Municipal Fixed Income

Quarterly Market Commentary

Third Quarter 2015

Key Themes

- Global market events and continued speculation around short-term interest rate moves prompted volatility in the third quarter. The municipal asset class remained spirited and, ultimately, posted lower rates and positive returns for the quarter.
- Several states continued to work through the annual budgetary process and Puerto Rico's non-payment on appropriated debt illuminated an area of caution that many investors may not have traditionally considered.
- We continue to focus on sourcing A-rated revenue sector bonds. We expect municipal market fundamentals, such as supply and demand, to continue to positively influence the market in the near term.

Municipal Market Review

During a quarter marked by both equity and fixed-income market volatility, the municipal bond market remained resilient posting positive returns across the curve. Financial markets vacillated around anemic global economic growth rates, with particular consternation surrounding China's future growth prospects. Investor flight to the safe haven of U.S. Treasuries and sub 2% inflation measurements helped drive municipal bond returns (Table 1). For investors focused on after-tax total return, the tax advantages that municipal securities offer continue to provide a strong tailwind for investment in the sector. Long-duration assets, and notably mid- and low-grade credit rating groups, continued to perform best. The S&P Municipal Bond Intermediate Index led the way, posting a return of 1.74% for the quarter and 1.88% for the calendar year-to-date. Performance for the quarter and year-to-date can be attributed to declining interest rates across the municipal yield curve coupled with stable risk premiums across the credit curve in the municipal sector.

TABLE 1	S&P Municipal Bond Index Returns 3Q15			YTD Return
Index	Total Return	Price Return	Interest Return	2015
Main	1.71%	1.08%	0.63%	1.72%
Intermediate	1.74%	1.18%	0.56%	1.88%
Short-Intermediate	1.09%	0.71%	0.38%	1.44%
Short	0.63%	0.38%	0.25%	0.88%

Source: Thompson Reuters

After reversing course a few times throughout the quarter, municipal interest rates ended September on a downward trajectory. The 10- and 30-year AAA municipal rates ended the quarter at 2.03% and 3.04%, down 25 and 24 basis points (bps), respectively, from the close of the second quarter (Table 2). Disappointing global economic growth, low inflation, and declining commodity prices acted as bullish catalysts for fixed income rates.

TABLE 2	AAA Municipal Rates				
Date	2 Yr	5 Yr	10 Yr	15 Yr	30 Yr
12/31/14	0.48%	1.32%	2.04%	2.33%	2.86%
3/31/15	0.49%	1.24%	1.96%	2.45%	2.80%
6/30/15	0.63%	1.38%	2.28%	2.77%	3.28%
9/30/15	0.55%	1.27%	2.03%	2.52%	3.04%
Quarterly change	-8 bps	-11 bps	-25 bps	-25 bps	-24 bps
Annual change	7 bps	-5 bps	-1 bps	19 bps	18 bps

Source: Thompson Reuters

U.S. interest rate policy continued to dominate the narrative as the Federal Reserve Bank's Open Market Committee (FOMC) met twice during the quarter and opted not to increase the policy rate. It appears the FOMC is grappling with the perceived relative strength of the domestic economy juxtaposed against a possibly deteriorating global economy and the impact a U.S. rate increase will have on financial conditions abroad. This development was not remarkable to our team as it was noted in our 2015 outlook that we would not be surprised to see a zero interest rate policy continue into 2016.

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Continuing a trend that developed during the second quarter, mutual fund flows were negative for each month in the third quarter, with outflows totaling close to $3 billion over the period. Investors have supported the municipal sector year-to-date with positive flows, but certainly not with conviction. Supply continues to trend positively and new issuance for the period was $79.8 billion, up 13.6% when compared to third quarter 2014. Total volume year-to-date is far ahead of the consensus for 2015 which called for around $350 billion in gross issuance, representing 3.8% growth over 2014.

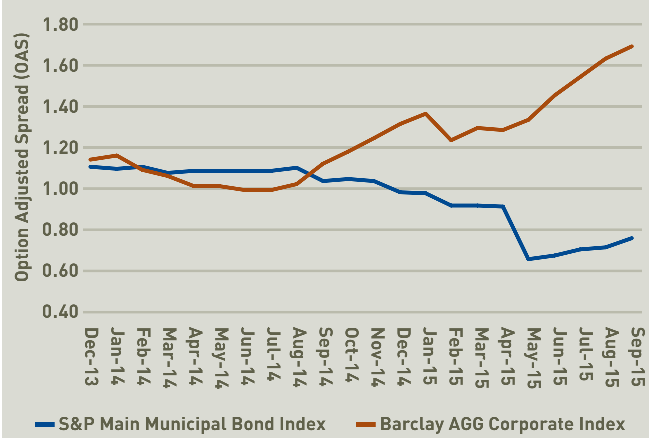
TABLE 3	10 Year Municipal Credit Spreads		
Date	AA	A	BBB
12/31/14	20 bps	54 bps	97 bps
3/31/15	23 bps	52 bps	93 bps
6/30/15	21 bps	54 bps	96 bps
9/30/15	20 bps	55 bps	97 bps
Quarterly change	-1 bps	1 bps	1 bps
Annual change	0 bps	1 bps	0 bps

Source: Thompson Reuters

Credit Highlights

Municipal credit risk premiums contracted as the perpetuation of low interest rates coupled with firming issuer fundamentals compelled investors to reach down the credit curve to enhance yield. Credit spreads on A and BBB rated bonds relative to AAA bonds were unchanged as each widened by 1bp by quarter end. Municipal risk premiums are essentially unchanged for the year (Table 3). This is notable as risk premiums as measured by Option-Adjusted Spread (OAS) have widened materially in both the high yield and investment-grade corporate (IG) credit sectors (Chart 1)[1]. Catalysts for widening in the IG sectors could be attributed to deteriorating credit fundamentals, record supply year-to-date, and declining valuation in the energy sector. We view the municipal sector to be at fair value from an OAS perspective as the drivers of the widening experienced in other spread sectors have not yet permeated the municipal sector. However, it is our assertion that it would be imprudent to ignore cross-sector credit conditions and we will continue to monitor all spread sector risk premiums as a potential precursor to municipal weakness.

CHART 1: Municipal vs. Corporate OA Spreads



Source: S&P and Bloomberg

Notable Credit Events

Appropriation

Appropriation-backed bonds typically require an annual budgetary allotment of general revenues by the issuing government for debt service payments to be funded. In August, two notable credit events were directly related to this particular sector and more can be read in the August publication Puerto Rico: The Case for Understanding Appropriation Risk in Municipals.

Most notably, on August 1, 2015, the Puerto Rico Public Finance Corporation failed to deliver a payment of approximately $60 million to bondholders given that such funds were not appropriated in the Commonwealth's fiscal 2016 budget. As non-appropriation is not considered to be an event of default under the bonds' terms and conditions, bondholders have very limited remedies to recover the unpaid funds. Accordingly, no subsequently due payments have been made since the initial August 1 non-payment and all of the non-payments remain unresolved.

Secondly, S&P downgraded Chicago Metropolitan Pier and Exposition Authority to BBB+ from AAA. This meaningful seven notch adjustment resulted from appropriation-related risk previously unforeseen by S&P. The appropriation-related risk is tied to the state and its lack of a fiscal year budget.

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State General Obligation (GO)
S&P upgraded California's GO rating to AA- from A+. The agency viewed favorably California's recent budget, which was built upon improving revenues and reflected continuing efforts to build reserves and pay down debt.

Puerto Rico released financial projections for the period spanning fiscal years 2016 through 2020. The Commonwealth has indicated that it will seek an unprecedented $14 billion in voluntary adjustments from bondholders to solve the gap, though specifics are not yet known.

Pennsylvania's Governor Wolf vetoed a temporary budget advanced by the Commonwealth's legislature. The veto message implies that negotiating a budget agreement covering the full fiscal year was the preferred solution.

Illinois remains without a budget one quarter into its fiscal year and the negotiating parties remain far apart. Current spending is on pace to greatly exceed planned revenue due to judicial decrees mandating large portions of the government expenditures. The state's overall financial standing has not been significantly impacted as of yet and no rating agencies have acted against the current ratings.

Public Power
The Environmental Protection Agency (EPA) announced the Clean Power Plan final rule which targets a reduction of greenhouse gas emission by the nation's power plants of 32% by 2030 from 2005 levels. Coal-fired power plants, as large emitters of carbon dioxide, will remain under pressure not only from regulatory headwinds, but also from cheap natural gas and cost-competitive renewable energy sources.

PNC Capital Advisors Composite Strategy Insights

PNC Capital Advisors' municipal strategies will continue to be both term structure and duration neutral relative to benchmarks. We continue to add exposure to select A category credits, particularly in the revenue sectors. We are looking primarily to the transportation, higher education, health care, and housing sectors for excess return in the composites. In the state GO sector, we do think Illinois will fare better in 2016 than it has thus far in 2015. GO debt issued by New Jersey, Pennsylvania, and Connecticut could present opportunities over the next few quarters if risk premiums continue to rise. We continue to remain overweight higher education, airport, and public power sectors in the composites, with an underweight in appropriated (state and local) and local GO debt.

Looking Ahead

While the total return prospects for the rest of the year could be challenging, the municipal sector is poised to perform well relative to other fixed-income sectors, including Treasuries, during the fourth quarter. The tax exemption continues to provide a strong after-tax total return tail wind. We are not focused on rate hikes by the Fed. We suspect if the Fed raises rates in the fourth quarter, it will have very little impact on the yield curve. Municipal credit stability will persist for the next few quarters in our view and there is little evidence that risk premiums will change materially for the rest of 2015. Year-end tax selling will most likely be muted this year, bolstering the municipal market technical position going into 2016.

If you have questions regarding this commentary, please contact Jamie Horn, Portfolio Specialist, at Jamie.Horn@pnc.com or 215-585-6864.

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[1] Option- Adjusted Spread is a measurement tool for evaluating price differences between similar products with different embedded options such as call, put or sink features. A larger OAS implies a greater return for greater risks