LPL RESEARCH

BOND MARKET PERSPECTIVES

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MUNICIPAL BONDS: IS THE PAIN OVER?

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KEY TAKEAWAYS

Municipal bonds have underperformed Treasuries by a sizeable amount in recent months.

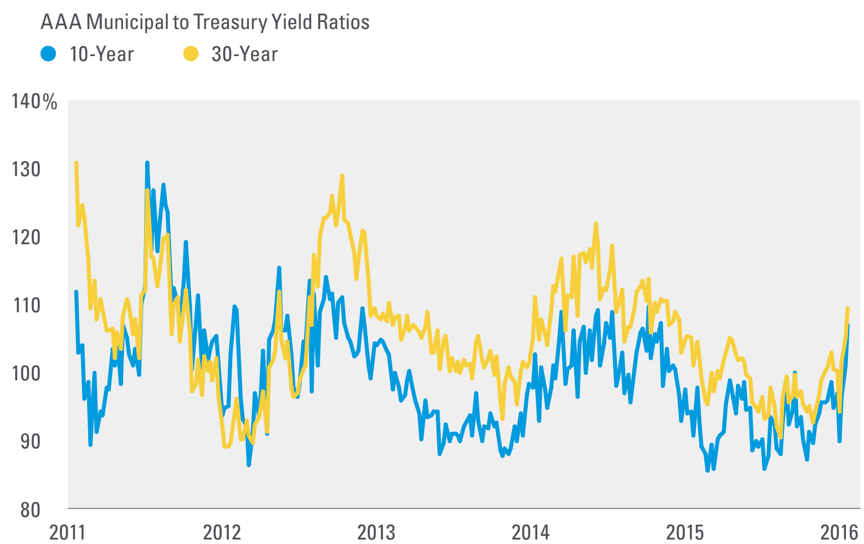
The selloff may have created an opportunity for high-quality municipals given more attractive yields and relative valuations.

High yield municipals, given their credit and interest rate sensitivity, may see continued headwinds.

What goes up must come down. Investors hear the saying all the time, and that was certainly the case for municipal bonds since September. A confluence of forces created strong headwinds for municipal bonds: an increase in new issue supply, proposed changes to taxation, and the threat of additional spending adding to inflation. As year end approaches, municipal investors are wondering if the pain is over.

Municipal bond underperformance has been dramatic over the last three months. The Barclays Bloomberg Municipal Bond Index (MBI) posted losses of -0.5% in September, -1.0% in October, and -3.7% in November (the worst month since September 2008), compared with -0.1%, -0.8%, and -2.4% for the Barclays Aggregate Bond Index. Prior to September, investors experienced 14 straight months of gains, the longest consecutive winning streak for MBI, making this underperformance somewhat unexpected and understandably jarring. Coupled with early year record cash inflows into municipal bond funds for 54 straight

1 MUNICIPAL BOND VALUATIONS HAVE BECOME MORE ATTRACTIVE IN RECENT WEEKS



Source: LPL Research, Bloomberg 12/02/16

Performance is historical and no guarantee of future results.

Yield ratio is a comparison of the expected yield of one bond to the expected yield of another. The yield ratio of municipal bonds to U.S. Treasuries is a common barometer of municipal bond valuations.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Federally tax free but other state and local taxes may apply.

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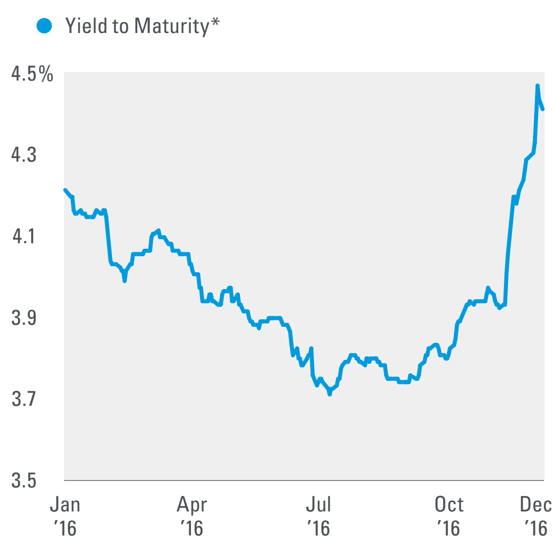
weeks, investors were tempted to reach for yield and increase risk. The recent price adjustment was severe, but municipal bonds have begun to stabilize, and ratio analysis (the municipal yield divided by the Treasury yield) shows that municipal bonds are attractive. In addition to lower prices, new issue supply looks muted for the remainder of the year and the higher rates make it more costly for issuers to price new bonds. The same cannot be said for municipal high-yield bonds, which we think have potentially more downside risk due to the longer maturity profile. Adding high-quality, shorter-duration municipals after this backup could represent potential value to suitable investors and be additive to a well-diversified fixed-income portfolio.

2 MUNICIPAL YIELDS HAVE BECOME MORE ATTRACTIVE AS RATES HAVE INCREASED



Source: LPL Research, *The Bond Buyer* 12/02/16

*This is representative of *The Bond Buyer* US 40 Index.

The Bond Buyer Municipal Bond Index is based on prices for 40 long-term municipal bonds. The index is calculated by taking price estimates from Standard & Poor's Securities Evaluations for the 40 bonds, converting them to fit a standard 6% coupon, averaging the converted prices, and multiplying the result by a smoothing coefficient that compensates for the changes made twice a month in the index's composition.

It is an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

RELATIVE VALUATIONS

Municipal bond investors often pay a higher price (lower yield) for the added benefit of the tax-free income they receive. When municipal prices are below comparable taxable bond prices, municipal bonds are said to be cheap. Another way to compare relative value is to look at the ratio analysis by taking the municipal yield divided by the Treasury yield [Figure 1]. Historically, ratios over 80% represent attractive valuations and current ratios are above 100%. The 10-year ratio is currently 106.3%, well above the 5-year average of 96.2%. The 30-year is even wider at 109.2%, above the 5-year average of 103.0%.

In addition to attractive ratios, absolute yields are compelling as well. *The Bond Buyer* US 40 Bond Index, which measures characteristics for 40 municipal bonds, has had an average yield to maturity of 3.9% on a year-to-date basis. This index reached its highest yield (lowest price) of 4.5% last week on December 1, 2016 [Figure 2]. Even the highest-rated bonds are cheap. The AAA Bloomberg Municipal Benchmark 10-Year Index, also registered its lowest year-to-date price on December 1, to yield 2.6%. This is 88 basis points cheaper than the year-to-date average for the index.

SUPPLY

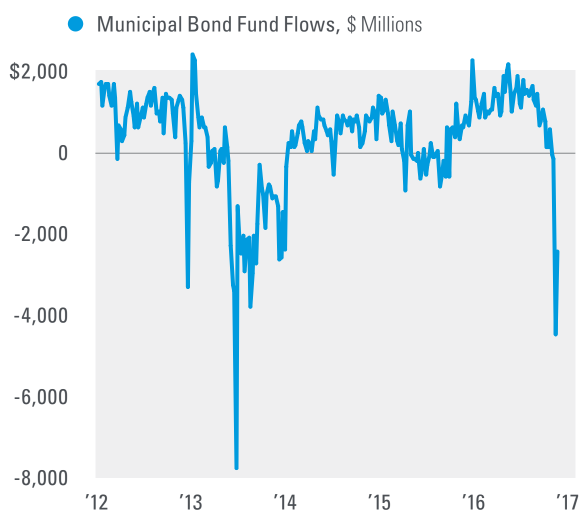
The supply of new bonds priced in the primary market also affects the relative value of municipal bonds. October issuance of $52.7 billion was the highest for any month on record since the mid 1980s. This combined with robust issuance of $46.5 billion in August and $39.6 billion in September, was all that was needed to solidify a negative tone in the market. Issuers raced to price deals ahead of the presidential election, taking full advantage of the high prices being paid for bonds. Secondary selling activity was also high in November with the largest daily sales volume for the year occurring on November 14, according to Bloomberg data. Nearly

$2.6 billion bonds were available to be sold that day, well above the daily average of $599 million. This high volume of selling adds supply to the market which drives prices down.

TECHNICAL FACTORS

With the majority of supply headwinds behind us, the monthly cash flow into and out of municipal bond funds should drive demand moving forward [Figure 3]. December and January are heavy coupon reinvestment periods, as this tends to be when many interest rate payments are received by bondholders. With a rise in interest rates, maturity and called bond cash flows may be reinvested back into tax-exempt bonds. Historically, high cash inflows lead to greater demand during these two months. With the supply picture turning more favorable, prices should remain stable, providing a potential opportunity for investors to reenter the market at more attractive yields.

3 MUNICIPAL BOND FUNDS HAVE EXPERIENCED OUTFLOWS IN RECENT WEEKS



Source: LPL Research, Investment Company Institute (ICI), Bloomberg 12/02/16

Figures shown are historical and no guarantee of future results.

MUNICIPAL HIGH YIELD

Although we see a potential buying opportunity in investment-grade municipals, more time is needed for the supply/demand imbalances to normalize in municipal high yield. November was a reminder of the volatility that exists in this sector. The Bloomberg Barclays Municipal High Yield Index, with its long duration (a measure of interest rate sensitivity) profile of 9.1 years, returned -5.9% for the month of November 2016. By mid-month, outflows set a record as investors pulled $1.6 billion from municipal high yield, according to Lipper data.

Municipal high-yield bonds are comprised of lower-rated issues with sub-sectors that are difficult to analyze such as tobacco, dirt bonds, nursing homes, distressed credits, charter schools, and many other categories. Security pledges on the bonds generally rely on the revenues derived from the individual projects, which often represents additional risk to the investor. In volatile markets, investors tend to shed longer risk first, such as what was seen in November. Investors should be aware of the risks and proceed with caution in this sector, as liquidity could become more challenging moving into year end.

CONCLUSION

During 2016, bond investors have truly felt the meaning of what goes up must come down. Moving forward however, supply is expected to be lighter through year end, and outflows may be offset with coupon cash coming back into the market when investors reinvest cash flows. Tax-free yields relative to taxable U.S. Treasuries are high, which may entice taxable buyers to reenter the municipal market and further stabilize municipal rates. We continue to recommend a well-diversified investment approach, with more exposure to high-grade municipal bonds for suitable investors. We remain neutral to underweight municipal high-yield as the longer maturity profile is volatile in rising rate environments. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Federally tax free but other state and local taxes may apply.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

The credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade.

INDEX DEFINITIONS

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

The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

The Barclays US Municipal High Yield Index measures the non-investment grade and non-rated US dollar-denominated, fixed-rate, taxexempt bond market within the 50 United States and four other qualifying regions (Washington DC, Puerto Rico, Guam and the Virgin Islands).

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