May 2016

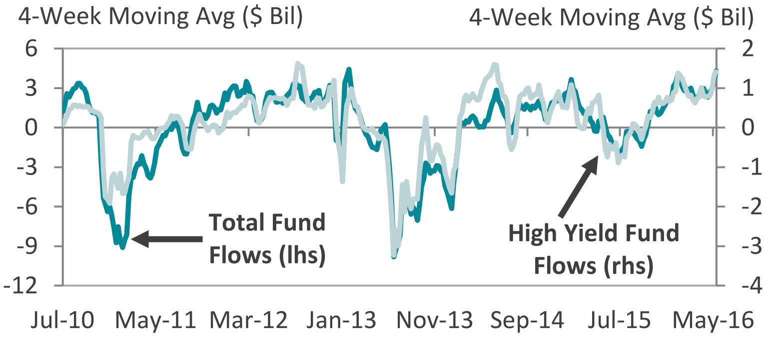
No Thanks, We'll Pass

"Muni bond yields set record low with funds awash in cash." "No price too steep for high-yield muni funds desperate for bonds." "Foreign banks and pension funds look towards municipal bonds." The three-year bull market in municipal bonds has been well reported in the media and both traditional and non-traditional investors in U.S. Municipal debt cannot seem to get enough. While many investors in, and issuers of, municipal debt are rejoicing, we have found opportunities in the current environment increasingly sparse. Whether viewed versus U.S. Treasuries, taxable Corporates, or just in an absolute sense, valuations are historically tight and increasingly stretched.

Persistently strong mutual fund demand has served as a powerful driver of Municipal valuations. Overall industry flows have now been positive for each of the last 33 weeks and High Yield flows have also been noteworthy. With much of the world's developed bond markets in negative yield territory, even foreign investors have become interested in Municipals. As has been the case since the Financial Crisis, new issuance has barely been adequate to satisfy ordinary principal and interest reinvestment, let alone these strong new capital flows. In this environment, our outlook has become reflexively cautious as rates and spreads have moved lower. Simply put, in fixed income, what is good for returns today often hurts returns in the future.

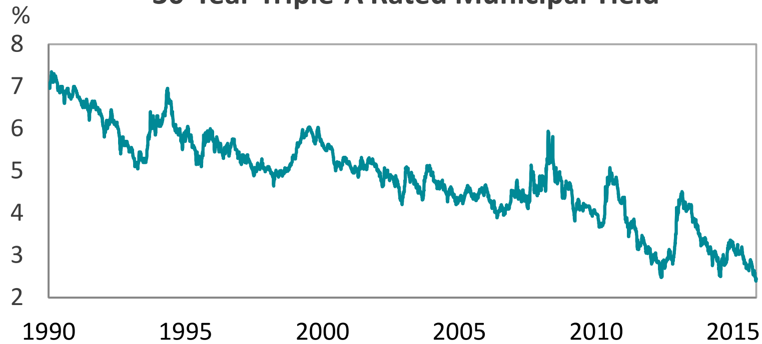
Whereas the taxable Corporate bond market has endured nearly a two-year bear market, credit-sensitive Municipals have been strong performers, particularly in High Yield. Unlike Corporate bonds whose High Yield sector is defined by non-investment grade ratings, High Yield Municipals may have investment grade ratings. Much less developed and diversified than in the Corporate bond market, High Yield Municipals have pronounced concentrations in legacy tobacco settlement bonds (issued pre-Crisis) speculative real estate developments, corporate-run projects, and senior care facilities. Recent additions to this list in the last couple of years include obligations from Puerto Rico. Few High Yield credits satisfy our underwriting criteria.

Municipal Fund Flows



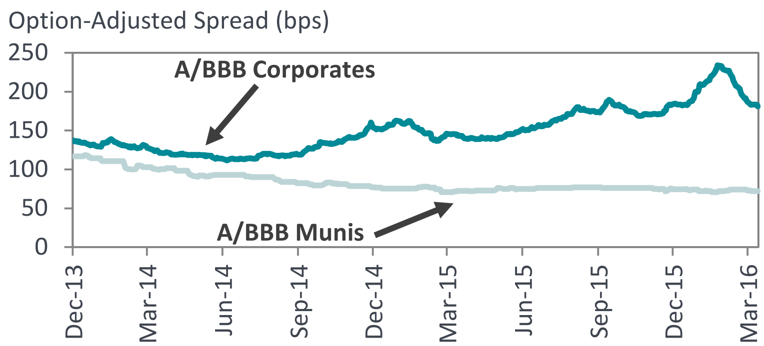
Data as of July 7, 2010 to May 18, 2016
Sources: Lipper U.S. Fund Flows and BBH Analysis

30-Year Triple-A Rated Municipal Yield

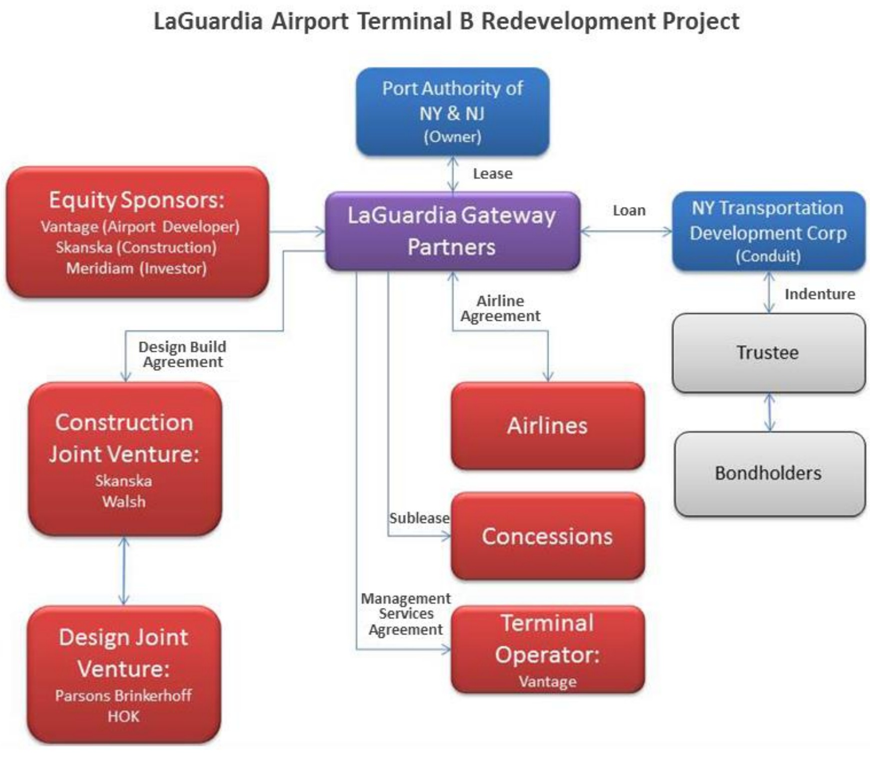


Data as of July 16, 1990 to May 20, 2016
Sources: Thomson Financial Services and BBH Analysis

A Tale of Two Credit Markets



Data as of December 19, 2013 to March 31, 2016
Sources: Bloomberg, Merrill Lynch, Thomson Financial , and BBH Analysis



Source: BBH Analysis

We recently passed on one of the year's marquee new issues, a $2-plus billion deal to fund improvements for New York City's LaGuardia Airport. The deal had underlying ratings of middle-to-low triple-B with a level of complexity that we have rarely seen (as shown on the right). The risk of construction delays permeates the project as its stages are largely sequential in nature. There are many ways that delays can occur from permitting, to geological challenges, to congested access, and to contamination remediation. Financial responsibility for delays shifts between parties depending on the stage of the project. Consequently, appropriately evaluating this deal requires underwriting several construction-related obligors, in addition to the airport. Construction must occur around an active terminal and the lease requires that 33 out of Terminal B's 35 gates remain active at all times. This is no simple project. Even if we assume construction is completed according to plan, on-schedule, and airport traffic growth materializes as projected, we would be left with an airport that does not satisfy our criteria, based on its leverage metrics.

While we are regular investors in other airport debt, the LaGuardia deal was far from regular. Saying no to LaGuardia was not difficult given the deal's complexity, credit weaknesses, and downright meager yields. With an order book exceeding $20 billion, demand for LaGuardia bonds was intense and pricing reflected it. At over $500 million apiece, the two largest securities in the deal mature in 2046 and 2050. We were incredulous that bonds with the long list of aforementioned risks and these extended maturities would only offer yields close to 3.3%, with option-adjusted spreads of only 100 basis points above triple-A rated Municipals. This is what we would call an issuer's market!

Our credit work serves as the foundation of our investment process. When an issuer fails to satisfy our criteria for a durable credit, we will not invest. If we lack the confidence that a credit is money good, its yield simply does not matter to us. Deals like LaGuardia highlight that the current environment calls for caution and healthy reserve balances, not exuberance. These days, we find ourselves saying "no thanks" quite often as Municipal bond demand has become increasingly indiscriminate — our attention to capital protection and value demand it. The current fervor for Municipals won't last forever. When it finally does end, a much wider range of opportunities will emerge. For now, we largely find ourselves to be spectators.

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RISKS

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax. The interest payments of TIPS are variable, they generally rise with inflation and fall with deflation. The adjustment to a security's face value is taxable income on the income earned every year including the increase in value of the bond should rates fall.

The Consumer Price Index is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

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