Municipal Fixed Income

Quarterly Market Commentary

First Quarter 2019

Key Themes

- The S&P Municipal Bond Index generated a 2.76% return for the 1st quarter of 2019. The municipal market outperformed the broad U.S. Treasury market index and underperformed the corporate bond index for the period.
- Impressive performance in the quarter benefited from declining yields across the curve. Rate movement corresponded with stronger returns for longer-duration portfolios.
- The slope of the yield curve flattened, as the 30-year rate declined more than the 2-year rate from the end of 2018.
- New issuance in the quarter was up 14.4% from the prior year. Credit spreads narrowed markedly in the 'A' and 'BBB' categories.

Municipal Market Review

The municipal market showed impressive performance in the first quarter, generating a return of 2.76% (Table 1). The market sprinted to the finish line, with approximately one-third of the total return generated in the last two weeks of March. Municipal yields declined throughout the quarter and accelerated downward after the March 20 Federal Open Market Committee (FOMC) meeting. The relative strength in the muni market, driven largely by supply and demand factors, further supplemented price performance. The municipal yield curve flattened, as measured from the 2- and 30 year rates (Table 2). The municipal 2-year rate declined by 29 basis points (bps) and the 30-year rate declined by a strong 42 bps in the quarter, resulting in the curve flattening.

TABLE 1	S&P Municipal Bond Index Returns 1Q19			YTD Total
Index	Total Return	Price Return	Interest Return	Return 2019
Main	2.76%	2.12%	0.64%	2.76%
Intermediate	2.74%	2.16%	0.58%	2.74%
Short-Intermediate	1.84%	1.35%	0.49%	1.84%
Short	1.11%	0.66%	0.45%	1.11%

Source: S&P Dow Jones Indices, LLC

TABLE 2	Municipal Yield Curve Slope	
	12/31/18	3/29/19
2-year rate	1.78%	1.49%
30-year rate	3.02%	2.60%
Slope	1.24%	1.11%

Source: Thomson Reuters TM3-MMD

The flattening of the curve in the first quarter was observable in the return differentials, with longer-term bonds outpacing shorter ones. Rates declined significantly across the term structure (Table 3). Consequently, portfolios biased toward greater interest-rate sensitivity easily outperformed those carrying shorter durations. Yield ratios of 10-year AAA municipals relative to US Treasuries moved sharply lower in the quarter to 0.77 from 0.85, driven by strong technical factors within the municipal market (Table 4). At the current ratio, municipals are the richest they have been to Treasuries since 2010.

TABLE 3	AAA Municipal Rates					
Date	SIFMA	2 Yr	5 Yr	10 Yr	15 Yr	30 Yr
12/31/18	1.71%	1.78%	1.94%	2.28%	2.57%	3.02%
3/29/19	1.50%	1.49%	1.57%	1.86%	2.21%	2.60%
Quarterly change	-0.21%	-0.29%	-0.37%	-0.42%	-0.36%	-0.42%

Source: Thomson Reuters TM3-MMD, Bloomberg

After four policy rate moves in 2018, the FOMC has declined to take action on rates at two meetings thus far in 2019. The policy rate remains at a target of 2.25% to 2.50%. Following its March 20 meeting, the FOMC softened its stance on economic growth prospects. The market has followed suit and begun to contemplate the potential of current target rates at the cyclical peak. The market has begun pricing in probabilities of rate cuts in 2019. Despite a neutral stance from the FOMC, municipal short-term rates, as represented by the SIFMA Municipal Swap Index Yield (SIFMA), displayed volatility through the quarter ranging from 1.28% on January 16 to 1.74% on February 27. SIFMA finished the quarter at 1.50%.

TABLE 4	Municipal-to-Treasury Yield Ratios
	10-year Ratios
12/31/18	0.85
3/29/19	0.77

Source: Thomson Reuters TM3-MMD

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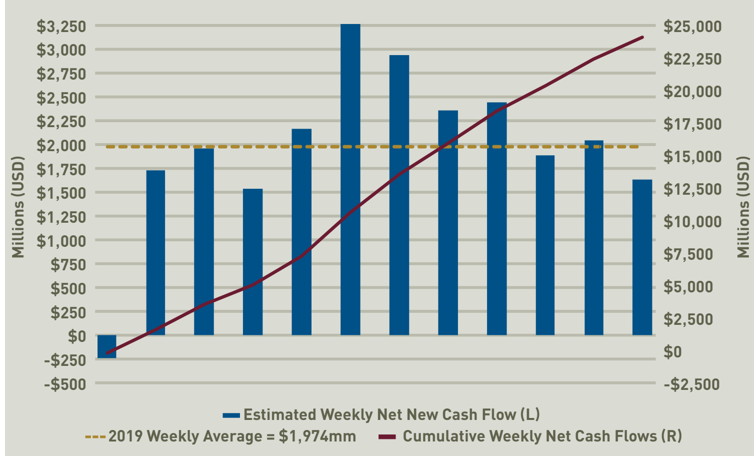
During the first quarter, municipal bond mutual funds experienced the strongest net inflows since such collection began in 1992. Through March 27, municipal bond mutual funds received $25.7 billion worth of net inflows, averaging roughly $1.98 billion per week. Weekly inflows were greater than $2.0 billion for over half of the quarter and peaked at $3.3 billion during the first week of February (Table 5). Some have attributed the surge in inflows to certain high rate taxpayers seeking substitutions for the newly curtailed state and local tax (SALT) deduction. The unprecedented strength of inflows contributed to the aforementioned relative outperformance of the municipal market thus far in 2019.

Issuance activity in the first quarter of the year accelerated by 14.4%, or $9.4 billion, compared to a historically weak first quarter in 2018 when the market was digesting the implementation of the Tax Cuts and Jobs Act (TCJA). Total volume for first quarter 2019 was $75.0 billion, compared to $65.6 billion in the prior year (Table 6). Issuance in January, February, and March totaled $24.7 billion, $26.1 billion, and $24.3 billion respectively. Specifically, January and February saw issuance increase by 14.7% and 45.2%, respectively, while March saw a slight decline of 7.0% from a year prior (Table 7). As issuers have familiarized themselves with the TCJA, the amount of refunding deals in the first quarter increased by 40.0%, or $3.5 billion, to $12.2 billion compared to the first quarter of the law's implementation. The increase in refunding deals roughly matched the 56.7%, or $2.8 billion, year-over-year increase in taxable deals brought to market during the quarter. Issuance from the nation's largest borrowers, California, New York, and Texas, increased 55.6%, 2.0%, and 29.7%, respectively, in the first quarter of 2019 from a year prior.

Municipal Credit Review

Municipal credit performance added to returns in the first quarter. Relatively positive news from Puerto Rico's restructuring spurred confidence among investors in lower quality debt. The rising tide from Puerto Rico, combined with a very favorable technical environment, and a pivot towards accommodative monetary policy by the FOMC also brought a stronger bid to investment grade bonds. Ten-year credit risk premiums for A-rated bonds responded particularly well, with spreads narrowing 11bps to end at 36bps above the AAA rate. Likewise, BBB-rated bonds narrowed 8bps, to close the quarter at a spread of 75 bps (Table 8).

TABLE 5
2019 YTD Mutual Fund Weekly Net New Cash Flows - Municipals

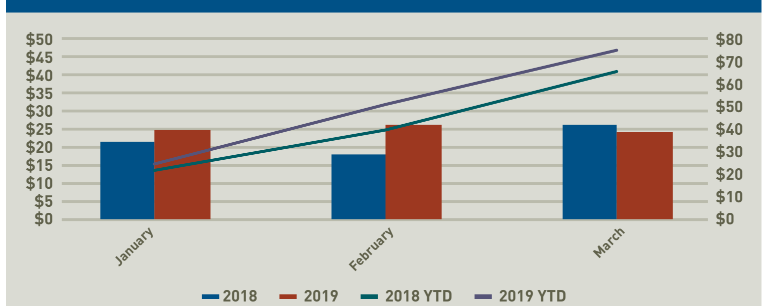


Source: Investment Company Institute

TABLE 6 Supply ($millions)	2018	2019	% YOY
QTD	$65,564	$75,027	14.4%
YTD	$65,564	$75,027	14.4%

Source: Bond Buyer; Thompson Reuters

TABLE 7
Monthly and YTD Muni Supply ($ billions)



Source: Bond Buyer; Thompson Reuters

TABLE 8	10-Year Municipal Credit Spreads		
Date	AA	A	BBB
12/31/18	16 bps	47 bps	83 bps
3/29/19	12 bps	36 bps	75 bps
Quarterly change	-4	-11	-8

Source: Thomson Reuters TM3-MMD

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Notable Credit Events in the Quarter

On February 4, Judge Laura Swain approved the negotiated settlement concerning $17 billion in Puerto Rico Sales Tax Financing Corporation (better known as COFINA) debt. Per the settlement, COFINA bondholders will receive 53% of future sales tax revenues with the balance flowing directly to the Commonwealth. Prior to the settlement, COFINA bondholders received 100% of Commonwealth sales tax revenues until annual debt service was accumulated. The settlement was achieved via a debt exchange where Senior bondholders received new COFINA securities representing 93% of their original holdings while Subordinate bondholders received new securities approximating 56% of their prior positions.

Despite the failed Amazon headquarters deal, the City of New York garnered an upgrade in March from Moody's to just a notch below Aaa. As a rationale for the upgrade to Aa1, the rating agency cited the city's "continued strengthening and diversification" of its economy, coupled with a "young and highly skilled labor pool", among other factors. Going forward, city officials will be challenged to maintain budgetary balance as a slowing economy and rising fixed costs pressure the city's finances.

In March, New Jersey Governor released his Fiscal Year 2020 state budget proposal. Through new tax revenues, departmental spending cuts and changes to public employee health care plans, the budget proposal forecasts an increase in the balance of the rainy day fund to over $1 billion. The largest source of revenue is $450 million expected from extending the millionaire's tax of 10.75% to incomes over $1 million. Almost $600 million of the planned $1 billion increase in spending is expected to come from an increase in pension contributions to $3.8 billion, reflecting 70% of the Annual Required Contribution.

Looking Ahead

After a strong fourth quarter of 2018, the municipal market followed with an encore performance in the first quarter. Accordingly, total returns favored longer-duration and lower credit quality portfolios. The Fed softened its stance on the economy in the first leg of 2019, which may portend economic weakness and the possibility of rate cuts as the year proceeds. While the total return backdrop appears favorable for the municipal sector for the remainder of the year, we would not be surprised if returns were flat to negative for 2Q19. Interest rates have declined significantly and may settle in current levels or even meander higher over the next few months. The current relative richness of municipals will impact the calculus for tax-sensitive buyers and could dampen investor demand for tax exempt bonds which could push relative yield valuations higher. Municipal credit performance added to positive returns in the quarter but that performance pushes already-stretched credit valuations even higher. In short, much of the performance for the year could have already occurred during the first quarter and positive returns for 2Q19 could be challenged.

If you have questions regarding this commentary, please contact Jamie Horn, Client Portfolio Manager, at Jamie.Horn@pnc.com or 215-585-5552.

INVESTMENT MANAGEMENT TEAM

Adam Mackey
Managing Director,
Municipal Fixed Income

Robert Howells
Portfolio Manager

William Bonawitz, CFA
Director of
Municipal Research

Lisa Kreiling, Ph.D., CFA
Senior Analyst

Kenneth Weinstein
Senior Analyst

Cesar Avila
Senior Analyst

William Davis
Quantitative Analyst

Daniel Salahub, CFA
Trader

Courtney Wood
Associate Trader

Jamie Horn
Client Portfolio Manager

Jeffrey Neer, CFA
Client Portfolio Manager

Phillip Sapovits
Managing Director,
Portfolio Analytics

Germán Sanchez, CFA
Research Associate

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Key Definitions

Slope: an increase in slope yield indicates that the economy may be functioning normally, that yields rise as maturity lengthens.

Basis point (bps):1 bps (basis point) is equal to 0.01%.

Indexes

The **S&P Municipal Bond Index** is a broad, market value-weighted index that seeks to measure the performance of the U.S. municipal bond market. The index includes bonds of all quality—from "AAA" to non-rated, including defaulted bonds — from all sectors of the municipal bond market.

The **SIFMA Municipal Swap Index** is a 7-day high-grade market index comprised of tax-exempt VRDOs reset rates that are reported to the Municipal Securities Rule Making Board's (MSRB's) SHORT reporting system. The index is calculated on an actual/actual basis and is published every Wednesday.

Indexes are unmanaged and not available for direct investment.

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All graphs reflect data, as of 3/31/19, unless otherwise listed.

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