Our Perspective

MID-YEAR UPDATE – JUNE 2017

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As we approach the halfway point for 2017, tax exempt bonds have returned a solid 4.20% YTD, outperforming Treasury returns of 2.64%.[1] Despite two rate increases by the Federal Reserve Board, and the strong possibility of a third increase later this year, AAA 10yr muni yields have declined 45bps and the AAA 30yr muni yield has declined 33bps YTD (see exhibit 1 below). Performance has been primarily technically driven as issuance has declined 13.3% YOY and muni fund flows have been positive. Muni returns have also benefited from political turmoil surrounding President Trump that has cast doubt on major policy reforms being enacted in 2017. While we continue to believe that the municipal bond tax exemption is safe, federal policy risk surrounding healthcare and tax reform for our asset class remains high for the remainder of the year.

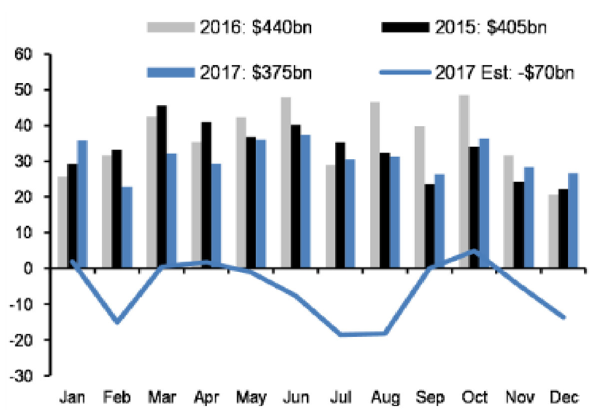
Exhibit 1: Municipal Bond Yields

Source: Thomson Reuters, Municipal Market Data

Supply and Demand

Overall, the supply-demand technical foundation remains supportive for municipal bond performance for the next few months. The current issuance forecast for 2017 is an estimated -$70bn of supply (see exhibit 2), which should be positive overall for performance, but will likely have the typical seasonal technical patterns of strong summer returns and weaker technicals in the fall months.

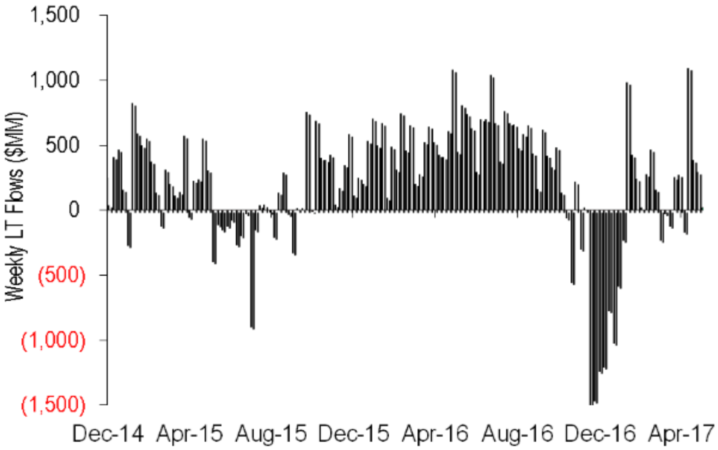
Exhibit 2: Issuance Forecast, $bn



Source: S&P, Bloomberg, Fitch, Moody's, TRACE, Thomson Reuters, J.P. Morgan

[1]Bloomberg Barclays Indices as of 6/26/17

Exhibit 3: Weekly Municipal long-Term Fund Flows

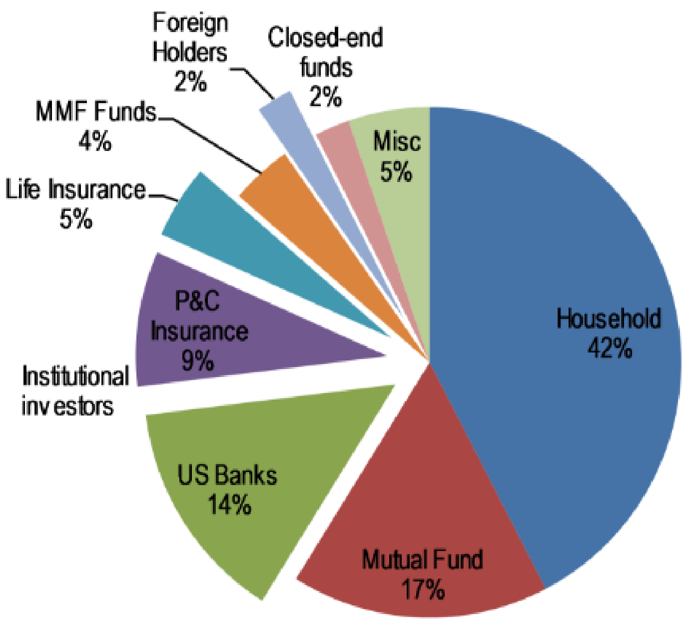


Source: Citi Research and Lipper

Municipal fund flows have been positive for 2017; with aggregate inflows of $7.3bn and overall change in tax exempt AUM that has totaled +$30.9bn.

We continue to believe the tax exemption for municipal bonds is safe from federal tax reform. However, Paul Ryan has promised to "fix this nation's tax code" by the end of 2017, and we believe a lowering of the corporate tax rate remains a high probability. As you can see in exhibit 4, corporations such as insurers and banks now own approximately 30% of the municipal market, and lowering the corporate tax rate is likely to lower their tax exempt investing going forward as munis would be less attractive versus taxable alternatives.

Exhibit 4: Proportion of the Municipal Market Held by Investor Classes



Source: Fed Flow of Funds, J.P. Morgan as of 3/31/17

Fundamentals

Fiscal and economic conditions for U.S. states and cities continue to exhibit modest improvement YOY, with first quarter revenues up 4.1%.[1] Despite the economic recovery, some states and cities are experiencing credit stress and may be running out of time to put their houses in order before another recession strikes. As we approach the new fiscal year on July 1st, as many as 15 states are still trying to reach budget agreements earlier this week. In addition, 18 of the 50 states have yet to reach the level of tax collection seen in 2008 (see exhibit 5 below). Negative headlines are likely to grow surrounding structural deficits and unfunded pension liabilities in several states (IL, NJ, PA, AK, KY, and CT). Only state and local credits that have had the political fortitude and strong fiscal management to build up budgetary reserves and enact pension reform will outperform in the next economic downturn.

Exhibit 5: 18 of the 50 States Have Yet to Reach the Level of Tax Collection Seen in 2008

	Real % Change from 2008 to 2016		
	Total	Sales	PIT
United States	5.1	7.2	10.0
Alabama	-2.6	1.0	1.0
Alaska	-89.4		
Arizona	-11.0	-12.0	-7.5
Arkansas	11.7	-0.3	5.6
California	17.7	4.8	29.0
Colorado	18.4	9.3	13.9
Connecticut	-2.7	-5.8	-1.8
Delaware	7.0		-5.3
Florida	-20.2	-14.8	
Georgia	2.7	-19.1	5.1
Hawaii	19.7	9.0	18.5
Idaho	2.6	3.0	-5.9
Illinois	6.4	1.8	19.1
Indiana	3.6	5.6	-4.0
Iowa	22.8	28.9	11.1
Kansas	0.2	27.4	-32.5
Kentucky	4.4	7.2	9.4
Louisiana	-24.7	-20.1	-22.1
Maine	-2.9	14.1	-11.6
Maryland	18.1	4.9	9.3
Massachusetts	10.1	32.3	2.8
Michigan	-1.4	-3.5	15.3
Minnesota	22.4	9.2	22.9
Mississippi	1.1	-8.7	3.3
Missouri	-0.2	-5.6	4.8

	Real % Change from 2008 to 2016		
	Total	Sales	PIT
Montana	-4.8		20.8
Nebraska	7.7	3.5	15.8
Nevada	11.2	16.0	
New Hampshire	4.5		-33.6
New Jersey	-8.3	-7.5	-5.7
New Mexico	-13.7	-6.0	4.7
New York	11.0	6.7	13.3
North Carolina	2.3	21.4	-2.5
North Dakota	42.8	50.3	-14.9
Ohio	-2.0	38.4	-26.1
Oklahoma	-9.3	2.5	-4.3
Oregon	24.6		20.0
Pennsylvania	3.6	2.6	2.1
Rhode Island	3.1	-2.9	0.8
South Carolina	-4.0	-11.7	3.5
South Dakota	16.9	14.9	
Tennessee	3.3	-8.7	-0.9
Texas	1.9	32.2	
Utah	3.2	-5.6	15.9
Vermont	5.1	-2.5	4.3
Virginia	-0.7	-5.5	4.4
Washington	10.4	6.4	
West Virginia	-6.5	-0.5	6.3
Wisconsin	5.1	5.5	3.1
Wyoming	-37.9	-41.8	

Source: S&P, Bloomberg, J.P. Morgan

[1]Census Bureau

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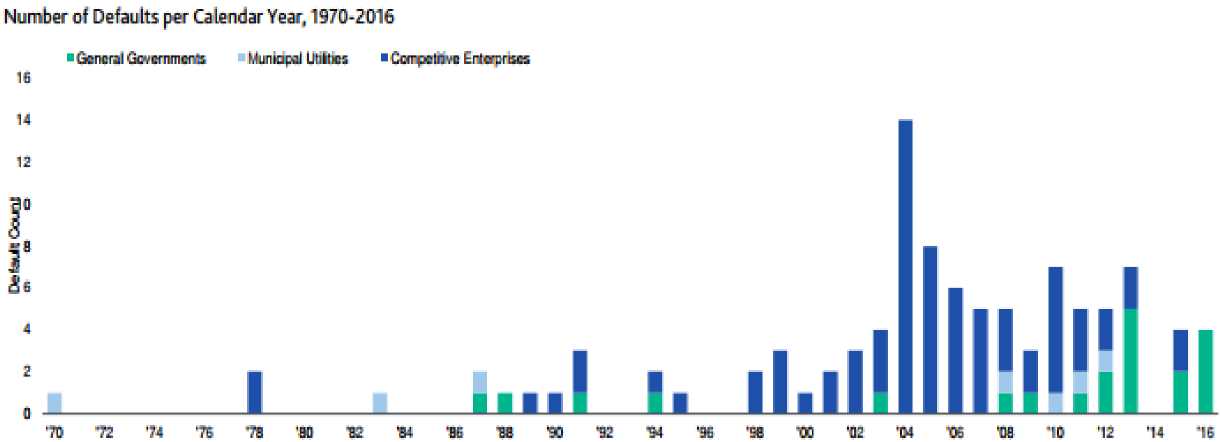
As we have repeatedly previously commented on, growing entitlement expenditures for pensions and healthcare is the primary credit issue facing our asset class. The fiscal squeeze for some states and cities caused by flat to declining revenues and growing expenditure pressures from the cost of retiree benefits is likely to increase due to an aging population and a huge backlog of vital infrastructure spending. If pension and healthcare costs continue to increase faster than revenues, the fiscal situation for some municipalities will weaken. While municipal defaults remain rare at 0.15%, particularly compared to corporate defaults at 6.92%[1], they have become more common in the last decade (see exhibit 6). The key credit drivers for the remainder of 2017 will surround possible policy changes on healthcare and tax reform and growing unfunded pension liabilities. We are most likely in the late stages of the credit cycle with limited potential for credit spreads to tighten significantly from here.

Exhibit 6: Overall Default Frequency Has Increased



Source: Moody's Investors Service

While the first half of 2017 has resulted in strong total returns for our asset class, policy risk will remain high for the remainder of the year and could result in substantial shifts in tax exempt investor demand. Given the sharp rally in tax exempt yields, and the relative tight credit spread environment, we believe current valuations are rich and upside potential is somewhat limited at this point. As a result, we will continue to use the strong technical environment over the summer months to establish a defensive up-in-quality credit posture heading into the fall months.

[1]Moody's U.S. Municipal Bond Defaults and Recoveries, 1970-2016