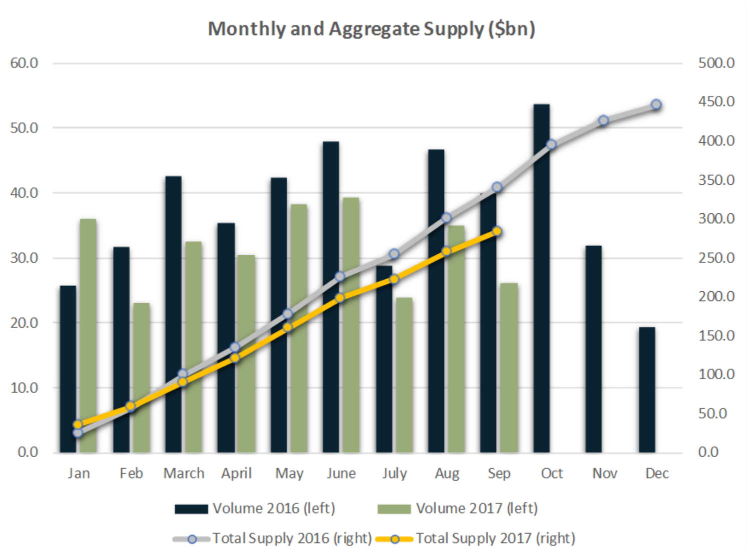
Supply Wanes As Demand for Municipals Remains Strong

The end of the quarter proved eventful as several peripheral factors unexpectedly drove both Treasury and municipal yields higher by quarter-end. Investors flight to safety in response to the news of substantial hurricane damage, initially pushed municipal yields lower. However, by the second half of September, the market saw a reversal of that trend.

Hawkish comments by Fed Chairwoman Janet Yellen caused the 10-year Treasury yield to spike. In response to her comments that the Fed will continue to raise rates despite subdued inflation data, the SIFMA index reached its highest point since 2008, prompting a similar move on the short-end of the municipal yield curve. The market's expectation of a December rate hike climbed to 70% on this news and the Fed's announcement that it would continue to unwind its balance sheet.

The final contributing factor was the release of the Republican Party's tax reform plan. Though most believe the plan is unlikely to pass in its current form, the market took the news as a positive for future growth and inflationary prospects, placing upward pressure on yields. As a result, municipals finished the month with higher yields in the short and intermediate spots, and a negative monthly total return. *For more on the effects of potential tax reform on the municipal market, see page 4 of this publication "Tax Reform Proposals: The Possible Effect on the Municipal Market."*



Source: Barclays Research, SIFMA.org, Bloomberg

Total muni supply for September came in at $26.2 billion, which brought total issuance for the quarter to $84.9 billion. This was a decrease of 21% quarter over quarter, during what is traditionally a lackluster period of supply. Year to date issuance fell further behind last year's pace, as 2017 volumes are now 17% lower than through the same period in 2016.

The forward calendar looks robust, and we expect supply to follow the traditional cyclical pattern of picking up before year end. However, with demand remaining strong, we expect the market to easily absorb any uptick in issuance. The end of September marked 11 consecutive weeks of inflows, bringing the totals for the month and year to $2 billion and $22 billion, respectively.

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Demand remains strong and we expect the municipal market to easily absorb any uptick in issuance

In This Issue

ACHA Impact on Municipals

The third quarter of 2017 continued to be defined by political turmoil in Washington, especially with regards to the nation's healthcare system. However, despite spending a large amount of time debating the subject, Congress has yet to find a solution for repealing and replacing the Affordable Care Act (ACA).

In a last-ditch effort to pass a bill with a simple majority through the budget reconciliation process, U.S. Senators Cassidy and Graham unveiled a new draft of their bill to replace the ACA. The draft included new funding provisions and regulatory changes aimed at securing support from Republican senators who had expressed concerns with previous versions.

The Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) then published a preliminary estimate of the new legislation's impact. They wrote that by 2026, the original version of this new legislation would reduce the federal deficit by at least $133 billion, but that it would leave fewer people without health insurance compared to the current Act.

Partially as a result of the findings in this report, three GOP senators then announced that they would not support the bill. The next day, Senate Republicans withdrew a planned vote on the bill due to insufficient support. Republicans have now turned their attention to tax reform, and seem to be eyeing early 2018 as the earliest chance to revisit "repeal and replace"

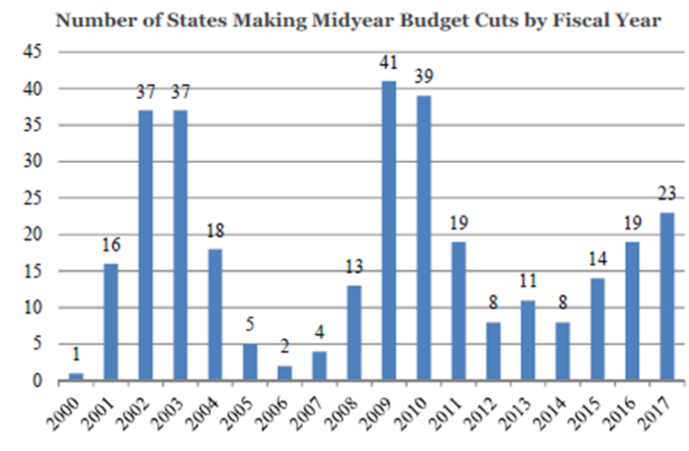
APA will continue to monitor any new health care legislation and the potential effects on the healthcare sector of the municipal bond market.

APA Credit Spotlight

State Report Card

State revenue growth, while still generally positive, has slowed over the past few years, with 2016 calendar year growth totaling just 0.5%. However, state revenue growth seems to be improving in 2017, as in the first two quarters of 2017 state tax revenues grew by an annualized rate of 3.1%. Preliminary data for the third quarter of 2017 shows a 2.3% year-over-year growth in state revenues. Higher sales tax revenues are leading the way, with Q2 sales tax revenues increasing by an estimated 3.2%. Sales taxes are projected to have increased in the third quarter as well, being bolstered by rebuilding efforts and an increase in car and light truck sales in states hit by recent hurricanes. However, the damages caused by the hurricanes may lead to declines in property tax collections.

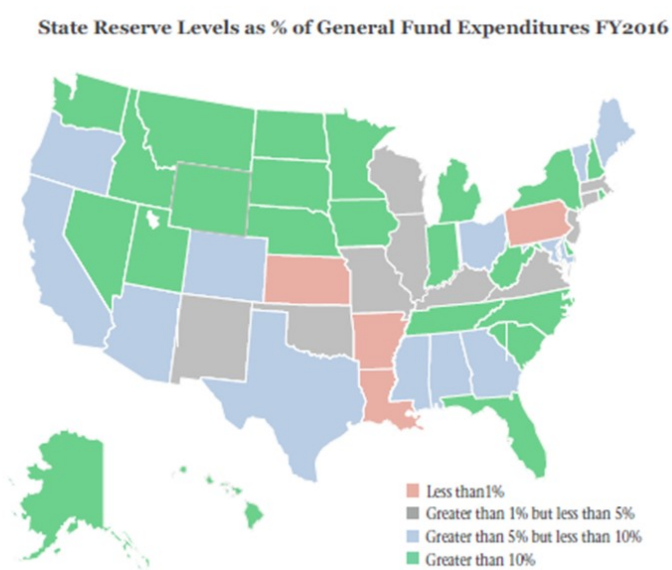
States have begun to focus on mid-year budget reductions and have initiated tax changes to bolster financial operations. In 2017, 23 states made mid-year budget reductions, an increase from 19 states in 2016 and 14 in 2015. In addition, some states have made tax changes, with eight states increasing taxes and six reducing taxes. As a result, general fund reserves at the state level are relatively strong, and state debt levels have not increased as many states have tightened their belts, increasing debt less than 1% annually over the past four years.



Source: NASBO

With regards to various states and their overall economic performance, the Connecticut State Department of Labor released a report ranking of state economies based on: 1) the number of total business established; 2) total covered employment; 3) real covered wages and 4) the unemployment rate.

Each of the four components was given a 25% weighting, with 2010 as a base year of 100%. The report showed only 29 of 50 states improved their overall scores from 2015 to 2016, compared with 45 that did so between 2014 and 2015. The state with the highest ranking was Colorado, followed by Nevada, California, South Carolina and Hawaii. At the bottom of the list was Wyoming, New Mexico, Louisiana, Oklahoma and West Virginia.



Source: NASBO

APA State Credit Watch List

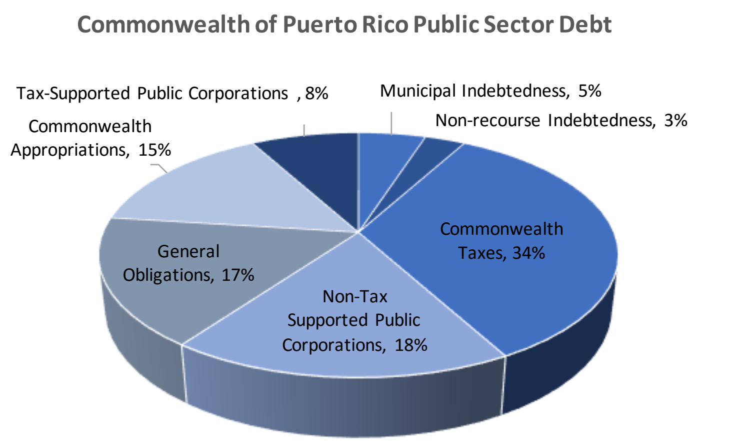
	Total Direct Debt Per Capita	Total Funded Ratio Pension & OPEB Liability	Rationale for Selectivity
Puerto Rico	12,479	7%	monitoring for default and/or restructuing, avoiding all Puerto Rico credits
Illinois	2,343	40%	underfunded pension liabilities, significant political and fiscal challenges
Kentucky	1,841	39%	underfunded pension liabilities, underperforming economy, challenged financial operations
Connecticut	6,220	49%	underfunded pension liabilities, underperforming economy, challenged financial operations
New Jersey	5,454	29%	underfunded pension liabilities, high debt levels, relatively high tax rates
Alaska	2,100	68%	low oil prices pressuring state finances
Rhode Island	2,538	54%	challenged economy and state financials, above average debt and pension costs
Pennsylvania	915	59%	slow economic recovery, challenged financial operations, increasing pension costs
Lousiana	1,580	63%	low oil prices pressuring state finances
Oklahoma	317	86%	low oil prices pressuring state finances, budgetary shortfalls
Kansas	1,584	63%	underfunded pension liabilities, school funding contribution will increase

Source: Merritt Research; data as of July 31, 2016

Puerto Rico: The State of a Non-State

Puerto Rico represents the largest government restructuring in the history of public finance. While "bankruptcy" had been dominating recent headlines, damage from the hurricane has taken over. The storm brought with it an estimated $95 billion in damages to the territory. Puerto Rico, still facing a financial crisis, now has to figure out how to take on and finance a massive rebuilding.

Together, Puerto Rico's general obligation (G/O) debt and sales-tax revenue backed debt (COFINA) encompass about half of the island's outstanding debt. While G/O holders and COFINA holders have been engaged in a fight, any court decision on their perceived right to be paid has been postponed to early 2018. Additionally, Judge Laura Taylor Swain is expected to release an order on the legal status of the island of Puerto Rico's post-hurricane federal financial aid in order to keep creditors from staking any claim to the funds. Under Title III that was enacted last year, the Oversight Board has the authority to appoint an overseer, which would override the power of the Governor in directing the expected federal aid.



Source: Government Development Bank for Puerto Rico; MSRB Puerto Rico Bond Trading and Outstanding Debt, data as of July 31, 2016

Puerto Rico's Electric Power Authority (PREPA) is faced with the need for a massive rebuilding of the aging and damaged electrical infrastructure of the island. More than a month after the storm, the majority of the island's population is still without power and is reported to remain that way for an estimated six-month period before power can be restored. As such, PREPA has had to work with the Army Corps of Engineers to determine a plan to repair approximately 2,478 miles of transmission lines. Before the hurricane damage, PREPA said it needed more than $4 billion to update the aging electrical grid and outdated power plants. With one of the highest electricity rates in the Unites States and its territories and a significant debt burden that drove it to bankruptcy, the already struggling agency faces an uphill battle.

With an unemployment rate at twice the average of the U.S. and high poverty rates, outmigration from the territory has been an ongoing trend over the last 10 years such that more Puerto Ricans live on the mainland than the island. Hurricane damage and the lack of electricity, food and water are likely to drive a greater portion of the population to emigrate from the island to the mainland in coming months. Without a massive infusion of federal aid, Puerto Rico may not be able to complete an overhaul of the electrical system that it needs in a timeframe that keeps its already declining population from running for the exit.

Final Thoughts

By Ken Woods

"Tax Reform Proposals: The Possible Effect on the Municipal Bond Market"

While the Trump Administration's tax reform proposal is vague and lacks specific details, we will focus on some of the expected points and how they might impact the municipal bond market. In positive news for the municipal bond market, current tax proposals do not call for the elimination of the tax-exempt status municipal bonds. This dark cloud, which has hovered over the municipal bond market since a federal court decision in South Carolina in 1982 stated that the federal government could legally tax municipal bonds, has kept the market in a cold sweat during discussions of tax reform. The quote by Gideon Tucker that "no man's life, liberty, or property are safe while the legislature is in session" has certainly held true in relation to the tax-exempt status of municipal bonds.

Current proposals could have both positive and negative effects on the municipal bond market. We have highlighted several of these points below:

⇒ **Reduction of the top marginal income tax rate**

Trump's plan calls for a simplification of the tax code and likely the reduction of the number of federal income tax brackets to three: 12%, 25% and 35%. To compensate for the reduction in the highest tax bracket from the current rate of 39.6%, analysis by JPMorgan suggests municipal yields would need to adjust higher by approximately 20bps to make individual investors whole.

⇒ **Reduced corporate tax rate**

Corporations own about 23% of the outstanding bonds in the municipal market, with a majority of that being held by banks and property & causality insurance companies. The current plan calls for the reduction of the corporate tax rate to 20%, which would make tax-exempt bonds less desirable to these companies. Under this scenario, municipal yields would need to adjust higher by roughly 39 bps to make corporate investors whole for the reduction in the after-tax value bonds.

⇒ **Elimination of interest deduction for corporate debt**

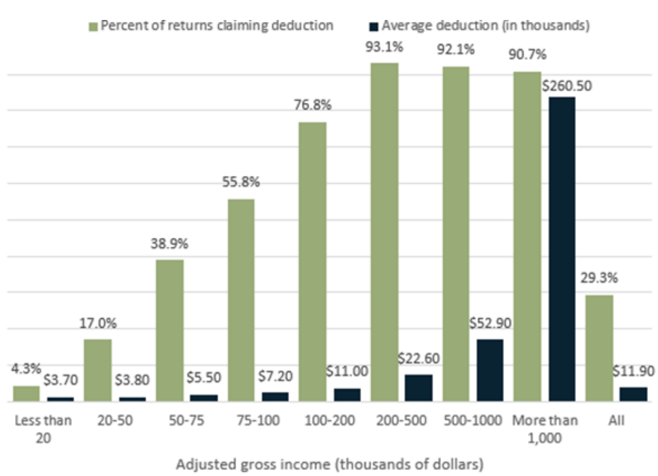
If congress were to eliminate the deductibility of interest on new corporate debt, then companies would be more inclined to raise capital through equity markets. While we concede that this is a long shot, any reduction in corporate supply would likely be a positive for prices on bonds in the municipal bond market.

⇒ **Elimination of the alternative minimum tax (AMT)**

Certain sectors of the municipal bond market are subject to AMT. Such bonds include those issued by not-for-profit 501 (c)(3) organizations, and other "private activity" issuers like airports and certain types of housing agencies. Eliminating this tax would be a positive for this sector, but in general a net neutral for the overall market.

⇒ **State and local tax (SALT) deduction**

Although not specifically detailed, the elimination of the SALT deduction certainly appears to be a part of the reform conversations. Per the Tax Foundation, the SALT deduction will cost the federal government $1.8 trillion over the next 10 years. IRS data shows that the SALT deduction primarily benefits high earning taxpayers in high tax states. It also shows that six states – California, New York, New Jersey, Illinois, Texas, and Pennsylvania – claim more than half of the value of the deduction. California residents deducted nearly $110 billion in SALT in tax year 2015, or 20.5% of the total nationwide value of the deduction. The political strength of these large states will make it difficult to get this deduction past the tax writing committees.



Source: Urban-Brookings Tax Policy Center, based on data from the IRS, tax year 2014

⇒ **What are the odds that tax reform will get done this year or in early 2018?**

While the continued upward trajectory of the stock market is at least partially attributable to many on Wall Street believing some type of tax reform will be implemented over the near term, APA believes the reality is there are numerous hurdles to be cleared in Washington. Supporting the prospect of reform is the budget reconciliation process, which would allow Republicans in the Senate to pass tax reform with a simple 51-vote majority, affording the Republicans only two deflections. While members of the GOP seem to be in general agreement with their desire to reform the tax code, the narrow margin for error does not allow for any cracks amongst the party members. We expect a bumpy but navigable road ahead.

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