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C.W. HENDERSON
& ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING
IN TAX-EXEMPT MUNICIPAL SECURITIES

The Investor's Edge

Hurricanes and Municipal Credits

Market Environment

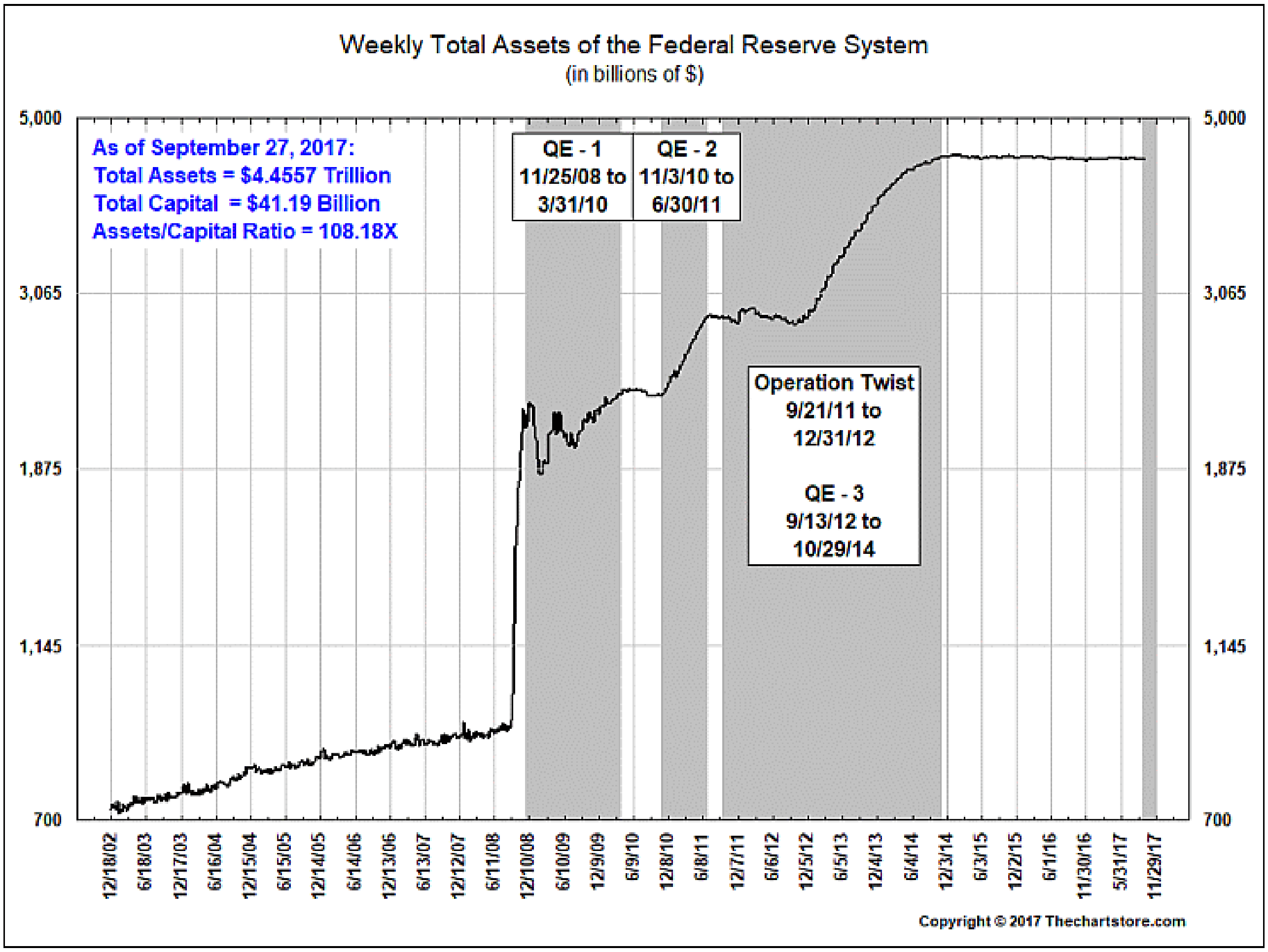
The turbulent third quarter was characterized by repeated hurricanes, Mexican earthquakes, North Korean belligerence, Special Council Mueller's investigation, continued Middle East unrest and the horrible events in Charlottesville and Las Vegas. The unsettled environment enhanced the attractiveness of safe harbor high quality bonds during much of the quarter causing the ten year Treasury yield to fall from a 2.40% high in July to 2.05% in early September, when North Korean threats were most pronounced, before subsequently trending higher and closing September at 2.33%. Municipals followed a similar pattern with ten year prime yields falling from 2.00% at the beginning of the quarter to 1.81% in early September before closing the period at 2.02%.

Economic growth continues to advance at a moderate pace. Real GDP rose to the 3.1% level in the second quarter after a tepid start to the year and is expected to generally continue at about a 2½% pace over the near term. Hurricane relief should precipitate a surge in durable goods sales as impacted areas rebuild and bolster growth to some extent in the fourth quarter and early next year. Inflation pressures remain contained with market indicators pointing to less than 2.0% inflation over the near to intermediate horizon. Subdued wage pressures, despite unemployment at 4.4%, reinforce this view.

Federal Reserve Action

Continued U.S. economic growth and building global momentum are keeping the monetary authorities on a cautious path towards higher rates. In contrast to the Fed's rapid response in late 2007 and through 2008 that brought the Fed Funds rate from 5.25% to near zero in ten moves, movement to the upside has been sluggish. The first 25 basis point increase in late 2015 was followed by another last December and two additional increases in March and June of this year. Chairperson Yellen has indicated that another Fed Funds increase is on the docket this December and will be followed by additional increases next year.

Ms. Yellen also announced that the Fed is proceeding with plans to reduce the size of their $4.50 trillion balance sheet. The chart below, courtesy of The Chart Store, illustrates the dramatic growth in Federal Reserve assets starting in late 2008 as the three quantitative easing programs were implemented. Proceeds from maturing securities will not be reinvested starting this month with the roll off increasing to $50 billion per month over the next year. Continued implementation of this plan along with additional rate increases will, as always, be dependent on the economic environment and market conditions. What does appear certain is that the Fed's balance sheet will remain expanded well into the future.



Ms. Yellen's term as Fed Chair expires in early February. She is on the list for possible reappointment, but there are also other candidates being considered. In addition, the terms of four of the seven Fed Governors will soon expire. Whether possible new leadership would continue the current game plan next year is uncertain.

Interest Rate Outlook

Demand for fixed income investments from a growing cohort of retiring baby boomers in a moderate growth, low inflation environment suggests that interest rate pressures will remain subdued. We continue to anticipate increases in short rates as the Fed makes periodic tightening moves, but the climb is likely to be slow and protracted. In regard to longer rates, a move back to the 2.50% to 2.75% range on the ten year Treasury seems possible but a dramatic move to higher levels does not appear to be in the cards near term. (We would consider extending portfolio durations at the 2.75% level.) Additional yield curve flattening seems likely.

Limited Municipal Supply

Following the pattern of the first half, tax-exempt new issuance was again muted in the third quarter. Year to date supply totaled $285 billion, down approximately 17% from last year. Some increase in supply is anticipated in the fourth quarter, but with limited refunding activity we expect new issuance to continue to lag 2016 levels.

On the flip side, demand remains strong. Mutual fund inflows have been robust as has buying by individuals. In addition to investor demand for income and safety, strong stock market gains have skewed equity/fixed portfolio ratios prompting allocations to bond investments as accounts are rebalanced.

Hurricane Impact on Credit Quality

Harvey and Irma inflicted serious damage to the Houston area and many parts of Florida. Despite the severity of the storms, most areas should recover in the coming months as federal relief funds coupled with state support and insurance payments provide funding for rebuilding. The price impact on strong Houston area and Florida municipal bonds has been minimal and limited to a few basis point of yield change. C.W. Henderson's exposure to Texas bonds is focused on school districts backed by the $37+ billion Texas Permanent School Fund which provides substantial security. Likewise, exposure to Florida securities is concentrated in credits with strong financials.

The extent to which casualty insurance companies are impacted by claims related to these storms remains to be seen. These providers may be prompted to shed some municipal holdings in their investment portfolios in response to reduced profitability. Given limited municipal new issuance, any incremental supply in the secondary market would likely be readily absorbed.

The impact of hurricane Maria on Puerto Rico is another story. Most of the island remains without power and many areas without fresh water. Destroyed homes, mud slides, wrecked bridges, etc. will require massive rebuilding. FEMA and the military are providing relief efforts but recovery is going to be extremely protracted and encumbered by Puerto Rico's limited financial reserves and lack of access to the capital markets. The 11% population decline since 2004 could accelerate as residents migrate to the continental U.S. It has been estimated that an additional 500,000 residents, out of 3.4 million, might opt to relocate.

On the financial side, creditor/debtor issues in Puerto Rico will be set aside for an extended period as recovery efforts take precedence over consideration of the island's debt obligations. With creditor negotiations on hold, Puerto Rico securities have been hard hit. It was recently reported that the Commonwealth's benchmark 8.0% general obligation bonds due in 2035, that initial sold at dollar price of 93 in 2014, traded in the low 30s. After visiting the island President Trump opined that Puerto Rico's debt should be "wiped out". The feasibility of such action is questionable.

Tight Credit Spreads

Strong demand in the face of limited supply has caused credit spreads to narrow considerably as aggressive investors reach for yield. Prevailing yield levels and credit spreads are shown in the following table for varying maturity AAA, single A and BBB credits. Current yield levels and credit spreads are contrasted with the market that prevailed five years earlier when spreads were considerably wider.

	Yields			Spreads	
9/30/17	**AAA**	**Single A**	**BBB**	**AAA/A**	**AAA/BBB**
5 Year	1.37%	1.75%	2.17%	38 BP	80 BP
10 Year	2.02	2.43	2.91	41	89
15 Year	2.39	2.80	3.27	41	88
20 Year	2.65	3.06	3.55	41	90
9/30/12					
5 Year	0.63	1.15	2.29	52	166
10 Year	1.66	2.24	3.54	58	188
15 Year	2.10	2.75	3.98	65	188
20 Year	2.42	3.16	4.23	74	181

Credit spreads may remain narrow for the foreseeable future, but a credit event or an increase in rates could result in rapid and significant spread expansion. We feel that this risk should be controlled. The universe of securities held in C.W. Henderson managed portfolios includes under 5.0% single A credits, mostly with shorter maturities. The majority of all client holdings are rated AA or AAA. Bonds rated BBB are expressly avoided as we focus on high credit quality and liquidity in our security selection.

Tax Reform

After the late September second attempt at ACA repeal/revamp again faltered, tax reform is next on the GOP's legislative agenda with plans for personal and corporate tax rate reductions. This would clearly have a stimulative impact on the economy next year and beyond, especially if accompanied by regulatory reform. The administration's proposal calls for a $1.5 trillion cut over ten years and incorporates fewer tax brackets, larger standard deductions and elimination of the alternative minimum and estate taxes. Reduced deductions would partially offset revenue losses as would expected stronger growth that bolsters tax receipts. Maximum personal and corporate tax rates would be set, respectively, at 35% and 20%. Elimination of municipal tax exemption is not in the administration plan. The House Ways and Means and Senate Finance committees will next weigh in with their proposals that will need to be reconciled. The timing and content of ultimate legislation remains to be seen.

A lower corporate rate would reduce the incentive for banks, casualty insurers and other corporate entities to hold tax-exempt securities. Any diminished demand from these buyers would likely be absorbed by mutual fund and ETF portfolio managers and by individuals. However, lower personal rates could prompt modest upward yield adjustments on tax-exempt securities to recalibrate comparisons with taxable rate levels.

Accounting for Post-Employment Health Care

The Governmental Accounting Standards Board has urged that municipalities include post-employment health care liabilities on their FY 2018 balance sheets rather than disclosing commitments in footnotes. With most retiree health benefits paid on an ongoing basis rather than being reserved for, this disclosure will spotlight significant municipal liabilities that are estimated to total approximately $650 billion. This is in addition to unfunded pension liabilities that exceed $1.1 trillion. Careful consideration of all post-employment commitments is critical when analyzing credit quality. Assessment of these liabilities is a core element in the C.W. Henderson credit group's approval process.

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