LPL RESEARCH

BOND MARKET PERSPECTIVES

November 8 2016

TURNING POINT FOR MUNIS?

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KEY TAKEAWAYS

October was the worst month for municipal bonds since August 2013 as record supply and rising rates took their toll on the sector.

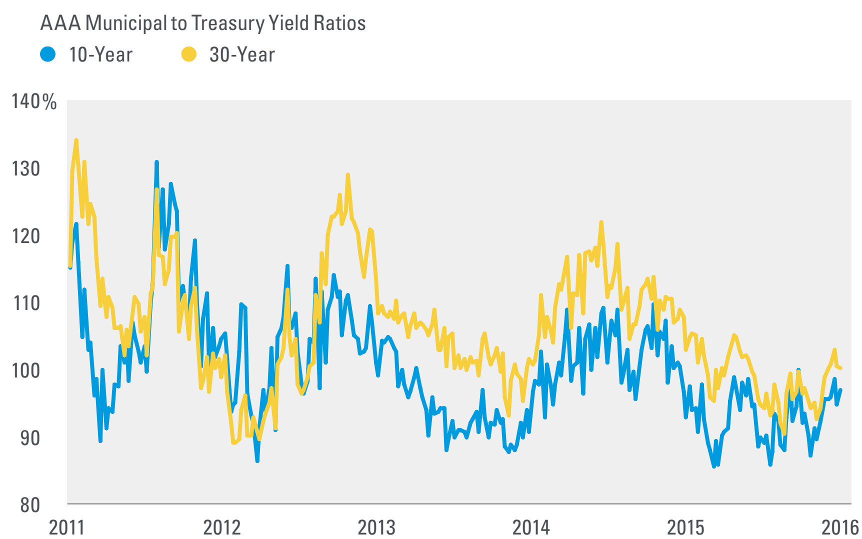
Supply hit monthly records in August and September, and an all-time record in October, as municipalities tried to get issues to the market prior to any potential election- or Fed-driven volatility.

A combination of slowing supply and improving valuations may point toward a turning point for municipal performance, though rising rates remain a risk to total returns and slowing investor demand remains a question.

Municipal performance has been weak in recent months, with rising rates and record supply taking their toll on the sector. Monthly returns (as measured by the Barclays Municipal Bond Index) turned negative in September 2016 for the first time since June 2015, and October's loss of 1.05% was the sector's worst monthly performance since August 2013. Rising rates were a major culprit in the recent decline, with the 10-year Treasury yield moving from 1.57% at the beginning of September to 1.82% as of October 31. However, supply has also been a headwind all year, with 2016 poised to eclipse 2010's previous issuance record.

Municipal bonds normally outperform Treasuries in rising rate environments, but the addition of elevated supply actually led munis to underperform Treasuries as rates rose, leading to better relative valuations. 10- and 30-year AAA Municipal to Treasury ratios are now at 97% and 100% respectively, toward the cheaper end of their recent range, though just approaching the middle of their 5-year range [Figure 1].

1 MUNICIPAL BOND VALUATIONS HAVE IMPROVED IN RECENT MONTHS



Source: LPL Research, Bloomberg 11/04/16

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.

SUPPLY HEADWIND FADING?

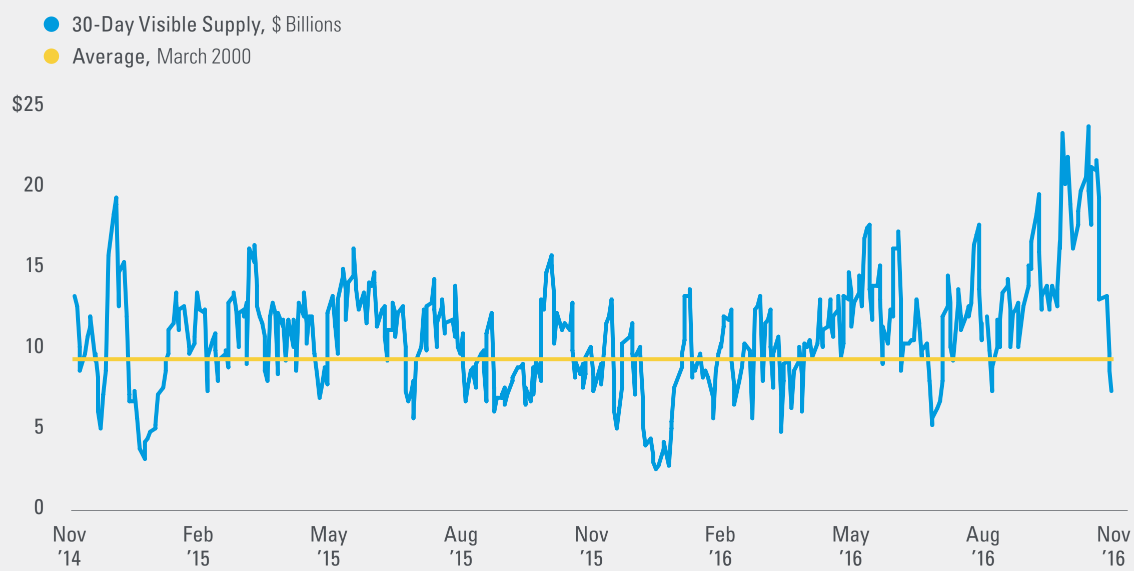
Total municipal bond issuance of $392 billion year to date is second only to 2010's record $433 billion, and with two months left it is looking very possible that 2016 could end up being a record year, though this year has seen heavier amounts of refinancing than 2010. Issuance has picked up even more in recent months, with August and September hitting monthly records, while October's $53 billion in issuance ranked as the largest month since recordkeeping began in 1980, as low yields and the spectre of volatility from upcoming events such as the election and a likely Fed rate hike in December have led issuers to push offerings to the market.

A few larger issues, including $1-billion-plus offerings from NJ Transportation and Illinois General Obligation (GO) Refunding, have made up a large portion of recent issuance. The drive to get these issues out ahead of any potential election-related volatility has led to less new issuance in the pipeline, as evidenced by a significant drop in *The Bond Buyer* 30-Day Visible Supply over the past few weeks. Estimated upcoming issuance by this measure hit a 2-year high in October, but has since fallen back below its longer-term average [Figure 2]. Based on this, it appears that a lot of the issuance that may normally take place in November was likely pushed back to October, meaning supply for the rest of the year may be lower and less of a headwind for the municipal market moving forward.

THE QUESTION OF DEMAND

Demand has also been elevated this year, and has helped the market weather the headwind of increased supply. The continued reach for yield is helping fuel municipal bond demand from retail investors (including year-to-date inflows of nearly $53 billion into municipal bond mutual funds according to Investment Company Institute [ICI] data), and is even reportedly bringing in demand

2 VISIBLE SUPPLY FOR MUNICIPAL BONDS HAS FALLEN SIGINFICANTLY IN RECENT WEEKS



Source: LPL Research, *The Bond Buyer* 30-Day Visible Supply, Bloomberg 11/04/16 from foreign buyers, which is relatively uncommon for municipals, given that foreign owners generally don't receive any tax benefit for holding U.S. municipal bonds.

In recent weeks ICI's reported inflows have slowed, and Lipper (another source of fund flows data) has reported two weekly outflows (following a previous streak of uninterrupted weekly inflows that lasted more than a year), showing that demand is likely slowing. The municipal bond market is largely made up of retail investors, meaning demand can fade (or return) quickly, but a continued reach for yield in a low-yield environment, coupled with more attractive valuations versus Treasuries, may continue to benefit demand in the near term. To this point, taxable equivalent yields remain attractive for investors across a range of tax rates [Figure 3].

3 TAXABLE EQUIVALENT YIELDS FOR MUNICIPAL BONDS REMAIN ATTRACTIVE VERSUS OTHER HIGH-QUALITY OPTIONS

	Taxable Equivalent Yield	
Tax Rate	10-Year	30-Year
10%	1.91%	2.85%
15%	2.03%	3.02%
25%	2.30%	3.42%
28%	2.39%	3.57%
33%	2.57%	3.83%
35%	2.65%	3.95%
39.6%	2.85%	4.25%

Source: LPL Research, Bloomberg 11/04/16

Based on Bloomberg 10-year and 30-year benchmark municipal bond yields of 1.72% and 2.57% respectively.

Yields are subject to change. Tax equivalent yield is the pre-tax yield that a comparable high-quality taxable bond needs to possess for its after-tax yield to be equal to that of a tax-free municipal bond.

CONCLUSION

A drop in visible supply, improving valuations, and a low yield environment may act as tailwinds for municipal bonds in the near term, potentially helping the sector to turn the corner away from recent weakness. We continue to believe that interest rates will remain rangebound for the remainder of the year, though events such as the election and a potential Fed rate hike in December could add additional volatility. Such volatility may benefit high-quality sectors of the bond market such as municipal bonds, though the potential for rising rates presents a risk, leaving us neutral on the asset class overall. ■

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.

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.

General obligation (GO) bonds are municipal bonds backed by the credit and “taxing power” of the issuing jurisdiction rather than the revenue from a given project.

INDEX DESCRIPTIONS

The Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. It is an unmanaged index and cannot be invested into directly.

RES 5681 1116 | Tracking #1-553451 (Exp. 11/17)