**Quarterly Commentary Q4 2017: Leveraged Enthusiasm**

The Trump Administration registered its first legislative victory with the passage of its Tax Reform package. Equity markets have received the news with open arms pushing stock markets higher in anticipation that the new lower corporate tax rate would lead to further investment, job growth and profits. Debates surrounding how the benefits might affect middle income individuals seem to be unclear as tax savings may be offset by the reduction or elimination of some prized deductions. How corporations intend to utilize their new windfall remains to be seen. Some CEOs have stated they intend to use their new found monies to buy back stock, which would do little to help working individuals.

The debate over the impact of the tax cuts will be unknown for a period of time, but estimates reveal that these cuts won't be revenue neutral and will add at least $1 trillion or more to the deficit over the next 10 years. This is concerning because the gross federal deficit is currently more than 100% of GDP. With monetary policy that has seen the Fed Funds rate increase three times in 2017, more increases are likely in 2018 and with quantitative tightening growing, increasing the federal deficit further could create diminishing returns on the tax cuts. During an environment in which outstanding debt and leverage are at elevated levels, higher interest rates make servicing the debt burdensome and provides an environment which will incentivize deleveraging. This could be a counterbalance to the Trump administration's objective.

While corporations may work to lessen their debt load as the cost of carry increases, the same can be said at the individual level. During what has been a prolonged equity rally consumer spending has been solid, even in the face of substandard wage growth. Ultimately, borrowing has supported this behavior. While the tax cuts should provide some added cushion in individuals' paychecks, the windfall may not be enough to offset previous spending behaviors, thus slowing potential growth prospects.

Brexit negotiations have continued to meet with limited headway in ironing out trade related details in the UK's exit from the EU. Discussions have become so contentious that talks of a possible second referendum have been swirling with both sides ("leave" and "remain") fairly confident they would be victorious. While the likelihood of another vote seems remote, talks between the EU and UK are beginning to show signs of fatigue as a recent EU guidance stated the UK would become a "third country" forcing UK firms to relocate to Europe or risk seeing existing trade contracts terminated if a deal isn't reached. In spite of the turmoil, the Eurozone has shown continued positive growth lead by Germany and France. This continued growth has put additional pressure on US dollar.

The proposed tax plans brought by the both the House and Senate had the potential to reshape the municipal market landscape. The final signed bill dampened down some of the original proposals minimizing the overall impacts of the legislation. The most immediate impact will be a smaller supply in the upcoming year. As the tax proposal loomed, many municipal issuers brought 2018 deals to market in December in order to avoid any potential fallout from the new law. Private activity bonds, which typically help fund hospitals, airports, and electrical utilities, to name a few, the exemption was left untouched. Advanced refundings, which allow issuers to take advantage of refinancing opportunities, lost their tax-exempt status, putting additional financial stress on municipalities and potentially adding a hurdle to infrastructure projects.

Demand impacts could be a bit more of a mixed bag. Retails investors, who make up a disproportionate component of the investor base, should continue that trend as the cap on state and local tax (SALT) deductions may increase investor appetite. Feeding into this theory is the fact that while the top marginal bracket was reduced the move wasn't significant enough to provide a material impact to demand. Bonds subject to the alternative minimum tax (AMT) could face yield compression due to the new provision that

would see fewer individuals subject to the tax and therefore AMT bonds would trade closer to non-AMT bonds. On the contrary, corporations, insurance companies and perhaps banks, having seen the corporate tax rate reduced to 21% should see their demand for municipals wane somewhat.

Passage of tax cuts created excitement among equity investors, as well as an avalanche of municipal issuance. The heavy December municipal primary calendar was absorbed by market participants, but led to a mixed performance as US Treasuries outperformed in the short end while municipals performed better in longer dated securities. As the outlook on the Fed to raise short term rates multiple times in 2018 grows, the yield curve continues its flattening trajectory. US Treasury outperformance in shorted dated maturities resulted in yield ratios once again reflecting relative value all along the yield curve.

| **US Treasury Yields** | | | |
|---|---|---|---|
| | 9/30/2017 | 12/31/2017 | Change |
| **1 Year** | 1.31 | 1.72 | 41 bps |
| **3 Year** | 1.65 | 2.01 | 36 bps |
| **5 Year** | 1.95 | 2.20 | 25 bps |
| **10 Year** | 2.34 | 2.42 | 8 bps |
| **20 Year** | 2.67 | 2.60 | -7 bps |
| **AAA Municipal Yields** | | | |
| | 9/30/2017 | 12/31/2017 | Change |
| **1 Year** | 0.92 | 1.44 | 52 bps |
| **3 Year** | 1.13 | 1.59 | 46 bps |
| **5 Year** | 1.37 | 1.70 | 33 bps |
| **10 Year** | 2.00 | 2.01 | 1 bp |
| **20 Year** | 2.70 | 2.51 | -19 bps |

While the passage of the tax reform package has been viewed positively by equity investors and companies alike, the exuberance should be tempered. Initial impacts of the cuts may be positive, however true merit has to be judged over an economic cycle. If the forecasts are even partially correct regarding the tax reform package adding to the country's bulging debt burden, and it serves to hamper continued economic prosperity, then enthusiasm may dwindle.

All the best,

R. Scott Richter

Tobias M. Tolino

RICHTER BOBER
ASSET MANAGEMENT