Muni bonds still going strong

Highlights
- Muni bonds delivered a fourth consecutive month of positive returns in August.
- Seasonal market patterns provided the tailwind of net negative supply.
- Our outlook is more cautious as the fall months typically are less favorable for munis.

Market overview
In the fourth consecutive month of positive performance, the S&P Municipal Bond Index gained 0.19% in August, bringing its year-to-date return to 0.42%. Interest rates migrated lower over the month as investors focused more on the ongoing macro uncertainties - geopolitical concerns, trade negotiations and Mueller’s Trump election investigation - versus continued strong U.S. economic growth. (Bond prices typically move inversely to interest rates.)

Demand for the asset class has remained firm. Notably, alongside the recent divestment from equities, investor flows into municipal bond mutual funds have been yield-driven and concentrated in long-term and high yield funds. The stronger performing areas of the market in August included high yield, led by Puerto Rico and tobacco, bonds with terms of 15 years+, the hospital and education sectors, and issues of high-tax states such as New Jersey, California, Illinois and Massachusetts.

Gross issuance levels are gradually returning to normal after a dearth experienced earlier in the year. Still, the muni market continued to benefit from the tailwind of net negative supply that typically occurs in the summer months. For the month of August, gross issuance of $32.4 billion paired against the seasonal swell of capital reinvestment resulted in net negative supply of -$7.2 billion.

Looking to the fall months ahead, we maintain a cautious outlook on the asset class as the market is poised to transition back to net positive supply, which has historically pressured performance. Additionally, we see potential for an increase in volatility should uncertainty heighten around upcoming Fed moves, the midterm elections and geopolitical developments.

Strategy insights
We maintain a neutral duration bias expressed via barbell yield curve positioning. Concentrations in the 0-2 year and 20 year+ segments can provide added liquidity while taking advantage of increasingly attractive relative valuations in the long end of the curve. We continue to prefer lower-rated investment grade credits, revenue bonds, and the transportation, healthcare and tobacco sectors. The active use of hedges can help dampen volatility and protect against rising interest rates.

Yield curve
Barbell strategy, preferring 0-2 and 20+ years

Overweights
- State tax-backed and essential-service bonds, particularly in the Northwest, Sun Belt and Plains
- School districts

Underweights
- U.S. territories and their authorities
- States and locals with poorly funded pensions (IL, NJ, KY, PA, CT)
- Single-site hospitals in Medicaid non-expansion states
Investment involves risk. 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 may be taxable. Some investors may be subject to Alternative Minimum Tax (AMT). Capital gains distributions, if any, are taxable.

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