

Quarterly Market Review

Spring 2017

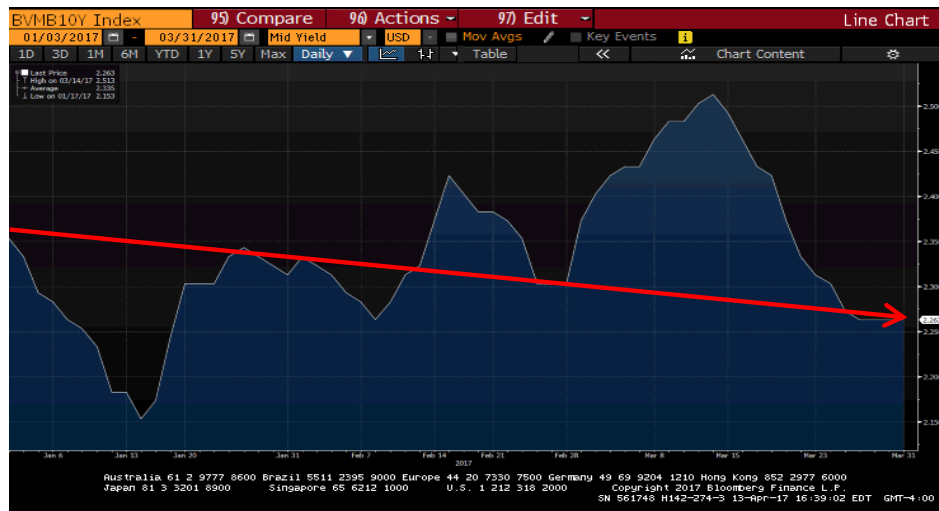
Market Update:

The post-election bond market volatility that occurred during the fourth quarter of 2016 continued into the first quarter of 2017. The 10-year AAA MMD index reached a low of 2.14% on January 18th and topped out at 2.49% on March 14th. The difference between the high and low yield for the quarter looks large, however; in absolute terms the yield change over the quarter was muted as the index ended the quarter yielding 2.23%, after starting the quarter at 2.31%.

New deal issuance in the first quarter was \$89.4 billion(b) vs \$99.9b for the same period in 2016. The majority of the volume was in refunding deals as issuers continue to take advantage of low rates and refinance their debt. March volume was the lowest since 2014, due in part to the uncertainty at the beginning of the month surrounding the Federal Reserve Bank's decision regarding raising its overnight lending rate. The 30-day visible supply of issuance for the week ending March 31st is \$12.3b an increase from the previous week's figure of \$10.9b.

Source: SIFMA

10-Year AAA Municipal Average Yields – 1st Quarter 2017



Source: Bloomberg

Paving the Way for Infrastructure Investment:

Healthcare and tax reform have dominated news headlines since President Trump took office. The recent failure of the proposed healthcare reform package has brought the third pillar of his campaign themes to the forefront...infrastructure spending.

President Trump's infrastructure plan calls for investing \$1 trillion over 10-years in U.S. infrastructure. Transportation Secretary Elaine Chao announced, on Tuesday, April 4th, that a package could be brought forward as soon as May. The ability of the administration to pass an infrastructure plan is currently in question given the failure of the recent healthcare initiative.

Our take: The biggest questions about infrastructure for municipal market participants are: 1) will the proposed plan enhance or harm the current municipal market dynamic and 2) how will it affect market yields?

Studies show tax exempt financing is an efficient way for state and local municipalities to raise investment capital. P3 projects and tax credits for private investment, two additional funding alternatives, are funded by private investors and present benefits but also come at a higher cost. These extra costs may be passed onto municipalities and ultimately, taxpayers. Municipalities have come under pressure as they continue to deal with mounting pension benefits and statutory debt limits. A successful infrastructure plan will utilize multiple forms of financing and continue to rely on the 100-year old municipal market.

The Federal Reserve supports an infrastructure spending plan, as it sees the program as a catalyst for economic growth. A successful infrastructure program, along with the possibility of lower taxes, will fuel economic growth. Increased economic growth allows the Fed to continue to increase the federal funds rate and begin the process of unwinding other monetary policy decisions in recent years. Historically, these factors help push long term yields higher.

Source: Watts, Jim. "Private Investments Seen as Key to Infrastructure Funding." *Bond Buyer*. N.p., 11 Apr. 2017. Web. 13 Apr. 2017. <https://www.bondbuyer.com/news/blackrock-ceo-private-investments-trump-bonds-for-infrastructure-renewal/feed=0000015a-fd09-d93b-abda-fddf17b30000>

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Who says a 2.20% 10-year isn't attractive?

The Federal Reserve raised the federal funds overnight lending rate to a range of 0.75%-1.00% at its March meeting. The Fed also signaled its intention of hiking the fed funds rate two more times this year as monetary policy remains accommodative, from a historical perspective.

The Fed, in its post meeting statement, did acknowledge a moderate rise in consumer spending, as well as a firming of business fixed investments. It also seemed more confident on inflation reaching its target of 2%.

There was continued demand in the Treasury auctions, particularly from indirect bidders (used as a rough proxy for foreign investors). The most recent 5-year auction, for example, had a bid to cover of 2.37 vs 2.29 for the prior month. Indirect bidders took 68% of the award vs 58% for the month prior. The 7-year auction saw similar results.

Our take: The Fed needs to be wary of foreign buying of mid/long term U.S. Treasuries. Strong buying from foreign investors has the potential to exacerbate the flattening of the yield curve normally seen during a Fed tightening cycle. As the Fed continues to raise short term rates, if strong overseas demand persists in the medium/long term, it has the potential to invert the yield curve. Historically, this has been a precursor to a recession.

This is the conundrum the Fed faces, how to raise interest rates while maintaining a steep yield curve? Economic growth and more specifically inflation have been the historical drivers of a steep curve. As long as other rates around the world remain near 0%, demand from foreign buyers will not start to subside. The U.S. 10-year yield looks "attractive" relative to the rest of the developed world, as shown by the screen shot to the right of developed countries 10-year government yields.

Developed		97) Settings			
91) Bonds		92) Spreads		93) Curves	
Maturity	10 Year	Trading Mode			
Country	CMI	Security	Bid	Ask	Yield
1) Switzerland		SWISS 3 1/4 27	135,546	136,034	-0.240
2) Japan		JGB 0.1 03/27	100,891	101,001	-0.001
3) Germany		DBR0 1/4 02/27	100,698	100,731	0.175
4) Finland		RFGB 0 1/2 26	101,678	101,804	0.296
5) Austria		RAGB 0 3/4 26	103,069	103,222	0.404
6) Netherlands		NETHER0 3/4 27	103,183	103,244	0.425
7) Denmark		DGB0 1/2 11/27	100,205	100,470	0.454
8) Sweden		SGB1 11/12/26	104,338	104,573	0.509
9) Belgium		BGB 0.8 06/27	100,363	100,439	0.755
10) Ireland		IRISH 1 05/26	100,816	101,039	0.880
11) France		FRTR 0 1/4 26	94,024	94,084	0.896
12) United Kingdom		UKT4 1/4 12/27	132,143	132,170	1.046
13) Hong Kong		HKGB 1.51 27	99,215	100,636	1.446
14) Canada		CAN1 1/2 06/26	100,292	100,349	1.459
15) Norway		NGB1 3/4 02/27	101,812	102,200	1.507
16) Spain		SPGB 1 1/2 27	98,518	98,667	1.645
17) Singapore		SIGB 3 1/2 27	112,300	112,500	2.091
18) Israel		ILGOV 2 03/27	98,910	99,000	2.124
19) <u>United States</u>		T 2 1/4 02/27	100-12	100-12+	<u>2.205</u>
20) Italy		BTPS2.2 06/27	99,655	99,732	2.242
21) Australia		ACGB 4 3/4 27	119,878	119,971	2.483
22) New Zealand		NZGB 4 1/2 27	112,936	113,305	2.952

Source: Bloomberg

Credit Corner: Is Help on the Way for Illinois Local Governments?**Spring 2017**

Potential new legislation developed by the Chicago Civic Federation intends recommends establishing an authority to provide fiscal guidance to financially distressed local governments. House Bill 2575 would create the Illinois Local Government Protection Authority (LGPA) to help local units of government navigate financial difficulties. The Authority would be administered by nine trustees: four chosen by the Illinois Municipal League, and one each of remaining five appointed by the Governor, the House speaker, the House minority leader, the Senate speaker and the Senate minority leader respectively. The LGPA would help distressed local governments determine what level of government services could be maintained taking into account potential revenue increases and cost reductions. The potential program participants would need to meet certain criteria such as low liquidity levels, poor pension funding metrics, overdue bills, and sustained budget imbalances, in order to qualify for assistance. Given retirement obligation funding challenges are pervasive in Illinois, the authority would also be charged with recommending whether a local government would benefit from a trust to fund OPEB obligations or whether the local government should offer 401(k) style retirement plans over defined-benefit pensions.

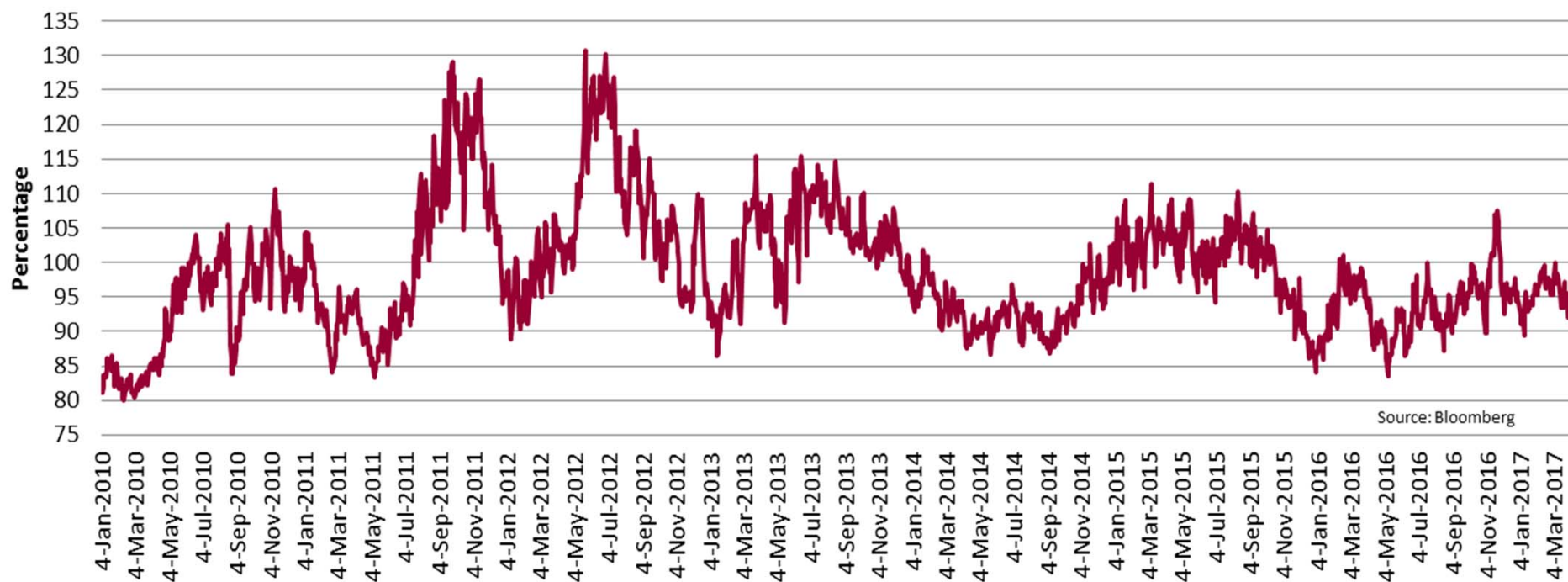
The LGPA bill faces stiff opposition from the majority Democratic party in both houses of the General Assembly with legislators pointing to existing legislation (the Financial Distressed City Act and the Local Government Financial Planning and Supervision Act) in place allowing for state intervention through the creation of a special oversight authority. Proponents of House Bill 2575 point to limitations under the current legislation and examples like East St. Louis that have remained distressed after leaving such oversight. The Distressed City Act, for example, takes only tax rates and per capita tax yields into account for participation, while the Supervision Act has a population cap of 25,000 for eligible municipalities. The LGPA Bill would rectify these limitations by establishing a systematic way of monitoring distressed municipalities, proponents claim.

If LGPA legislation is enacted, Illinois would not be alone among states in establishing such a finance authority. Twenty-two states review financial information from local governments in order to assess their fiscal conditions, according to a report published by the Pew Charitable Trusts. The report highlights multiple challenges and solutions to the various approaches used by states to monitor local governments' fiscal situations. When either developing new fiscal monitoring systems or strengthening existing systems, the most common challenges are inconsistent monitoring due to informal procedures, learning about fiscal distress too late, and tensions between state and local government officials. The solutions discussed by Pew relate closely to the aims of the proposed Local Government Protection Authority. Formalized policies and procedures must be codified in state statutes to establish specific fiscal indicators for state review, in order to combat the challenge of inconsistent monitoring. Tension between state and local officials can be mitigated by strategies such as hiring local personnel for state divisions that deal with counties and municipalities to create opportunities for constructive interaction between the two.

North Carolina's State and Local Government Finance Division (SLGFD) is an example of best practices in state financial oversight. The SLGFD analyzes local financial data, provides local municipalities with multiple layers of support and advice, and issues debt on behalf of local entities. The SLGFD also offers an online benchmarking tool for local officials to compare their finances to their peers. The LGPA incorporates many of these practices into its model. As the legislation was redirected to the House Rules Committee on March 31st, it remains to be seen whether Illinois legislators will establish more systematic involvement in their local municipalities' financial health.

Source: the Pew Charitable Trusts. "State Strategies to Detect Local Fiscal Distress"
Published September 2016.
http://www.pewtrusts.org/~media/assets/2016/09/detecting_local_distress_report.pdf

10 year Muni/Treasury Yield Ratio



Today	93.51	10-year average:	99.04
High:	130.76	5-year average:	99.21
Low:	80.06		
Average:	98.54		

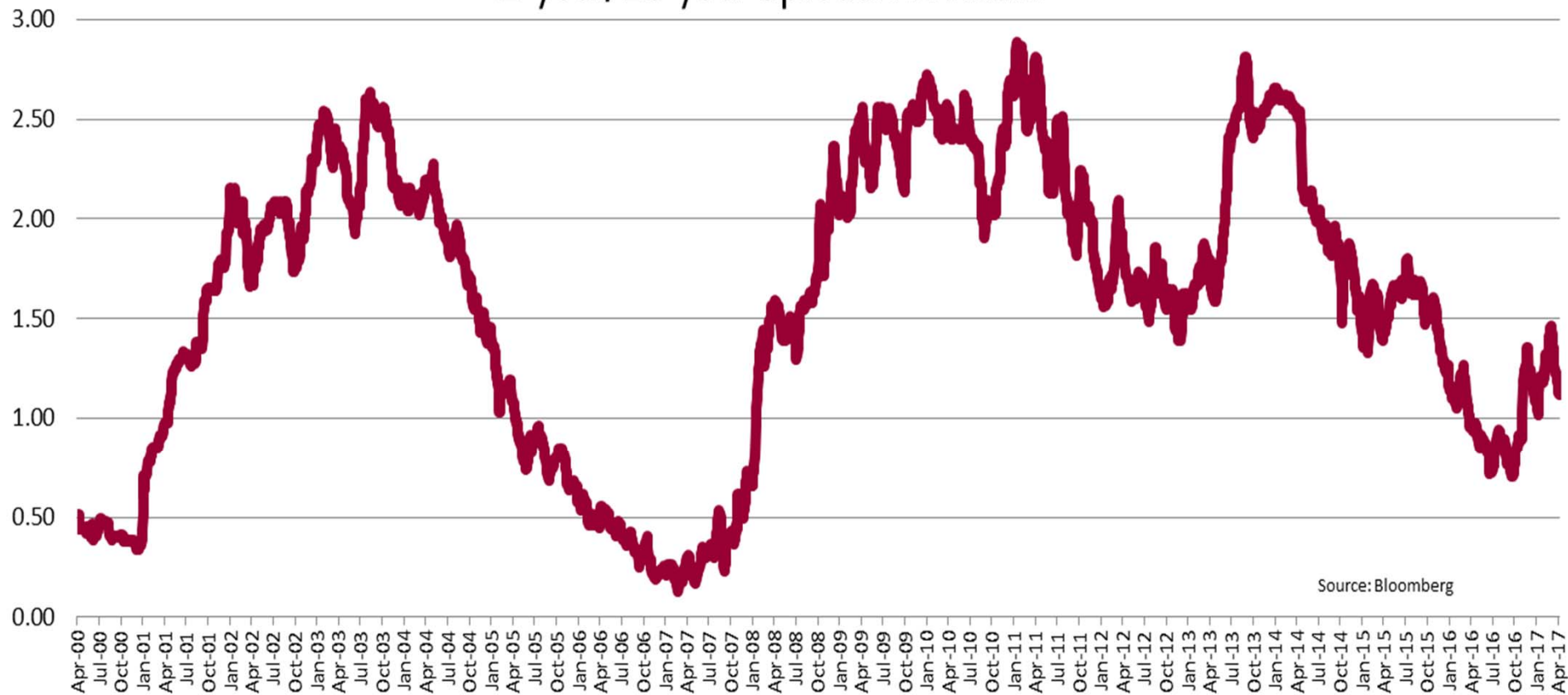
10-Year AAA Muni



Quarterly Chart Book

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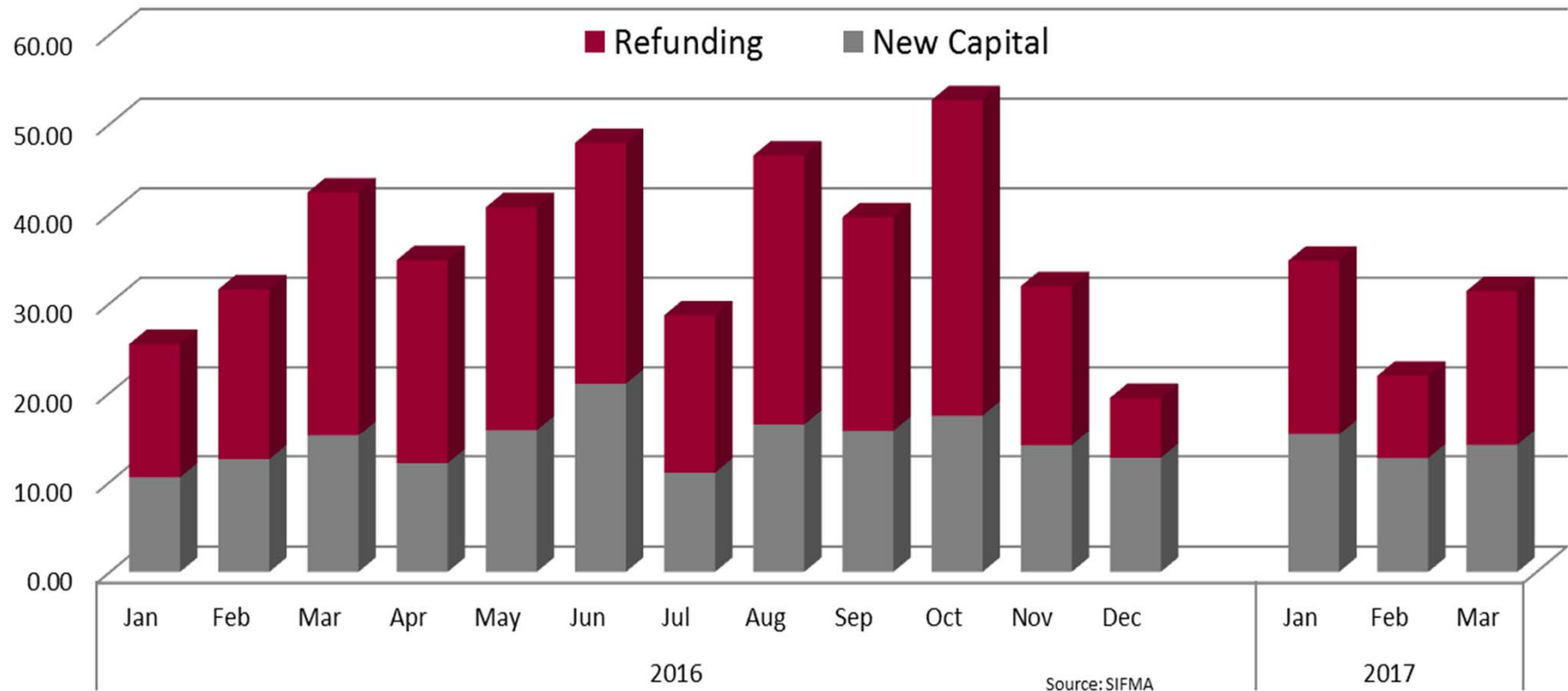
2-year/10-year Spread: AAA Muni



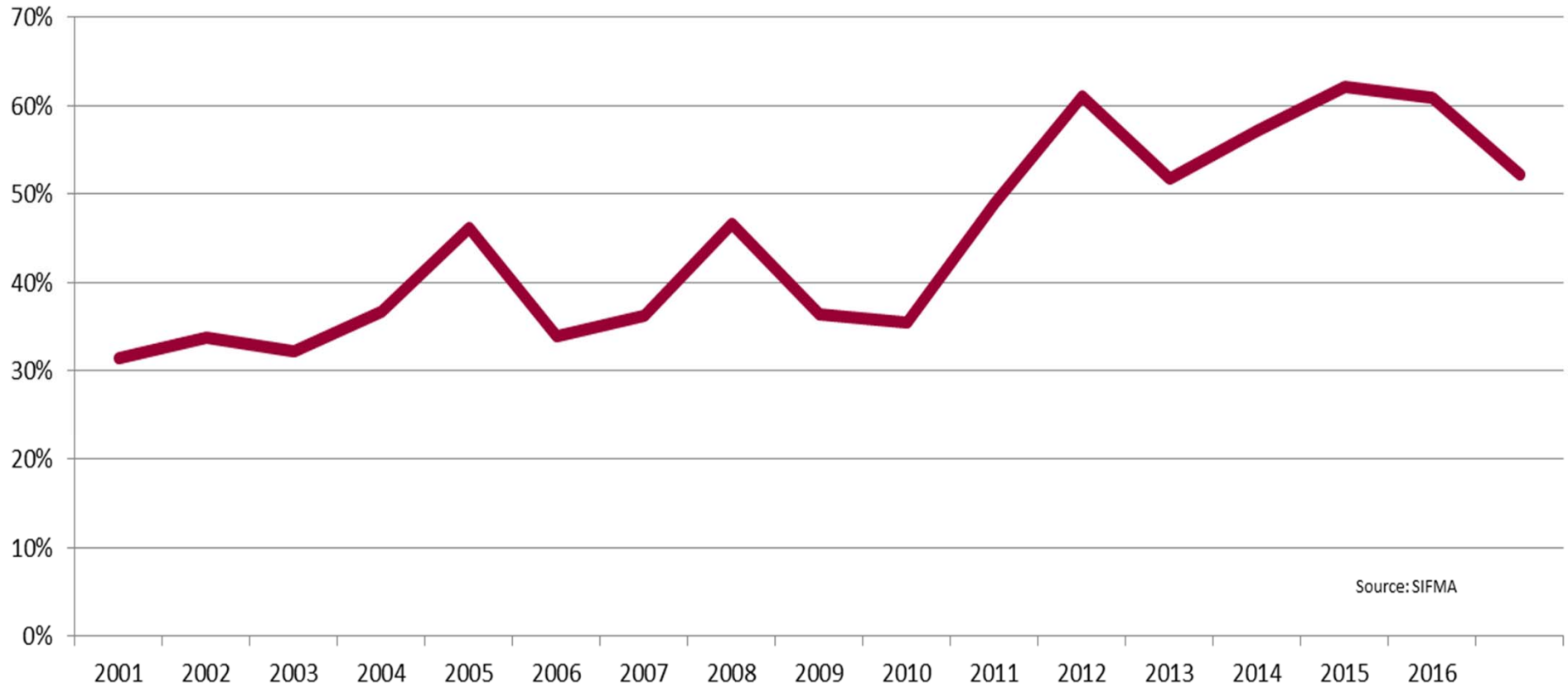
Source: Bloomberg

Today	1.12
High:	2.88
Low:	0.13
Average:	1.58

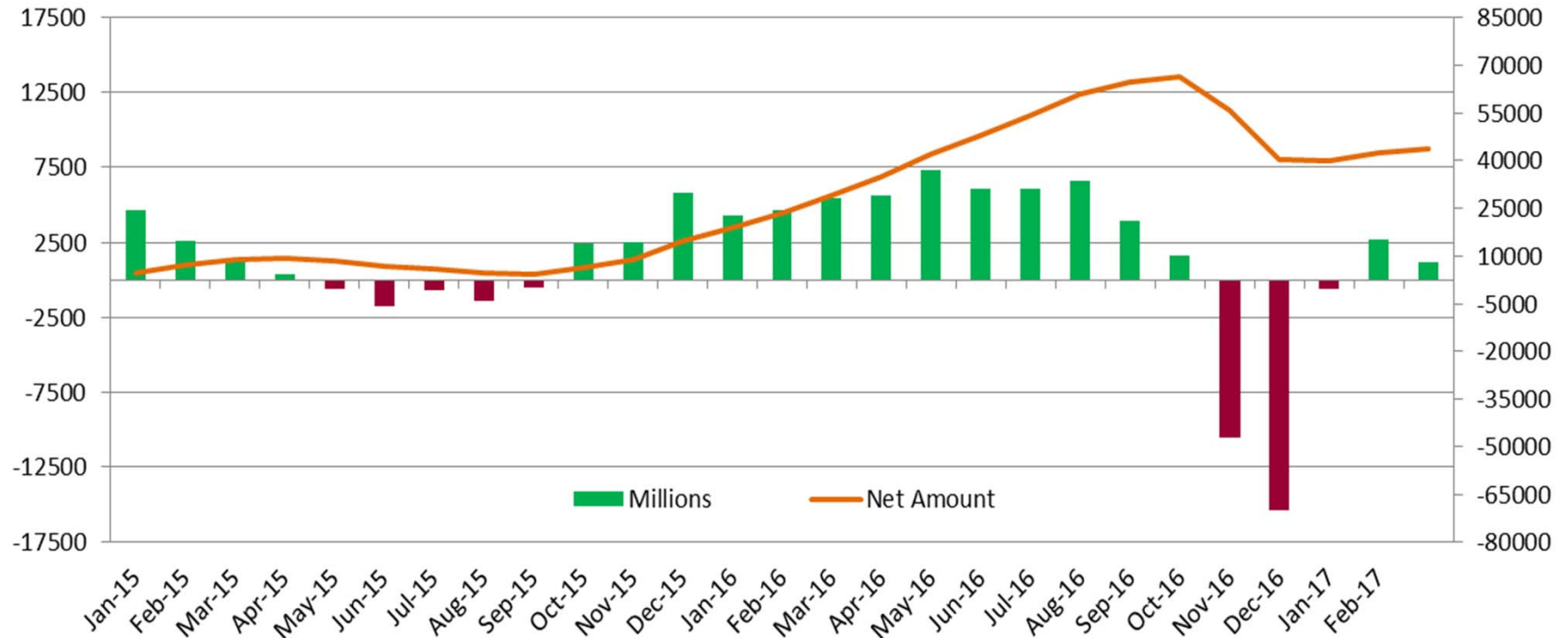
New Issuance



Refunding Pct. of New Issuance



ICI Municipal Bond Fund Flows



Source: Investment Company Institute

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