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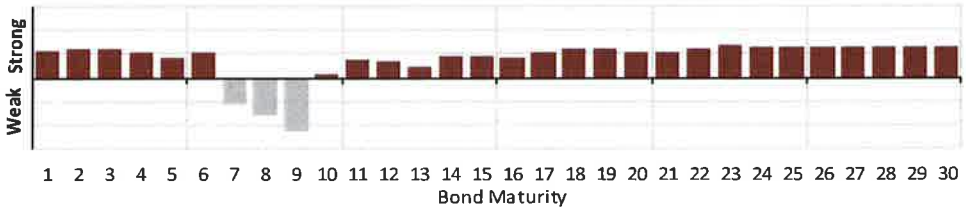
MUNICIPAL MARKET JOURNAL

Strong or Weak Market for Bond Sellers



MMA 5% AAA Benchmark

	11/11/16	11/4/16	Change
2-yr	0.93%	0.87%	6
5-yr	1.28%	1.16%	12
10-yr	1.97%	1.75%	22
30-yr	2.88%	2.64%	24

*Investors hoping to take advantage of last week's correction should do so only cautiously as tax reform expectations imply that any near-term price floor may be a false one. And indeed **MMA's** mean reversion metrics do not scream value, but rather that the market has not yet moved enough to make things interesting for buyers as most maturities are still reading is overvalued. The current situation likely encourages a pause more than anything else, though pressure has continued through today*

MARKET UPDATE

A Trump Presidency has the bond market turning defensive, but its real damage to municipals and infrastructure might be via tax reform that undermines the exemption and in the near-term inhibits demand.

HIGHLIGHTS

- Bond yields have risen sharply since the election of Donald Trump as the next President.
- There are numerous factors at work, but two principal ones are: 1) a reduced predictability of US policies under President-Elect Trump; and 2) an unwinding of expectations for continued bond-friendly vectors under a Democratic Administration.
- While tax-exempt bond yields ended the week 22-25 basis points higher beyond the 10-year, US Treasuries cheapened (i.e. increased in yield) by as much as 38 basis points and are beginning this week with renewed losses (**Figure 1**).
- Municipal yields are now at November 2015 levels, having retraced roughly a third of their rally since September 2013. Longer Treasuries have retraced roughly half of their post-'13 rally.
- Municipal credit spreads have not yet moved appreciably, but **MMA** expects that large mutual fund outflows have become likely with most fund NAVs dropping 1.0-1.8% last week alone (**Figure 2**).
- However, Lipper reported inflows of roughly $63M into municipal bond mutual funds for the week ending 11/9, marking another week of inconsistent flows that have added to an uncertain demand context.
- Hypothetical selling pressure—noting an uptick in bids wanted and customer trades on Thursday—could disrupt spreads and trouble the prospects for this week's large new issue calendar ($11.5B—**Figure 3**), which may be subject to reduction if yields rise too steeply.
- The problem remains that, although much higher yields would normally (and still might) galvanize demand for municipal product, the now very real prospects for tax reform and related damage on the tax exemption in early 2017 make it difficult for investors to speculate that a municipal bond price floor has been reached.
- Investors may instead have no choice but to allow spreads to gap appreciably wider, in particular for smaller rural and/or specialized issuers that most benefit from the tax exemption.

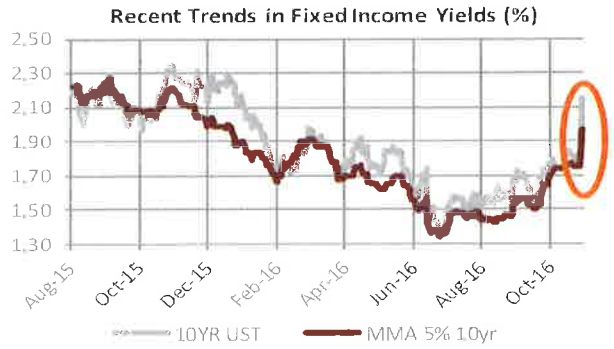


***Figure 1:** After today's session, municipal 10-year yields approached levels last seen in November 2015.*

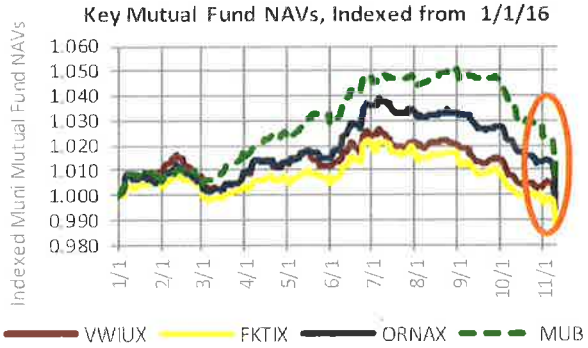


***Figure 2**: Plunging mutual fund NAV's set up real potential for large outflows this week, particularly is losses continue to accrue.*

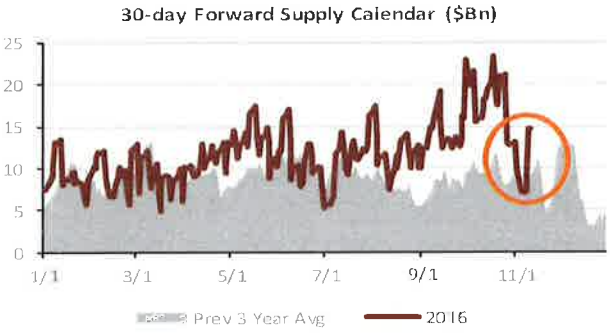


***Figure 3:** After a sharp decline in issuance during election week, the visible calendar has picked up, leading with a large Tobacco sale on Wed.*

TRUMP VICTORY BENEFITS INDUSTRY BUT NOT YIELDS

A Republican President backed by a fully Republican Congress breaks the gridlock of recent years, and, within the limits of Democratic filibuster, increases the odds of recent GOP proposals becoming law. We do not believe that the fundamentally depressive rate effect of slow long-term economic growth and high legacy liability costs have abated. However, **MMA** believes near-term policy choices will tend to skew both taxable and, in particular, tax-exempt yields materially higher, all else being equal, over the next four years. Some early thoughts are below:

Tax Reform: Above 50% potential for reform, with significant risk of damage to (or at a minimum, a narrowing of) the tax exemption. Admittedly, an enfeebled tax exemption undermines President-Elect Trump's murky but enthusiastic plan for investing in American infrastructure; however, we find that Washington's "infrastructure" promoters rarely appear to care much about what happens below the Federal level.

President-Elect Trump's tax reform aspirations are focused on cutting marginal rates and are less concerned with broadening the base through the elimination of tax preferences as Republican plans have been. Still, it follows that off-the-shelf legislation will have an advantage over unfunded and deficit-positive plans: a negative for municipals. GOP ideas are best viewed via the "A Better Way for Tax Reform" report published by the House Republican Task Force on Tax Reform in June. Among other things, the plan would reduce marginal regular (individual and corporate) income tax and capital gains tax rates, eliminate the AMT, provide a 50% deduction for capital gains and make all investment income taxable at the capital gains rate, and remove all existing itemized deductions save those for mortgage interest and charitable giving. The municipal bond tax preference, which is an exemption not a deduction, is not mentioned, and so it's unclear if the authors intend it to be capped or not. Of course, by reducing income tax rates and the tax burden on competing investment products, the municipal tax exemption would lose some economic value. Note that the Camp tax reform bill of 2014—which also cut marginal rates and removed a host of deductions—more directly impacted the municipal tax exemption, levying a 10% surtax on municipal bond interest from high income households and removing the exemption entirely for private activity bonds and advance refundings.

Financial Services Regulation: Above 50% potential for reform, with positives for industry market making but generally negative implications for pricing of risk-free assets. President-Elect Trump's polemic against Dodd-Frank may also be more road-ready than assumed, noting the CHOICE Act passed by the House Financial Services Committee a few months ago. This was generally dismissed by most analysts as unlikely to become law under a Democratic President. That the bill is championed by Jeb Hensarling (R-TX), who is a rumored candidate to be Secretary of the Treasury, now lends it credibility. Still, major CHOICE provisions—like a reduction in the CFPB and a shift in penalties for banks—would produce strong Democratic opposition that the Republican majority in the Senate would be unable to overcome. The act would thus need adjustment before becoming law.

The CHOICE Act purports to provide banks with a voluntary "off-ramp" from Dodd-Frank and BASEL-related regulatory standards, allowing banks to use a simple 10% leverage test to replace the existing regime of complex and overlapping risk-weighted asset and liquidity tests (such as LCR/HQLA, Fed stress tests, etc.).

The most direct rates impact here is a reduced regulatory mandate for banks to hold US Treasuries as risk-free assets, almost surely releasing a portion of what had been an artificial but still structural bid for UST in recent years. Combined with the CHOICE Act's enhancements of Congressional control over the Fed—which could reasonably lead to less UST buying by the central bank—and a shift to more "rules based" monetary policy—rather than today's more qualitative system that Republicans argue has led to overly permissive rates for too long—there would be clear pressure for rates to rise, dragging tax-exempt rates higher in the process.

The CHOICE Act would eliminate the Volcker Rule entirely, which, along with reduced regulation of bank assets generally, would encourage more adventurous market making by dealer firms. **MMA** assumes this would be the case even in municipal bonds despite the Volcker Rule's carve out of our sector. On the other hand, CHOICE's reduction of the regulatory burden on smaller banks, so as to make America lend again, strongly implies a weaker bid for municipal bonds by community and regional banks.

Finally, CHOICE would make serious adjustment to the financial regulatory bureaucracy, setting a moratorium on all new regulations and, going forward, subjecting new "major" regulations to Congressional approval. The Department of Labor's fiduciary rule would be immediately suspect, as would other bond-related rule making such as fee and price transparency initiatives. On the other hand, **MMA sees little potential for reversal of any municipal-specific rule making aimed at standardizing the treatment of municipals with other asset classes.** The bill would require organizational changes to the SEC, including downgrading the Office of Municipal Securities from a direct report to the SEC chair to an office within the Division of Trading and Markets. It would also redirect all penalty fees related to MSRB rule violations to the US Treasury instead of the current 50/50 split between the SEC and MSRB. The Act also aims at reducing the barrier to entry for new rating agencies.