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Perspectives: Alpine View™

1Q/17 Fixed Income Review & Outlook

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What will the impact of Trump's proposed infrastructure spending likely be for municipal bond investors?

Mark Taylor: We believe the infrastructure spending plan in its current form may have a moderately positive impact to the Municipal bond market. President Trump has proposed a very large infrastructure spending plan totaling approximately $1 trillion over a 10 year period. The plan, which is short on details, includes $137 billion in federal tax credits to private investors tied to transportation related projects. Such a plan claims to be revenue neutral as the tax credits provided to private construction companies would be offset by tax revenue generated by new construction worker jobs as well as additional income derived from the construction companies' profits. Without revenue neutrality, it is unlikely that fiscal conservatives in Congress will vote for the plan. We could see a positive impact for the Municipal bond market with increased supply if the final plan were to include significant funding to incentivize states and local municipalities to issue tax-exempt debt to finance a portion of certain infrastructure projects.

Under the plan, Alpine believes that a number of large infrastructure projects are designed to be accomplished through the private sector using tolls or user fees to pay for a project's cost. The plan does not directly finance new infrastructure such as bridges, roads and water & sewer systems, rather it provides tax breaks to the private sector companies that finance profitable construction projects. Therefore, without the use of more traditional infrastructure financings options, including, the issuance of tax-exempt debt by state and local governments, federal grants and federal highway aid, many infrastructure improvements may not be addressed by the plan.

Tax rates are thought to be coming down. How will this likely affect municipal prices and yields relative to taxable bonds?

Mark Taylor: The Trump administration is expected to focus on tax reform now that Congress has failed to pass the American Health Care Act in late March. Alpine believes that any successful tax reform passed by Congress will likely have a minimal to moderate negative impact on Municipal bond yields. However, in our opinion, Municipal bonds should still provide more favorable risk adjusted yields than similarly maturing taxable corporate and Treasury securities. Alpine's base case for tax reform for individual tax rates places the top tax rate at 35%. We doubt Congress will lower the top tax rate to 33% as proposed by the Trump administration without further expense reductions to make the tax cuts revenue neutral.

What is your perspective on the looming pension crisis that many states face, how might that play out and how might it impact the municipal market?

Jonathan Mondillo: More than half of U.S. states do not currently fully fund their pensions on an annual basis. States with the largest shortfalls are Kentucky, New Jersey, Illinois, and Texas. These states are also among the highest for unfunded pension liabilities. Unfortunately, for local municipalities within struggling states, problems could start to roll downhill as they try to push more of the burden to local governments through decreased revenue distributions, which as of 2014 made up 32% of local government revenues. And while we feel it's important to not shy away from investing in these states, we feel investors are better off focusing on revenue backed bonds rather than tax backed bonds.

The risk of making investments in states that have high unfunded pension liabilities is real and can present difficulties, but it also can create an opportunity to capture additional yield.

As pensions put added stress on municipalities both at the state and the local level, it is our belief that situations that were seen in the Detroit bankruptcy will become more common place. Seeking relief from outsized pension and debt burdens, municipalities will ultimately force bondholders to take haircuts. This outcome seems the most likely scenario versus forcing pension holders to take losses which would be politically unpopular.

We haven't heard much about Puerto Rico's debt situation lately. Can you provide an update?

Mark Taylor: In mid-March, the Oversight Board for the Commonwealth of Puerto Rico approved Governor Ricardo Rossello's long term fiscal plan. Overall the plan is worse for bondholders than expected with only $7.9 billion of net cash flows available to pay $35 billion of debt service over the next decade or less than a 23% recovery. As a result, uninsured Puerto Rico General Obligation bonds 8% coupon 2035s initially sold off from about $73 to $67 and were recently trading below $65. Alpine continues to only hold Puerto Rico bonds that are insured by a "AA" rated bond insurer as we believe the uninsured bonds are not a good value and may continue to deteriorate in price.

Many claimed increased regulations in the securities and banking industry led to reduced liquidity for securities like municipals (higher capital requirements for banks with municipal desks for example.) With the expectation for reduced regulation (rollback of Dodd Frank) does your outlook include any material improvements in liquidity for municipal bonds?

Jonathan Mondillo: With the potential for increased issuance in order to fund infrastructure in the United States, as well as potential tax reform, it is our hope that some level of reduced regulation will occur. If tax policy at the corporate level changes dramatically, we see possible decreased demand from insurance companies on the long end of the municipal bond curve.

In this instance, allowing banks to take on more municipal debt by repealing parts of Dodd Frank will be important for the overall liquidity of the marketplace.

Any changes in our views of education and charter schools with new Board of Education leadership?

Mark Taylor: The new Secretary of Education, Betsy DeVos, is known for being pro charter schools. In general, this should bode well for the charter school sector as she has focused on expanding student choice in education. Additionally, DeVos is in favor of school vouchers which dovetails well with President Trump's education platform that calls for a $20 billion voucher program focused on low income families.

Apline's view on the education sector remains neutral to slightly positive. The new administration has indicated that there is a good chance of a reduction of federal mandates placed upon local school districts. Although Common Core is not technically a mandate, states did put themselves in a better position for federal education funding under the prior administration when they adopt Common Core standards. Favorably, the new administration's philosophy is likely to put fewer restrictions on its federal aid to local schools going forward which should be positive for the sector.

What's your outlook for the remainder of 2017 and what expectations should investors have for both the Ultra Short Municipal Fund and the High Yield Managed Duration Municipal Fund?

Jonathan Mondillo: Our overall outlook for the rest of the year is to see increasing interest rates both at the short end and the long end of the municipal bond curve. With the Federal Reserve stating 2–3 additional rate hikes for 2017 and starting to decrease positions on their balance sheet, this should put pressure on interest rates. As we have seen through the first quarter of 2017, interest rates are going to be volatile, and in our opinion they will continue to behave this way on their path higher.

Despite yields being higher across the credit spectrum following the presidential election, credit spreads have tightened. Immediately after the election credit spreads widened but have since retraced and tightened to pre-election levels. This spread tightening is most apparent in maturities out past 7 years, and with the exception of some opportunistic buying that we have been doing over the past three months, the most recent tightening only reiterates, in our opinion, the need to maintain higher levels of high grade paper in both strategies, especially further out in duration.

We see a continued credit deterioration in tax backed municipal bonds from states with high unfunded pension liabilities such as Illinois, New Jersey, Kentucky, Pennsylvania and Connecticut. As such, we will continue to monitor the situation and expect to maintain our underweight positions with regard to general obligations from these states, along with select local municipalities that have come under stress as well.

In terms of sector positives and negatives, we like the Continuing Care Retirement Community (CCRC) sector along with Charter School's on a state by state basis. With an aging demographic, we see a continued demand for quality senior living facilities in the US. And with an emphasis on education, in particular alternatives to traditional public education, we think Charter Schools will continue to be an area of value, albeit on a case-by-case basis given it's a highly politicized issue. We see the Tobacco space and Hospitals as areas of more caution. With smoking trends continuing to decline, increased use in electronic cigarettes and vaporizers, and higher taxes on cigarette purchases, we see the space as volatile. The Hospital sector we remain cautious on as well given the Republican's continued efforts to repeal the Affordable Care Act, which in large part was a benefit to Hospital revenues. That being said, there are opportunities on a case by case basis with larger multi-site/state hospital systems that may have traded down due to the negative headlines following the November election.

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