

## Spring Market Review

05/16/2018

### Market Review & Bernardi 3-Year Outlook

Rates continued to move higher across the yield curve through the first half of 2018. As of 05/15/18, the 10-Year Treasury rate stood at 3.08% versus 2.40% at the end of 2017 (28% increase). Tax-free yields have moved in a similar fashion with AAA market average tax-free yields moving up to 2.51% as of 5/15/2018. This represents a 26% increase from prior year-end.

We expect the current Federal Reserve tightening cycle to provide a floor on rates. We also anticipate price and credit volatility to increase as rates move higher. This volatility should lead to investment opportunities and spread widening among different rating classes.

Specific to the municipal market, issuers who relied on easy money through low rates will be tested making credit analysis even more valuable to investors than in the past. Underfunded pension issues will continue to burden certain issuers. Without pension reform, certain states/municipalities will remain in unstable situations and potentially witness further credit deterioration. On the whole, however, municipal credits are improving and the majority have prudently managed their fiscal balances. We expect headline risk to remain, resulting in increased price volatility. This should lead to long-term buying opportunities.

### Best Ideas/Strategy

#### Total Return Portfolios

*BAM Strategies:* Short-Term Municipal, Tactical Ladder Municipal, Short Taxable, & Intermediate Taxable

We have witnessed more volatility over the past five months than was seen over the prior two years. We expect this volatility to last as the Federal Reserve continues to tighten and gradually unwinds its \$4.5 trillion balance sheet. We would not be surprised if rates continue to creep higher across the curve. For that reason, we are currently aiming to be short duration versus comparable benchmarks for total return portfolios. If/when the 10-Year Treasury is within the 3.25-3.50% range, we will look to bring duration in-line.

#### Goals-Based Portfolios

*BAM Strategies:* Ultra-Short Municipal & High Income Municipal

Many clients employ goals-based investment strategies. For these portfolios, investments are made in accordance with specific goals versus a total return focus. These goals may include: target yield thresholds (ask about our BAM High Income Strategy), specific time period cash flow needs, or ultra-short investing as a cash alternative (ask about our BAM Ultra-Short Strategy). For these strategies, the client/advisor's goal(s) take precedence over relative performance to a benchmark.

#### Values in the Market

We continue to find value in high quality credits in out-of-favor states. High quality credits within the state of Illinois continue to be a good example. High quality issues located within Illinois are yielding anywhere from 25-50 basis points more than similar benchmark yields for strong credits outside the state. We continue to keep our eye on spreads between AAA and A rated issues, but they remain tight. Despite the recent push higher in yields, the "search for yield" still exists which has often kept rates on lower-quality issues unattractive. If volatility persists and rates keep trending upward, we would expect to see these spreads widen. Additionally, each incremental move upward in rates will wear on weaker credits. To quote Warren Buffett, "we may soon see who is swimming naked when the tide goes out."

For more information on our strategies please ask your Investment Specialist or Portfolio Manager.

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**Trader's Corner**

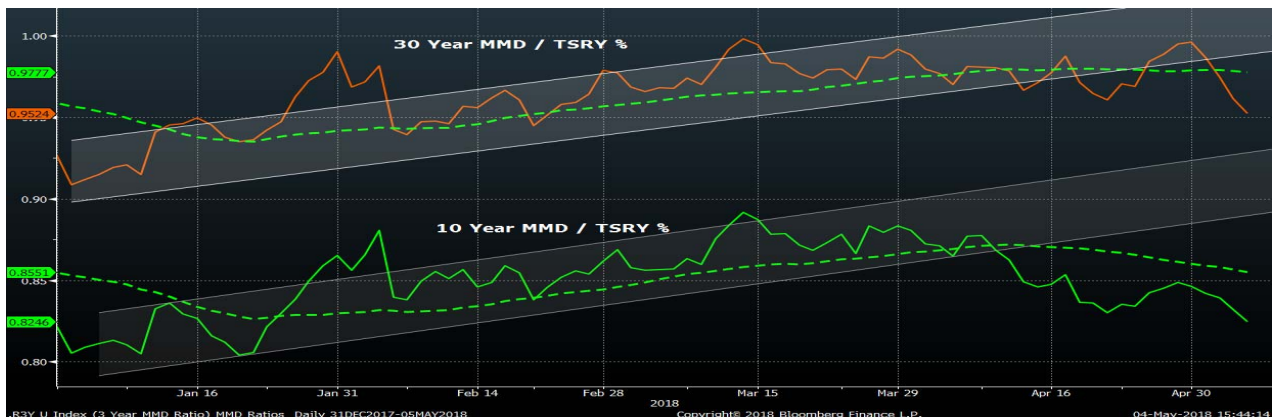
Dealers in the secondary market were faced with a great amount of supply heading into the final weeks of 2017. Due to recent tax law changes, advance refunding's (~22% of new issuance in 2017) are now a thing of the past. Before these new changes took effect, issuers rushed into the market to realize interest cost savings. Market participants entered Q4 with the overwhelming opinion that the deluge of supply during the quarter would lower municipal prices at the end of the year. They believed this "sell-off" would reverse course during the beginning months of 2018, as new issuance would drop dramatically while demand remained strong. This one-way trade, however, backfired.



Source: Bloomberg

As issuance ramped up at the end of 2017, dealers and institutions actually drove prices up in order to take advantage of this "obvious" trade. By mid-January, dealer desks found their inventories to be inflated and began trying to unload positions. They soon realized the marketplace had more sellers than buyers, however. As a result, municipal prices fell as investors were forced to sell at lower prices. When some retail customers joined the selling, the situation was exacerbated. As a result, municipals underperformed for the majority of Q1 and even into April.

As of this writing, supply has been reduced since the issuance influx in Q4 2017. Year-to-date new issuance is down more than 25% (\$92 Billion versus 3-year average of \$125B). Recent retail investor selling has abated. In fact, during the first week of May the exempt sector as a whole outperformed Treasuries. Could it be that the trade everyone saw coming is finally upon us? The ratio that AAA municipals trade to Treasuries has begun to improve and could be building momentum. The chart below shows the 10-Year and 30-Year Municipal/Treasury ratio since the beginning of the 2018. As municipal prices sold off in the beginning of the year, you see the solid green line creep higher. As supply declined and demand remained steady, the 10-year ratio started moving downward in late-March. With supply seemingly headed for an anemic year and the top marginal federal income tax rate relatively unchanged, it seems municipals have broken out of their year-to-date underperformance trend and long bonds (see 30-year chart below) seem to be poised to do the same.



Source: Bloomberg

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### We Know What We Don't Know

As the 10-year Treasury has moved from a Brexit low of 1.35% (July 2016) to above 3.00% at the time of this writing, most investors are wondering: Where are rates going? Can the economy handle higher rates?

At Bernardi, we have never tried to predict the long-term future path of interest rates. We spend little time trying to decipher almost unknowable answers to quite complex social economic systems. That said, we do want to try to understand what will affect rates and their path forward.

What we do know, the *known-knowns*, include short-term trading factors, supply/demand factors, or backward (“lagging”) and forward (“leading”) looking indicators. These are important metrics in telling us where we have been or where things **look to be going**, but not necessarily **where we are going**.

The *unknown-unknowns* are the “black swan” events. These events impact the market significantly but are priced in minimally, if at all. Often times, those who correctly diagnose the disease have a hard time predicting the symptoms and their timing. Additionally, Black Swan visionaries tend to fixate on bad events (“permabears”), but black swans can also be constructive (i.e. US shale oil boom).

The *known-unknowns* are the factors we tend to focus on, as it pertains to the question of “where are rates going?” Our investigative exercise, however, is more academic than practical.

In our opinion the three major known-unknowns impacting the future path of interest rates are:

1. Tax Reform
2. Quantitative Tightening
3. Yield Curve Shape

#### *Tax Reform*

The effects of the Tax Cuts and Jobs Act that was passed in 2017 may not be felt for many months and the discussion of the long term effects is a polarizing and widely debated topic. Opponents point to projected deficits and long term debt accumulation due to fiscal shortfalls created by legislation. Proponents argue the act will fuel a mid-1990s Ireland-like economy where corporations will not only stop leaving, but be catalyzed to further invest in the best – and now one of the most economical – places to do business.

#### *Quantitative Tightening*

The Fed has made sure to be both patient and transparent with its plans to continue pulling two quantitative tightening levers: raising the overnight borrowing rate and reducing its \$4.5 trillion balance sheet. Our analysis, which is based on the balance sheet as a percent of GDP, shows that it will take until mid-2022 to right-size the balance sheet to pre-crisis levels (6% of GDP). This, however, is based off of the Fed's current projection which is subject to significant changes should the economy react more or less favorably to the tightening's impact.

This time *is* different, however. Central bank balance sheets across the globe have never been this large. The effect of this tightening cycle, especially if/when other global central banks join in, is impossible to predict and there is no historical experience of this magnitude to analyze. We do not aim to predict the unknown impact on rates and economies at large.

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### *Yield Curve Shape*

The inversion of the yield curve has long been an indicator of an imminent recession. A flat to negative yield curve impacts banks' willingness to loan due to low to negative net interest margins. Additionally, a flat yield curve signals overly tight monetary policy. We are currently in the longest period since the last yield curve inversion. It has been over 2,800 trading days. The previous record was 2,265 trading days in 1998.

That said, during the early-to-mid 90s (post a recession), we sustained a 2-year/10-year spread at lower levels than what we are experiencing today.

Judging by this recent history, the flatness of today's curve does not portend recession. In terms of an outright inversion, Japan's yield curve has not inverted in almost 30 years, yet they have experienced multiple recessions. This is the unknown aspect of the known condition.

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Investors do not like the unknown. They want certainty. For our clients we look to provide a platform that achieves a consistent stream of income with capital preservation being paramount. We do not believe in trying to time the market but seek attractive values in the market at any given point in time. *Capital preservation, income generation, and consistent returns* are our way of protecting our clients in a world full of unknowns.

Please reach out to a Bernardi Investment Specialist or Portfolio Manager with questions about the municipal market.