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Ron is a Senior Portfolio Manager focused on the Tax-Exempt Strategies. He has worked in the investment management industry since 1982. Ron received a B.A. in Business Administration from Adelphi University and is a CFA Charterholder and a member of the CFA Society of Orlando.



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Scott is the Director of Municipal Research for Seix Investment Advisors. He has more than 17 years of investment experience. He earned his MPA from USC and is a current officer of the National Federation of Municipal Analysts.

### CONTRIBUTORS

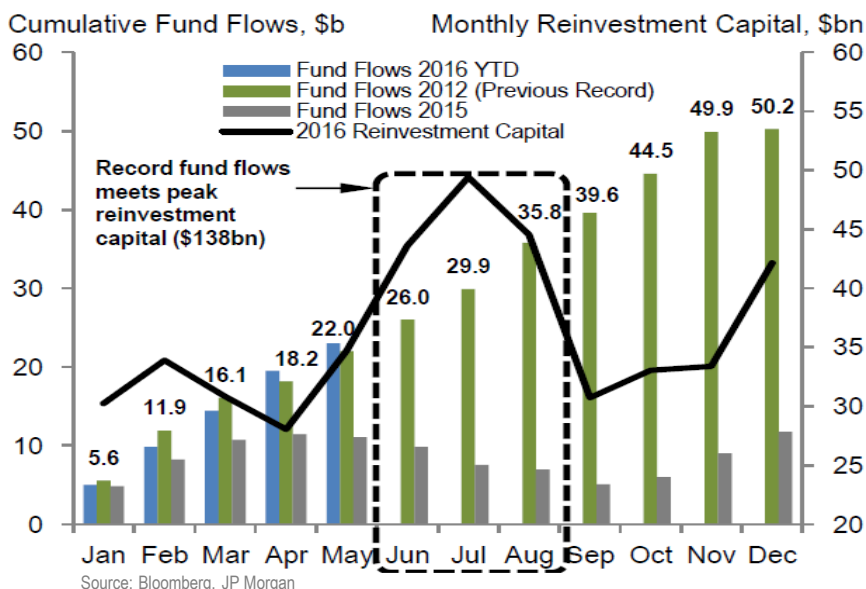
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Tax exempt fund inflows have been strong for 33 straight weeks setting a record for YTD aggregate inflows at \$25.3bn as of May 18<sup>th</sup>.<sup>1</sup> Municipal funds have now erased all of the 2013 outflows and tax exempt yields are at their lowest in five decades. As a result, spread compression has been broad based, with high yield sectors seeing greater tightening than investment grade as investors chase the riskiest credits for any incremental yield. The strong demand is likely to continue as the municipal market enters its peak reinvestment period over the next three months (see chart below). The strong market technical factors have resulted in rich valuations that do not reflect fundamental conditions that have weakened this year as a result of softening revenue growth and increasing entitlement expenditures.

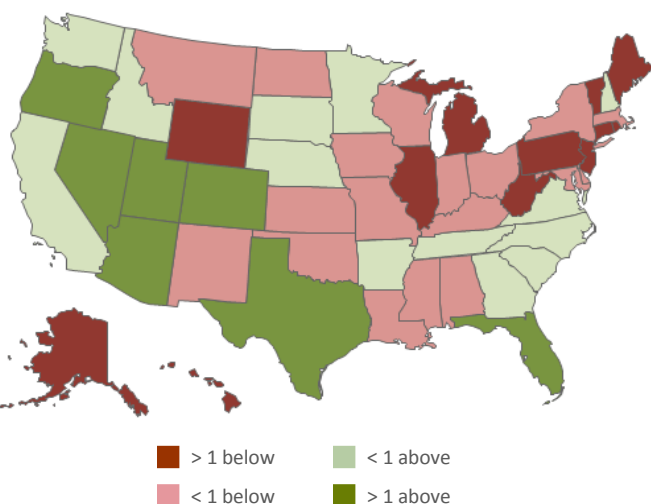


### Revenue Growth Has Softened for Most States and Has Turned Negative for Some

Tax revenue growth in 2016 has slowed in many states and for some it has actually declined from last year. With only one month left in fiscal year 2016, a remarkably high 22 states have a current operating shortfall. Several states have also recently announced notable budget deficits for the next fiscal year that begins on July 1st because of weaker than expected April income tax revenues. Moody's and S&P now have 11 states on negative credit outlooks. As we have previously discussed, the decline in oil prices is one of the primary reasons for a decline in revenues for the energy commodity states. However, even the non-energy states are experiencing softer tax revenues as a result of poor stock performance in 2015 and a more muted economic environment. S&P is now projecting lower or even negative GDP growth over the next few years for several states (see Exhibit 1 on next page). The Far West and South Atlantic regions should continue to outperform the nation due to dynamic demographics and continued economic growth (see Exhibit 2 on next page).

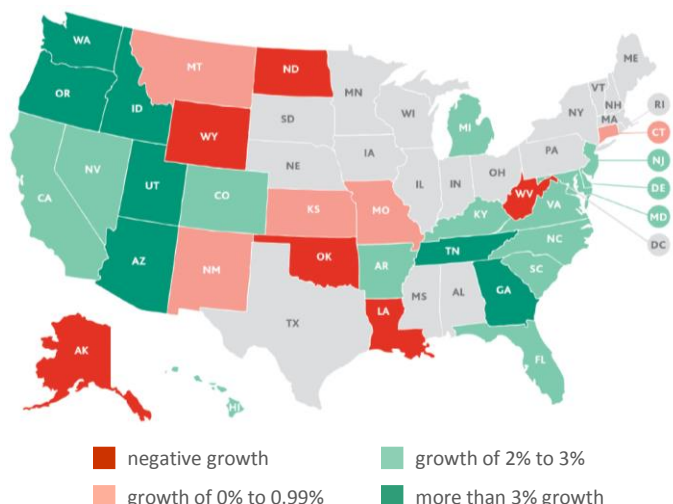
<sup>1</sup>JP Morgan Municipal Research, Lipper as of 5/18/16

**Exhibit 1:**  
Projected Compound Average Annual Real GDP Growth 2016-2019  
(Standard deviation above/below U.S.)



Source: Standard & Poor's – Calculation using IHS/Connect projected growth rates

**Exhibit 2:**  
Regional Economic Trends Play Key Role in Tax Revenue  
(Employment growth from March 2015 to March 2016)



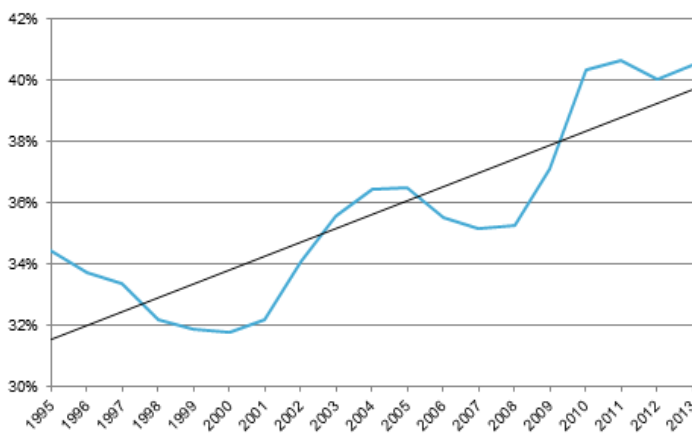
Source: U.S. Bureau of Labor Statistics

### Pension Expenditures Are Increasing

Lackluster stock returns are not only hurting state revenues, but are also negatively impacting U.S. state and city pensions. Public pension systems posted their worst results since the financial crisis, recording a median increase of 0.36% for 2015, and only 1.24% in the first quarter, falling far short of their 7%-8% targeted annual returns.<sup>2</sup> Pension asset growth has not kept pace with unfunded liabilities as a result of weak investment returns, inadequate contributions and the graying demographics of public workers. State pensions had 74 percent of assets required to meet obligations to retirees in fiscal 2015, down from 77 percent in the prior year.<sup>2</sup> As you can see in Exhibits 3 and 4 on the next page, growing entitlement expenditures for pensions and healthcare are increasing while capital spending is declining. The fiscal squeeze 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.

<sup>2</sup>Bloomberg, Wilshire Trust Universe Comparison Service

Exhibit 3:  
Entitlement Benefits as a Share of Total State Expenditures



Source: Standard & Poor's, U.S. Census Bureau

Exhibit 4:  
Capital Outlay as Percent of Total State Expenditures



Source: Standard & Poor's, U.S. Census Bureau

We are now in the seventh year of the economic recovery from the Great Recession. Despite the economic recovery, some states and cities are still experiencing credit stress and may be running out of time to put their houses in order before another recession strikes. 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. As we have previously stated, we continue to believe long term rates will remain lower for longer and we remain constructive on the municipal sector over the next several months because of its tax exempt income, strong technical factors, and compelling yields compared to other global fixed income rates. That being said, we believe that muni fundamentals most likely peaked in 2015 and we are in the late stages of the credit cycle with limited potential for credit spreads to tighten significantly from here. As a result, we have been upgrading our portfolios to take advantage of the strong technical environment.

The assertions in this perspective are Seix Investment Advisors' opinion.

**BofA Merrill Lynch Municipal Master Index** tracks the performance of the investment-grade U.S. tax-exempt bond market. Qualifying bonds must have at least one year remaining term to maturity, a fixed coupon schedule, and an investment grade rating (based on average of Moody's, S&P, and Fitch).

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