DCM ADVISORS

January 2019

Municipal Bond Outlook Q1 2019

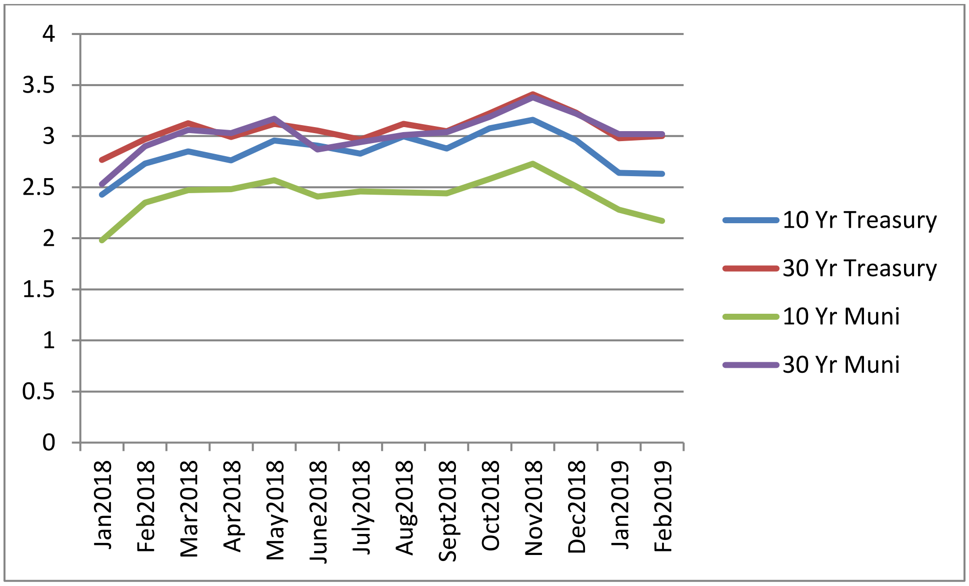
The New Year and the Old Fears

For a fixed income investor, the outlook for interest rates is the ongoing question. Will they go up? Will a change in the economy strengthen or weaken the credit behind the bond's interest cash flow and ultimate maturity payment? These old fears are just as prevalent today as they were in other economic periods. Given the uncertainty in our lives right now, what is our opinion about investing in the bond market?

On January 29th and 30th, 2019, the Federal Reserve's Federal Open Market Committee ("FOMC") met for the first time in 2019. There was no accompanying interest rate increase. In December of 2018, the FOMC had raised short term rates to a range of 2.25% to 2.50%. To put this in perspective, the Fed Funds rate range was 0% to 0.25% from December 2008, during the financial crisis, to December 2015, when there was the first quarter of a percent increase in the range. A year later there was the next quarter of a percent increase, bringing the range to 0.50% to 0.75%. In 2017, as economic conditions continued to improve, there were three rate increases, closing the year with a range of 1.25% to 1.50%. In 2018, there were four increases, with the last occurring, as mentioned above, in December, bringing the range up to 2.25% to 2.50%. With each rate increase, the FOMC indicated in their accompanying statement that they anticipated a gradual, event-driven, series of rate increases guided by their mandates for job creation and monitoring the inflationary outlook. The newest statement deleted the reference to potentially impending rate increases and was more pragmatic and patient about its future activities to support these dual guidelines.

As we had reported last year in our outlook for the fourth quarter of 2018, the bond market was marked by rising rates and lower bond prices. By the middle of the fourth quarter, this spike-up of rates did attract investors, helping to stabilize the market. Additionally, there was a growing concern that perhaps the economy would slow down. This concern was based upon the declining stimulus from the tax cuts, growing slowdowns in China and Europe and vacillating trade talks. As a result, Fed Fund futures, as reported by Bloomberg, showed a high probability of a December rate increase but much less likely for any rate increases after that. These trends have carried over into the first month of 2019. As mentioned at the start of this opinion piece, the FOMC did not vote to increase rates in January and the Fed actually issued a much more passive statement. In a follow-up piece, the Fed also indicated it would continue to roll off $50 Billion per month from the balance sheet that it accumulated due to the Quantitative Easing it employed over the last decade.

Graphically, how have the bond markets reacted over the last year to all the FOMC tightening of short term rates? Using the start of the month opening Treasury rates for the current ten-year maturity Notes and thirty-year maturity Bonds from Bloomberg Data, and the equivalent maturity AAA municipal composite rates from Municipal Market Data, the leading municipal bond analytical service, the following graph shows the yield movements during this most recent period.



As you can see, the spread between the long municipal and Treasury bonds tightened up while the ten-year maturity bonds maintained a fairly consistent divergence in yields. Given the unknowns about the new tax rates as we entered 2018, the possible upward direction of interest rates, and the concern about the economy, municipal bond investors in 2018 wanted more reward to extend out on the yield curve.

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Where are we now? What are the contradictory issues?

1.) **The U.S. Treasury will continue to run a substantial deficit.** Total debt issued by the Treasury, to fund this increasing shortfall, has been expected to reach a trillion dollars for this coming year.
2.) **Various projections for municipal bond new issuance fluctuate between $350 Billion and $380 Billion.** 2018 issuance has been estimated to have been $335 Billion. While an increase, given the continuing volume of maturing debt, in our opinion, this is manageable.
3.) **Municipal pensions and selected budget shortfalls remain a concern for investors.** States like Illinois, New Jersey, and the City of Chicago are coping with pension underfunding, or current account deficits. It is also our opinion that the more financial issues are discussed, the more likely there will finally be a solution, no matter how difficult it may be.
4.) **Tax policy and tax rates will be debated, heading into the 2020 Presidential election**. Many candidates have already tossed their hats into the proverbial ring, citing inequality. As such, the more the discussion focuses upon federal tax increases upon the wealthy, the greater the attractiveness of tax-free municipal bonds.

Our Thoughts

Municipal bonds will continue to offer a benefit for wealthy investors. With the limitations on the amount of deductibility of state and local taxes, any security that is exempt from state or local taxes as well as federal income tax, has a greater return than a bond with a higher nominal rate, but subject to increasing state and local tax bills. Add to this an increase in the federal rate, and the overall attractiveness of a municipal bond can only rise. Since timing is always important, we are less sanguine about the specific peak or valley in any cycle. Hence, in our view, it is better to spread maturities over a specified time period and keep access to liquidity through a defensive outlook. Naturally, if you have any questions about our thoughts, please feel free to share them with us.

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