Tax Efficient Fixed Income Market Commentary

January 2017

FIERA CAPITAL

Overview

- Presidential election shifts market dynamics; yields rise significantly
- Federal Reserve raises target federal funds rate as anticipated
- Fourth quarter closes out record year of municipal issuance
- CA and CT pension plans lower expectations for investment returns

Fourth Quarter Highlights

A trifecta of record municipal issuance, higher US interest rates and concerns over how the new administration's policies would impact municipal bonds led to one of the worst quarters for muni bond returns in recent memory. In the wake of such volatility, the Fed's decision to raise the federal funds rate by ¼ point in December proved anticlimactic.

Treasuries saw their yields rise steadily, ending the quarter 60-90 bps higher depending on the maturity node. The municipal market's movements were comparable to Treasury movements after initially underperforming post-election. In December, municipal yields fell modestly as some of the pessimism may have been overdone.

The magnitude of the increase in municipal yields prompted us to begin extending our portfolio durations modestly. Contributing to this decision is our belief that the consensus economic outlook may be overly optimistic and that seasonal factors are likely to become far more supportive of municipals during the first quarter. We employed tax loss harvesting in portfolios whenever transaction costs weren't prohibitive.

LOOKING AHEAD

We will be closely watching the developments out of Washington over the next several quarters. Tax reform will be of particular interest to the market participants. Revamping the tax code will be a complex process and there are many potential outcomes. We believe lower marginal tax rates are forthcoming. However, an outright repeal of the tax exemption of municipal bonds seems less likely. A relatively weak long-term correlation between marginal tax rates and Muni/Treasury ratios, coupled with the rise in yields post-election, may mean the market is already positioned for this outcome. Other significant policy areas include:

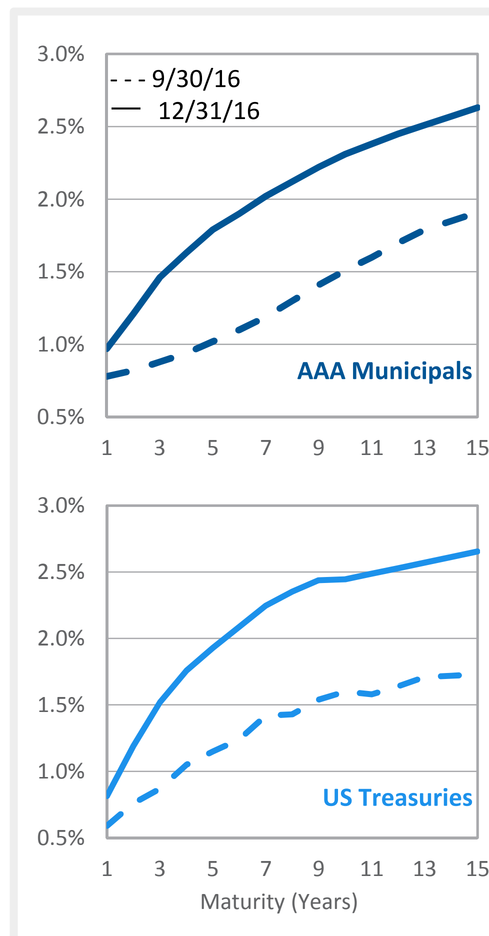
- **Health Care**: Repealing the Affordable Care Act is a top priority of the new administration. The details of the transition and subsequent replacement will be critical to the municipal healthcare sector.
- **Infrastructure:** An ambitious infrastructure plan is being targeted. The ultimate size and structure of any new federal program has the potential to either spur muni bond issuance or detract from it.

Market Returns

	4Q16	2016
BB Muni Index	-3.62%	**0.25%**
1 Year	-0.17%	**0.30%**
3 Year	-1.11%	**0.08%**
5 Year	-2.63%	**-0.39%**
7 Year	-3.67%	**-0.50%**
10 Year	-4.29%	**-0.12%**
20 Year	-4.52%	**0.49%**
1-10 Year	-2.62%	**-0.10%**
Prerefunded	-0.96%	**-0.01%**
AAA	-3.32%	**-0.17%**
AA	-3.44%	**0.05%**
A	-3.96%	**0.85%**
BBB	-4.45%	**0.35%**
Muni High Yield	-5.84%	**2.99%**
S&P 500	3.82%	**11.96%**

Source: Bloomberg Barclays

Yield Curves



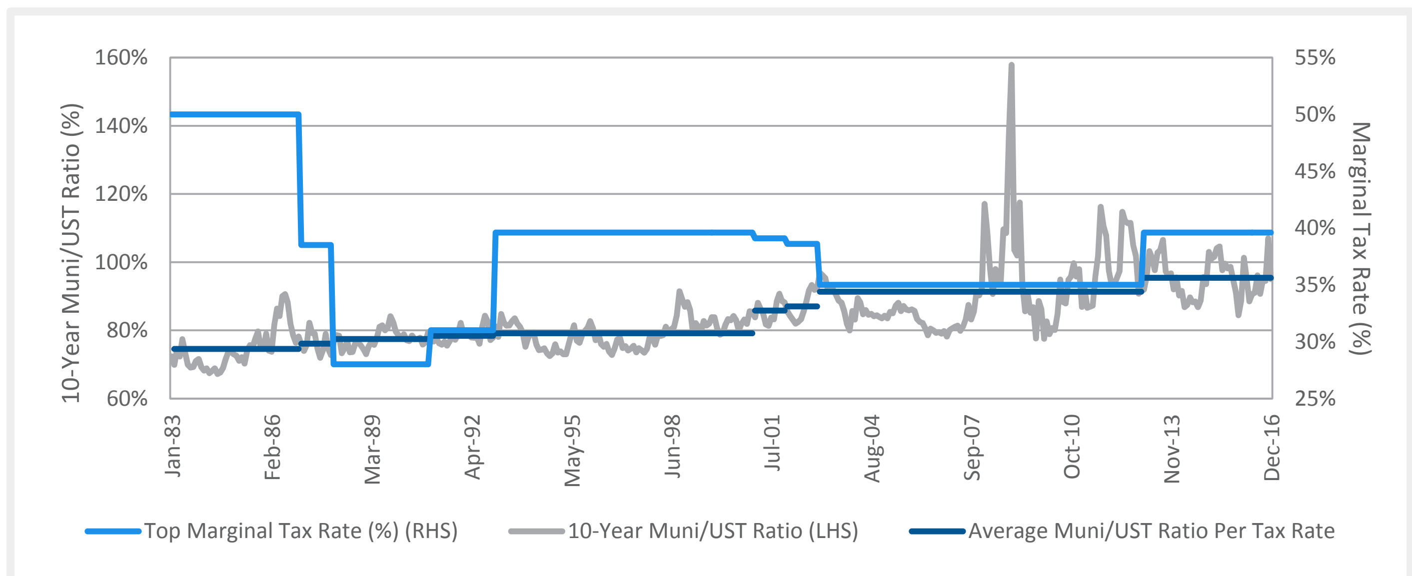
Source: Bloomberg

Past performance is not a guarantee of future results. Inherent in any investment is the potential for loss.

Tax Rates and Muni/Treasury Ratios

With the prospect of lower top marginal tax rates on the horizon, it is important to consider how lower rates may impact municipals. One key measure of relative value of municipal bonds is the ratio of AAA municipal yields to Treasury yields. One would expect that a lower marginal tax rate would result in higher municipal yields, and thus a higher Muni/Treasury ratio. However, the historical relationship between tax rates and ratios has not been particularly strong. The chart below shows the Muni/Treasury ratio during several key tax regimes since the 1980's.

10 Year AAA Muni/UST Ratio vs. Top Marginal Tax Rate



Source: Thomson Reuters and Tax Foundation.

Muni Market Factors

2016 was a record year for municipal bond issuance. The annual total of $445 billion surpassed the record set in 2010, driven by the pending expiration of the Build America Bond Program. Refunding continued to be a key driver of the elevated volume. The fourth quarter calendar was heavy at $104 billion and over half of that volume came in the month of October alone.[1] This likely reflected a desire for issuers to come to market ahead of the November election and December Fed meeting. Fund flows turned sharply negative following Election Day, reversing what had been a strong year of inflows. Outflows averaged $2.2 billion in the seven weeks following the election.[2]

Credit Insight

While much of the attention throughout the quarter focused on potential actions at the federal level, there were also important changes made by two states facing significant long-term pension liabilities. In December, the California Public Employees' Retirement System (CalPERS) approved a plan to gradually lower its targeted investment return from 7.5% to 7.0% over the next several years.[3] In the same month, the State Employees Retirement System of Connecticut agreed to lower its targeted return from 8.0% to 6.9%.[4] While lowering the discount rate does not change ultimate obligation to retirees, it does increase the size of the reported liability. A larger reported liability results in high required annual pension contributions. While the increased contributions add to employer budget strains, the result is more assets in the pension trust. Plan assets can potentially be invested more conservatively with a lower return target. The potential for increased contributions and lower volatility make lowering the discount rate a credit positive move, though one can argue the assumed rates are still too aggressive.

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IN DEPTH: DE MINIMIS

One way in which Fiera Capital structures portfolios to weather a rising rate environment is to purchase bonds that are less likely to be penalized by what is known as the "De Minimis" or Market Discount Rule. Given the abrupt rise in interest rates experienced recently, it seems a good time to revisit this rule and its implications for municipal bond investors.

To determine our exposure to the De Minimis Rule, we must calculate the market discount of a bond and compare it to the maximum amount of discount allowed by the tax code. A bond is determined to have a discount if it is purchased in the secondary market at a price which is less than the current amortized value of that bond. For bonds originally issued at a premium, the bond has a discount if it is purchased below par. If the discount is greater than the de minimis amount allowed by the tax code (equal to 1/4 point in price per year left to maturity), the income associated with the discount is taxable.

Crossing the de minimis threshold does not create taxable income if the bonds were purchased into a portfolio at a higher price. However, the rule still impacts these bonds. As yields rise, the price of a de minimis bond will fall more rapidly in order to compensate for the partial taxability of the bond to the next owner. This can have a significant negative impact on the value and return of a portfolio.

Generally we find that bonds which are at risk of crossing the market discount threshold do not offer adequate compensation for this risk so we prefer to own higher coupon bonds which limit this risk. However, in our experience, bonds that are already trading through the threshold often sell for less than their intrinsic value which is an opportunity we consider for our portfolios.

1 Source: The Bond Buyer as of January 1, 2017

2 Source: Lipper as of December 30, 2016

3 Source: CalPERS as of December 21, 2016

4 Source: State of Connecticut as of December 9, 2016

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Index Definitions:

- The Bloomberg Barclays Municipal Bond Index is a rules-based and market value weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of transaction of at least $75 million. The bonds must be fixed rate, have a double date after December 31, 1990, and must be at least one year from maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.
  - Subindices include: 1 Year (1-2 year maturities), 3 Year (2-4 year maturities), 5 Year (4-6 year maturities), 7 Year (6-8 year maturities), 10 Year (8-12 year maturities), 15 Year (12-17 year maturities), 20 Year (17-22 year maturities), 1-10 Year (1-12 year maturities).
- The Bloomberg Barclays Muni High Yield Index is composed of bonds rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.
- The S&P 500, or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.