BERNARDI SECURITIES INC.

MUNICIPAL BOND SPECIALISTS

Municipal Market Spotlight

Tax-exempt bonds have enjoyed a strong first half of 2019, outperforming the taxable market for most of the year. The impetus for the rally is two-parted. Generally, yields have moved lower as many market participants expect 2-3 Fed rate *cuts* over the next 12 months due to a slowdown in international growth and the ratcheting up of trade tensions. Relatively, municipals have rallied as investors feel the pinch of SALT deduction caps in the new tax code and new issue supply levels remain moderate. In high tax states, such as California and New York (which are also largest issuers of debt), local investors have piled into the market which has lifted prices market-wide.

There are many indications that state and local revenues have been exceeding expectations and the upgrade cycle we saw last year remains intact (see "*A Healthy Muni Market*" below). Although negative headlines regarding the Puerto Rico debacle continue, negative headlines regarding the muni market have generally receded as compared to previous years. The overall picture of creditworthiness in the sector is on solid footing.

New issue competitive loans have struggled in recent weeks to find homes for paper in the 2030-2038 year range, while anything shorter has found enormous demand. Although the tax-free municipal curve is fairly flat, spreads have widened from 8 to 12 years. We would expect bonds in the 12-16 year part of the curve to tighten (demand increase) if rates remain calm, and even outperform if yields were to move higher.

A Healthy Muni Market

Moody's recently analyzed the recession preparedness for each state and found all but two states would be able to weather a moderate recession with no major negative credit implications.[1] The four major factors analyzed were revenue volatility (25%), coverage by reserves (25%), financial flexibility (30%) and pension risk (20%). In all, 22 states scored in the "stronger" category, 26 in the "moderate "category, and only two in the "weak" category. It is not surprising that the two "weaker" states were Illinois and New Jersey.

Although we remain vigilant of Illinois credits, NOT ALL issuers within Illinois should be lumped in with the state of Illinois' "weaker" category (see "Throwing the Baby Out with the Bath Water?"). At the state level, Illinois has several significant fiscal issues including recurring structural budget deficits and severely underfunded pension plans. We are not investors of State of Illinois debt and certain state agencies and related entities. That said, there are many strong, fiscally-sound municipal entities within the state that offer attractive investment values for our clients. In accordance with our value strategy, we seek out and participate in these municipal offerings. This has benefited our clients' portfolios as **Illinois municipals are one of the best performing states this year**.

Our in-house credit analysis process analyzes the actual metrics and entities backing each individual bond issue. Capital preservation is the primary goal within our client portfolios, with income generation a secondary goal. There are many municipal entities within the state of Illinois that allow our client portfolios to benefit from both capital preservation and income generation. Negative news headlines and reports focusing on Illinois government at the state level oftentimes create additional value of adding these approved holdings to our clients' portfolios.

[1] - *Most States Have the Financial Flexibility and Reserves to Manage a Recession. pp. 1–11, Moody's Investor Service.*

Not So "Special" Revenues

The US Court of Appeals for the 1st Circuit ruled in favor of Puerto Rico on March 26th, stating it was not required to pay "special revenue" debt service on Puerto Rico Hotel & Tourism Association (PRHTA) bonds. Such a ruling, if upheld by the Supreme Court or not contradicted by other Circuit Courts, could make a significant impact on the municipal bond market.

In fact, the effect of this ruling has already made its way into the broader municipal market. Recently Moody's placed various issuers on review for downgrade due to confusion about the special revenue lien. This includes: Dallas, TX Water & Sewer, Chicago, IL Water, and Cleveland, OH Water among others. In fact, Moody's downgraded Illinois State Toll Highway Authority (ISTHA) from Aa3 to A1 to align the credit more closely with the state's rating.

Moody's stated, the Puerto Rico ruling "calls into question the strength of credit separations between a general government and its enterprises and component units."[2] We agree with Moody's opinion. However, practically speaking we believe this ruling only impacts revenue bonds where the overlapping municipality is on much weaker financial footing and the credit quality of those revenue issuers is higher than their municipal governments. In recent municipal bankruptcies, revenue issues have fared well with investors receiving higher than average recovery rates, due to the legal precedent that the revenue pledge was not subject to the automatic stay of the Bankruptcy Code (unlike GO bonds). In Detroit, for example, water and sewer bondholder were paid 100 cents on the dollar.

We remain proponents of "essential-purpose" revenue issues but recommend in-depth credit analysis. Much of municipal bankruptcy is still largely unchartered waters and even clearly defined precedence is challenged. Accordingly, underlying credit, deal purpose, and structure analysis remain critically important. We remain wary of old and newfound securitization structures which aim to protect particular enterprise bondholders based within weak overlapping municipals entities.

[2] - Rating Action: Moody's places the Illinois State Toll Highway Authority Aa3 rating under review for downgrade in wake of recent court ruling on special revenue pledges. Pp 1-5, Moody's Investor Service.

A Balanced Approach When Battling Interest Rates

Interest rates are the primary "opponent" we face when investing bond portfolios. Like any opponent on the battlefield, they are unpredictable. An overly aggressive approach - based on speculative bets - will lead to defeat in the long run. A strategy that is too defensive will keep us on our heels and lead to immense opportunity cost.

By first understanding the terrain (credit quality) and drawing upon our own experience, we can develop a calculated, fluid, and balanced approach to successfully navigate through the everchanging interest rate environment. Which brings us to today's current "battle" with interest rates.

In the second half of 2018, we shifted our investment strategy to a full-fledged frontal assault. As bond prices fell (yields rose), we were in 'attack mode'. This strategy paid off, as we captured higher yields than we had seen over the previous five years. Helped by their recent ally the Federal Reserve, interest rates have declined as concerns over the stability of the global economy have risen. As the market dynamic changed, it was essential for our battle strategy to change as well. Like the Kung Fu saying goes,

"The hand which strikes also blocks."

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A Balanced Approach When Battling Interest Rates continued...

Over the past six months, we have shifted to a more defensive stance enabling the following tactics:

1. **Defense in Depth -** Slow the pace of reinvestment and invest in high coupon structures
2. **Fortify Our Position -** Utilize a strong "seller's "market
3. **Establish the High Ground -** Utilize the laddered portfolio structural advantage
4. **Dig Trenches -** Focus investment in AA-rated issues, while avoiding tight spreads in lower quality issuers

To start, we began to slow the pace of reinvestment of principal/interest proceeds. Unlike the market in the last quarter of 2018 when 3.00%+ tax-free yields were available as short as the 7-8 year range, in today's market those levels are not available until 15+ years for high quality, tax-free issues. We have since slowed the pace of reinvestment in client portfolios, allowing us more time to sift through the "noise" in the current market. This defense in depth position, has created space between our client portfolios and lower rates.

Although lower rates can be frustrating, it has provided a strong sell-side to the market which we have utilized to our client's advantage. This has allowed us to fortify portfolios by swapping out of issues bought back in mid-2017 when interest rates were at all-time lows. Currently, we are often able to capture attractive bid prices for these issues and reinvest in higher relative yields, increasing overall portfolio yield.

Our investment strategy has always incorporated the laddered portfolio structure. This is an inherently defensive position that we believe gives our client portfolios the high ground over interest rates. Our clients' portfolios are well laddered across the curve, having locked in higher long-term rates and having liquidity on the front end.

Lastly, we have dug trenches for our clients by focusing reinvestment in solid quality names. The yield spread between AA and A/NR credits remain unattractive (not wide enough), in our opinion. Additionally, only 0.02% of AA-rated municipals defaulted between 1970-2017. The yields spread between investing in a AA-rated municipal versus a AAA-rated municipal is attractive given the historically low AA default rate. This dynamic, historically low default rates coupled with unattractive yield spreads for lower quality issues, makes us believe AA-rated issues offer the best values in the current market environment.

We believe our disciplined approach to municipal bond SMA's focusing on principal preservation and tax-exempt income helps enables a fluid and balanced investment strategy for our clients. This is essential when facing the ever-changing interest rate market.

Please reach out to your Investment Specialist or Portfolio Manager with any questions.

Thomas P. Bernardi, CFA - Vice President, Portfolio Manager
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BERNARDI ASSET MANAGEMENT LLC

Bernardi Asset Management ("BAM")

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BAM Strategies & Manager Comments

Total Return Portfolios
BAM Strategies: Short-Term Municipal, Tactical Ladder Municipal, Short Taxable, & Intermediate Taxable

Our Total Return strategies performed well in the first half of 2019. We were able to lock in many attractive yields at the end of last year which helped drive performance with the rally in rates through mid-2019. We remain short duration versus the respective strategy benchmarks. That said, we have slowly increased duration by capturing higher yields in intermediate term maturities. We are targeting the 6 - 12 year part of the curve and higher coupon bonds within those maturity rungs.

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, including: target yield thresholds (BAM High Income Strategy), specific time period cash flow needs, or ultra-short investing as a cash alternative (ask BAM Ultra-Short Strategy). For these strategies, the client/advisor's goal(s) take precedence over relative performance to a benchmark.

Manager Comments
We continue to focus investment in high-grade, AA-rated names while opportunistically investing in A and Non-Rated issuers. As rates have decreased over the past three months so have spreads between different rating tranches. In general, the additional spread earned by going down the credit spectrum is not worthy of the extra credit risk taken. We continue to surveil the market for A/Non-Rated values but remain cautious when investing within those rating spectrums.

For more information on our strategies please ask your Investment Specialist or Portfolio Manager. Strategy Fact Sheets available upon request.