NOVEMBER 2017
MARKET COMMENTARY

KEY TAKEAWAYS

• Tax reform in focus. Municipal bonds underperformed Treasuries, as issuance soared in advance of expected tax reforms that could eliminate certain types of municipal issuance.

• The Treasury curve flattened to levels not seen since the third quarter of 2007.

• Agency MBS spreads remained tight in November, amid continued low volatility, benign prepayments and investor demand for high-quality spread product.

MARKET REVIEW

New Tax Plan Planning

In our recent piece Not Yet in Lockstep: E-Commerce, Sales Tax and Muni Credit, Adam Stern, Breckinridge’s co-head of research, provided insight into just which state receives the tax revenues when a consumer orders that new, sought after pair of jeans online. As the battle for online sales tax revenues continues to heat up, Amazon announced in November that effective January 1, it will collect a sales tax from third-party sellers shipping orders to Washington, Amazon’s home state.

Few times in history have tax burdens and tax revenues been more in focus, but of course, in November, the focus was on overall tax reform proposals from Congress. Tax reform played a key role in investment grade (IG) performance in November, particularly in terms of the municipal technical backdrop and the flattening of the Treasury curve.

While equity performance was strong, fixed income was more mixed. The Treasury curve flattened to levels not seen since the third quarter of 2007, as Treasury yields across shorter maturities moved higher over month (two-to five-year maturities jumped 10-20bps higher), while 10-year and longer maturities remained rangebound. The 30-year was the outperformer, decreasing 5bps to close at 2.83 percent, after dropping to as low as 2.75 percent during the month. In IG municipal bonds, the curve also flattened, while IG corporate spreads saw slight widening.

The curve flattening was partly due to still-elevated expectations of a December rate hike, partly due to solid economic data. Third quarter GDP was revised to 3.3 percent, while nonfarm payrolls increased 228,000 in November, which was stronger than expected. The Consumer Confidence Index increased to 129.5 for November, the highest level since 2000.

Financial conditions remain accommodative, as the FOMC held the Fed Funds target steady in November at 1.25 percent, as expected. Jerome Powell was nominated as the next Fed Chair, and he is expected to keep more of a status quo to the current FOMC trajectory versus other candidates. There is, however, sentiment across the market that other new Fed seats that will open up will be replaced by more hawkish candidates.
MUNICIPAL MARKET REVIEW
Decoding the New Potential Tax Code

The Bloomberg Barclays Municipal Bond Index returned -54bps for November, marking the third month of negative returns for the year (following June and September). Similar to Treasury bonds, the municipal curve flattened. The two- to five-year AAA municipal yields jumped roughly 35-48bps higher, while the longer end, anchored by limited inflation fears, rose 13bps in 10 years and fell 3bps in 30 years. The 10-year yield closed November at 2.15 percent, an increase of 34bps from the 1.81 percent year-to-date low set in early September. Municipal bonds underperformed Treasuries, as issuance soared in advance of expected tax reforms that could eliminate certain types of municipal issuance such as private activity bonds (PABs) and advance refunding bonds (see our blog post, Supply: A Q&A with CIO David Madigan). The potential implications of tax reform are wide ranging. See Figure 1 for some highlights of how tax reform could impact the municipal market.

Given the underperformance of munis versus Treasury bonds, ratios rose significantly in shorter maturities in November. The two- to five-year AAA municipal yields jumped roughly 35-48bps higher, while the longer end, anchored by limited inflation fears, rose 13bps in 10 years and fell 3bps in 30 years. The 10-year yield closed November at 2.15 percent, an increase of 34bps from the 1.81 percent year-to-date low set in early September. Municipal bonds underperformed Treasuries, as issuance soared in advance of expected tax reforms that could eliminate certain types of municipal issuance such as private activity bonds (PABs) and advance refunding bonds (see our blog post, Supply: A Q&A with CIO David Madigan). The potential implications of tax reform are wide ranging. See Figure 1 for some highlights of how tax reform could impact the municipal market.

In terms of supply, November posted $36.8 billion in volume, an 11 percent increase from November 2016 and surpassing the $30 billion monthly average for November over the past 20 years. Year-to-date, issuance is still below the same period in 2016, but the forward calendar shows a significant rise in issuance expected for the remainder of the year. The primary market calendar for the week of December 4 was among the highest on record, with deal volume reaching roughly $20 billion. The Bond Buyer’s 30-day visible supply totaled $21 billion as of December 1.

Demand was strong for November, illustrating that investors are aware of a possible curb in supply next year. To start this month, fund flows saw a large outflow of $331 million for the week ending November 1, after several weeks of modest to strong inflows. However, the trend improved during the month, with each of the subsequent weeks at or over $400 million. Year-to-date, aggregate inflows are just over $18 billion.

From a credit perspective, we continue to closely monitor states with budgetary strains, particularly given pension and OPEB risks that have risen since the financial crisis.

**Figure 1: House/Senate Tax Reform Bills - Key Provisions for the Muni Market**

<table>
<thead>
<tr>
<th>DIRECT Impact to Munis</th>
<th>House Bill</th>
<th>Senate Bill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advance Refundings</td>
<td>Eliminated</td>
<td>Eliminated</td>
</tr>
<tr>
<td>Private Activity Bonds (PABs)</td>
<td>Eliminated</td>
<td>Remains</td>
</tr>
<tr>
<td>State and Local Tax Deduction (SALT)</td>
<td>SALT eliminated; Can deduct up to $10K in property tax.</td>
<td>SALT eliminated; Can deduct up to $10K in property tax.</td>
</tr>
<tr>
<td>Alternative Minimum Tax (AMT)</td>
<td>Eliminated</td>
<td>Remains, but with higher threshold for exemption.</td>
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<table>
<thead>
<tr>
<th>INDIRECT Impact to Munis</th>
<th>House Bill</th>
<th>Senate Bill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top Individual Tax Rate</td>
<td>39.60%</td>
<td>38.50%</td>
</tr>
<tr>
<td>Mortgage Interest</td>
<td>Deductible on first $500K of principal; Eliminated for home equity loans.</td>
<td>Deductible for acquisition of house (no limit); Eliminated for home equity loans.</td>
</tr>
<tr>
<td>Standard Deduction</td>
<td>Doubled ($24,000 for joint filers).</td>
<td>Doubled ($24,000 for joint filers).</td>
</tr>
<tr>
<td>Corporate Tax Rate</td>
<td>To 20% from 35%</td>
<td>To 20% from 35%</td>
</tr>
<tr>
<td>Pass-Through Rate</td>
<td>Caps rate at 25%</td>
<td>23% of income can be deducted (Creating top effective tax rate of just under 30%)*</td>
</tr>
<tr>
<td>Estate Tax</td>
<td>Doubles estate tax exemption for couples to $10M; full repeal after 2024.</td>
<td>Doubles estate tax exemption; no repeal.</td>
</tr>
<tr>
<td>Individual ACA Mandate</td>
<td>Remains</td>
<td>Eliminated</td>
</tr>
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*This is a simplified description.
crisis. However, with strong equity returns year-to-date, we may see improvement in some of these trends.

CORPORATE MARKET REVIEW

Corporate Tax Cut and Braced

The option-adjusted spread on the Bloomberg Barclays Credit Index widened 1bp, to 92bps. The Index outperformed duration matched Treasuries by 3bps. On a total return basis, the Bloomberg Barclays Corporate Index generated -15bps in November, with intermediate maturities down 35bps and long maturities up 29bps, partly due to the Treasury market flattening.

While spreads ended the month only slightly wider, this masks more notable spread movement throughout the month. Spreads widened the first couple weeks of the month, with the Bloomberg Barclays Corporate Index closing as high as 103bps (November 15). This occurred despite improvement in oil prices and a strong jobs report to start the month. The softness was likely due to new issue fatigue, as new supply was over $70 billion the first couple weeks of the month-above expectations, per Bank of America Merrill Lynch (BAML). In addition, at the start of November, dealer inventories were already at the higher end of the range for the year. Furthermore, credit-specific news, mainly M&A, caused some weakness in certain names. For example, CVS Health Corp. announced that it would purchase Aetna Inc. for $69 billion in both cash and debt financing, which led to widening in CVS spreads.

By the end of the month though, spreads rebounded back to close to where they started the month, as the primary market slowed some going into the holiday and some optimism about tax reform was supportive. Both the House and Senate bills have the corporate tax rate being lowered to 20 percent, effective 2018 for the House, and effective 2019 for the Senate. The bills also include a cap on interest deductibility, but this is more relevant for higher-leveraged companies. For more thoughts and details on tax reform, see our third quarter corporate commentary.

Illustrating the continued risk-on posture in IG corporate credit, from a ratings standpoint, crossover bonds fared the best, while Aa+ credits fared the worst. However, single-A names outperformed BBB, which is a shift from prior months. The best-performing sectors were Metals and Mining, Supermarkets and Packaging. The worst-performing were Oil Field Services, Midstream, Cable Satellite, Pharmaceuticals and Technology. Metals and Mining benefited from improving commodity pricing (iron ore, oil, copper). However, Oil Field Services and Midstream still underperformed partly due to rising geopolitical risks in the Middle East. Cable and Telecom names underperformed due largely to M&A announcements. News outlets reported that Sprint Corp.’s owner (Softbank Group Corp.) was calling off merger negotiations with T-Mobile US Inc. because the two companies could not agree on ownership terms for the combined entity. Also, headlines included a bid by Broadcom Limited for Qualcomm Inc. for $70 a share, or total consideration of more than $100 billion. While Qualcomm rejected this bid, Broadcom could become more aggressive and spreads for both credits were negatively impacted. In addition, Qualcomm was under scrutiny due to concerns surrounding Apple Inc., one of its biggest customers.

Also on the tech side, Oracle came to the market with an unexpected $10 billion deal, and had to give a significant spread concession which spooked the market, but that was temporary as buyers began to buy at wider spreads.

Also putting pressure on markets in November, supply was robust, totaling $120 billion. This is down from $132 billion in October, but way up from $78 billion in November 2016. On the demand side, Per Wells (EPFR data), IG funds reported $18.2 billion of inflows bringing the year-to-date inflow total to $317.3 billion. Deals were well received, reflecting continued interest in the space particularly from foreign buyers.

SECURITIZED MARKET REVIEW

Fed Unwind on the Mind

Asset-backed security (ABS) spreads remain rangebound with no significant catalysts to break the current cycle on the horizon. Carry, diversification and strong underlying credit fundamentals remain the story in the sector. Demand for consumer ABS remains strong given that investors are seeking higher-yielding, high-quality assets. Consumer ABS issuance came at a fast pace in November. Year-to-date, 346 deals totaling $235 billion have priced, an increase of 24 percent versus the same period last year.3 Agency mortgage-backed security (MBS) spreads remained tight in November, amid continued low volatility, benign prepayments and investor demand for high-quality spread product. The Bloomberg
Barclays U.S. MBS Index concluded November at an average spread of 69.5bps. Curve flattening has been the dominant theme in the sector, with 2s10s below 60bps, down from over 130bps in 1Q17. The curve flattening shortens MBS durations—especially in higher coupon MBS—which are most exposed to faster prepayment speeds, but prepayments have held in thus far.

In recent years, MBS have outperformed the investment grade sector during periods of market stress, per BAML. However, we are monitoring any volatility that could come from the Fed’s unwind of its balance sheet, as a large buyer of the asset class will be removed as spreads are at multi-year tights. Net agency MBS supply for November was $31 billion, which will bring net supply for 2017 to over $300 billion, which is the highest the market has seen since 2009. Next year, we expect organic supply to again reach around $300 billion, and when combined with the approximate $150 billion that will run off from the Fed, the private market will have a significant amount of paper to digest.

**STRATEGY AND OUTLOOK**

**Taxing Times**

We remain duration neutral in our municipal credit strategies and neutral to slightly short in our government credit strategies. We are closely monitoring the Treasury curve given the significant flattening that has occurred, and our outlook considers potential outcomes for inflation. While inflation is still low, in our view, we recognize some expected positive impacts from tax reform, solid GDP data and low unemployment. In terms of tax reform, we recognize that the final construct of the bill is still uncertain. We continue to think that the U.S. Treasury market is not adequately pricing in higher commodity prices nor the Fed’s desire to normalize rates more quickly. Commodities had another solid showing in November, with WTI oil up $4 per barrel to about $58.

For IG municipal bonds, the credit environment remains stable despite some softening in state tax revenues and some tax reform provisions that could further challenge revenues [such as limits on exemptions for property taxes]. In addition, states such as Connecticut and Illinois remain on our radar given pension and budgetary issues that could filter out to local municipal credit quality and overall market sentiment on the asset class. Importantly, Illinois continued to come to market in November with deals from the Chicago Board of Education, Illinois Toll and others. Despite weakening credit fundamentals in Illinois, the deals were well-received, underscoring strong market demand.

On the corporate bond side, November finally saw a turn in the outperformance of higher-beta credits, which we have seen for most of 2017. While spreads widened slightly in November, overall spreads remain tight and we are cautious on the corporate credit cycle given still-elevated debt leverage. Also, an uptick in M&A (such as the announced CVS/Aetna transaction) is one example showing that many IG companies continue to have an aggressive credit posture. As we have noted in past reports, we have seen improvement in the Banking sector credit quality post-crisis, as management teams have focused on bolstering capital positions. Standard & Poor’s upgraded Bank of America in late November, as improvement of that bank filtered through to its public credit rating.

In general, we think that tax reform will be an overall positive for the corporate market given expected lower debt issuance and higher economic growth.

1. Lipper, as of December 6, 2017.
2. Bloomberg Barclays, as of December 1, 2017.