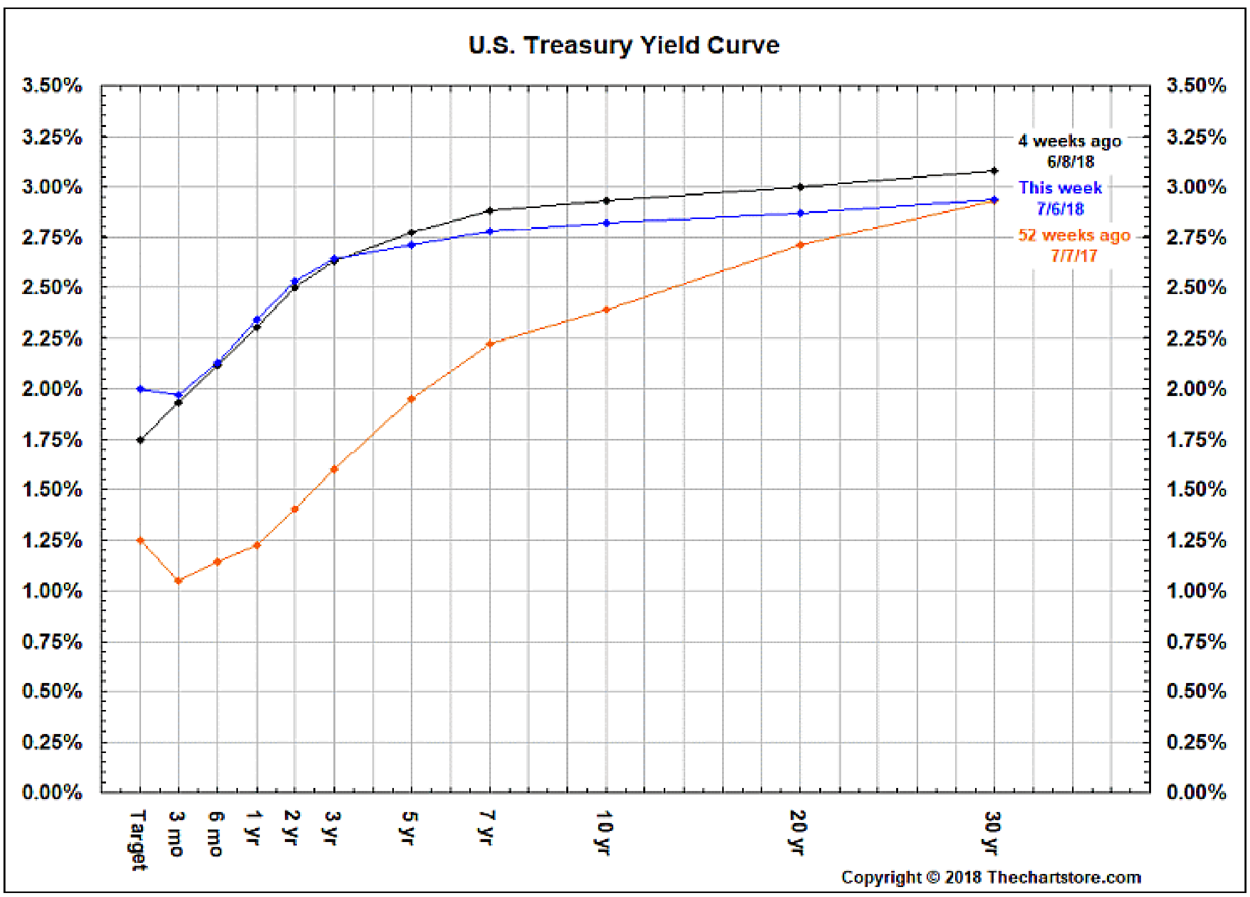
C.W. HENDERSON
& ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING IN TAX-EXEMPT MUNICIPAL SECURITIES

The Investor's Edge

Market Environment

Disharmony among NATO allies, withdrawal from the Iran nuclear agreement, uncertain North Korea talks and, most importantly, trade war fears have combined to foster investor nervousness. Despite the uncertainty, the fixed income markets have been relatively tranquil in contrast to equity market volatility. As shown in the following chart, the short end of the Treasury yield curve has moved sharply higher over the past year in response to Federal Reserve tightening. Two quarter point moves in March and June of this year brought the targeted Federal Funds range to 1.75-2.00%. Two additional tightening moves this year are now expected. Longer rates moved higher during much of the first half of this year in response to stronger growth and fear of building inflation. Heavy Treasury financing in response to tax cut induced deficits and the paring of the Fed's balance sheet added to investor nervousness. The ten year Treasury yield peaked at 3.11% in mid-May but subsequently retreated and is currently trading at the 2.86% level.



As is evident, the yield curve flattened considerably with the spread between two and ten year Treasury yields now at about 30 basis points compared to a 51 basis point spread at the end of last year and 93 basis points a year ago. Will additional Fed tightening ultimately be translated along the yield curve and cause longer rates to move higher? Quite possibly, but we feel the impact on longer yields will be modest as long as inflation pressures remains contained. The Fed's preferred inflation index, personal consumption expenditures excluding food and energy, rose 2% in May on a year-over-year basis hitting the Fed's target for the first time in several years. Inflation could move somewhat higher in the coming months, but with wage increases remaining reasonably contained (up a modest 2.7% over the past year) despite a relatively low 4% unemployment rate, we feel near term inflation pressures will be controlled. Demand for safe harbor fixed income assets in the turbulent global environment is also working to moderate rate pressures.

Municipal Market Fundamentals

The table below illustrates the trend in prime municipal yields over the past year which, early on, followed the pattern evidenced in the Treasury market. However the tax-exempt curve has not flattened to the same extent as the taxable market due to demand for short maturity securities. The two to ten year prime municipal spread is currently 79 basis points, more than double the Treasury market spread.

Prime Municipal Yields

	Current	5-9-18	3-31-18	12-31-17	6-30-17
1 Yr.	1.48%	1.73%	1.56%	1.41%	0.92%
2	1.63	1.84	1.66	1.55	1.07
5	1.97	2.06	2.04	1.66	1.37
10	2.42	2.42	2.44	1.98	2.00
15	2.63	2.67	2.67	2.25	2.44
20	2.76	2.84	2.80	2.40	2.65
30	2.88	2.98	2.93	2.52	2.79

In contrast to the Treasury market where $800 billion bonds are being marketed this year and possibly a trillion in FY 2019, supply in the municipal sector has fallen sharply from last year. First half new issue volume at $156 billion is 17% lower than last year's level. The reduction reflects the impact of tax legislation enacted last year that eliminated the ability of municipalities to advance refund outstanding issues. A rush of refunding issues in the fourth quarter of last year ballooned 2017 volume to $436 billion. Total supply this year is now estimated to fall 25% or more from the 2017 level.

While volume is lower, demand remains strong. The drop in the corporate tax rate from 35% to 21% has dampened demand from banks and casualty insurance companies and modest portfolio liquidations have been evidenced from several institutions. In contrast, individual investor demand remains robust and is more than offsetting the decline in institutional demand. Any rate pressure in the Treasury market could be translated, to some extent, into the tax-exempt sector but we would expect the impact to be muted due to the very favorable municipal supply/demand balance. Portfolio durations of accounts managed by C.W. Henderson & Associates are targeted at a modest 3.80 years. High credit quality barbell account structures continue to be employed.

Demand In High Tax States

There has always been demand for in-state bonds by residents in states with high income tax rates if income from in-state bonds is exempt from state taxation. The attractiveness of home state municipals is evident when viewed on a tax equivalent basis. An individual in the maximum federal bracket will be taxed at 37.0% plus

3.8% for Medicare. In California where the maximum tax rate is 13.3%, the combined federal and state tax rate can total 54.1%. Assuming an in-state municipal can be purchased yielding 2.50%, a 5.45% taxable yield would be required to obtain a commensurate after tax return (2.50 divided by (1 – .541)). Comparable calculations can be done for New York, Connecticut, New Jersey, etc.

The tax act limited the federal tax return deduction for state and local taxes to $10,000. This has heightened demand for in-state municipals in several states that exempt income from in-state municipals. California and New York paper has especially been impacted. State of California bonds that last year traded at about 25 basis points over the triple A scale are now providing only about 5 basis points of additional yield. Less frequent issuers of high quality bonds are trading at even richer levels. As an example, a recent offering of AA University of California revenue bonds traded at nine basis points less yield than the AAA scale. This trend is likely to persist in high tax states.

Filling a portfolio with in-state bonds has great appeal from a tax avoidance standpoint, but should not be viewed only from that perspective. Restricting purchases to bonds from only one state limits diversification and can potentially cause an investor to compromise credit quality standards and/or purchase bonds with poor structures (e.g. negative convexity: long maturity bonds with low coupons and short calls that have limited upside price potential and de minimis risk).

In addition, with many in-state bonds trading at very rich levels as noted above, it is often possible to find bonds from states without an income tax (e.g. Texas) trading at yields that largely compensate for state taxes. As an example, assume a highest bracket California investor can purchase an in-state bond yielding 2.50% or a comparable quality non-California bond at 2.80%. The after state tax yield on the latter bond would be 2.43% (2.80 X .867), a relatively small yield reduction in net yield for improved diversification and a potentially better bond structure.

U.S Supreme Court Rulings Impact Municipal Credits

In a suit brought by South Dakota, the Supreme Court ruled that states have the right to levy sales taxes on online transactions done with retailers that do not have a physical presence in their state. South Dakota estimates that it has been losing $50+ million in annual revenues. The Supreme Court found that sales tax collections only in instances where there is physical presence of the selling entity in the state was outdated and not reflecting economic reality. With an increasing amount of commerce being conducted online, states have missed considerable amounts of revenue. A Governmental Accountability Office study estimated that states and local governments could collectively realize increased annual tax collections ranging from $8.5 to $13.4 billion annually. Five states, Alaska, Delaware, Montana, New Hampshire and Oregon do not have sales taxes. On average sales taxes currently represent 21.6% of overall revenues for the remaining states although there is a wide range with Florida's reliance being the highest at close to 77%.

Another Court ruling banned public unions from compelling non-union members to pay union fees. The decision may reduce union membership as well as union revenues and political influence. However, it could also cause labor negotiations to be more strident as unions work to maintain pay, benefits and influence. Whether this ruling ultimately impacts pension plan funding remains to be seen.

De-Annexation

A recent development in Georgia involves the restructuring of the city of Stockbridge that is located south of Atlanta. A component of the population intends to break away from the city and form a new town, Eagles

Landing, with a higher median income, a different racial balance and without reapportioning the city's $15.5 million outstanding debt. Eagle's Landing would assume half of the tax base and only 32% of the population. To our knowledge no other break away plans are currently contemplated, but state's approval of de-annexation legislation opens the door for additional municipalities to take similar action. Local Georgia debt must now be viewed as having an additional risk element. Stockbridge is not the type of credit we would consider for client portfolios, but once again illustrates the need for in depth credit analysis to assure that securities purchased for client portfolios have strong financial backing.

C.W. Henderson Short Term Product

We again highlight this product that provides an alternative for investors seeking tax-exempt income with limited volatility. The objective of the product is to provide returns that exceed money market yields while also providing principal stability. Short Term accounts are constructed with short effective duration securities that have limited volatility characteristics. Portfolio durations are generally maintained at six months or less. Quarterly returns have been consistently positive since the Fed began tightening in late 2015. As rates rise with additional Federal Reserve tightening the attractiveness of these accounts will be further enhanced.

Firm News

We are pleased to announce two additions to the C.W. Henderson team. Fran Michl will join the trading and portfolio management group. Fran has over twenty years of experience in the municipal bond industry and was most recently a Partner and Managing Director with Gurtin Fixed Income. His knowledge and trading experience will add depth and expertise to our trading team. Weston Hirschey, a recent graduate of the University of Indiana with a double major in Finance and Operations Management, will join the Operations and Client Service Group to provide additional support as our client base builds. Welcome aboard!

Craig W. Henderson Thomas L. Mallman, CFA Matthew S. Andrews