LPL RESEARCH
BOND MARKET PERSPECTIVES

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MUNICIPAL CHECK-IN

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KEY TAKEAWAYS

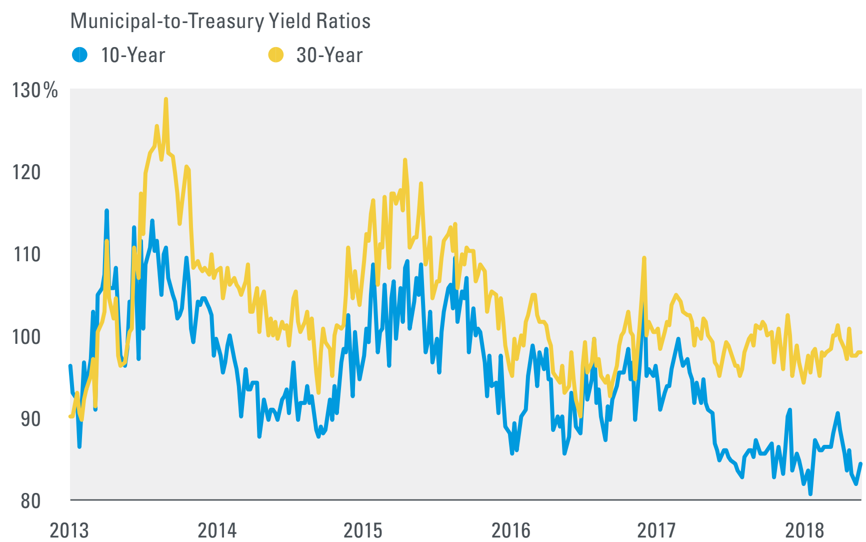
Municipal bonds have outperformed broad high-quality fixed income since early 2017.

Valuations relative to Treasuries are quite elevated as a result.

Credit quality trends remain positive and defaults remain low as the market adjusts to lower supply post-tax plan.

Municipal bonds have held up well year to date, given the significant rise in interest rates across the yield curve, leading to expensive valuations by some measures. The Bloomberg Barclays Municipal Index has notched a total return of -0.9% year to date through May 24, 2018. The Bloomberg Barclays U.S. Aggregate Index, a broad proxy for high-quality bonds, returned -2.2% over that same period. Since early 2017, municipals have outperformed by even more, at 4.5% vs. 1.2%. This has richened municipals relative to Treasuries, as evidenced by quite low municipal-to-Treasury yield ratios [Figure 1] (the 10-year ratio has been below current levels just 5.6% of the time over the last 10 years). So while the outperformance over the last 18 months has been notable, it has left municipals on the expensive side relative to Treasuries.

1 MUNICIPAL OUTPERFORMANCE HAS LED TO EXPENSIVE VALUATIONS



Source: LPL Research, Bloomberg 05/25/18

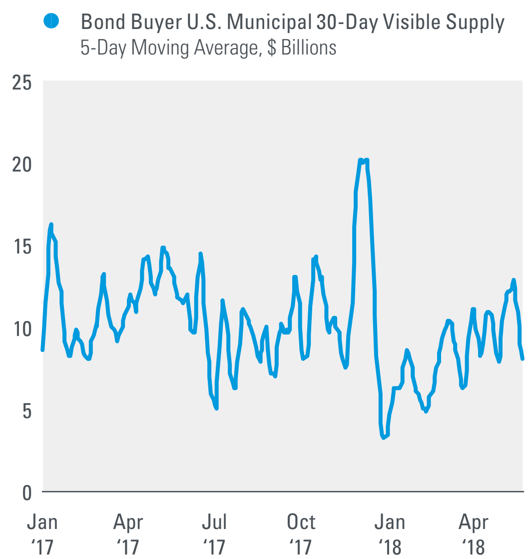
The Municipal-to-Treasury Yield ratio compares the current yield of municipal bonds to US Treasuries of the same maturity. If the ratio is at 100%, it indicates that the yield on an AAA-rated municipal bond is the same as a Treasury security of the same maturity. The ratio can be used as a gauge of price levels of municipal bonds relative to Treasuries.

Past performance is no guarantee of future results.

SINKING SUPPLY

One tailwind for the municipal market year to date has been supply—specifically the lack thereof. Changes to rules around what types of municipal issues qualify for tax-free treatment are partially responsible. While only advance refunding bonds were denied tax-free treatment in the 2017 Tax Cuts and Jobs Act, markets were concerned that private activity bonds would similarly be denied tax-free treatment. As a result of this uncertainty, the fourth quarter of 2017 saw very heavy municipal supply ahead of the bill's likely passage, which weighed on the market. However, we've seen lower-than-average supply year to date as a result; and that, coupled with consistent demand, has helped municipals outperform the broad high-quality bond market so far this year.

2 MUNICIPAL SUPPLY LOW IN 2018 AFTER HEAVY END TO 2017



Source: LPL Research, Bloomberg 05/25/18

LEGISLATIVE CROSSWINDS

One factor driving optimism within the investment-grade municipal market is their new designation as high-quality liquid assets (HQLA) to satisfy capital requirements on banks' balance sheets. Post-financial crisis regulations have mandated that banks hold certain amounts of cash and/or other securities on their balance sheets, relative to the size of the bank and its lending practices. This is to ensure they have sufficient cash, or securities that can easily be converted to cash, on hand in case of an economic crisis. Various types of securities, such as Treasuries, had previously been acceptable as HQLA. Now that investment-grade municipal securities have been designated as HQLA, demand from banks could increase, all else equal, providing a tailwind for the municipal market overall.

Other legislation may be counteracting that effect, however. Because of the cut in overall corporate tax rates to 21%, municipal bonds are not as attractive as they previously were, relative to other investment options such as similar-quality corporate bonds. Lower individual tax rates may also lessen demand from top income earners. Having said that, the HQLA designation is a small positive for municipal demand, all else equal.

POSITIONING PREFERENCES

With approximately 1 million individual issues outstanding, the municipal market is very complex. Active management may add value in the municipal space by overweighting certain segments of the market and underweighting areas that could pose risks for investors. Our preferences for managing interest rate risk in municipal investments mirror our views in other segments of fixed income. We think appropriate investors should consider portfolios with intermediate, slightly below benchmark duration (interest rate sensitivity). By doing so, investors may be able to limit the impact of rising interest rates on their portfolios while simultaneously retaining the potential diversification benefits of high-quality fixed income, because the diversification benefit may not be as pronounced with very short-term municipal debt.

CONCLUSION

Municipal defaults remain historically low and credit conditions for municipalities are stable, but issues remain in states with budget concerns and underfunded pension liabilities. Investors should remain vigilant against these and other risks by considering active management or, at the very least, employing a meticulous security selection process. ■

INDEX DEFINITIONS

The Bloomberg Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year.

The Bloomberg Barclays U.S. Aggregate Credit Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Bloomberg Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

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