DCM ADVISORS

July 2018

Municipal Bond Outlook Q3 2018

As we enter the second half of 2018, we would like to review some of the possible positives and negatives that we discussed in our earlier Outlooks to see how the market coped with these potentially dramatic issues brought about by the Tax Cuts and Jobs Act of 2017 (the "Tax Reform Act") and a new head of the Federal Reserve Bank (the "Fed"). As a review, the specific elements of the Tax Reform Act that had the most potential impact on tax-free municipal bonds were the change in tax rates, the capping of state and local tax deductions, and the elimination of advance refunding of municipal bonds prior to the first call date. All these "municipal bond-centric issues" were within an interest rate environment that appeared primed to increase interest rates because of economic growth as well as to fund the Federal Government's substantially growing deficit. Below are a few observations about the first half of 2018, how the municipal bond market fared, and then a comment about our outlook.

The Positives:

Demand for municipals remained viable, in spite of the changes in the tax code. There was an initial fear that a decline in tax rates would negate the benefit of tax exemption. In reality, wealthy taxpayers, especially those in states with high state and local tax rates, had little or no tax relief. While state and local tax rates are always subject to change, using the current rates, a California resident in the top income bracket pays 13.3% while a New York City resident pays 8.82% State tax and 3.875% City income tax. In 2017, using a Federal bracket of 39.6% and deducting for state and local taxes, there was a net tax of 47.6% to a California resident and 46.7% to a New Yorker. In 2018, using the new 37% top bracket, the same tax payers will face 50.3% and 49.7% respectively. To put it in round numbers, for any tax payer in the effective 50% bracket this means that a 2% tax-free return is equal to a taxable bond earning 4% (with half the return going to various taxing entities).

In the last two months of 2017, with the impending end of advance refunding, there was a burst of new issues all designed to prepay older bonds with higher interest rates. Starting January 1, 2018, new issue supply declined due to a lack of refunding issues. In the first six months of 2017, there was $200 Billion in new issue volume. In the same period in 2018, there was $161 Billion in new issuance volume equating to an almost 20% decline. Although there was a decline in new issuance volume, the demand remained fairly strong despite the changes in tax brackets and did not evaporate as some had feared.

The Unknowns:

Banks have traditionally been big purchasers of municipal bonds. With the drop in the corporate rates, there was concern that they would leave the market. To a certain degree this is true. However, there has been a legislative push to include certain quality municipal bonds as part of a bank's "high quality liquid assets" for their liquidity ratios. At the time of this Outlook, such proposal is still being considered and its impact is something that market analysts are closely monitoring.

While the Fed has announced it projected several rate hikes this year, the hawkish tone is not reflected as clearly in the Fed Funds Futures market, as reported by Bloomberg Analytics. There have been two rate increases already this year. The most current rate change was from 1.75% to 2.00%. The Fed Funds Futures market predicts one rate increase in September with 2.00% to 2.25% as the range. It currently predicts the chances of another rate increase in 2018 at less than a 50% possibility.

You have heard our concerns about the health of governmental pension and post-employment benefits funds for some time now. While this is still a great overhang on municipal budgets, more attention is being focused on it. This does allow for any needed tax increases, benefit negotiations, and other options, however expensive or painful, to be enacted. Within the last month I have attended several webinars by market participants all trying to examine various routes to fund retirement benefits. The fictitious answer from years ago was that an unrealistic growth expectation for the retirement investment portfolio would solve all problems. This has been replaced by more of an effort to come up with real solutions. There is still a long way to go, but the issue is getting more political exposure, which is the first step to finding solutions.

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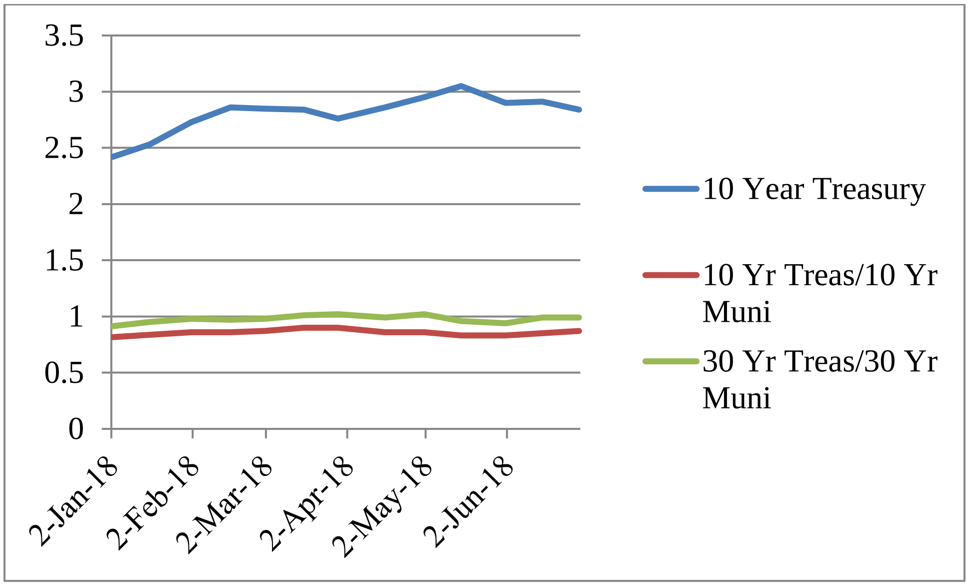
Rate Recap:

The new Fed Chair raised the Fed Funds rate in the March meeting, and subsequently in June. The Fed has warned of possibly two more rate increases this year, although the Fed Funds Futures market has an implied increase in September, and less clear as to the timing of any increase after that. The bellwether Ten Year Maturity Treasury Note increased from 2.42% at the start of the year, touched the 3.05% range in May, and has come back to 2.85% by the end of June. Municipal bond rates tightened up relative to the movement in Treasuries, providing the investor more yield increases relative to the Treasury movement.



* The above data is compiled from the daily Treasury quotes provided by Bloomberg Analytics 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 gross yields of the ten-year maturity Treasury Notes, and the relationship of comparable maturity municipals (10 and 30 years) to Treasuries. The ratio of municipals to Treasuries in 10-year maturities went from 81.6% to 87%. The 30-year maturity ratios increased from 91% to 99%.

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Our Outlook:

As we have mentioned before, we welcome the gradual increase in municipal bond rates. Our standard portfolio strategy has been to hold shorter maturities to take advantage of any future rate increases. We naturally would take advantage of an opportunity that, in our opinion, might present itself beyond the traditional buying patterns we have employed. We anticipate extending maturities as yields and opportunities appear to be favorable for you, our investors. Naturally, please feel free to contact us with your questions or concerns.

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