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

The Investor's Edge

Tax Reform Alters Municipal Bond Dynamics

Both supply and demand will be altered by the recently enacted tax reform bill. A significant factor in regard to future supply is the elimination of tax exempt refunding issues. The congressional tax writing committees also discussed eliminating the tax exemption for private activity bonds (hospitals, stadiums, airports, etc.) but these financings have thus far survived. The refunding prohibition and threat to private activity bonds caused issuers to rush to market in the fourth quarter which ballooned new issue supply to $145 billion, 8% above the 2010 fourth quarter record, and brought the 2017 annual supply to $438 billion, just shy of the record $452 billion 2016 volume. After the late year issuance spurt and the elimination of refunding issues, supply this year is currently forecast to fall dramatically to perhaps as little as $275 billion.

On the demand side we expect that retail investors will continue seek tax-exempt income and actively support the market. In contrast, bank and insurance buyers are expected to have less interest in municipal securities in response to the sharp drop in the corporate tax rate from 35% to 21%. The impact of hurricane and wild fire claims on casualty insurers will further reduce corporate demand. It would not be surprising if some net selling is initiated by impacted insurance companies.

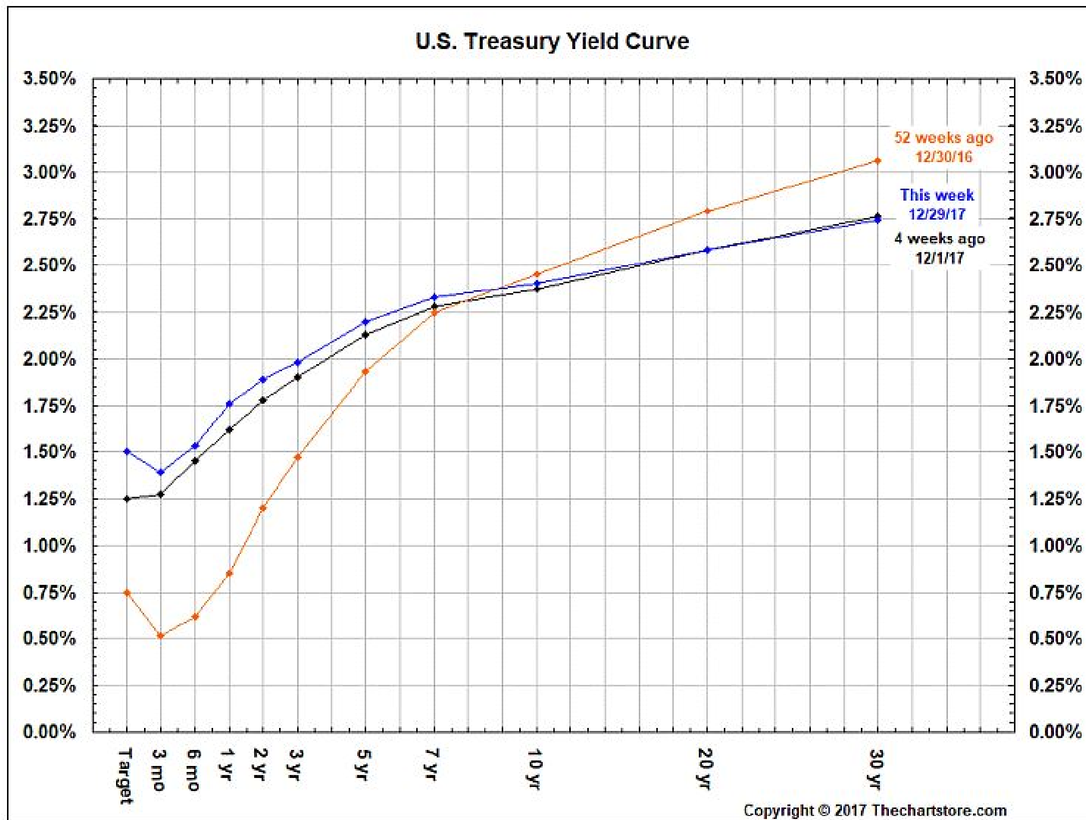
Limitation of state and local tax deductions on personal tax returns to $10,000 will increase demand for in-state bonds, especially by residents in states with high income tax rates. Strongest demand will likely come from high net worth individuals in states with rates exceeding 6.0%.

Interest Rates in 2018?

It appears that U.S. GDP growth near 3% was sustained in the fourth quarter in line with the second and third quarters. The tax cut should provide additional momentum in the U.S. at the same time global growth is building. An infrastructure spending program, should it be passed, would provide additional fiscal stimulus. Forecasts indicate that the Treasury will need to fund significant deficits both this year and next. A large supply of government securities is coming as the Federal Reserve is raising short rates. This picture suggests that longer interest rates should move higher, especially with a 4.1% unemployment rate and the potential for advancing wage pressures. We would not be surprised if the benchmark ten year Treasury yield, currently at 2.55%, trends higher by 25 to 50 basis points over the course of the year.

However, inflationary pressures thus far remain relatively docile. The core CPI (ex food and energy) was up 1.7% year over year through November while the core Personal Consumer Expenditures Index (the Fed's preferred measure) rose 1.5%, well below their 2.0% target. Assuming continued employment growth, it seems likely that increased wage gains will eventually follow with inflation measures moving somewhat higher. However, market indicators continue to indicate moderate inflation. The spread between Treasury yields and like maturity Treasury Income Protected Securities (TIPS) yields (2.55% vs 0.52% in ten years) suggests that annual inflation levels will remain near 2%.

What does appear more certain is that the yield curve will continue to flatten as short rates rise. Jerome Powell takes over as Fed chair next month and will likely continue, at least over the near term, on the monetary policy path laid out by Janet Yellen. The Fed's tentative agenda calls for three Federal Funds rate increases this year and a continued reduction in the size of their $4.5 trillion balance sheet. Three quarter point rate tightening moves would bring the targeted fed funds rate to the 2.00% - 2.25% range. Without an increase in longer rates, the Treasury yield curve would be almost flat through ten years. We doubt this will happen. Either longer rates will move higher as expected or the FOMC will alter their game plan. The chart below, courtesy of The Chart Store, illustrates the change in the Treasury curve over the past year. The impact of the Fed's three 2017 tightening moves is reflected in the increase in short rates.



Municipal Market Outlook

The table below illustrates the levels of prime tax-exempt yields during the past year. As shown, rates were relatively steady during much of the year but, similar to the Treasury curve, long rates declined late in the period while short rates rose resulting in a flatter curve.

	12/31/17	9/30/17	6/30/17	3/31/17	12/31/16
1 Yr.	1.41%	0.94%	0.92%	0.87%	0.99%
5 Yrs.	1.66	1.38	1.37	1.58	1.79
10 Yrs.	1.98	2.02	2.00	2.26	2.31
15 Yrs.	2.25	2.39	2.44	2.69	2.62
20 Yrs.	2.40	2.65	2.65	2.92	2.90
30 Yrs.	2.52	2.84	2.79	3.04	3.06

Will tax-exempt rates follow the Treasury market if taxable rates rise? Clearly the Treasury sector influences the municipal market, but the two do not always move in lock step. We anticipate that the tax-exempt yield curve will flatten further as the Fed tightens and would not be surprised if longer rates move moderately higher. However, given the forecast for significantly reduced new issue supply, strong retail demand should moderate upward rate pressures. A growing cohort of 65+ year old U.S. investors (up 40% since 2000 and growing) will maintain their healthy appetite for tax-exempt income. Rising rates would stimulate even stronger demand. Bottom line, we anticipate upward pressure along the yield curve, but limited actual rate increases in longer maturity tax-exempt instruments.

The viability of short duration portfolios has been enhanced by the increase in the front end of the yield curve after the long period of near zero short rates. The C.W. Henderson short-term product will provide increasing value as short rates continue to rise.

Impact of Tax Reform on Municipal Budgets

The recently enacted tax reform is not a plus for municipal government finances. The previously mentioned elimination of advance refunding issues will limit financing flexibility. More significant is the $10,000 cap on state and local tax deductions. Tax increases at the state and local level (income, sales, property, etc.) will be more difficult going forward and restrict budgetary flexibility. Some analysts have suggested that housing values in some areas could be impacted as potential home buyers factor increased home ownership expense.

Push back from the states has begun. New York's Governor Cuomo has floated the idea of eliminating the state income tax (max rate of 8.97%) and replacing it with a payroll tax paid by employers which remains deductible. Employers could be made whole through tax credits or some other mechanism. Implementation of the plan would face numerous challenges. Would employee gross wages be reduced to adjust for the elimination of state taxes? How would union contracts be impacted? Would New York City residents' taxes (3.65% max rate) also be eliminated? How states with high tax levels ultimately react remains to be seen.

Securitized Financings

To avoid high financing expenses, municipalities with low credit ratings are exploring credit enhancements when marketing new debt. A City of Chicago financing provides a recent example. The city established a special corporation that marketed $743 million new bonds last month ($571 million taxable securities and $172 million tax-exempt) that are backed by a first claim on the city's $700 million annual sales tax revenues. The issue is rated AAA by Standard and Poor's in contrast to S&P's BBB+ ratings on the city's general obligation debt.

Assuming Chicago's economic environment remains stable, the bonds should be secure. However, in a severe downturn this structure could be challenged as municipal workers and pensioners claim priority in regard to available resources. This structure is not a substitute for solid credit research that focuses on finding GO credits with growing populations, high average median income levels, diversified tax bases, strong tax collections, well funded pensions, etc.

State Medicaid Funding

Adding to the challenges facing states is a growing Medicaid expense burden. It has been reported that states, in aggregate, spent 20+% of their general fund budgets on Medicaid in 2016, up from 16.9% in 2007 and costs are projected to rise further as the population ages. In addition, states are assuming an increasing portion of the coverage for an expanding Medicaid universe under Affordable Care Act requirements. Medicaid funding represents an additional expense that needs to be considered when analyzing state credits.

Municipal Bond Fund Safety

A recent article titled "Muni Bonds May Not Be The Safe Bet Any Longer" appeared in the "Wall Street Journal". The focus of the article is on the credit quality of bond fund holdings in light of credit disruptions in Stockton and San Bernardino in California, Detroit, Puerto Rico, etc. and also mentioned the challenges some municipalities are facing with unfunded pensions. The article suggests that it is no longer prudent to simply use municipal bond funds as core holdings in portfolios for tax-exempt income generation without reviewing the credit quality of existing fund holdings and knowing the latitude fund managers have regarding the use of lower rated securities. This is sound advice and argues for using stand-alone portfolios constructed with specific high quality bonds the client owns that are vetted by a professional investment team.

Defaults are extreme and very rare in the municipal market. However, as we discussed in our September newsletter, credit spreads have contracted considerably over the past five years as investors have reached for yield in the prevailing low rate environment. Spreads between AAA and BBB credits have fallen by over 50% along most of the yield curve over the past five years (e.g. from 188 basis points to 89 basis points for ten year securities). This condition continues to prevail and is likely to persist for the foreseeable future. However, it will not last forever. When rates rise, spreads will again widen with corresponding pressure on bond prices. This risk should not be ignored.

Another factor to consider in the use of bond funds is extended durations. Even intermediate funds can have portfolio durations of six or seven years or longer compared to the 3.70 year duration we are currently targeting in the Intermediate accounts we manage. Volatility management is an important component of overall risk management.

A Solid 2017

We are pleased to announce that assets under management at C.W. Henderson & Associates ended the year at $3.15 billion. We once again thank our clients, business partners and friends for the support provided to us. We are also pleased to announce that Amanda Sweis, a 2016 Loyola University Chicago graduate, has joined the C.W. Henderson team as the Firm's Office Administrator.

We wish all a healthy and prosperous 2018.

Craig W. Henderson Thomas L. Mallman, CFA Matt Andrews

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