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Notes from the Ambassador Bank Vault **November 7, 2016**

Our Market Take: Tax-Exempt Municipal Bonds Provide Advantage In Uncertain Times

"The only difference between death and taxes is that death doesn't get worse every time Congress meets." – Will Rogers

Tax-exempt municipal ("muni") bonds have become a preferred investment among savvy portfolio managers given their risk-adjusted returns, diversification benefits, tax efficiencies, and hedge against commercial bank balance sheets. This asset class has consistently out-performed other investment classes; and Ambassador Financial believes it will continue to do so over the long term, particularly as tax exempt municipal bonds represent a safe haven asset class that benefits from the "flight to quality" trade.

Tax-exempt munis perform differently than traditional asset/liability models suggest because pricing typically does not move directly with markets. **Said differently, when interest rates fluctuate, the yields on munis do not react in perfect correlation with Treasury instruments, mortgage-backed securities, or other taxable bonds.** This is due to numerous factors including the tax-exempt feature, which implies that a beta adjustment should be applied to the asset/liability modeling.

- The municipal bond asset class trades based on supply/demand fundamentals and headline risk rather than primarily on overall interest rate movements.
- There are seasonal supply shifts, which cause yields to rise and prices to fall.
- Because of the depth of investors in the muni market, tax-exempt munis often have strong liquidity characteristics.

There are often great buying opportunities for municipal bonds. For instance, headline risks emanating from news stories such as a possible Puerto Rico default can create a softening in the entire sector as the "baby is thrown out with the bath water." Historically, that has generally represented a phenomenal buying opportunity, particularly for banks as the focus is on stronger credits. Ambassador Financial, therefore, always examines negative headlines in the muni space closely as they can represent a green light to purchase strong credits for the long term.

The pre-tax yields of munis are historically cheap to Treasuries across the curve as spreads are well over 100%. Historically, munis are attractive when the pre-tax yields are around 85%-90% of Treasuries as the fully taxable equivalent yields (TEY) push them well above Treasuries. At the present time, pre-tax yields range from 110%-125% of Treasuries depending on the part of the curve, so taxable equivalent yields are extremely attractive. There is a tremendous opportunity to build a ladder of maturities across the curve. Depending on duration constraints, some banks are focusing the ladder on maturities in 5 to 10 years while others are building ladders with 10 to 15+ year munis. As an example, the TEY on 5 year munis is currently 2.15% while the TEY on 10 and 15 year munis is 3.25% and 4.10% respectively. These yields are even more attractive when factoring in the preferential risk weighting treatment of 20% on general obligations and 50% for revenue bonds.

Tax-exempt munis allow banks to diversify assets, improve tax efficiency, and provide a natural hedge against the core business. As rates rise - typically associated with a stronger economy - the loan portfolio should perform well from a credit perspective and banks will enjoy the benefit of increasing yields on prime based commercial loans. Conversely, if rates fall, tax-exempt munis enjoy better convexity characteristics than mortgage-backed securities meaning prices will improve at a greater rate. As declining rates are often associated with a slowing economy and perhaps a recession, munis provide an excellent hedge against any potential credit issues on the loan side. Furthermore, when investors flock into munis as a flight to safety, prices can move even higher generating outsized gains and total return.

Bank Qualified issuance has remained strong in 2016. Year-to-date, $19.66 billion has been issued, the highest amount at this point in the year since 2012. Over the past 5 years, the average monthly BQ issuance in November and December has averaged around $2 billion each month. The average supply issued over the past five years in January has been $1.5 billion. **This decreased issuance of almost $500 million in January often creates scarcity value in munis, causing spreads to tighten and yields to fall.** We expect to see a similar trend this year with elevated supply though November and the early part of December as municipalities try to issue before year end. The elevated issuance as year-end approaches often presents a buying opportunity as yields tend to move higher. Conversely, as yields typically fall in January with the limited supply, this is generally a good time for clients that need to harvest gains to sell tax-exempt munis.

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