Muni bonds hit a speed bump as rates rise

Highlights
- A sharp rise in rates resulted in negative performance for muni bonds in September.
- The advantages of owning municipals continues to support firm demand.
- Puerto Rico bonds sold off as the fiscally troubled island suffered hurricane damages.

Market overview
Municipal bonds broadly ticked down in September as interest rates moved sharply higher across the yield curve. (Bond prices fall as rates rise.) Investors shed some of their fixed income holdings in favor of riskier assets as hurricane damages turned out to be less severe than forecasted, the Federal Reserve announced its balance sheet normalization policy and maintained its expectation for a December rate hike, and Republican leaders released their much-anticipated framework for tax reform. Municipal bonds fared better than Treasury bonds due to a favorable supply-and-demand dynamic in the muni market. Muni issuance of $26.7 billion in September was 33% lower than the same month last year, continuing this year’s below-average trend, while demand for the asset class remained firm. The expanded proposal for tax reform did not mention the municipal tax exemption, however, there have been no indications of reduced support. The proposed changes to individual tax brackets pose little threat to the value of municipal bonds on a tax-adjusted basis, and the administration’s intent to further limit deductions would leave muni bonds as one of the few remaining avenues for tax shelter – a positive for demand. From a credit perspective, Puerto Rico and Connecticut are a current focus for investors. Read more in the Credit Research Update that follows.

Strategy and outlook
Our stance is more defensive as valuations remain rich while supply is likely to pick up from the summer-time lull. Central bank policy tightening, among other factors, points toward a grind higher in interest rates between now and year end. Nonetheless, the advantages of owning municipal bonds – high-quality, tax-exempt income, low volatility and portfolio diversification – continue to support firm demand. From a strategy perspective, we moved slightly lower in duration, while maintaining a neutral bias. We prefer the A-rated space, longer-dated issues and revenue bonds.

Yield curve
Neutral bias overall, preferring 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) or high oil dependence (AK, NM, ND, OK, WY)
- Single-site hospitals in Medicaid expansion states
Credit research update

Puerto Rico bonds fell precipitously as investors expected the damage from Hurricane Maria to exacerbate the island’s ongoing fiscal crisis. The federal government will play an important role in the rebuilding of the island’s infrastructure, particularly through the infusion of federal aid. However, the absence of essential needs, such as power and water, for an extended period of time could result in accelerated outmigration, providing Puerto Rico’s Oversight Board an avenue to further attempt a haircut on its debt. In contrast, investors in the municipalities of Florida and Texas that endured the wrath of Hurricanes Irma and Harvey, respectively, were relieved as actual damages reported were much less than initially expected.

Municipalities in Connecticut may face increased financial strain as the state has yet to balance its budget this year. Connecticut has been struggling with declining revenues and escalating legacy costs that could eventually lead to lower funding to local governments, exacerbating the financial stress in its troubled cities. Hartford is particularly at risk of running out of money, potentially triggering a bankruptcy filing and defaulting on its debt service payments. In the affluent suburbs, residents may be facing higher property taxes in order to offset a reduction in state aid or the shifting of pension costs.

By the numbers

The sharp rise in interest rates knocked the S&P Municipal Bond Index down -0.45% in September, bringing year-to-date performance to 4.28%. The high yield sector was particularly challenged by the selloff in Puerto Rico bonds.

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. Index performance is shown for illustrative purposes only. You cannot invest directly in an index. Past performance is no guarantee of future results.

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Monthly change in yields

<table>
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<th>Term</th>
<th>AAA Muni yield (%)</th>
<th>Treasury yield (%)</th>
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<tr>
<td>2 years</td>
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<td>1.33</td>
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<tr>
<td>5 years</td>
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<tr>
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<tr>
<td>30 years</td>
<td>2.70</td>
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Municipal and Treasury curves as of 9/30/17

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