LPL RESEARCH

BOND MARKET PERSPECTIVES

June 6 2017

MUNICIPALS ON THE MENU

Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

Municipal bonds have performed well in 2017, mirroring the direction of Treasury bonds.

Valuations are stretched, however manageable supply and heavy coupon reinvestment during the summer months may stabilize prices in the near term.

Municipal bonds have very little correlation to stocks and high-yield bonds and therefore could be used to potentially increase credit quality and diversify portfolios.

Thus far in 2017, municipal bonds have performed well, similar to the positive returns experienced in the first half of 2016. This has many wondering if it is 2016 all over again, when municipals sold-off in the second half of the year. Similarities to 2016 include returns, stretched valuations, and higher prices; however, we are forecasting a more gradual increase in supply to close 2017, as opposed to 2016, when supply spiked at year-end as issuers priced deals in advance of the U.S. election. This dynamic, coupled with the delay in political programs centered on taxation and infrastructure spending, may relieve some of the headwinds that were prevalent last year. Although credit issues have surfaced in Puerto Rico and more recently in Illinois (though not to the same extent), they appear to be isolated. Despite higher prices to date, we continue to favor high-quality municipals as they offer a tax-advantaged way to help diversify portfolios, with very little correlation to stocks and higher risk bonds.

> Similarities to 2016 include returns, stretched valuations, and higher prices; however, we are forecasting a more gradual increase in supply to close 2017, as opposed to 2016, when supply spiked at year-end as issuers priced deals in advance of the U.S. election.

PERFORMANCE HAS BEEN SOLID...

The Bloomberg Barclays Municipal Bond Index posted a total return of 1.5% in May, and 4.4% year to date. This is much improved from the sell-off that occurred in late 2016 when the index lost 3.7% in November (the worst month since September 2008), underperforming the Bloomberg Barclays Aggregate Bond Index by 1%. Although performance has been better and the similarities in returns to 2016 are worth noting, it is important to realize that the technical setup then was different. Last year, municipals experienced 56 weeks of cash inflows prior to October 2016, resulting in greater demand. This year, inflows have been positive but muted, resulting in less overbought conditions, which could provide stability to the market.

...BUT RELATIVE VALUATIONS ARE STRETCHED

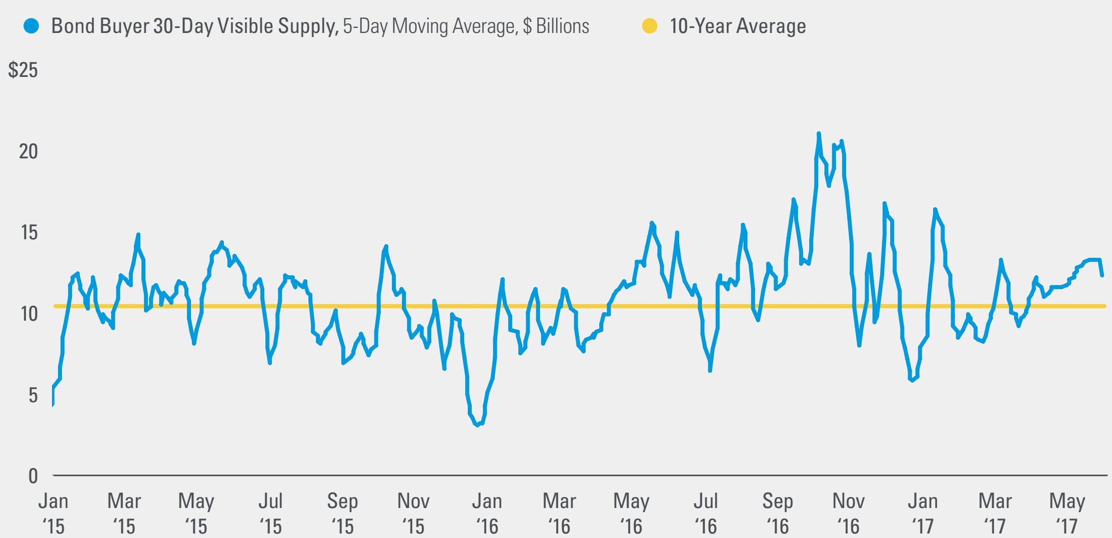
Municipal bond investors often pay a higher price (and receive less yield) for the added benefit of the tax-free income they receive. Generally, when municipal prices are below comparable taxable bond prices, municipal bonds are said to be cheap. Another way to compare relative value is to look at the ratio of municipal bond yields to similarly dated Treasury bond yields, where higher ratios represent cheaper relative valuations for municipals. Historically, using Bloomberg pricing data, a 10-year ratio above 85% and a 30-year ratio above 95% is thought to represent value. Currently, the 10-year ratio is 86%, above the historic average, but more expensive than the 5-year average of 96.2%. The 30-year ratio is now at 97%, also above its historic level, but expensive compared to the 5-year average of 102%. (Note that ratio figures may differ depending on the data source used.)

In addition to ratios showing that municipals are slightly expensive, absolute yields are coming down as well. The AAA Bloomberg Municipal Benchmark 10-Year Index, which measures characteristics for highly rated AAA municipal bonds, now yields 1.85%, well below the multi-year high in yield of 2.57% on December 1, 2016.

BOND SUPPLY

The supply of new bonds priced in the primary market also affects the relative value of municipals [Figure 1]. May's issuance of $13.2 billion was higher than the 10-year monthly average of $11 billion but this has caused very little price weakness in the market. Historically, demand increases and supply tends to shrink between July and August, making this a decent time for municipal bonds. That said, with demand higher and yields lower, issuers may take advantage of the high prices being paid for bonds and issue after the summer months, which could lead to price weakness.

1 30-DAY VISIBLE SUPPLY PEAKED IN MAY BUT HISTORICALLY DECLINES IN SUMMER MONTHS



Source: LPL Research, Bond Buyer 06/06/17

Performance is historical and no guarantee of future results.

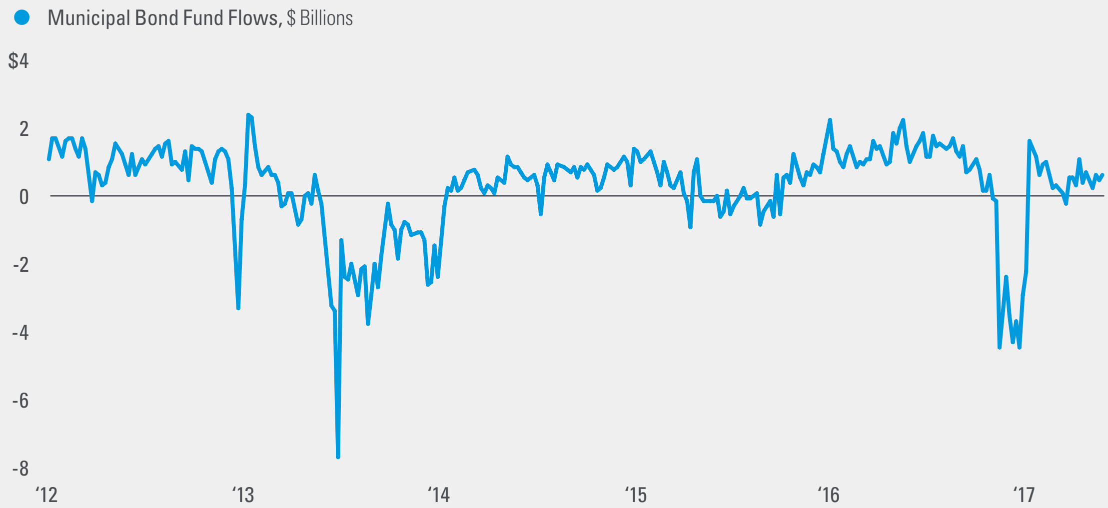
INFLOWS ARE POSITIVE, FOR NOW

With the seasonally high municipal supply months of March through May behind us, the monthly cash flows into and out of municipal bond funds will be a more important driver of demand moving forward [Figure 2]. June is a heavy coupon reinvestment period, when many interest rate payments are received and reinvested back into the market, which should keep prices in check. High cash inflows lead to greater demand, which in turn drives yields lower, all else equal. With the supply picture turning more favorable and the potential for fund inflows to remain positive, prices should remain stable. This may provide the confidence investors need to reenter the market, even at these stretched prices.

CONCLUSION

Investment-grade and high-yield municipals are off to a good start in 2017. Moving forward, we do not expect a repeat of 2016's second half sell-off as supply is expected to be lighter through the summer months, and outflows may be offset with coupon cash coming back into the market when investors reinvest cash flows. Tax-free yields relative to taxable U.S. Treasuries are lower than in late 2016, but with proposed tax cuts and increased infrastructure spending potentially pushed back to 2018, we are forecasting a more stable year-end for municipals in 2017. We favor investment-grade municipal bonds as they offer very little correlation to stocks and can be used to potentially increase credit quality and diversify portfolios. We remain neutral to underweight municipal high yield as the longer maturity profile can be volatile in rising rate environments. ■

2 MUNICIPAL BOND FUNDS HAVE EXPERIENCED INFLOWS YEAR TO DATE



Source: LPL Research, Investment Company Institute (ICI), Bloomberg 06/06/17

Performance is historical and no guarantee of future results.

Investing in mutual funds involves risk, including possible loss of principal. Municipal Bond mutual fund's concentrated holdings will subject it to greater volatility than a fund that invests more broadly.

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.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

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.

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 rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

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.

Correlation is a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management.

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of $11.18 trillion and serve nearly 90 million shareholders.

INDEX DEFINITIONS

The Bloomberg Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

AAA Bloomberg Municipal Benchmark 10-Year Index is an unmanaged index with maturities between nine and twelve years. The Bloomberg Barclays 10-Year Municipal Bond Index is the 10-Year total return subset of the Bloomberg Barclays Municipal Bond Index.

RES 5936 0617 | Tracking #1-614949 (Exp. 06/18)