Legislation's Impact on Municipal Supply

The passage of the largest U.S. tax overhaul in decades promised a tumultuous quarter for municipals with the evidence reflected in monthly and quarterly aggregate supply numbers. Total municipal supply for March came in at $25 billion, which brought issuance for the quarter to $63.2 billion, or a decrease of 60% quarter-over-quarter. This decrease is largely attributable to the rush of supply the market experienced before year-end 2017, as issuers "moved up the calendar" to issue advanced refunding bonds, which were eliminated as part of the Tax Cuts and Jobs Act as well as private activity bonds that were threatened, but ultimately made the cut and remained in the bill.

Net issuance was +$4 billion for March, with year-to-date net supply totaling -$19 billion. The negative supply has been somewhat offset by reduced corporate demand from banks and insurance companies as a result of lower corporate tax rates. Despite a record amount of issuance in fourth quarter 2017, the municipal market easily absorbed the uptick in issuance. Demand remained strong into first quarter, 2018 as muni fund inflows averaged $350 million per week.

Source: Barclays Research, SIFMA.org, Bloomberg

Yields moved higher with 10-year US Treasury yields rising from 2.41% to 2.74% and AAA-municipals in the 10-year spot rising from 1.99% to 2.44%, during the first quarter. Overall, performance was mixed across the yield curve, with short dated municipals outperforming the rest of the curve with positive absolute performance. Despite posting negative absolute returns in the intermediate spot, municipals outperformed Treasuries for the period. In our opinion, the relative steepness of the municipal curve continues to lend itself to our preferred barbell strategy.

By quarter end, in response to the "strengthening economic outlook in recent months," the US Federal Reserve (Fed) voted unanimously to raise short-term rates by 25 basis points (bps); the Fed's sixth rate hike since December 2015 and Fed Chairman Jay Powell's first as chairman.

Year to date municipal issuance decreased 60% quarter-over-quarter, largely the result of lower supply after a rush to "move up the calendar" prior to year-end 2017

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

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Municipal Market Supply & Performance Trends

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APA 1Q 2018: Credit Spotlight

STATE OF THE STATES, CITIES AND TERRITORIES

The State of Illinois

The most recent release of Illinois financials, its Fiscal Year 2017 Comprehensive Annual Financial Report (CAFR), revealed a growing deficit. Currently, the largest of any state in the U.S., Illinois' long-term deficit ballooned by an additional $10 billion in a one year period, reaching $141.7 billion . Nearly twice as large as the next largest state deficit, Illinois continues to struggle with out of control spending and a debt laden balance sheet.

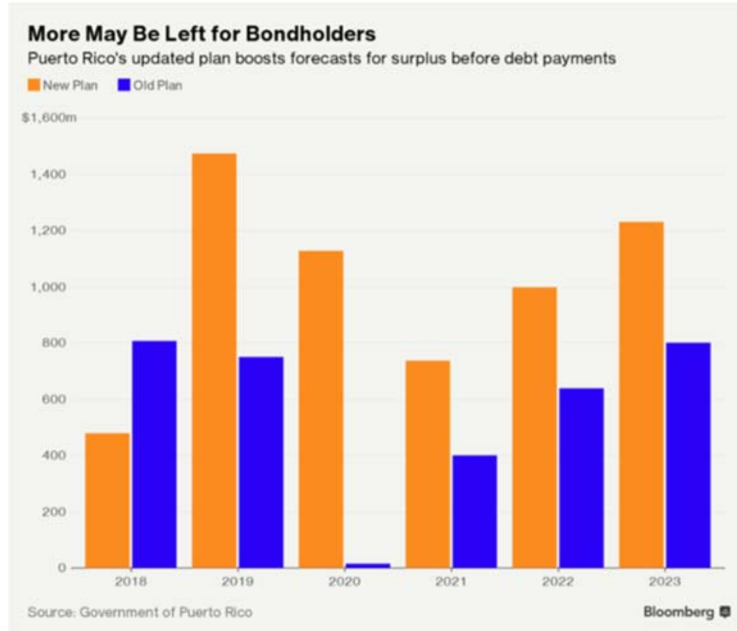
The CAFR's outlook cited "budgetary challenges along with the accumulated deficit in the General Fund, continued growth in the net pension liability and post-employment benefit costs, and rating downgrades on debt issuances of the state may impact the state's ability to access credit markets to pay operational expenditures more timely and may increase interest costs of those borrowings."

The largest contributors to the state's growing deficit were from pension liabilities, which increased $21.6 billion, and Medicaid spending, which increased by $1.8 billion to $6.1 billion, a 40% increase. The CAFR also highlighted the approximate $806 million cost of not paying its bills on time.

On a positive note, revenues were up 4.1% after a 5.8% decline in 2016. Governor Rauner's proposed budget for Fiscal Year 2019 calls for pushing pension costs onto local governments and cutting healthcare benefits for employees. APA does not expect the state's fiscal and budgetary issues to be resolved in the near-term and continues to monitor the state for further credit deterioration and downgrades. The state holds a Baa3 rating with a negative outlook from Moody's.

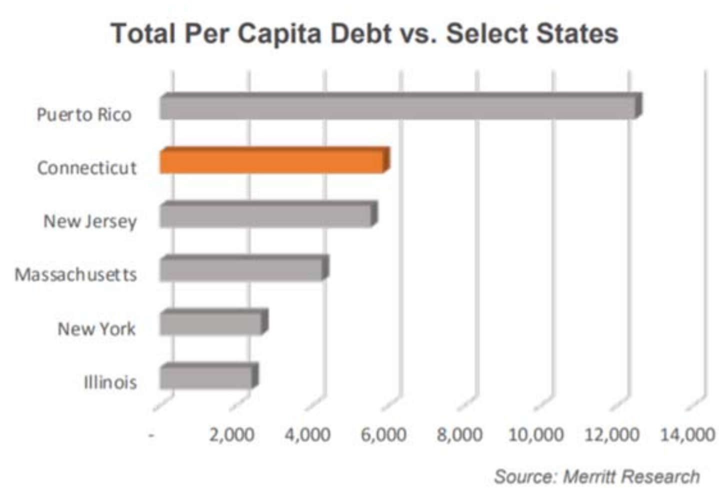
Puerto Rico

After years of negative news headlines, Puerto Rico was finally able to report a positive line item on their balance sheet. The bankrupt island saw an increase in its projected five-year surplus to $6 billion from $3.4 billion, the prior year. Bond prices on various Puerto Rico issues, including general obligation, sales-tax backed (COFINA), electric power (PREPA) and others have rallied as recovery prospects seemingly improve. Despite the positive news, Puerto Rico continues to struggle with population loss, astronomical pension and debt costs, and weak infrastructure as residents try to recover and rebuild the island after substantial damage from Hurricane Maria. Despite the higher projected surplus and potential for more funds being freed to pay bondholders, Puerto Rico's massive debt burden and pension liabilities are of concern to APA's credit research group, who continues to monitor the federal oversight board's actions as well as the potential negotiation of creditors.



Hartford, CT

APA's recent white paper, "Hartford We Have a Problem" discusses the economic struggle within the state of Connecticut. Chiefly, the state's high debt levels and ballooning pension costs. The state recently extended a lifeline to its capital city, Hartford, by assuming the city's $755 million in debt payments. The deal, viewed favorably by Standard and Poor's, earned Hartford a "Watch Positive." Connecticut, already the most indebted state on a per-capita basis, will help the city avoid a potential bankruptcy as the sate assumes the debt burden provides oversight. While it is rare for a state to take on the debt of a city, state programs to help municipalities recover are prevalent. Connecticut helped Waterbury from 2001-2006 while another capital city, Harrisburg entered Pennsylvania's receivership program in 2011. Pittsburgh, Pennsylvania, entered the state's Municipal Financial Recovery Act program in 2003 and did not officially shed its distressed status until 2018, a 14-year period. As pension liabilities, Medicaid and other costs increase, APA expects more states and larger issuers to offer assistance through similar distressed municipality programs.



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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

Janus v. American Federation of State, County and Municipal Employees (AFSCME)

Janus v. AFSCME originated in the state of Illinois after child support specialist, Mark Janus, sued his union, AFSCME. Janus protested the dues, or "agency fees," required to support union policies that he does not agree with, which he claims, violate his First Amendment rights. He and his legal team argue that agency fees pay for activities that are inherently political. On the contrary, many union members feel their protections for a living wage, retirement security, and health and pension benefits are at risk of being stripped away.

Both sides were heard as the case was argued before the U.S. Supreme Court on Monday, February 26th; and with it, the power of influence public employee unions have on political elections, government policies, salaries, as well as pensions and other post-employment benefits could be coming to an end.

Keep in mind, this was not the first time the Court had heard this argument. Similar arguments were made in 2016 with Friedrichs v. California Teachers Association. The case ended in a 4-4 tie, as a result of Justice Antonin Scalia passing away before the vote. The outcome of Janus v. AFSCME hinges on the vote of the court's newest Justice, Neil Gorsuch.

What could this mean for municipal bonds?

If the Court sides with Illinois state employee Mark Janus, state and local governments could gain the upper hand and the U.S. could turn into a right-to-work country for purposes of public employment.

Currently, right-to-work laws are statutes in only 28 states, prohibiting union security agreements between employers and workers' unions. Union members and, in-turn, politicians would have reduced influence on their state or local governments due to significant funding cuts from less 'lobbying' for increased government spending. Just how much influence could unions have on political funding? During the 2016 Presidential Election, it was reported by the Center for Responsive Politics that $108.2 million was spent by Labor Union campaigns with nearly 85% of their spending supporting Democrats. This was up from $78 million in 2012 and $59.1 million in 2008.

Lastly, when considering the impact of possible decreased spending on government employees, investors who hold bonds in states where labor costs run high may see improved credit quality. This improvement in credit quality may lead to higher bond values for those municipalities.

Will Justice Gorsuch's vote sway towards the Union representatives or towards Janus?

The ruling on the case is expected at the beginning of the summer. APA will continue to monitor the case and provide updates in our quarterly commentary as it pertains to the credit quality of certain bonds, sectors and the overall impact on the municipal bond market as a whole and any precedent that may be set by the outcome of this case.

Regardless of the verdict, the Court's decision will have a profound impact on the power of Unions not only in Illinois, but the entire U.S.

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"There is Nothing Free About a Freeway"

By Ken Woods

Most stakeholders in a capitalist system know there is no such thing as a free lunch; this holds true for the U.S. surface infrastructure. The leadership in the U.S. has chosen to "kick the can down the road" instead of taking the necessary steps to secure funding for improvements. *The result:* an infrastructure system that is a prodigious drag on the economy.

Over the past six months, both the Democrats and Republicans have made proposals to fix this country's infrastructure problem. President Trump proposed that the federal government fund $200 billion, with state and local governments raising the remaining $1.5 trillion. The Democratic proposal would restructure the 2018 tax cuts, in an effort to raise around $1.2 trillion over the next 10 years.

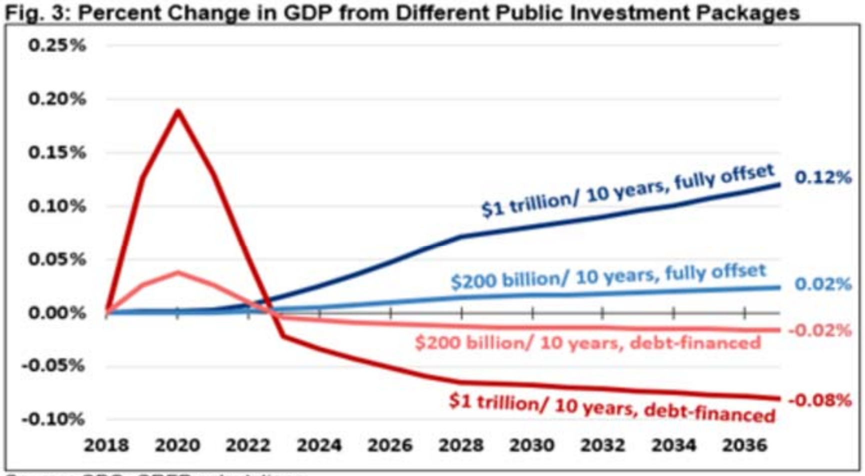
Both offer potential long-term solutions; however, the U.S. is facing an imminent crisis. The Highway Trust Fund is projected to run out of resources by 2020 (Congressional Budget Office, 2016.) Spending an estimated $45 billion a year, mostly on repairs, the fund currently spends more than it takes in on an annual basis. With inflows of only $34 billion, and primarily funded by the federal fuel tax, the fund is not robust enough to address the most basic infrastructure needs. Currently, the federal excise tax on gasoline is 18.4 cents per gallon and 24.4 cents per gallon for diesel fuel: last raised in 1993 and not indexed for inflation. When President Reagan was questioned about increasing the excise tax in 1982, he retorted that it was a 'user fee' and not a tax increase. Reagan's statement may be the simplest way to determine who should pay for highway funding; if you use a resource in a free enterprise system, you must share the cost.

Congress could pay for projected highway and mass transit spending by simply raising the federal tax rate on gasoline and diesel fuel. As Joseph Kile, *Assistant Director of Microeconomic Studies* at the Congressional Budget Office stated in a testimony before the United States Senate in 2014, a one-cent increase in motor fuels taxes dedicated to the Highway Trust Fund could raise revenues approximately $1.5 billion per year. Similarly, a Congressional Budget Office study concluded that a $1trillion infrastructure package would increase GDP after two decades if not financed by the federal government.

Advantages of Increasing the Federal Fuel Excise Tax:

- Timely implementation with little to no negative impact on states' and municipalities' general funds
- Phased in over several years to reduce the economic effect
- Serves as a stop gap measure, giving legislators and politicians time to consider other solutions
- Provides "tax credit" to the lower income brackets
- Provides incentive for drivers to use alternative forms of transportation
- Therefore, may reduce energy use over the long-term

Fig. 3: Percent Change in GDP from Different Public Investment Packages



Source: CBO, CRFB calculations.

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APA-18-279