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Investment perspectives

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Key highlights:

- In an uncertain market environment, diversification and a high-quality approach may help lessen the impact of volatility on a municipal portfolio.
- A key indicator signals a possible buying opportunity may be emerging for municipal bonds.
- For investors in the 22% tax bracket, there is a significant incentive to consider the municipal market.

Keep calm and stay in munis

A word on volatility

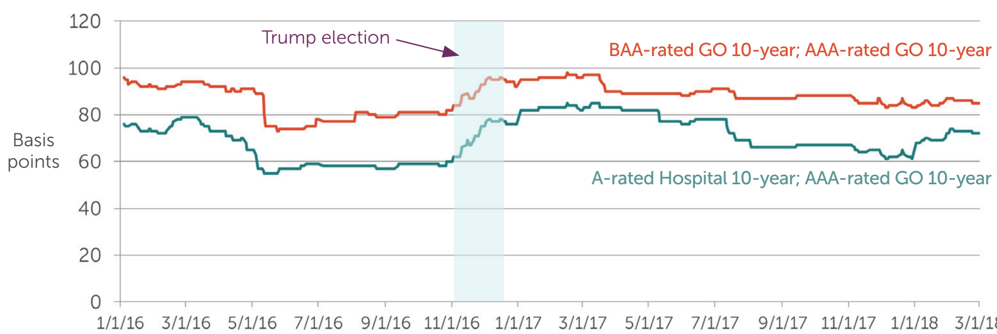
Volatility, which has recently re-emerged as a concern for many investors, may have an impact on municipal portfolios, however, many of the negative effects can be mitigated by adopting a high-quality, well-diversified investment approach. That is, the more we invest across different states, sectors and maturities, the less likely it is that a single event will negatively impact a given portfolio. Also, high quality assets tend to outperform lower quality in times of higher volatility. To more clearly illustrate this point, *Exhibit 1* compares two AAA-rated bonds to similar-maturity, lesser quality securities. During the run up to President Trump's election, a substantial spread widening occurred, suggesting that at a volatile moment in markets, investors preferred higher quality assets to lower rated peers. To better take full advantage of such opportunities, we recommend using tactical strategies wherever possible.

A key indicator flashes?

As noted in our March *Investment perspectives*, the New Jobs and Tax Cuts Act had a significant impact on the municipal securities market in 2017, with a record level of issuance and a surge in demand. Despite market dynamics pressuring prices downward, there have been positive municipal bond fund flows year to date, totaling $10.2 billion, suggesting that some investors still think there is substantial value in municipal securities.[1]

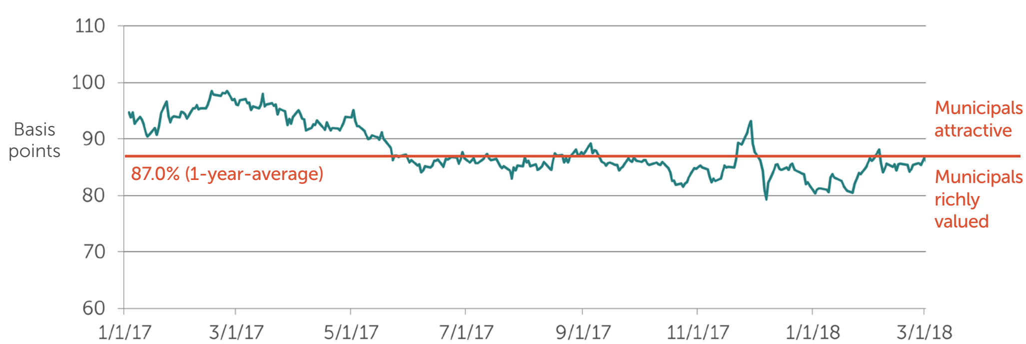
An indicator of the potential opportunities available in this market is shown in *Exhibit 2*. The municipal ratio, a comparison of 10-year AAA general obligation debt to 10-year U.S. Treasury yields, is a popular metric among municipal bond investors for gauging market valuations. In our opinion, if the one-year ratio average falls below 87.0%, then intermediate municipal bonds are trading lower than the average ratio for the year and may be less attractive to some buyers.

Exhibit 1: Municipal spreads widened during the run up to the presidential election



Source: Bloomberg, 3/1/2018

Exhibit 2: Municipal ratio (10-year AAA general obligation vs. 10-year U.S. Treasury)



Source: Bloomberg, 3/1/2018

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Exhibit 3: Individuals in the 22% tax bracket have opportunities in current municipal market

2018 single filer tax rate (%)	Taxable rate equivalent (Treasury yield)
10%	2.83%
12%	2.90%
22%	3.27%
24%	3.36%
32%	3.75%
35%	3.92%
37%	4.05%

Source: Bloomberg, 3/8/18. Based on 10-year municipal yield of 2.55%. Taxable equivalent yield equals tax exempt yield divided by 1 minus the single filer tax rate. For illustration purposes only.

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However, if the ratio is above 87.0%, then municipals are more appealing. Currently, the ratio suggests that municipal securities are, once again, nearing an attractive valuation which should be helpful in driving demand upward.

For investors who find themselves in the 22% tax bracket, in particular, we believe that it would be wise to consider buying tax exempt municipal securities at today's valuations versus U.S. Treasurys. The nearby table *(see Exhibit 3)* shows that such filers would need to find a taxable security yielding at least 3.27% in the market to match the profile of a 10-year municipal bond. With the 10-year U.S. Treasury currently yielding approximately 2.80% that represents nearly a 50 basis point difference to an investor who would likely have to consider a lower-rated bond or longer maturity to match the yield of the comparable municipal security.

What can investors expect in the coming months?

Industry expectations for 2018 issuance, based on projections for coupons, maturities and new bonds, suggest approximately $340 billion in supply with demand close to $460 billion. As a result, there is a potential gap of $120 billion in the marketplace that should benefit investors this year as technicals start to reflect this projected shortage. On the state level, tax receipts are improving which is encouraging. The overall economy still looks strong overall and the credit outlook continues to appear favorable. Due to the anticipated supply-demand imbalance, we believe that tax exempt securities will eventually outperform investment grade for 2018 and that municipal investors will be rewarded by sticking to their knitting as market technicals return to equilibrium. Also, given the trend in the municipal ratio, we feel that positive flows will continue to enter this market.

[1]*Source: ICI, 3/14/2018*

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