DCM ADVISORS

April 2018

Municipal Bond Outlook Q2 2018

As we enter the second quarter of 2018, the municipal bond market is still digesting the changes that made the first quarter as interesting and volatile as it was. In the fourth quarter of 2017, the Tax Cuts and Jobs Act of 2017 ("the Tax Reform Act") was enacted. In addition to lowering income tax rates, it limited the deductibility of state and local taxes as well as eliminating advance refundings of older municipal bonds. This resulted in a boom in supply in the end of the fourth quarter as municipalities rushed to refund as many older, higher interest rate bonds before the Tax Reform Act became effective. With that as the backdrop, what were the unknown issues and expectations entering 2018?

The Positives:

- High expected demand for bonds as substantial principal and interest payments due on January 1are usually rolled back into the market.
- Less new issue supply due to a bulge of issuances in late 2017 caused by the Tax Reform Act.
- Eliminating state and local tax deductibility creates a demand for tax free interest especially in high tax states like California and in the northeast.

The Negatives:

- Given the rapid advances in the stock market, will investors opt for more equity holdings or select the more assured return on a fixed income investment?
- Will inflation increase?
- Given there is a new Fed Chair, will the Fed be more hawkish about raising rates?
- The health of governmental pension and post-employment benefits funds has received substantial negative press.
- Budgets have received more scrutiny and are viewed with a greater political bias than has usually been the case.
- The Federal Government is running bigger and bigger deficits at a time when some economists fear the economic expansion that started approximately a decade ago might end.

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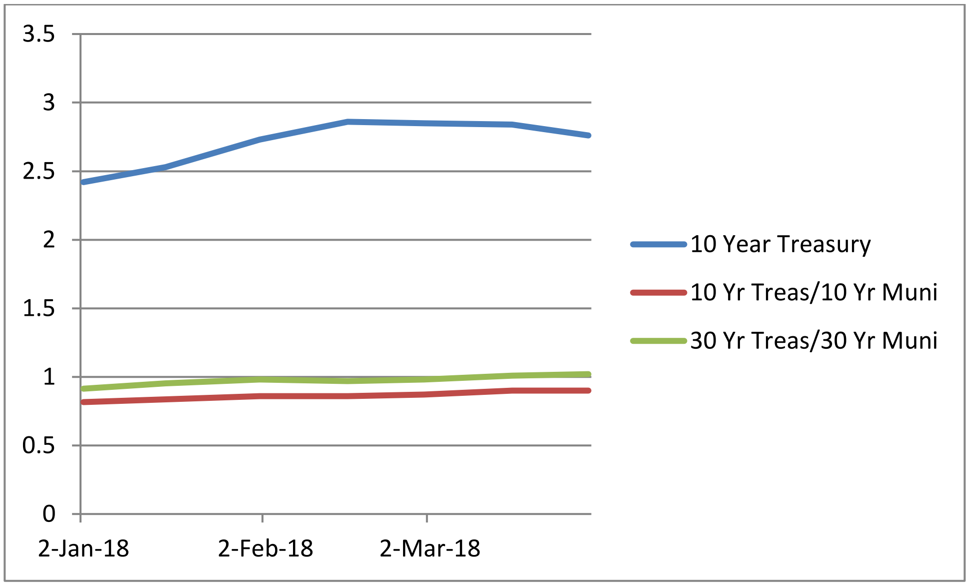
During the first quarter of 2018 the expected benefits of less supply and strong January demand failed to prop up the municipal bond market. The US Treasury Bond and Note market saw price declines and yield increases. Additionally, the new Fed Chair raised the Fed Funds rate at its March meeting. The Fed has warned of possibly three more rate increases this year, although the Fed Funds Futures market has an implied increase in June and is less clear as to the timing of the next increase. As a result, municipal bond rates increased, and on a greater ratio than Treasuries.



* The above data is compiled from the daily Treasury quotes provided by Bloomberg News Service and the municipal quotes are from Municipal Market Data, the leading industry source for yields in the municipal bond market.

The above quarterly chart reflects the yields of the ten year maturity Treasury Notes, and the relationship of comparable maturity municipals to Treasuries. The Treasury yield started at 2.42%, and ended at 2.76%. The ratio of municipals to Treasuries in 10 year maturities went from 81.6% to 90%. The 30 year maturity ratios increased from 91% to 102%.

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Our Outlook

While this may seem ironic, given that we have invested our clients in municipal bonds at varying rates and maturities for years, we welcome a continued slow increase in tax free interest rates. While it means that existing holdings could have paper losses if sold, as bonds approach final maturity or call date, the losses typically dwindle. On the other hand, the maturity provides capital to reinvest at hopefully higher rates. In our opinion, we have kept our client holdings on the front end of the maturity curve, to allow us to capture the gradually increasing rates when these bonds come due. Further, having watched the ebb and flow of municipal bonds for many decades, we welcome all the increased attention to the status of pension funds as well as the annual budgetary process. Anything that makes our investments' credits stronger and more transparent is to be encouraged. We encourage the Fed to gradually raise rates. We anticipate no change in our investment parameters. It is our opinion that investors select municipal bonds for the security and liquidity provided by them. While we may be opportunistic when unique situations present themselves, in general we anticipate taking a cautious approach to reinvestment. Naturally, please feel free to contact us with your questions or concerns.

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