LPL RESEARCH
BOND MARKET PERSPECTIVES

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MUNICIPAL CHALLENGES

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KEY TAKEAWAYS

We see a potentially brighter future ahead for municipal bonds, despite a difficult second quarter thus far, due to still attractive valuations, higher yields, and a favorable summer seasonal period.

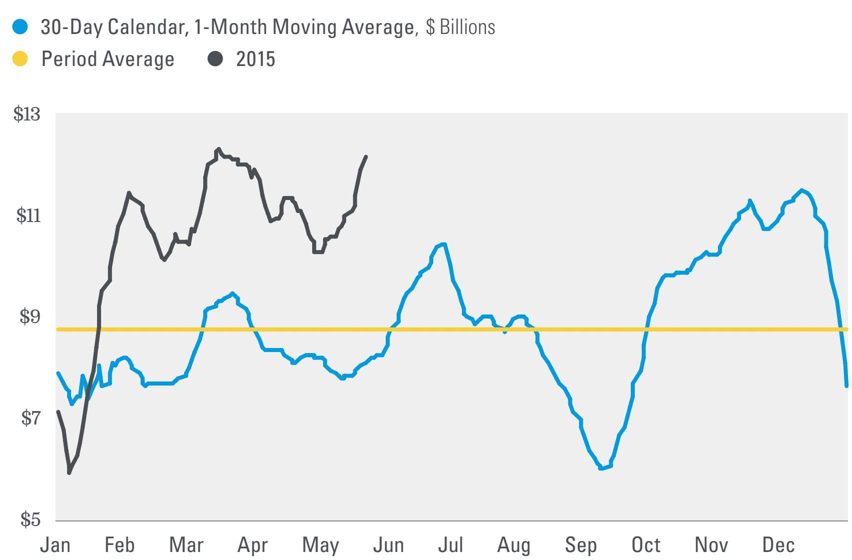
A low-single-digit total return is plausible given our expectation for a modest rise in interest rates coupled with valuation improvement relative to Treasuries.

Municipal bonds have endured a tough second quarter thus far, falling victim to taxable bond market weakness while managing the stiff headwind of increased new issuance supply. First quarter gains have been erased but we see a potentially brighter future ahead for municipal bonds due to still attractive valuations, higher yields, and a favorable summer seasonal period.

A steady dose of heavy supply has been a headwind for the municipal bond market so far in 2015. The 2015 pace of issuance has exceeded the average pace of the past five years by a notable margin [Figure 1]. In a few weeks, the supply surge should subside as the annual summer issuance lull takes place.

As noted in our *Bond Market Perspectives,* "Municipal Supply Surge" (March 31, 2015), municipal bond issuance has been driven primarily by refinancing as issuers take advantage of lower interest rates to refinance higher interest debt. The fall in interest rates over 2014 into early 2015, with only a modest increase since, has left long-term interest rates attractive for debt issuers. Refunding-related issuance is typically less problematic for the market because investors of redeemed debt are actively seeking to reinvest proceeds, while "new money" issuance can lead to supply surges that can at times overwhelm the market.

1 2015 MUNICIPAL BOND ISSUANCE IS RUNNING WELL AHEAD OF THE FIVE-YEAR AVERAGE



Source: LPL Research, *The Bond Buyer* 05/22/15

Chart shows 1-month moving average of 30-day expected new issuance (30-day calendar).

ONE MORE CLIMB

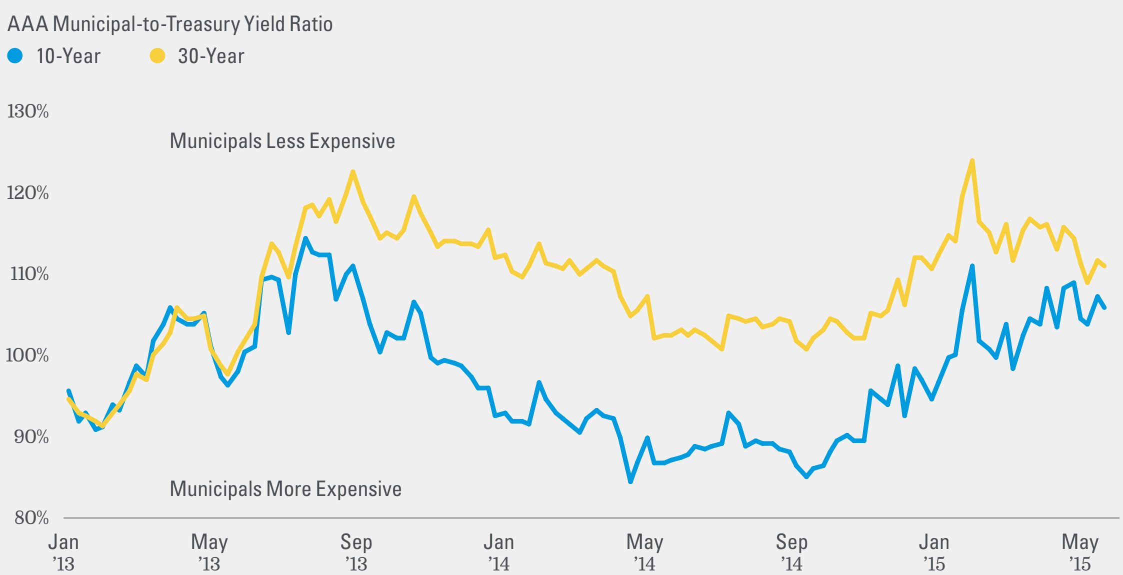
Before the issuance subsides, however, municipal bonds face a seasonally difficult first half of June. Early June typically witnesses a surge in issuance, as Figure 1 illustrates. This is one reason why the average total return for municipal bonds for the month of June is a mere 0.13% (since 1990, according to Barclays Municipal Bond Index), making it the third weakest month for municipal bond performance behind March (the worst) and October.

The end of June ushers in a historically strong period for municipal bond performance as July and August represent the top and fourth strongest months of performance during the calendar year, with average total returns of 0.89% and 0.71%, respectively. Figure 1 also illustrates how some of the issuance that is normally reserved for early June may have come early in 2015, as issuance has run up ahead of the normal time schedule. Therefore, not only might early June pose less of a headwind in 2015, but seasonal summer strength may begin earlier as investors put redeemed bond proceeds to work.

SILVER LINING

The challenges facing municipal bond investors have left municipal bond valuations attractive — a silver lining in recent weakness. Long-term valuations have actually improved as long-term municipal bonds have held their value slightly better compared with long-term Treasuries, while intermediate municipal bonds have remained near their cheapest levels to Treasuries in the past two years [Figure 2]. Municipal-to-Treasury yield ratios remain elevated, especially for intermediate maturity bonds. Yield ratios above 100% indicate top-rated municipal yields exceed those of comparable Treasuries and are compelling after taking into account the impact of taxes. Municipal-to-Treasury yield ratios have signaled attractive valuations for much of 2015, but the fading of

2 WHILE LONG-TERM VALUATIONS HAVE RICHENED, INTERMEDIATE VALUATIONS REMAIN NEAR THE CHEAPEST LEVELS OF THE PAST TWO YEARS



Source: LPL Research, Municipal Market Advisors (MMA) 05/22/15 new issuance in coming weeks and months may provide a much needed catalyst.

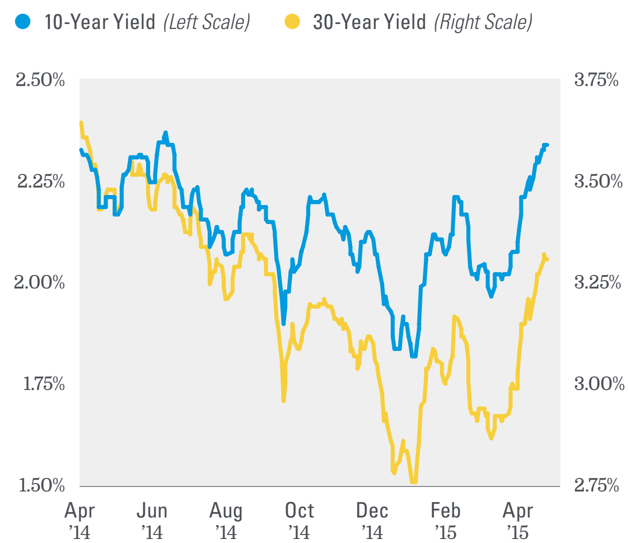
Higher yields boost the case for municipal bonds along with attractive valuations. Average yields on AAA-rated 10- and 30-year maturity bonds have increased by 0.3% to 0.4% in recent weeks [Figure 3]. Yields remain low in historical context but are at, or near, one-year highs among intermediate and longer-term bonds. After the steady decline in yields during 2014, the recent increase provides a window of opportunity in a challenging fixed income environment.

The combination of attractive valuations and higher yields make municipal bonds a compelling alternative within the high-quality bond market. Within the municipal bond market we favor intermediate municipal bonds as valuations remain most attractive relative to recent history.

Aside from supply, investors may need to brace for negative headlines from Chicago and Puerto Rico. Moody's recently downgraded the city of Chicago to Ba1, or "junk" status, as a result of the state of Illinois Supreme Court ruling that worker pensions could not be reduced, which included limiting future benefits. We do not view Chicago as another Detroit, however, due to the city's much more diverse and vibrant economy. To make up for the lost cost savings, both the state and the city will likely raise taxes and cut other expenses, which may hamper regional economic growth. So far, Illinois and Chicago news has had only a limited impact on the broader municipal bond market, affecting a limited number of states with greater pension funding shortfalls.

Puerto Rico, which has been a common source of negative headlines over the past year, may have bought some time. Passage of a bill to raise sales taxes to 11.5% gave Puerto Rico bonds a slight lift as the threat of a default is pushed back. Revenue from higher taxes, along with a planned oil tax–backed bond deal, will also help make up a budget shortfall for the fiscal year beginning July 1, 2015. The increased revenue will help for now,

3 INTERMEDIATE AND LONG-TERM MUNICIPAL BOND YIELDS ARE AT, OR NEAR, ONE-YEAR HIGHS



Source: LPL Research, MMA 05/22/15

but may hamper economic growth that is so badly needed for the commonwealth to ultimately repay a very large debt burden. The impact to the broader municipal bond market from Puerto Rico has been limited thus far.

Like Detroit and Michigan, we believe investors have, correctly in our opinion, viewed Illinois/Chicago and Puerto Rico as isolated incidents and not representative of the broader municipal bond market. Despite the greater share of headlines these troubled issuers may receive, investors should take note of the better value of municipal bonds.

MANAGING EXPECTATIONS

Opportunity may be present in municipal bonds but we do not expect a repeat of 2014 performance or close to it. A low-single-digit total return is more plausible given our expectation for a modest rise in interest rates, coupled with valuation improvement relative to Treasuries, as new issuance subsides and net growth of the outstanding municipal bond market remains negligible for 2015. ■

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.

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 rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

Investing in foreign fixed income securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with foreign market settlement. Investing in emerging markets may accentuate these risks.

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

INDEX DESCRIPTIONS

The 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 pre-refunded bonds.

DEFINITIONS

Credit quality, also referred to as a "bond rating," this is one of the principal criteria for judging the investment quality of a fixed income security. Credit quality informs investors of a security's creditworthiness or risk of default.

Different agencies employ different rating scales for credit quality. Standard & Poor's (S&P) and Fitch both use scales from AAA (highest) through AA, A, BBB, BB, B, CCC, CC, C to D (lowest). Moody's uses a scale from Aaa (highest) through Aa, A, Baa, Ba, B, Caa, Ca to C (lowest).

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