September 2018 Muni Market Monthly Report – "World Demand? Yes Please!"

In a time of seasonally weak technicals, munis outperformed taxables with a yield increase of 80% of taxable equivalents. *Lower than expected issuance and perceived stronger credit quality have munis the darling of the fixed income world in 2018.* We continue to see good fundamentals for munis, going forward, but caution that some of these are temporary and, at some point, sentiment will change.

Individual investors either direct or indirect (through a mutual fund), remain the biggest and most consistent investors in muni market, owning 68% to 72% of total muni holdings. Insurance companies and banks are also active participants. However, the recent decrease in corporate tax rates have many concerned that demand would be adversely impacted. Now, there is a new, fast growing investor to the muni world - *international buyers*, who have a preference for taxable munis, but are also interested in tax-exempts. This month, we look into how these muni buyers are affecting demand in the $3.5 trillion muni market.

Muni Market Review

In September, the muni market saw rates rise as the economy looks to be picking up speed and the Fed is forecasting more rate increases in the near future. Munis outperformed taxable rates, even though they were in a technically weak seasonal time period. Highlights as follows:

- Muni yields increased as follows:
    - 5 year yields up 18 bps
    - 10 year yields up 14 bps
    - 15 year yields up 12 bps
    - 30 year yields up 17 bps
- Taxable yields increased as follows:
    - 5 year yields up 19 bps
    - 10 year yields up 20 bps
    - 15 year yields up 21 bps
    - 30 year yields up 18 bps
- Year-to-date, muni issuance was starting to pick up, but seems to have hit another rut. Total issuance still lags 2017's by 14.1%.
- Credit Default Spreads (CDS) continue to tighten, telling investors that the markets think munis are safer for principal protection than they thought one year ago. For example CDO spreads have tightened as follows:
    - California 45%.
    - New Jersey 40%
    - Illinois 41%
    - State Average 23%

Now that the final payout have been made for Fund III*, MainLine is beginning the process of raising capital for Fund VI!* Please let us know if you have interest. Its investment timeline is more focused on when the opportunity occurs, as opposed to a specific date. *You will want to be in line when this happens.*

Market News and Credit Update

SOFR (Secured Overnight Financing Rate) continues to move closer to being the official replacement for Libor. Futures are now trading on the Chicago Board of Trade, swaps are now clearing in London, and there are a half a dozen issuers who have sold floating rate debt tied to it. A lot could change between now at 2021, but the trend looks good for SOFR.

A bubble in high yield munis? At this moment, high yield munis are roughly 160 bps off the index, they were 279 bps in January 2016. Some analyst are recommending it is time to upgrade the credit quality of your municipal portfolio. At this time, the demand still appears strong as deals get oversubscribed, yields cut from the original, and then the bonds still trade up in the secondary. At some point, the analyst will be right, but the strong economy should keep high yield bonds a good bet for a while longer.

ICI Municipal bond fund inflows have been positive for twelve weeks in a row now and totals roughly $6.5 billion. This appears positive, but is a big decline from the last two years. This amount represents 37% of 2017, and only 31% of 2016 inflows. Issuance is lower in 2018, but by roughly 13%. What does this mean? The market could remain weak and choppy for the upcoming months.

Changing Trends in Muni Demand

Retail, individual investors either direct or indirect through a mutual fund, remain the biggest investors in the muni market ranging from 68% to 72% of total holdings. Recently, there has been a few trends that are impacting demand outside of individuals. Tax reforms and the interest from foreign buyers have been changing, and their impact on demand could shape the value of munis in 2018 and beyond.

World Muni Demand? In Demand!

Why would an investor, outside the USA care about municipal bonds? Munis held by international investors, which are not receiving a tax advantage, has increased 30% from 2014 to 2016. Overall, including taxable munis, the growth has been much more impressive. Holdings of muni bonds has increased 136% from $45 bln in 2014, $106.4 bln in 2016. In fact, foreign investors have expanded their investments in US Munis every quarter over the last 5 years. Why? Let us count the reasons:

1. Low interest rate overseas has the positive yield on strong credit quality munis looking attractive to foreigners.
    - German 20-year yield is at .54%
    - United Kingdom 20-year yield is at 1.63%
    - South Korea 20-year yield is at 2.38%
    - US Muni 20-year yield is at 3.12%
2. Low default rates. The average default rate for investment grade muni bonds rated by S&P over the last 15 years is .03%.
3. Low volatility of price changes and essentiality of services, versus corporate bonds.
4. A new asset class that helps with diversification.
5. Taxable Build American Bonds are by far the most popular munis for foreign investor

In April, the state of California (AA-/Aa3 rated) sold $2.15 billion of taxable general obligation bonds. They did this versus tax-exempt bonds to cater to international buyers and give the State the flexibility to use the proceeds for whatever they wanted. It appears Japanese and Koreans investors were the big players in the deal. The maximum yield for 30-year bonds was 3.95%, and 3.45% for 20 years. Seems like a pretty good deal for foreign investors.

I am still not sure why the US Government won't resurrect the Build American Bond program as a means to help finance the huge infrastructure needs. There appears to be a demand from abroad, due to circumstances that may not exist forever (low overseas rates). It may be best to take advantage and help the states out while we can.

Effect of Corporate Tax Reform on Muni Demand? Yawn...

The decrease in corporate tax rates from 35% to 20% created a lot of concern for the demand of muni bonds by Insurance companies and Banks.

As of June 30, 2018, P&C Insurance Companies holdings of munis remains unchanged.

Banks have trimmed their holdings by 2.8% as of quarter-end numbers 6/30/18. The roll back of Dodd Frank and the allowance of munis in the banks liquidity calculation as of August 31, could change this trend. Some analyst think the net effect will be neutral.