

11/08/2017

Fall Market Review

Bond yields have remained range bound over the past four months. Through the first two months of the third quarter, bonds continued their rally. The 10-year Treasury started the quarter yielding 2.31% and by 8/31 had fallen to 2.15%. Yields reversed course during the last month of the quarter with the 10-Year Treasury hitting 2.46% on 10/26. Since then, yields have fallen with the current 10-Year yield back to where it started at the beginning of the 3rd quarter at 2.32%.

Minutes from the Federal Reserve meeting in September showed that a rate hike (to 1.25-1.50%) is highly probable in December. This, coupled with talks of potential tax reform and better than expected corporate earnings, has moved rates higher on the front end of the curve. As of 11/07, market participants were predicting a 97% chance for a rate hike in December, up from 70% as of 9/30.

Fed Funds Rate Probability

United States		Instrument		Futures: Fed Funds - Effective				Fed Effective Rate			
1) Overview		2) Future Implied Probability		3) Add/Remove Rates				Based on rate 1.00-1.25			
Dates	Meeting	Hike Prob	Cut Prob	0.75-1	1-1.25	1.25-1.5	1.5-1.75	1.75-2	2-2.25	2.25-2.5	
12/13/2017		97.1%	0.0%	0.0%	2.9%	97.1%	0.0%	0.0%	0.0%	0.0%	
01/31/2018		97.1%	0.0%	0.0%	2.9%	96.3%	0.8%	0.0%	0.0%	0.0%	
03/21/2018		98.4%	0.0%	0.0%	1.6%	54.5%	43.6%	0.4%	0.0%	0.0%	
05/02/2018		98.4%	0.0%	0.0%	1.6%	53.0%	43.9%	1.6%	0.0%	0.0%	
06/13/2018		98.9%	0.0%	0.0%	1.1%	36.5%	46.8%	15.2%	0.5%	0.0%	
08/01/2018		99.0%	0.0%	0.0%	1.0%	34.8%	46.3%	16.7%	1.2%	0.0%	
09/26/2018		99.2%	0.0%	0.0%	0.8%	28.0%	44.0%	22.6%	4.3%	0.3%	
11/08/2018		99.2%	0.0%	0.0%	0.8%	27.3%	43.5%	23.2%	4.8%	0.4%	
12/19/2018		99.4%	0.0%	0.0%	0.6%	20.6%	39.4%	28.3%	9.5%	1.5%	

Source: Bloomberg

Ditka, Top Gun, and... Tax Reform?

Much has changed since the Tax Reform Act of 1986. Back then, the Chicago Bears won Super Bowl XX under Da Coach's leadership and Tom Cruise - another Maverick of sorts- starred in Top Gun. The average home price in the U.S. was \$95,000, with the average 30-year mortgage at 10.19%. Today, the average home will cost you \$319,700 and a 30-year mortgage now averages only 3.81%.¹ Although much has changed since 1986, Tom's Cruise's appearance and the framework of our tax code remain the same.

Holding majorities in both houses of Congress, President Trump has set his sights on the rare goal of implementing tax reform. It is uncertain, however, if true reform will take place or simply a "tax reduction." On November 2nd, Republicans within the House of Representatives released their initial proposed tax legislation. The proposed legislation includes: reduced income tax brackets for individuals, an increase in the standard deduction, elimination of many personal exemptions, and lower corporate taxes among other changes. The elimination of certain deductions could provide a spark of demand for tax-free municipals. More importantly, the initial proposal kept the exemption of municipal interest out of the picture. This is a credit positive for issuers and the logical approach to ensure that our nation's infrastructure is funded. In fact, municipals finance 75% of this country's infrastructure and the exemption saves issuers billions of dollars when funding local projects.

The initial tax proposal called for the elimination of tax-exempt financing through private activity and advance refunding bonds, which came as a surprise to many within the industry. The elimination of tax-free financing through these two methods would increase costs for issuers. It would also reduce the supply of tax-free municipals within the market. Based on how the proposed tax legislation is currently written, we would expect demand for municipals to remain high. Any supply decrease could cause a further decline in yields, as these shifts in supply and demand dynamics take hold.

In terms of economic growth, the promise is that lower tax rates for individuals and corporations will spur economic activity as it did in the 1980's. This would result in an uptick in inflation and, therefore, a rise in interest rates. This would also be a positive for income-oriented investors as bond proceeds could be reinvested at higher rates. Hopefully, tax reform occurs before the release of Top Gun 2 (est. 2019) or another Bears' Super Bowl.

Weathering the Storm

2017 has provided a whirlwind of improbable weather. Three massive hurricanes made landfall on the southern part of the U.S. mainland in the matter of one month. Coming off of one of its worst droughts, Northern California witnessed its wettest winter since 1982, causing significant flooding and landslides. In early October, wildfires swept through Northern California burning hundreds of thousands of acres and leading to multiple deaths. These catastrophes caused hundreds of billions of dollars in real damage.

Over 1,000 tornadoes occur in the U.S. each year.³ Although hurricanes are less common, an average of two make landfall in the U.S. each year, with just under one being a category 3 or higher.⁴ Tack on earthquakes, floods, fires, snowstorms and it is clear to see that adverse weather is not something that we are inexperienced with in the U.S.

Often municipalities are affected by these weather conditions. It is important to know there are a number of safeguards such as Federal and State Aid or Private and Public Insurance to help offset most, if not all of the costs due to adverse events. For example, after Harvey hit, Congress passed a \$15.2 billion relief bill. FEMA reimburses anywhere from 75-90% of the costs incurred. Despite these safeguards, event and headline risks have forced some investors to question the sustainability of an issuer's fiscal health. Here are two strategies we use to mitigate event and headline risks:

1. Credit Research

This is a key to identifying whether a municipality has the financial flexibility and market access to pay its bills, following a unique event. Municipalities such as Houston, Miami, and Tampa were hit hard by hurricanes Harvey and Irma but have the financial flexibility to weather the storms. Weaker credits such as Puerto Rico or the U.S. Virgin Islands were in financial trouble before the storms hit. The impact of these storms on their dire financial pictures has pushed them further into a financial hole.

2. Portfolio Diversification

Diversification will mitigate the impact of event and headline risk for a particular region. The risk of weather damage is an omnipresent threat faced by municipality and their constituents.

Weather related emergencies create problems and additional costs. That said, upfront due diligence via in-depth credit research and proper portfolio diversification can help reduce the effects these events have on our clients' portfolios.

“Get Out of the Left Lane!”

Remember the time when you were stuck behind someone driving slow in the left lane? They were going 45 mph in a 50 mph speed zone. You became impatient, veered into the right lane (no blinker), hit the gas (now moving 65 mph), and zoomed past them only to return to the left lane while mumbling under your breath “get out of the left lane!” Next thing you know, red and blue flashing police lights are in your rearview mirror. Ticket issued: turn signal violation and speeding.

Whether this scenario has happened to you personally is not important. The point we are making is that emotions drove you to make irrational and dangerous decisions. Emotions drive our decisions in various aspects of our lives: driving, cooking, working, and yes, even investing. Behavioral finance, the study of how biases effect our investment decisions, is a hot topic within the industry. Behavioral finance focuses on two biases investors display: emotional and cognitive. Emotional biases occur when a decision is made based off of our emotions rather than facts. Cognitive biases occur when we processes information or facts incorrectly and make a decision based off of these miscalculations.

In today’s fixed income market, we are seeing many biases taking hold. The run-up in the equity markets has led many investors to stray from their strategic asset allocations, just to get a “piece of the gains.” This is a classic example of *herd mentality*. Investors start to act as one in the same, following in a trend. Additionally, investors have fallen into the trap of *recency bias* in this low rate environment. For many years, anytime there is a slight rise in rates, some investors proclaim, “this is the beginning of higher rates.” Unfortunately, this has yet to occur. Once we see rates begin to move up in a material fashion, we probably will experience *hindsight bias* or the “I knew it would happen all along” excuse. When (or if) this occurs, let’s make sure to remember how long it took to get there.

**“Only when we combine sound intellect
with emotional discipline do you get rational behavior.”
-Warren Buffett**

Many fixed income investors set a yield “bogey” for investing. This is a classic example of *anchoring bias*, when investors set a target even if there is no supporting data behind it or based off of past markets. Many investors refuse to purchase bonds until they can capture 4% yields. The anchor has been unrealistic in today’s environment for solid quality, non-taxable credits. For many investors, waiting on the sidelines has come at a cost. Those who have been able to capture 4% yields have invested in weaker credits for incremental additional yield. In other words, they are not being paid enough for the extra risks they are exposed to.

Speeding past the slow car in the left lane was an irrational decision based off of an emotional response. These same emotions can drive us to make irrational investment decisions. As Warren Buffet said, “Only when we combine sound intellect with emotional discipline do you get rational behavior.” In other words, establishing a disciplined investment plan and setting realistic investment goals are the best ways to combat these biases. Abiding by an asset allocation framework helps investors establish discipline and reduces the risk they let emotions drive their decisions.

If you have any questions, please contact your Investment Specialist or Portfolio Manager.

Footnotes

- (1) <https://fred.stlouisfed.org/series/MSPNHSUS> and <http://www.freddiemac.com/pmms/pmms30.html>
- (2) <http://www.aoml.noaa.gov/hrd/tcfaq/E11.html>
- (3) <https://www.ncdc.noaa.gov/climate-information/extreme-events/us-tornado-climatology>