LPL RESEARCH
BOND MARKET PERSPECTIVES

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MUNICIPALS BREAK LOSING STREAK

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KEY TAKEAWAYS

Municipal bonds managed to break a three-month losing streak in December.

Historically January is a good seasonal period for municipal bonds as supply declines and reinvestment demand picks up.

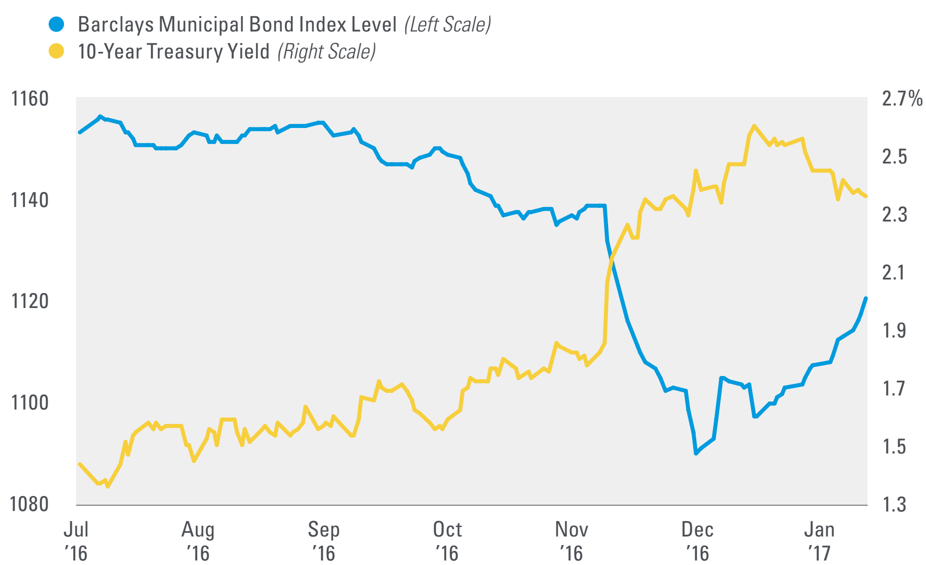
Personal tax reform is a potential headwind for municipal bonds, as lower tax rates could limit the impact of tax benefits.

Supply-induced headwinds in the municipal market faded in December, allowing the sector to break a three-month losing streak. September, October, and November 2016 all saw negative returns for the Barclays Municipal Bond Index, as factors including above-average supply and the impact of rising rates took their toll on the market. Following November 2016's -3.7% return—which registered as the worst monthly performance for the index since September 2008—the index gained 1.2% in December 2016, aided by more attractive valuations and falling supply. Since that time, the 10-year Treasury yield has taken a breather, helping municipal bond returns maintain their positive trajectory into January [Figure 1]. But is this new trend sustainable?

POSITIVE SEASONALS

January is generally a positive seasonal period for municipal bonds, ranking as the month with the highest median return (1.2%) over the past 10 years, and

1 THE 10-YEAR TREASURY YIELD HAS BECOME A TAILWIND FOR MUNICIPAL BONDS IN RECENT WEEKS



Source: LPL Research, FactSet, Bloomberg 01/12/17

The Barclays Municipal Bond Index is an unmanaged index which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

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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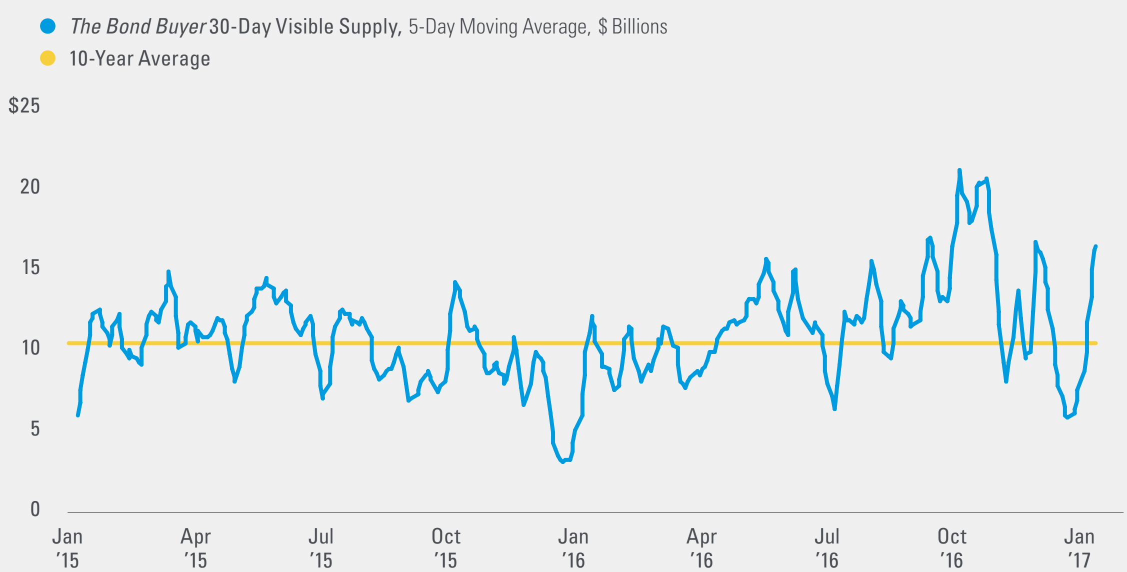
only two negative returns (in January 2007 and January 2011) over the same period. This seasonal performance has historically been driven by a lull in supply, coupled with stronger reinvestment demand as investors seek to reinvest coupon payments that often pay out in December.

2016 was a record year for municipal bond issuance, which remained strong into early December 2016 as borrowers rushed to take advantage of low rates ahead a well-telegraphed 0.25% increase in the fed funds rate at the Federal Reserve's (Fed) December 2016 meeting. Supply (as measured by a five-day moving average of *The Bond Buyer* 30-Day Visible Supply) fell to a one-year low of just under $6 billion in the week leading up to Christmas 2016, but has since increased, ending last week (January 9–13, 2017) near $16 billion. This is well above average levels, but also below the extreme levels of more than $20 billion reached in late 2016. The recent backup in rates, along with Fed comments indicating the potential for three rate hikes in 2017, may be leading issuers to take advantage of today's still-low rates. As long as this persists, supply may remain at least a slight headwind for the municipal market.

THE IMPACT OF DEMAND

Record supply was a headwind for municipal bonds in 2016, but the market also experienced a tailwind of strong demand, with municipal bond mutual funds experiencing more than a year of consecutive weekly inflows. Since the November 2016 presidential election this trend has reversed, and munis have now experienced outflows for 10 straight weeks according to Investment Company Institute (ICI) data, with the last eight weeks seeing outflows of more than $2 billion per week. Some of the larger outflows in December 2016 may have been due to year-end tax harvesting, as total return for the Barclays Municipal Bond Index had turned negative toward the end of last

2 MUNICIPAL ISSUANCE FELL HEADING INTO THE HOLIDAYS, BUT HAS SINCE PICKED UP



Source: LPL Research, *The Bond Buyer*, Bloomberg 01/12/17

Performance shown is historical and no guarantee of future results.

year. Investor demand is difficult to predict, and outflows continued into the first week of January 2017 (latest data are as of 1/4/17), leaving open the possibility that they continue to be a headwind.

COULD PERSONAL TAX REFORM BE A HEADWIND FOR MUNICIPALS?

One reason for continued outflows could be concerns surrounding tax reform. The idea that a personal tax cut could hurt municipal bonds sounds counterintuitive on the surface, as taxes are generally considered a negative for investors. But one of the key benefits of municipal bonds is the potential for tax-free income, and lower tax rates lower the value of the municipal exemption, making other non-tax advantaged bond sectors relatively more attractive. This can be illustrated by looking at the difference in tax equivalent yields at different tax rates [Figure 3]. Taxable equivalent yield indicates the taxable yield an investor would need to receive in order to match the after-tax return of a tax-free municipal bond. As we can see, lower rates mean lower tax equivalent yields, which may mean lower valuations to comparable taxable bonds if tax reform is enacted.

3 TAXABLE EQUIVALENT YIELDS FOR 30-YEAR MUNICIPAL BONDS

Tax Rate	Taxable Equivalent Yield*
10%	3.26%
15%	3.45%
25%	3.91%
28%	4.07%
33%	4.37%
35%	4.51%
39.6%	4.85%

Source: LPL Research, Bloomberg, Internal Revenue Service 01/12/17

*Based on benchmark yield of 2.93%.

CONCLUSION

Municipal returns have broken a three-month losing streak, and strong seasonals in January make it possible that the market may experience another positive month. But even though the market is looking stronger than it did late last year, the potential for continued outflows, the prospect of tax reform, and valuations that are slightly expensive relative to five-year averages (with 10- and 30-year municipal to Treasury ratios at 91% and 99%, respectively), remain headwinds for the market and leave us neutral on the asset class overall. Given our view that rates will see some volatility, but should move gradually higher during 2017, we continue to target below-benchmark duration for municipal bond (as well as other high-quality bond) holdings. ■

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.

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The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETF), and unit investment trusts (UIT). Members of ICI manage total assets of $11.18 trillion and serve nearly 90 million shareholders.

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.

INDEX DEFINITION

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

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