

August 29 2017

WILL MUNIS FALL WITH THE LEAVES?

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KEY TAKEAWAYS

Municipal bonds have performed well in 2017, but increased seasonal supply this fall may be an impending headwind.

Valuations are stretched—evident by taxable equivalent yields and ratio analysis.

Despite higher prices, investment-grade municipal bonds can offer a tax-advantaged way to potentially increase credit quality and diversify portfolios.

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.

With autumn around the corner, many municipal bond participants are wondering if the high prices are poised to drop, much like the fall leaves.

Thus far in 2017, municipal bonds have performed well, and as such, valuations are beginning to look stretched with higher prices and new issue supply expected to increase. Additionally, the threat of a budget impasse in September looms if Congress doesn't extend the debt ceiling and reach a 2018 budget agreement, which could weigh heavily on fixed income markets. Despite all of these factors, we continue to view municipals favorably, but there may be a better entry point after the new issue supply and the leaves have fallen.

1 MUNICIPAL BOND YIELDS HAVE FALLEN MORE QUICKLY THAN CORPORATES YEAR TO DATE

- Bloomberg Barclays Corporate Aggregate Index (Left Scale)
- Bloomberg Barclays Treasury Bond Index (Right Scale 1)
- Bloomberg Barclays Municipal Bond Index Index (Right Scale 2)



Source: LPL Research, Bloomberg 08/28/17

All indexes are unmanaged and 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 not indicative of future results.

June is typically a heavy coupon reinvestment period when many interest rate payments are received and reinvested back into the bond market, thus driving the demand higher later in the season.

YIELDS HAVE DECLINED, PRICES HAVE RISEN

Cheaper prices enticed buyers back into municipals at the beginning of the year, following a substantial sell-off in late 2016. The rally in prices can be seen by comparing the yield for the Bloomberg Barclays Municipal Bond Index against the Bloomberg Barclays Corporate Aggregate and Bloomberg Barclays Treasury Bond indexes [Figure 1]. Starting the year at 2.65%, the municipal index yield is now lower by 65 basis points (0.65%) at 2.09%, while the corporate index fell 26 basis points (3.37% to 3.11%), and the Treasury index lost 27 basis points (2.44% to 2.17%). When yields fall, prices rise (and vice versa), so the larger drop in municipal yields indicates stronger year-to-date performance.

RECENT PERFORMANCE HAS BEEN SOLID

The Bloomberg Barclays Municipal Bond Index has posted a total return of 0.66% this month (as of August 29, 2017) and 5.09% thus far this year. This is a slight rebound from return levels earlier in the summer. June is typically a heavy coupon reinvestment period when many interest rate payments are received and reinvested back into the bond market, thus driving the demand higher later in the season. Generally, when demand outpaces supply, prices rise and performance improves. Year to date, municipals are beating the Bloomberg Barclays U.S. Aggregate Bond Index, an index comprised of high-quality mortgage-backed bonds, U.S. Treasuries, and investment-grade corporates, by 1.65% (5.09% versus 3.44%).

...BUT RELATIVE VALUATIONS ARE STRETCHED

Municipal bond investors often pay a higher price (and receive less yield) for the added potential benefit of the tax-free income they receive. Generally, 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 of municipal bond yields to similarly dated Treasury bond yields, where higher ratios represent cheaper relative valuations. Historically, using Bloomberg pricing data, a 5-year ratio above 75%, a 10-year ratio above 85%, and a 30-year ratio above 95%, are thought to represent value. Currently, the 5-year ratio is 65%, which is well below the historic average of 90% (2001–2017), pointing to rich valuations in this part of the yield curve. The 10-year ratio is 86%, above the historic average, but more expensive than the 5-year average of 97.2%. The 30-year ratio is now at 100%, also above its historic level, but expensive compared to the 5-year average of 103%. Together, these indicate that relative valuations have become somewhat stretched. (Note that the ratio figures may differ depending on the data source used.)

BOND SUPPLY

In addition to ratios showing that municipals are slightly expensive, new issue supply may be growing. The supply of new bonds priced in the market also affects the relative value of municipals. July's issuance of \$33 billion was below the 10-year monthly average of \$36 billion according to

the Municipal Monthly New Issue Index, which caused price strength in the market. Historically, demand increases and supply tends to shrink between July and August [Figure 2]. However, issuers can take advantage of bonds' higher prices and issue after the summer months, which could lead to price weakness.

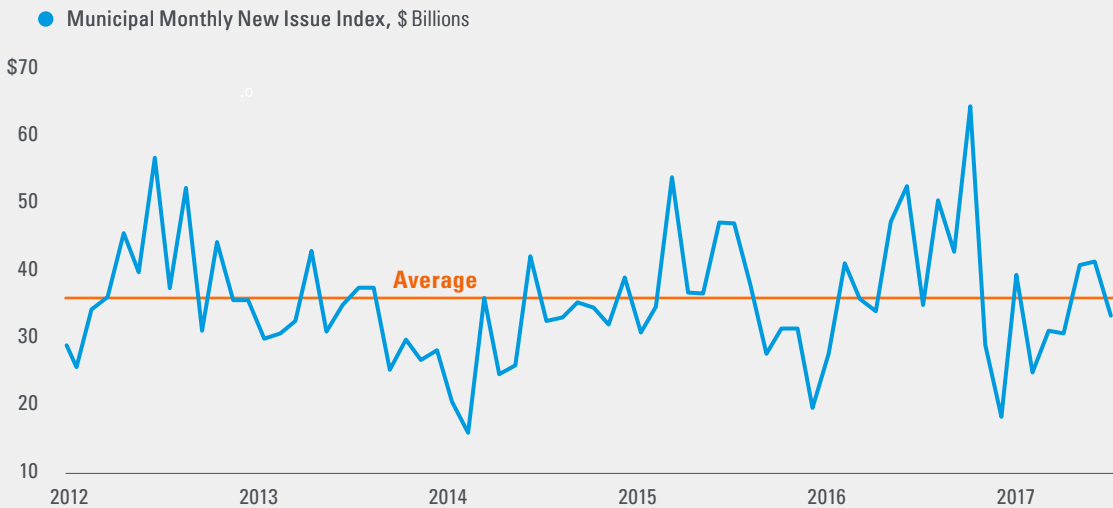
CONCLUSION

Investment-grade and high-yield municipals have performed well so far this year. We do not expect a second half sell-off like last year, but supply

is historically heavier after the summer months and inflows are expected to decrease based on seasonal trends. These factors could contribute to some market weakness in the near term. Tax-free yields relative to taxable U.S. Treasuries are lower than in early 2017, which may cause investors to look to other fixed income sectors for additional yield. While a better entry point may be ahead, we continue to favor investment-grade municipal bonds in a portfolio context for appropriate investors, as they offer very little correlation to stocks and can be used to potentially increase credit quality and diversify portfolios. ■

2

A SEASONAL SLOWDOWN IN ISSUANCE HELPED MUNICIPAL BOND PERFORMANCE IN JULY



Source: LPL Research, Bloomberg 08/28/17

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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.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

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.

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

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.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

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 US 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.

The Bloomberg Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. Bloomberg Barclay's U.S. Treasury Index includes public debt of the U.S. Treasury with a remaining maturity of one year or more.

The Bloomberg Barclays U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

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