Bonding ... with municipals

Municipal bond investors, even longtime devotees, may be battling feelings of unease in 2017. Policies of the new administration seemingly have the potential to upend long-held muni truisms, particularly those relating to tax treatment. Peter Hayes and Sean Carney address the uncertainties to help you reaffirm your bond with the tax-exempt asset class.

The big question: tax reform

At the top of investors’ worry list are tax reform proposals that could have implications for tax-exempt bonds. The two biggest: A reduction in tax rates for both corporations and individuals, and the elimination or capping of muni tax exemption.

Lower individual tax rates reduce the value of a municipal bond’s tax exemption. For example, a drop in the top tax rate from 43.4% to 33% means $4,340 in annual savings would be reduced to $3,300. And to the extent that lower benefit lessens the demand for municipal bonds, market valuations would suffer. Tax-exempt munis might need to produce higher yields to attract buyers, all else being equal.

Supply is likely to be manageable in 2017, though demand will be a wildcard given interest rate and policy uncertainties.

But the market has seen similar, and even more dramatic, tax changes before. The top marginal tax rate was lowered from 50% to 28% in 1986 and from 39.6% to 35% in the 2000s. Of course, as illustrated on the next page, investors still reap a benefit over taxable bonds, even at a 33% tax rate.
Munis offer yield benefit, even at lower tax rates

Yields before and after tax

Notably, corporate tax reform (more likely in 2017 than the complicated task of rewriting the individual tax code) could be an offsetting factor. Current law allows companies to deduct interest payments on bond income. Under reform proposals, that benefit may be repealed to compensate for lower corporate tax rates. This could conceivably lead to lower corporate bond issuance. Munis, in turn, would become a greater source of supply for income-seeking investors. The associated uptick in demand would mute the effect of other tax changes.

Ultimately, “tax reform” is a series of potential scenarios featuring many variables and offsetting factors. Which reforms are implemented and to what degree will determine the extent of the market impact. Uncertainty is perhaps the only certainty, although we can say with enough confidence that munis will retain some tax-exempt benefit. And there will always be an appetite for that very unique feature in an investment asset.

The role of rising rates and the Fed

Rising rates are the consensus view for 2017. Expectations are for the Federal Reserve to hike rates two to three times in 2017. We’d lean to the higher side and see potential for up to four hikes. With good economic momentum and potential for more fiscal spending by the new administration, the Fed could surprise by either moving earlier than many anticipate or imposing more hikes – or both.

Of course, higher rates mean lower bond prices. Whereas munis might normally be expected to fare better than Treasuries in a tightening cycle, the overlay of uncertain tax policy probably makes the asset class more highly correlated with Treasuries.

This leads us to favor the short to intermediate part of the yield curve, which may offer greater insulation from the effects of higher rates and uncertain tax policy. It also offers liquidity and flexibility to adjust as needed. For example, more Fed hikes than expected could cause volatility in short-term yields, prompting us to adjust toward the belly of the curve.

Regarding the fate of muni tax exemption, we see elimination as highly unlikely. States and municipalities rely on municipal debt as a low-cost, efficient way to finance capital improvements and fund infrastructure. The federal government hurts itself if it impedes state and local ability to create jobs, sustain their economies and improve the quality of life for Americans.

Even in the unlikely event that tax exemption were jettisoned, we expect existing bonds would be grandfathered under their current tax treatment. The hazard here is in creating a bifurcated market in which “old” bonds are valued above new issues (essentially assigned a “scarcity value” by the market). Other proposals center on capping the tax exemption at 28%.

Our analysis indicates that any market correction to overcome a drop in the highest tax rate from 43.4% to 33%, or a 28% cap on the tax exemption, would be manageable, potentially requiring some 15 (front end) to 50 basis points (long end) in higher yield to compensate for the reduced tax benefit. The market has digested adjustments of this magnitude in the past without a material change to the overall demand dynamic.
Performance expectations for 2017
We expect 2017 to feature more peaks and valleys than recent years. We see a positive (if modest) return for the year, but expect it to come from income and not price performance. Of course, that’s not an anathema. We’ve always said investors should own municipal bonds for income first and foremost. Given the outlook for greater volatility, we believe a nimble approach makes sense. This can be achieved in a professionally managed, flexible-duration strategy. And in a year driven by income, some allocation to high yield municipals may be additive, albeit volatility is likely to be more pronounced here.

Technically speaking
Supply and demand is a significant driver of the municipal bond market. Making a call on the former is easier than the latter given the political overhang that is certain to impact investor interest and demand.

The good news: We do not expect supply to be an impediment in 2017. After record issuance of $444 billion in 2016, we forecast a figure closer to $400 billion in 2017, partly because a higher-rate environment will mean less refunding activity.

Demand started the year in a negative trend that began after the November election. This followed an impressive 56 weeks of inflows. Based on historical trends during times of investor unease, the outflows could have more to go. That said, the post-election sell-off created attractive value in the market that has already served to interrupt the outflows.

Outflows following major events
Sources: BlackRock and ICI, as of Jan. 4, 2017.

<table>
<thead>
<tr>
<th>Year</th>
<th>Market return (%)</th>
<th>A-rated return (%)</th>
<th>Performance differential (basis points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>12.91</td>
<td>15.87</td>
<td>+296</td>
</tr>
<tr>
<td>2010</td>
<td>2.38</td>
<td>2.23</td>
<td>-15</td>
</tr>
<tr>
<td>2011</td>
<td>10.70</td>
<td>12.53</td>
<td>+183</td>
</tr>
<tr>
<td>2012</td>
<td>6.78</td>
<td>8.16</td>
<td>+138</td>
</tr>
<tr>
<td>2013</td>
<td>-2.55</td>
<td>-2.56</td>
<td>-1</td>
</tr>
<tr>
<td>2014</td>
<td>9.05</td>
<td>10.52</td>
<td>+147</td>
</tr>
<tr>
<td>2015</td>
<td>3.30</td>
<td>3.71</td>
<td>+41</td>
</tr>
<tr>
<td>2016</td>
<td>0.25</td>
<td>0.85</td>
<td>+60</td>
</tr>
</tbody>
</table>

Sources: BlackRock and Bloomberg Barclays Municipal Bond Index. Return figures shown are annual total returns. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Investment prescription for 2017
We’d offer four key ideas for managing your municipal bond allocation in 2017:

1. Favor short to intermediate maturities for liquidity, flexibility and insulation from interest rate and policy uncertainty.

2. Consider flexible strategies that allow you to be nimble and manage around rate risk.

3. Look to the A-rated space. Since the financial crisis, A-rated bonds have outpaced the broader muni market in up years, outperforming it by 12% overall since 2009.

4. Be choosy. The market is not one dimensional, so it’s important to choose your investments wisely. Credit is still challenged in places with pension problems (e.g., Illinois, Chicago Public Schools), and we expect this will be a factor in market performance. We see an advantage in owning a diversified, professionally managed portfolio of munis over single bonds.
Is now the time for munis?

Munis are a high-quality income work engine that deserve a place in any well-diversified portfolio – at all times. Despite the prevailing uncertainties, the base case for an investment in tax-exempt bonds remains intact: Munis are an important portfolio diversifier, providing a ballast to equity and equity-like risk. They provide the unique advantage of tax-free income (alterable, but not dispensable), and high credit quality among fixed income options.

Looking ahead, we expect the post-election momentum in financial markets (stocks up and bonds down) will be challenged. We would view periods of municipal market strength as a time to get defensive – and periods of weakness as a buying opportunity.

Want to know more?

blackrock.com  877-275-1255 (1-877-ASK-1BLK)

The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. There may be less information available on the financial condition of issuers of municipal securities than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. A portion of the income from tax-exempt bonds may be taxable and may be subject to Alternative Minimum Tax (AMT). Capital gains, if any, are taxable.

For a current prospectus or, if available, a summary prospectus of any BlackRock mutual fund, which contains more complete information, please call your financial professional or BlackRock at 800-882-0052. Before investing, consider the investment objectives, risks, charges and expenses of the fund(s) under consideration. This and other information can be found in each fund’s prospectus or, if available, summary prospectus. Read each prospectus carefully before you invest.

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are those of the investment professionals profiled as of January 2017, and may change as subsequent conditions vary. Individual portfolio managers for BlackRock may have opinions and/or make investment decisions that, in certain respects, may not be consistent with the information contained in this report. The information and opinions contained in this material are derived from proprietary and non-proprietary sources deemed by BlackRock to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. Past performance is no guarantee of future results. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader. Investment involves risks.

©2017 BlackRock, Inc. All Rights Reserved. BLACKROCK is a registered trademark of BlackRock, Inc. or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

Prepared by BlackRock Investments, LLC, member FINRA.

Not FDIC Insured • May Lose Value • No Bank Guarantee

Lit. No. MUNI-POV-0117  8049A_US4_0117 / USR-11411