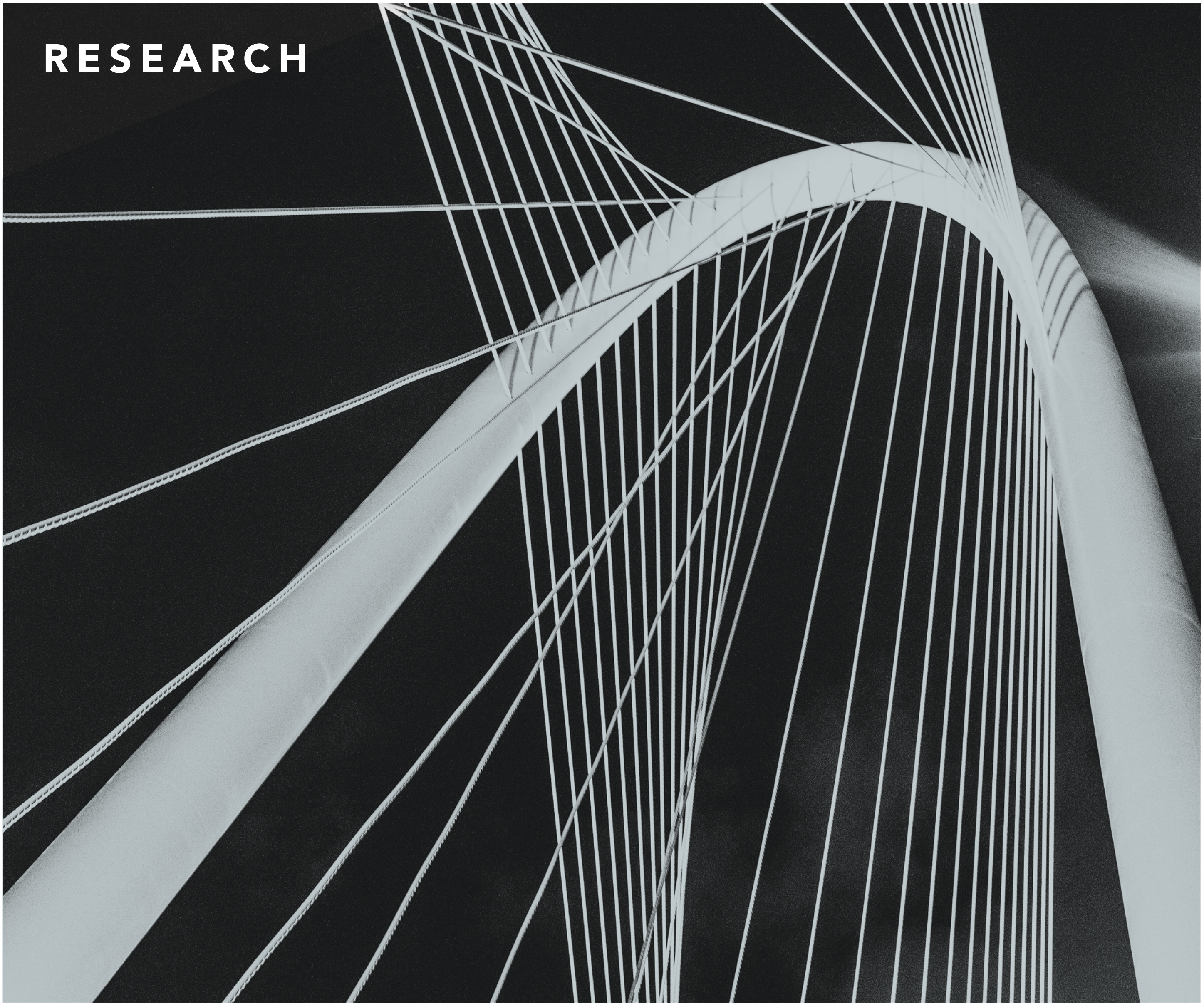
RESEARCH



CREDIT REVIEW & OUTLOOK
THE MUNICIPAL SECTOR

Miles Capital

THE MUNICIPAL SECTOR

The market for municipal bonds, the debt issued by states, cities and counties to fund projects, is a vast and complex sector of the economy. The size of the U.S. municipal bond market increased to $3.853 trillion in the second quarter of 2018, up from $3.851 trillion the prior quarter, according to data from the Federal Reserve.

With more than 50,000 issuers of municipal debt across the U.S., evaluating sound investments in this sector can be daunting. Our credit-selection process for municipal securities is rigorous and disciplined. Our overall approach is to review the sector on a fundamental, technical and valuation basis to determine which investments we believe are most sound for our clients.

The current state of the market is mixed. When looking at the overall municipal landscape, state revenues and fund balances are up in the near term, but long-term budget pressures such as unfunded pension liabilities and funding for key services such as education and infrastructure remain legitimate concerns.

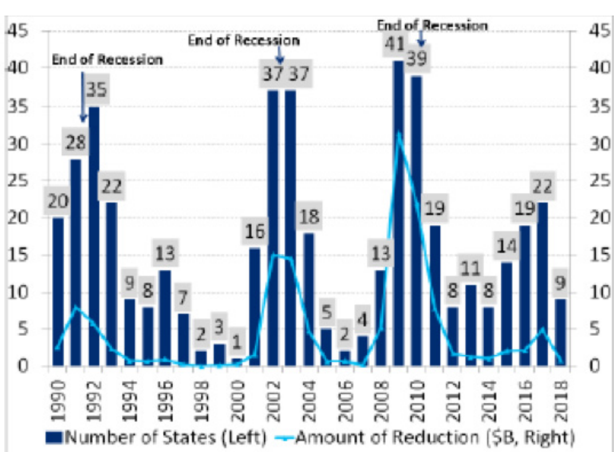
As a result, our credit outlook on the municipal sector remains slightly underweight, although there is considerable variance within the sector that demands careful attention. What follows is a high-level look at overall trends that are important for the sector, as well as positive and negative dynamics that we are observing in the municipal bond market.

MARKET FUNDAMENTALS

Total general revenue for all states grew an estimated 4.9 percent in fiscal 2018, while revenues over the same period in a few states were also bolstered temporarily by tax increases. Improved revenue conditions for states overall this fiscal year led to significantly fewer midyear budget reductions compared with recent budget cycles (See Figure 1). According to the National Association of State Budget Officers' 2018 spring report, 39 states met or exceeded their budgeted revenue projections, while 24 states came in below projections. Another 15 states were on target.

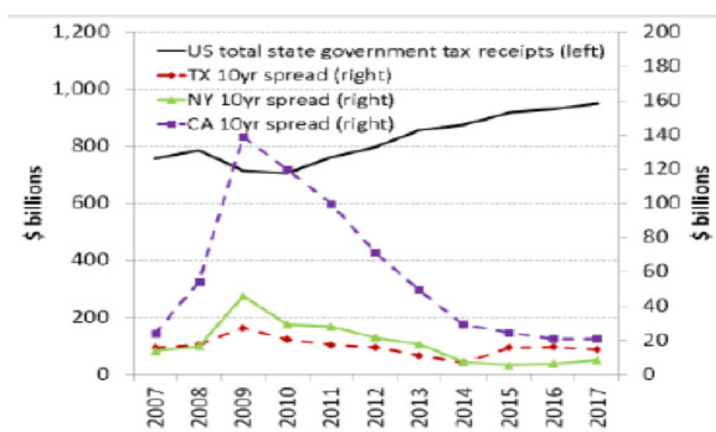
Twenty-seven states reported general fund spending levels in FY 2018 that were lower than their FY 2008 levels, after adjusting for inflation, including 11 states that were more than 10 percent below their pre-recession peak. This could suggest future economic challenges and the likelihood of widening spreads (See Figure 2).

FIGURE 1: NUMBER OF STATES MAKING BUDGET CUTS AFTER THE BUDGET HAS PASSED



Source: Citi Research

FIGURE 2: A DROP IN TAX REVENUE GROWTH OFTEN BEGETS A WIDENING OF SPREADS, ESPECIALLY IN HIGH TAX STATES



Source: Citi Research, US Census Bureau of Economic Analysis, Thompson Reuters

Sources: Miles Capital, NASBO, Bloomberg, Citi Research, Thomson Reuters, Barclays

While budget conditions vary by state, all states to some extent are facing long-term spending pressures in areas such as health care, pensions and K-12 education and infrastructure. On the technical side, overall supply is tighter and Insurance companies, traditionally major buyers of municipal bonds, are slowing their acquisitions.

When looking at valuations, option-adjusted spread are historically tight — at least for 1-2 years depending on security type and maturity band. Our view is that corporate bonds generally provide a better valuation.

TYPES OF BONDS

When considering an investment in the municipal market, it's important to understand the types of bonds available in the market. There are two main types of municipal securities that make up the bulk of most portfolios: revenue bonds and general obligation bonds.

Revenue bonds finance income-producing projects — such as hospitals, airports, toll roads, stadiums and other government-backed projects — and are secured by a specified revenue source. Within the revenue bond category are "essential service" revenue bonds, which are tied to vital government services such as water, sewer and power. These are generally more attractive and considered less risky because they are less affected by economic downturns.

General obligation bonds, on the other hand, are backed by the full faith and credit and taxing authority of the issuing organization, rather than by revenue generated by a project. Within this category are unlimited general obligation bonds, which are backed by a county's ability to raise property taxes or a state's ability to raise fees or taxes to meet the debt obligation. Less attractive general obligation bonds are those that require an annual appropriation from a governing body, such as a state legislature, which can be affected by shifting political trends.

TREASURIES VS. MUNICIPAL BONDS

After a two-year run of outperforming U.S. Treasuries, municipal bonds failed to provide higher returns than federal bonds during the first quarter of 2018. Although U.S. municipals still yielded positive returns during the first quarter of 2018, the Chinese-led global stock market decline created a more conducive environment for higher yields on U.S. Treasuries.

This unusual dynamic created a market anomaly, in which Treasury bonds had stronger after-tax yields than municipals. Despite this, many investors were still purchasing higher-risk municipals during this period. While the market eventually shifted back to a ratio that favored municipals, these are moments that merit backing off and re-evaluating an investment strategy. Given the current rising rate environment in which supply is still tight, a market anomaly like this is something investors need to be cognizant about during the investment process.

RANKING THE STATES

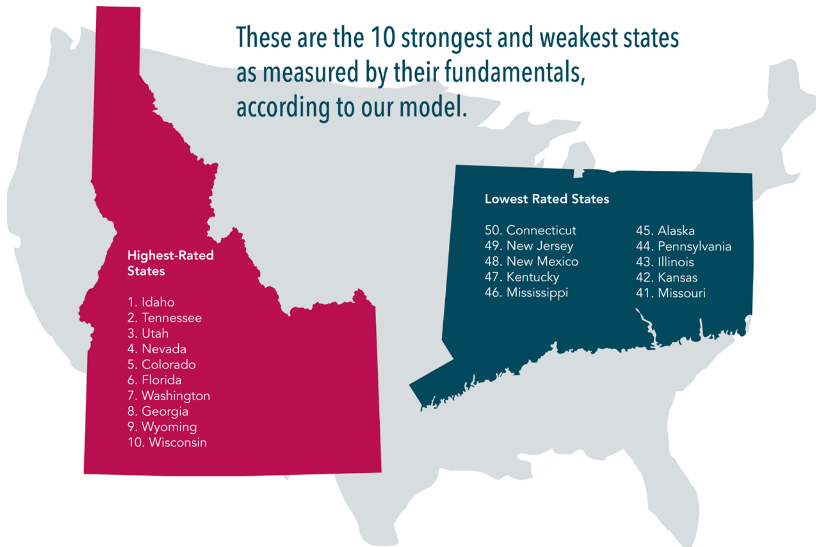
Our proprietary model ranks the states from 1 to 50 (See Figure 3), utilizing variables that are highly correlated with financial performance and ratings over time. Common themes among the highest-rated states are strong employment bases, high per capita income growth, diverse revenue sources, strong general fund balances relative to expenditures, low debt levels and high pension funding ratios. The inverse is true for the lower-ranking states.

Pension liabilities continue to be a considerable source of concern across the municipal landscape. Unfunded pension liabilities for states and major municipalities have increased substantially since the financial crisis, despite strong equities market performance and sustained low unemployment. Typically, stronger market fundamentals should allow municipalities to increase their pension funding.

Even though some of this change was driven by new accounting standards, an economic downturn could place substantial stress on pension funding for these municipalities. This warrants close attention moving forward.

Sources: Miles Capital, NASBO, Bloomberg, Citi Research, Thomson Reuters, Barclays

FIGURE 3: RANKING THE STATES



Source: Miles Capital

MARKET CONCERNS

Increasing costs for health care and pensions generally lead to more of a negative viewpoint for the municipal sector. Municipal spreads have compressed into an increasingly narrow range, and there is growing feeling in the market that an inflection point is approaching.

Even though some states are reducing their budgets, investors are becoming concerned over the divergence of elevated valuations and the continued under performance of state and local revenues. For example, in 2017, the median rainy-day fund balance grew from 1.9 percent as a share of general fund expenditures to 5.8 percent, surpassing the pre-recession peak of 4.9 percent. The median balance is projected to rise to 6.2 percent in fiscal 2019.

However, despite this sign of improving overall economic strength, quite a few major states have dropped their pension funding status by about 20 percent or more from 2008 levels. While a significant portion of the funding status changes has been caused by accounting rule changes, these are still concerning levels.

History shows that as the credit cycle reaches an inflection point and the economy enters a period of cooling activity, the change is directly reflected in state and local receipts. Generally a one-year lag exists whereby a slowdown in some measures of the economy or credit environment will be followed by a decline in tax receipts the next year. The trend affects bond spreads as well, although in low-tax states the effect is not as pronounced.

MAKING SENSE OF A FRAGMENTED MARKET

While our state ratings are a solid starting point for evaluating the credit ratings of municipal bond issuers, the overall picture is much more complex. The municipal market is extremely fragmented and bond quality varies quite strongly from issuer to issuer.

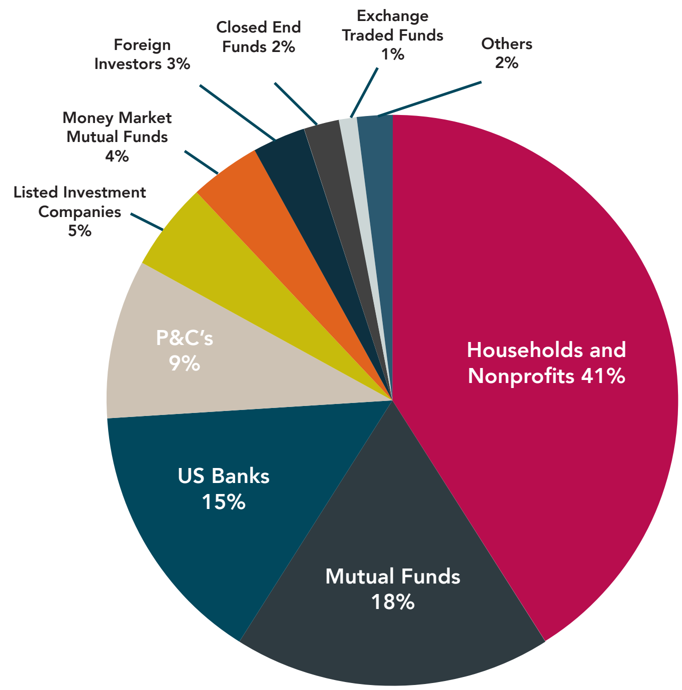
Sources: Miles Capital, NASBO, Bloomberg, Citi Research, Thomson Reuters, Barclays

Often we see states that are fundamentally struggling while smaller municipalities within that state are faring much better from a financial standpoint. Municipals are also a marketplace that is 60-70 percent dominated by high net worth investors (on the tax-exempt side), which can affect the market in unpredictable ways (See Figure 4).

It is therefore important to draw overall conclusions but also be mindful of individual dynamics and examine each bond closely on its own. Investors must dig into the official statements on bonds to find out the unique pros and cons of each municipality, such as demographics, fixed costs such as pension and health care, per capita income growth, economic diversity and major employers. Fundamental and technical evaluations are also important when evaluating municipal bonds.

Our proprietary ratings methodology and our experts steeped in the specifics of municipal bonds help investors properly assess the creditworthiness of the 50,000 municipal issuers across the U.S. to decide which issuers are the most appropriate fit for our clients.

FIGURE 4:MUNICIPAL BUYER BASE AS OF Q4 2017



Source: Citi Research

About Miles Capital

Investing requires a deep knowledge of the objectives, parameters, and regulatory constraints faced by each unique client. At Miles Capital, we offer our clients customized investing and relationships directly with portfolio management. We take a holistic view of our clients' needs, and build strategic partnerships that help support their broader goals.

CONTACT US TODAY AT 800.343.7084 FOR MORE INFORMATION

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Sources: Miles Capital, NASBO, Bloomberg, Citi Research, Thomson Reuters, Barclays