

**Quarterly Market Review**

**Summer 2017**

**Market Update:**

The second quarter was a wild ride for the 10-year U.S. Treasury note. The 10-year started the quarter yielding 2.35%, rose as high as 2.41% and fell as low as 2.14%. It finished the quarter at 2.31%. The 2-year U.S. Treasury dropped 14 basis points (0.14%) over the quarter, causing the yield curve to flatten by 18 basis points (see graph below). The Federal Reserve raised the Federal Funds rate by 25 basis points in June to a range of 1.00% - 1.25%. Historically, Federal Reserve tightening cycles (rising rates) are accompanied by a flattening yield curve. This once again appears to be the case.

New deal issuance within the municipal market for the second quarter was \$105.3 billion(b) vs. \$125.6b for the same period in 2016. Roughly 53% of the volume was refunding activity, which is similar to 1Q2017. For the past four years, the month of June has exhibited a drop in the 30-day visible supply (a widely used metric for supply). The most recent June supply figure is the second lowest recorded over those four years. The lowest supply figure was recorded on 12/27/2013, the same year the 10-year Treasury finished with a yield of 3.04% (currently 2.36%).

**US Treasury 10 year vs 2 year spread (2Q17)**



Source: SIFMA & Bloomberg

**Investment Opportunities Exist, Where Budgets Don't**

The State of Illinois finally passed a budget after three long years. Governor Rauner's veto was overridden by enough votes and although Illinois finally has a budget, political gridlock remains.

Illinois was not alone, however. Ten other states started their fiscal years (as of July 1<sup>st</sup>) without a budget. These include: Connecticut, Delaware, Maine, Massachusetts, Michigan, New Jersey, Oregon, Pennsylvania and Rhode Island. There are various reason for the lack of budgets within these states, including disagreements over taxes, healthcare, and infrastructure.

Many of these states will come to some sort of an agreement quickly, if they haven't already. These moments of uncertainty and political gridlock, however, will continue to impact the municipal entities within those states.

**Our take:**

Municipal issuers within these states will continue to pay higher costs (i.e. higher yields) given the headline risk and market uncertainty caused by political gridlock. This reinforces the importance of credit analysis within the municipal market.

For example, in Illinois, many investors are taking the "shoot, aim, ready" approach. As value-investors, we welcome these dislocated markets as they present investment opportunities for our clients. In today's low yield, low spread world, the Illinois budget impasse has created a pocket of value in high grade Illinois-credits. Proper credit analysis coupled with our market knowledge, helps us captures some of these opportunities for our clients.

Please see our latest commentary ["Throwing the Baby Out with the Bath Water?"](#) for additional insight into our opinion on the Illinois impasse.

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### Credit Corner:

A report by the National Association of State Budget Officers (NASBO) points to caution when it comes to state budgets for fiscal year 2018. “The Fiscal Survey of States” Spring 2017 edition, indicates the majority of states are dealing with stagnant revenue growth and uncertainty regarding the federal government.

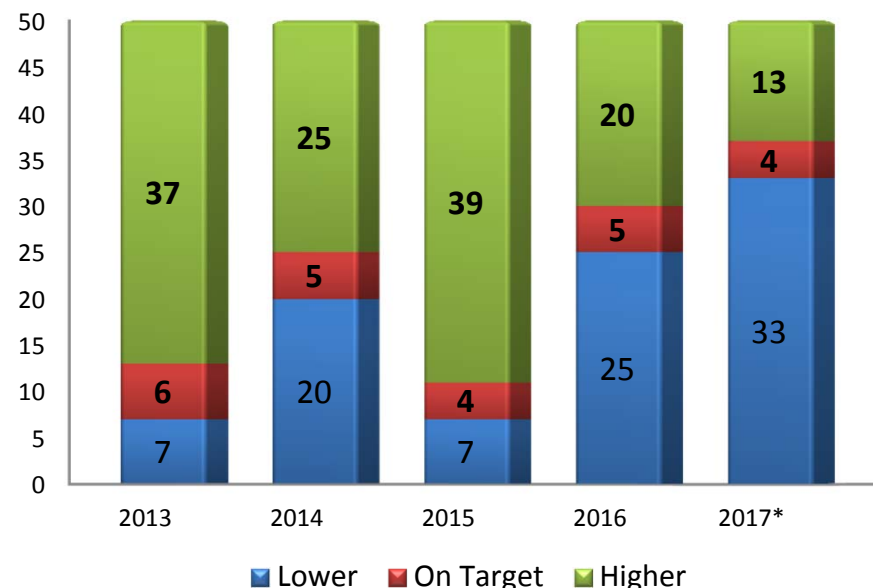
On average, revenue growth in fiscal 2016 was 1.8%, while estimated growth for fiscal 2017 is 2.4%. State sales tax collections were the primary factors for the sluggish state revenue growth. Typically a steady revenue source, sales taxes came in 2.5% below the budgeted amount in fiscal 2017. Lower than forecasted personal and corporate income tax collections also contributed to this trend. General fund revenues came in lower than projections in 33 states during fiscal year 2017, which precipitated mid-year budget cuts in 23 states totaling \$4.9 billion. This marks the highest number of states making mid-year budget reductions since the nation was dealing with the Great Recession in 2010--a figure that may still increase by the end of 2017. These expense adjustments reflect a credit positive.

General fund revenue growth is expected to be 3.1% for fiscal 2018, as states are demonstrating significant restraint in budgeted outlays. Fiscal 2018 general fund expenditures increased just 1% over fiscal 2017, the lowest growth rate in such expenditures since 2010. Most states face very limited budget flexibility, as pension obligations and health care costs rise at rates significantly higher than inflation and the state’s revenue growth. For instance, Medicaid expenditure growth was 2.7% in fiscal 2016 and is expected to be 5.2% in fiscal 2017. As Congress debates replacing the Affordable Care Act with the American Health Care Act (AHCA), Medicaid funding faces serious uncertainty. Estimates by the Congressional Budget Office show the AHCA would reduce federal support of Medicaid revenue to the states by \$834 billion over a 10-year period. This estimate is on the low end, as other estimates peg that number at closer to \$1.3 trillion over the same period. According to NASBO, Medicaid spending represented one third of state spending in 2016. The uncertainty of the potential new national healthcare bill may substantially affect state budgets depending on whether Medicaid funding from the federal government is reduced and if states are allowed to reduce their own Medicaid costs.

### Our take:

That said, most state budget officers appear to be taking a conservative approach and have realigned the more flexible areas of expenditure growth with softer revenue collections. Despite these recent difficulties, states continue to increase their rainy day fund balances. Rainy day funds allow states to set aside excess revenue for times of unexpected revenue shortfalls or budget deficits. Fiscal 2016 and 2017 saw total rainy day fund balances at \$49.7 and \$49.6 billion respectively. Fiscal 2018 sees a projected increase in total rainy day fund balance to the tune of \$4 billion. Though California’s projected addition of \$2.7 billion makes up a large portion of this increase, many other states are adjusting to the lower revenue collections. Should strong job growth continue, it could mitigate the potential decline in sales tax revenue growth while also buoying personal income tax revenue collections.

**General Fund Revenue Collections vs. Budget Projections By Fiscal Year**



Source: NASBO Fiscal Survey of States – Spring 2017

## “Higher Taxable Yields are Available”...consider TAXABLE municipal bonds?

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In the financial world today, it is a rarity when the phrases “higher yield” and “less risk” are used in the same sentence. We generally avoid using the two phrases in tandem, but in our view we do find value in taxable municipal bonds.

Most investors who invest in taxable fixed income securities are familiar with U.S. Treasury/Agency, corporate bond, mortgage backed securities, and certificate of deposit issues. These asset types pay interest which is taxable at the federal level. Many investors, however, are surprised to learn that there is a market for taxable municipal bonds.

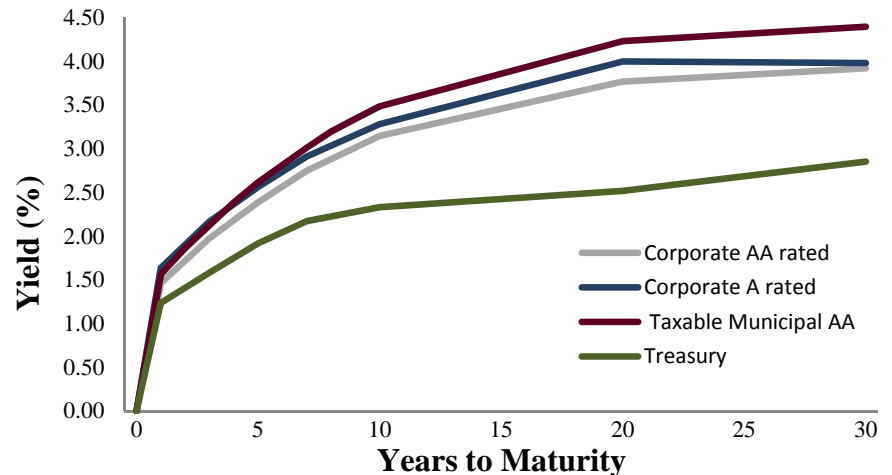
Like their tax-exempt siblings, taxable municipal bonds are issued by state, municipal, and county governments to finance any number of capital expenditures. In certain instances, the use of proceeds for a bond issue does not meet thresholds put out by the Internal Revenue Service to qualify for tax exemption. The interest payments from these municipal bonds is therefore taxed by the Federal government.

For client’s interested in our taxable strategies, we look at a number of taxable asset classes to achieve diversification. This also allows us to compare yield levels across various curves to provide our clients with the highest taxable yields available. We have found over time that taxable municipal bonds often provide the highest risk-adjusted returns. In fact, just looking at yield levels (Chart 1), AA rated taxable municipals provide higher yields than both Treasury and A rated corporate bonds. Additionally, looking at Chart 2, municipal bonds provide lower default rates than their corporate counterparts.

With higher yields and lower default rates, the risk adjusted returns for taxable municipal bonds are attractive. Incorporating taxable municipals into our taxable strategies is a value-add we provide to our clients. This has allowed them to capture higher risk adjusted returns.

Given the implementation of the DOL Fiduciary Rule and the changes it brings, if you would like to discuss our taxable strategies and use of taxable municipal bonds for IRA accounts, please contact us.

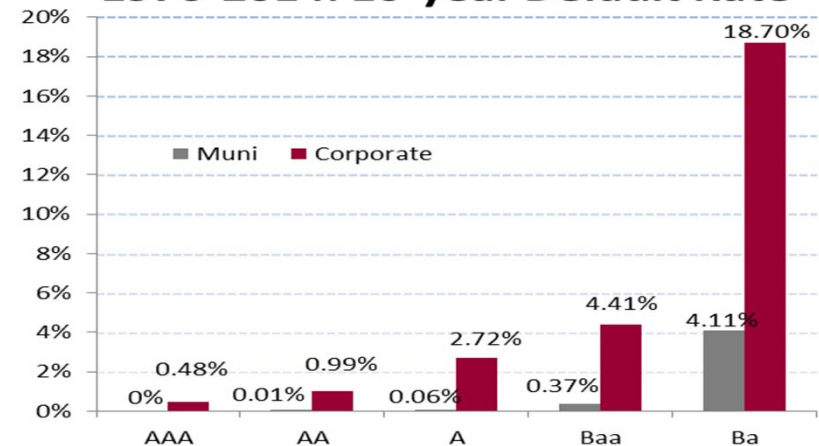
Chart 1



Source: Bloomberg

Chart 2

### 1970-2014: 10-year Default Rate



Source: Moody’s

**Tom Bernardi, CFA** – Portfolio Manager; (312) 281-2021

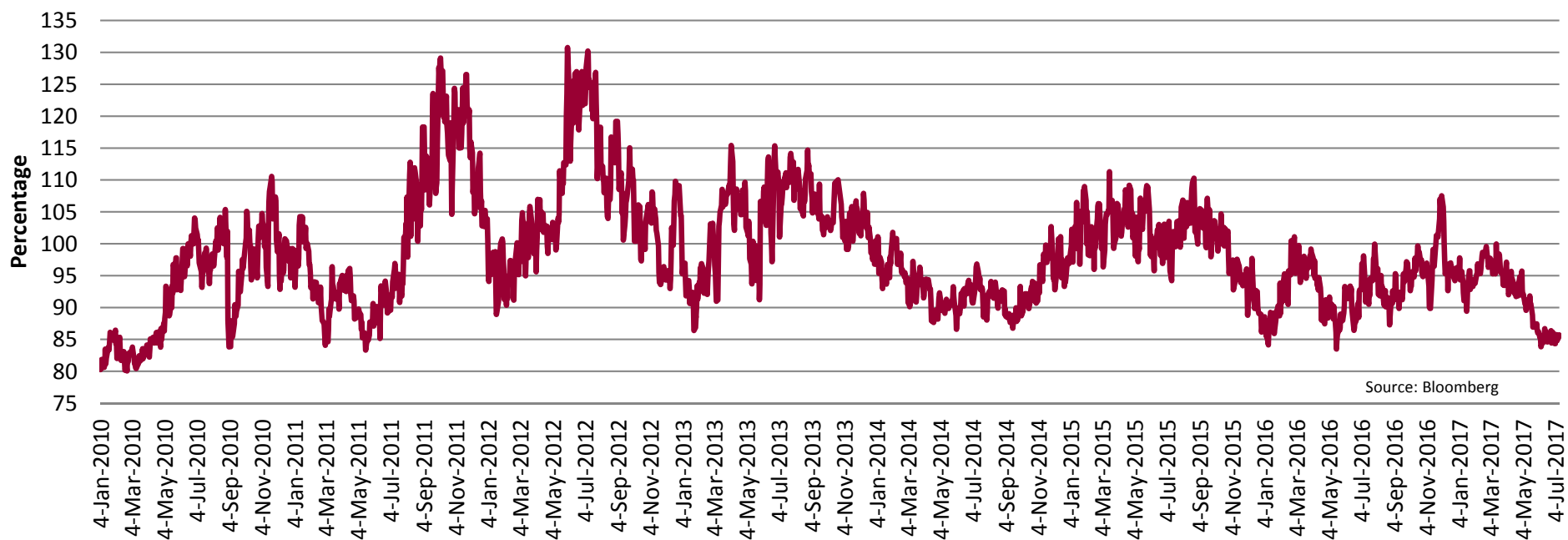
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10 year Muni/Treasury Yield Ratio



Source: Bloomberg

<b>Today</b>	85.73	<b>10-year average:</b>	99.21
<b>High:</b>	130.76	<b>5-year average:</b>	97.99
<b>Low:</b>	80.06		

### 10-Year AAA Muni



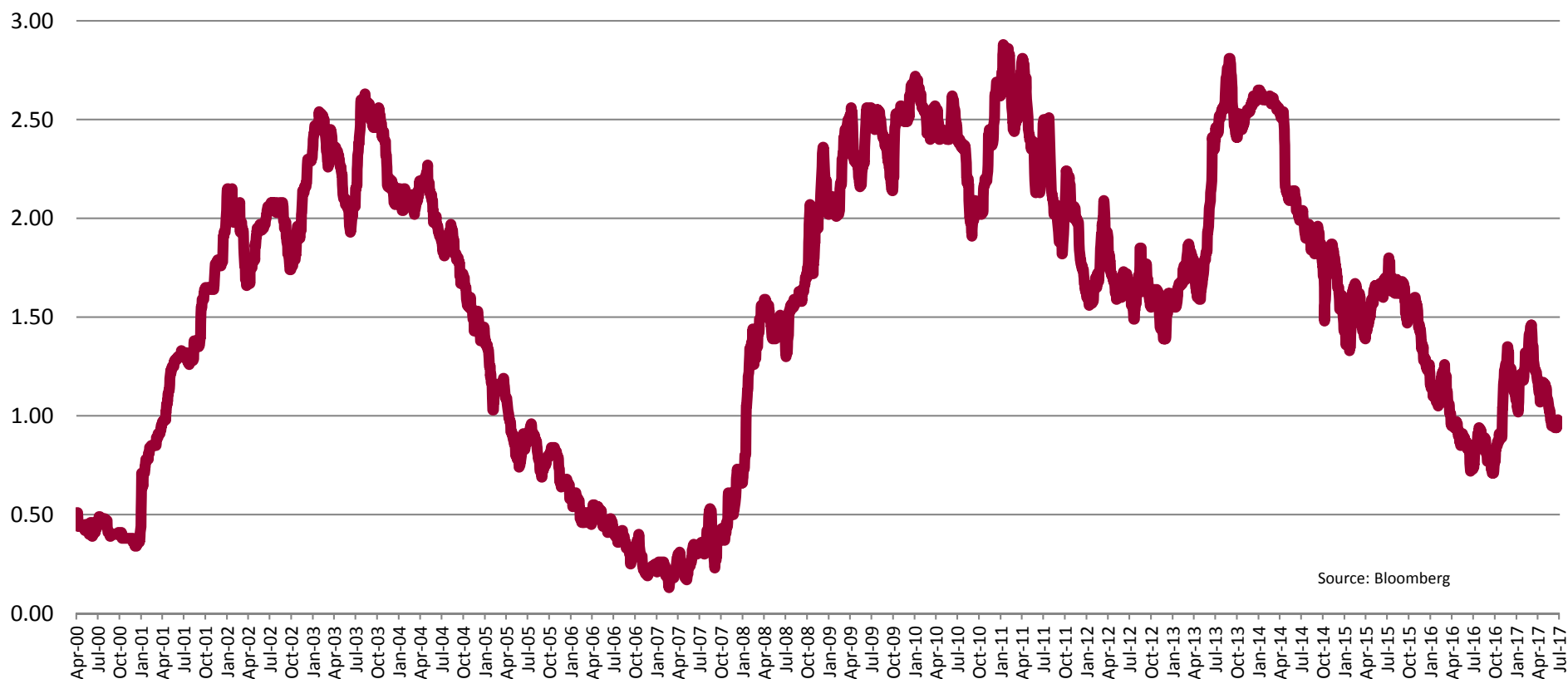
Source: Bloomberg

Source: Bloomberg

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**2-year/10-year Spread: AAA Muni**

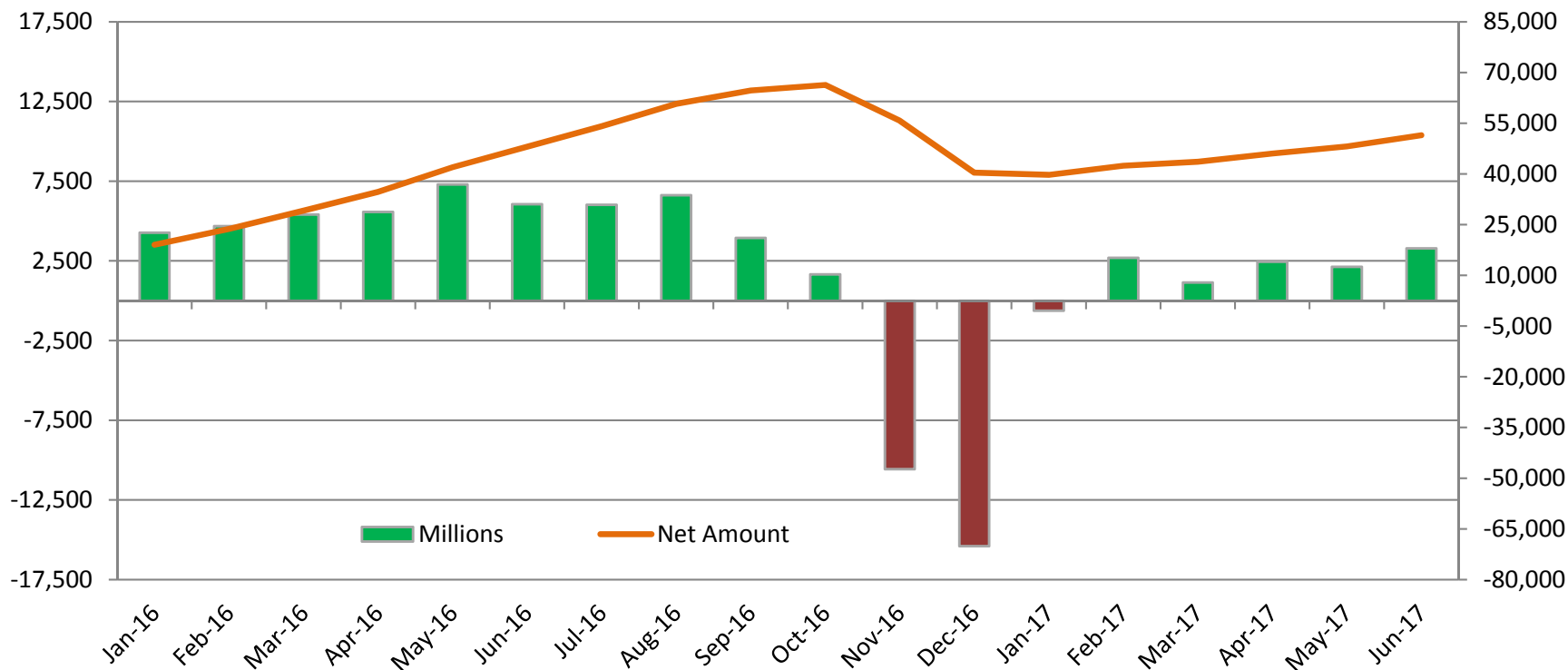


Source: Bloomberg

Source: Bloomberg

<b>Today</b>	0.97
<b>High:</b>	2.88
<b>Low:</b>	0.13
<b>Average:</b>	1.57

**ICI Municipal Bond Fund Flows (millions)**

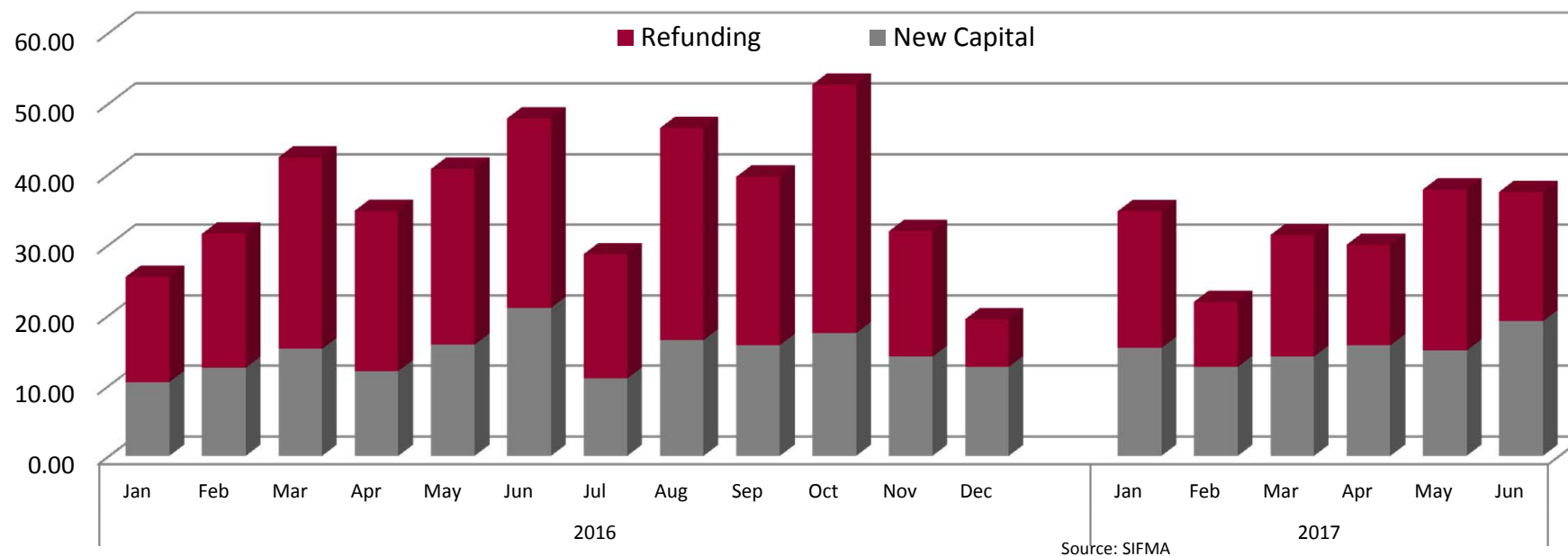


Source: Investment Company Institute

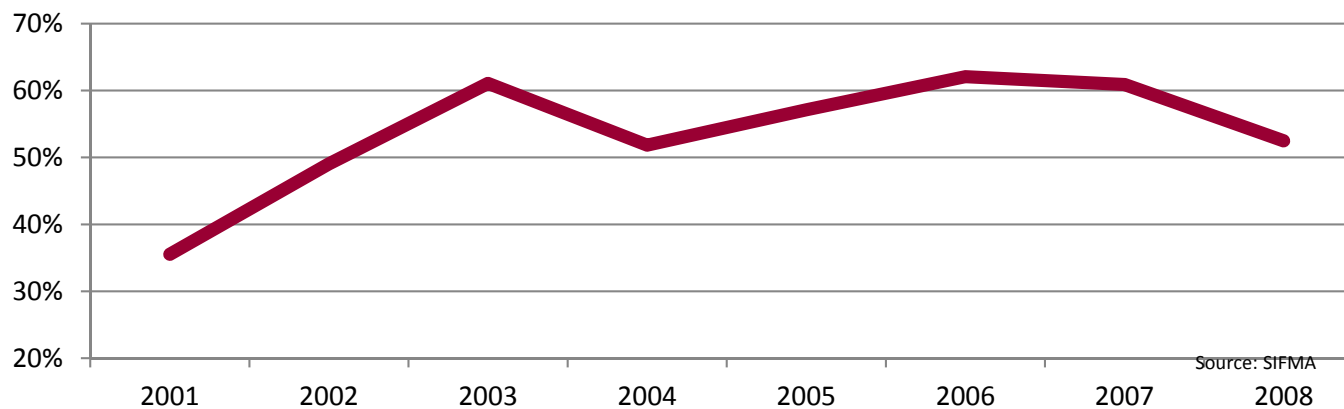
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**New Issuance**



**Refunding Pct. of New Issuance**





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**Municipal bonds not FDIC insured • May lose principal • Not appropriate for all investors**

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