



SECOND QUARTER 2017

MARKET COLOR

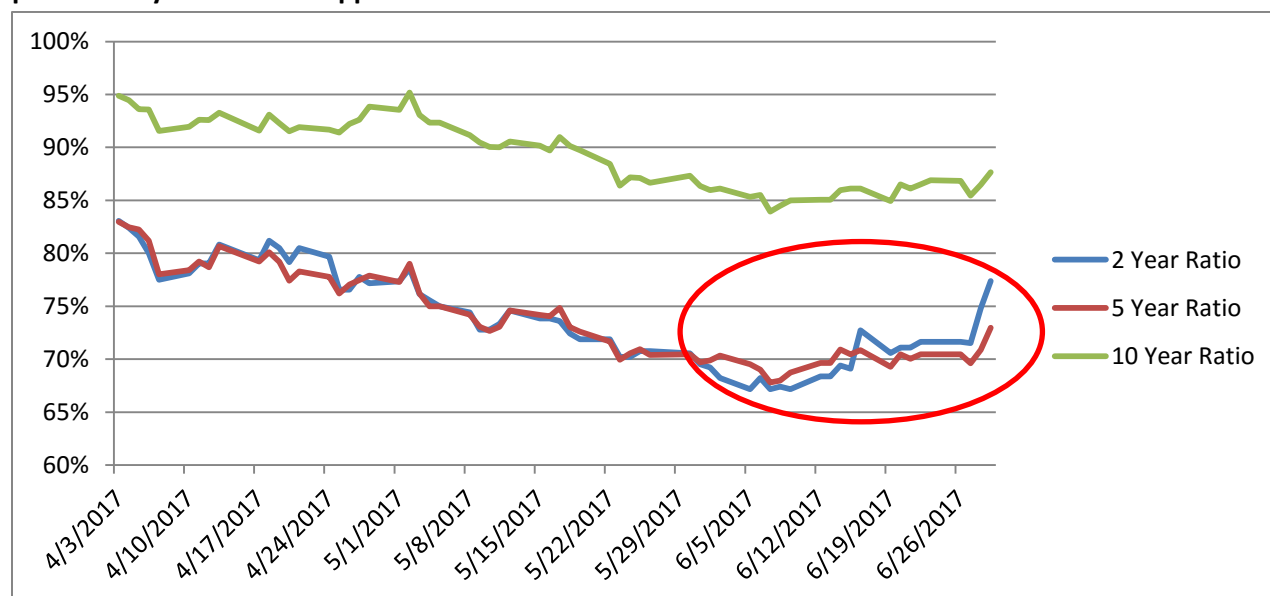
- The broad municipal index delivered a solid return of 1.96% for the first three months of the year.
- Largely in sympathy with the Treasury market, the benchmark municipal curve experienced a pronounced bull flattening, in which yields on longer maturity bonds decreased by more than shorter maturity bonds.
- Market tone over the second quarter was extremely strong, loudly restating many of the themes from the first quarter: supportive technical environment with demand far outpacing supply, ratio compression across the curve resulting in strong outperformance, and benign view of policy risk out of Washington.
- Market participants have driven valuations to historically rich levels. With the ongoing potential for news out of Washington or additional credit-related headlines, we believe the market is still vulnerable to a bear flattening scenario.
- However, even at much lower nominal yields, municipals still offer superior tax-adjusted value for in-state buyers—especially further out the curve—given that most states' all-in top tax rates are between 45%-50%.

FACTS & FIGURES

Technical Forces Continue to Drive Market Higher

Since heavy municipal fund outflows in the aftermath of the US election, fund flows have remained consistently positive in 2017 (\$11.9bn YTD), chasing limited supply and driving municipal-treasury ratios to historically low levels (67% on the two year ratio in early June). However, weakening ratios in the final weeks of the quarter may be an indication of market participants' growing caution over rich valuations and potential policy risks, both of which we think will prove strong headwinds to future outperformance of the sector.

Municipal-Treasury Yield Ratios Appear to Have Found Resistance





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MARKET HIGHLIGHT

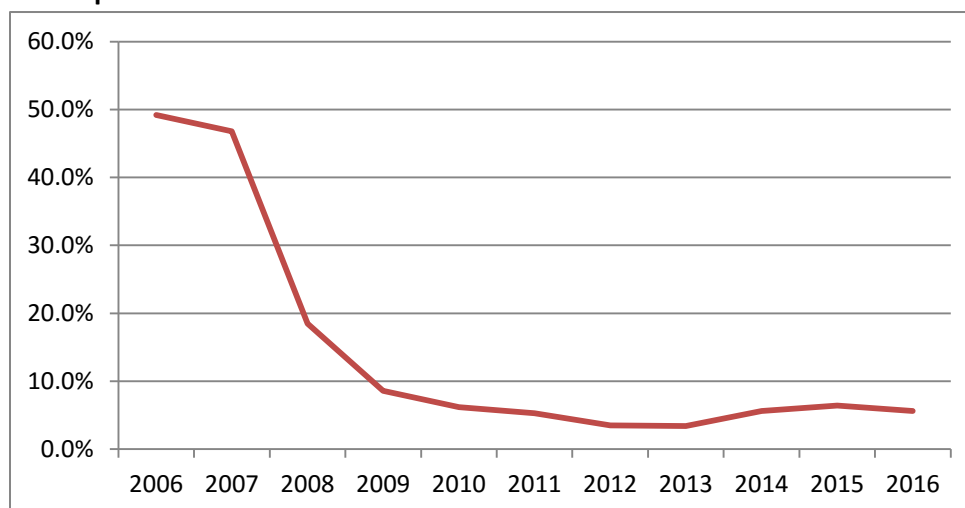
Where to for the municipal insurance industry?

Toward the end of June, National Public Finance Guaranty Corp (National), one of three remaining active municipal bond insurers, was downgraded from AA- to A by S&P, after being placed on negative credit watch along with Build America Mutual Assurance Co. (BAM) earlier in the month. In the municipal market, issuers will sometimes make an upfront payment to a monoline insurer when issuing to “wrap” their bonds—guaranteeing principal and interest payments—and therefore assume the insurer’s credit rating to lower their net interest cost. A downgrade for an insurer will therefore cause the downgrade of most of the bonds wrapped by them (in National’s case it has affected \$102bn of par outstanding). As BAM’s AA rating was subsequently affirmed and National’s market share is now only ~5%, the direct effect on the market as a whole has been muted, however, the downgrade and renewed caution on monoline insurers has the potential to further transform the municipal market.

Prior to the financial crisis, nine insurers carried a AAA rating, close to 50% of municipal bonds came wrapped and most issues traded in line with the insurers’ AAA ratings, regardless of underlying credit. In the years since, market penetration has plummeted (see below) and with lower interest rates and investor skepticism over the value of insurance in times of crisis, the pricing power for insurers has diminished: a typical wrapped bond now trades only 10-15bps tighter than the underlying rating (usually A or BBB).

As a result of the downgrade, National will no longer be able to compete with the remaining market players—the entire new business staff has reportedly been laid off. We anticipate that this latest move from S&P will accelerate consolidation of the monoline industry, potentially compress pricing for BAM and Assured as investors grow more cautious of sacrificing yield for insurance in the crosshairs of rating agencies, and continue to force a heavier focus on issuer credit research from market participants, potentially leading to greater spread dispersion.

Municipal Insurers – Market Penetration



Source: Bond Buyer

Insurer Market Share (3/31)	%
Assured Guaranty	58%
BAM	36%
National	5%
Berkshire Hathaway	1%

Source: BofA Merrill Lynch Global Research