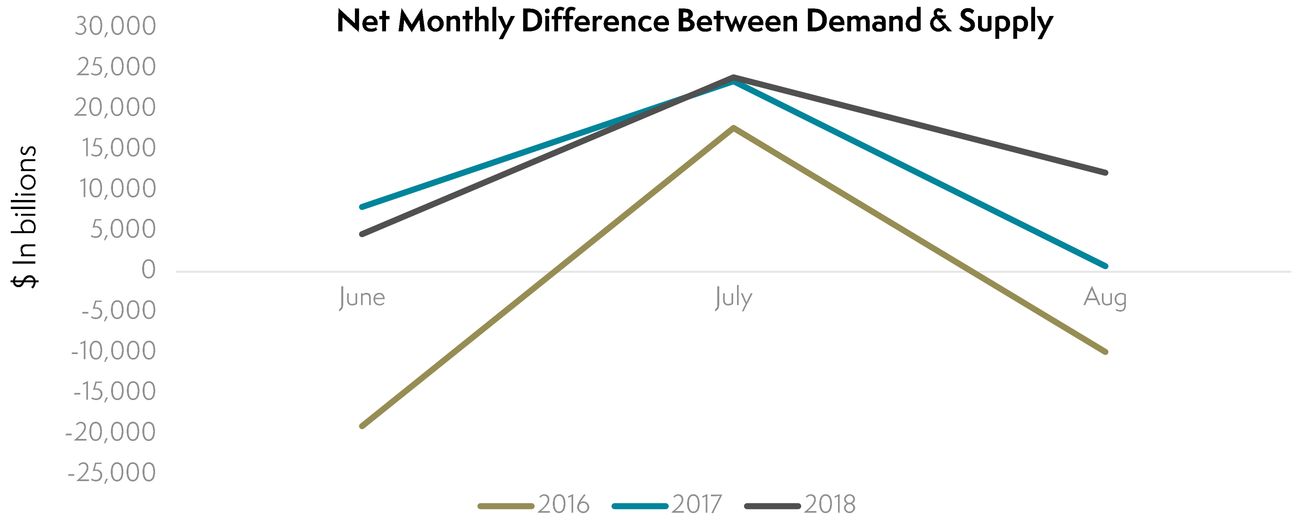
Summertime in Muni Land

As you make plans for the summer, we would recommend booking a visit to MuniLand. We see great conditions for a summer of good performance after a gloomy first 5 months of the year. This may finally be the "January rally" we were anticipating after the rough end to 2017. What makes for a perfect summer in MuniLand? How about a strong cool summer demand breeze, sunny rollback of regulations, no concerns of credit hurricanes, and low cost of financing the journey.

Summertime in MuniLand (cont'd)

Supply Versus Demand – A nice cool breeze in the muni market:
The summer months usually bring a bullish supply/demand technical to the market that then leads to outperformance by munis. In 2018, this looks to be even a stronger force than recent years.

The difference between anticipated maturities plus coupon payments (demand) and the forecast of new bond issuance (supply) can tell us how much cash will be available to reinvest in new bonds. If the difference is negative, that means we have planned new issuance (supply) greater than cash available (demand) and we will need new allocations and investors to the municipal market to purchase the excess bonds. This usually results in ***lower*** prices. If it is positive, then there will be more cash available to reinvest than new bonds available. This means the market will either need to lose investors and cash, or prices will ***increase***.



Demand Minus Supply in billions				
Year	June	July	August	3 Mo Total
2016	-19,030	17,708	-9,884	-11,206
2017	7,954	23,465	662	32,081
2018	4,626	23,943	12,194	40,763

The chart and graph shows munis in 2018 will have the greatest difference in demand than supply since 2015, an excess of $40.7 billion in cash. This should set a positive tone for good pricing performance for the next 60 to 90 days.

Regulation Changes – The sun is rising on a better trading environment for munis:

Yes, we finally have regulation changes that are going to benefit the municipal market. The rolling back of some of the Dodd Frank regulations will help improve the demand for munis. Munis will now be defined as a high-quality liquid asset, which will improve the demand for munis by banks. The tax reform hurt this demand earlier in the year, but this rollback should help bank demand improve. ***Some feel it will net out the negative impacts of the tax reform that we have felt for the first five months.***

There are also rumblings that the Volcker Rule may also be revised and allow banks to, once again, be active in running a much bigger trading book. We believe this could allow Banks more muni holdings and, therefore, create an environment of better liquidity.

Disappearing Credit Concerns? - No muni hurricanes on the horizon:

Over the last six months the outlook for Puerto Rico, Illinois, and general muni default trends have all improved. The market has enjoyed strong performance from these issuers and in high yield bonds.

- Puerto Rico has released a revised fiscal plan that shows a $6 billion surplus that investors have decided would be used to help meet debt service payments on the current defaulted bonds at some point in the future. This surplus is due, in part, to the $70 billion the US Government is sending to help rebuild the island after it was destroyed by Hurricane Marie.
- Puerto Rico bonds rallied on the news from 21 cents on the dollar to 45 cents.
- Illinois, after going almost three years without a budget until it passed one in the summer of 2017, has approved its 2018/2019 budget on time. What the budget contains (or doesn't contain) is not a concern to investors, as Illinois bonds have tightened 30 bps on the news. At least the state politicians are playing better in the sand box.
- The number of defaults year-to-date are down. Information as of March 24th from MMA is as follows:

2016		2017		2018	
# of Defaults	$ bln Defaults	# of Defaults	$ bln Defaults	# of Defaults	$ bln Defaults
22	$23.4	18	$.39 bln	7	$2.6 bln

The number of defaults year-to-date is down from 22 in 2016, 18 in 2017, to 7 in 2018.

7-Day Muni tax-exempt rate versus 3-month Libor – A good financing environment for munis:

The MainLine West Tax Advantage Opportunity Funds finance their trade by paying the 7-day tax-exempt rate, while receiving the 3-month Libor rate from its interest rate hedges. As highlighted in last month's credit review, 3-month Libor is relatively cheap and higher than it should be versus historical levels due, in some part, to the repatriation of cash from US firms due to tax reform.

That being said, the 7-day tax-exempt rate is now at a very low level versus historical relationships. The long-term average versus 1-month Libor is 70% to 72%, but it is now at 53%. As short-end rates have increased over the last year, fewer municipal issuers are choosing to finance short-term in the tax-exempt market. In fact, during the first quarter of 2018, there was a drop of 25% in bank support provided to the short-term muni market. This means there are fewer 7-day variable rate notes available for investing. As we discussed above, there is a lot of cash coming to the market in the next 60 to 90 days. The lower levels of VRDO's available has caused the 7-day investment rate to plunge.

Conclusion:

Pack those bags, and make sure you are fully invested this summer in MuniLand. ***MainLine feels the technicals, and the foundation supporting munis, are all in place for good performance for at least the next 60 to 90 days.***