RESEARCH | WEALTH MANAGEMENT INVESTMENT RESOURCES | JANUARY 17, 2018

Municipal Bond Monthly

NORTH AMERICA

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Special thanks to Ayden Syal for his contribution to this report.

Strategy:

- Low Ratios and Rate Weakness Suggest Caution
- Consider Entry Points Once Weakness Stabilizes
- Favor High Quality; Keep Some Dry Powder

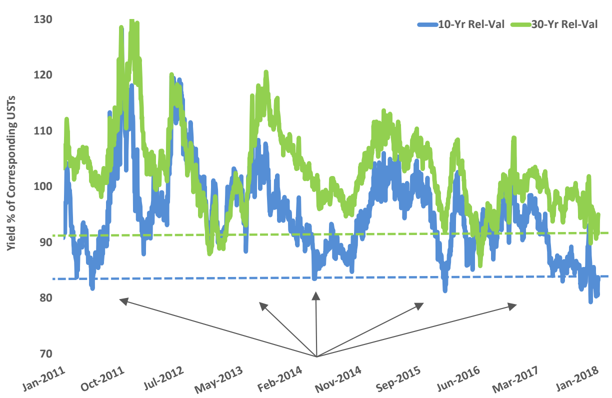
Credit Quality: High

Favored Sectors: See our Sector Outlooks Table

Duration: Short/Low-to-Neutral

Coupon Structure: 4.5% or Higher

Fig 1. Home Again—Ratios Settle Below Averages



Source: Morgan Stanley Wealth Management Municipal Research and Strategy, Bloomberg, Thomson Reuters Municipal Market Data (MMD) as of 1/16/18

Back Home Again

"Hey, it's good to be back home again …" Great song, right? John Denver's lyrics capture the visceral sentiment that many of us feel whenever we journey home to visit friends and family. Though as many of us who travel long distances can attest to, the nostalgic feeling of the return is indescribable, but even the familiar setting of home gradually changes as time goes on. As we will elaborate upon shortly, our market is inarguably "back home again" in a number of important ways; however, as familiar as this environment may be, the journey is always a new one moving forward.

What does this mean that the market is "back home" once again? Allow us to explain.... Importantly, what last year's tax reform legislation (the Tax Cuts and Jobs Act of 2017) didn't do may be far more material than what it actually did. Though the legislation may gradually mold the landscape of the market moving forward, the package held the potential to have a far more significant impact on investor sentiment and market pricing, particularly in the short term. Alongside the factors discussed in our recent publications, two important concerns were assuaged: (1) no material changes were made to the municipal bond tax exemption; and (2) personal income tax reductions appeared low enough to have a neutral impact on household demand. (Although these dynamics have bolstered the market and are important to our discussion, please review the considerations listed in our **Tax-Reform Breakdown Table** as well.)

As the market recognized that such possibilities were becoming realities, investor sentiment transitioned "back home." One of the most important, and even overlooked, developments of 2017 was the long-awaited return of municipal relative-value ratios to their long-term historical averages versus US Treasuries (USTs). These ratios represent how tax-exempt securities are valued versus their taxable counterparts, and exhibit that the asset class has yielded more, or traded weaker, than USTs for most of the last eight years. This sentiment surfaced for a variety of reasons, but we believe it should be greatly attributed to the American Jobs Act's 2011 proposal to cap the value of the municipal exemption at 28%. Consequently, investors discounted the possibility that a change, albeit minor, to the federal exemption was possible. Once this concern was assuaged, ratios returned to familiar territory. In fact, 10-year ratios have averaged just over 84% of USTs since last October, which marks the most extended period of comparative strength enjoyed by the asset class since 2010. In essence, the preservation of the exemption, coupled with tax-reduction clarity, helped the asset class to return home again.

Before delving into our investment strategy, it is important to stress that the aforementioned dynamic, as familiar as it may be, introduces variables that investors should consider. Though current ratios indicate that bond pricing has returned to familiar territory, they also exhibit that the market is priced “just so”—which hints that municipals have less room to potentially advance versus USTs moving forward. Should USTs continue to weaken (and interest rates rise), the market will approach a threshold where crossover investors will likely sell tax-exempt securities to increase their exposure to taxable ones. Quite simply, the more expensive municipals become, the more sensitive they will be to any future UST weakness.

What does this mean? For the first time in many years, this "home again" starting point suggests that municipal investors must pay even more attention to the global interest rate environment. It's always challenging to determine when and if a period of UST weakness will occur, but we must acknowledge the presence of potential catalysts (some are new) at the current juncture. The aforementioned include a weaker US dollar, stronger commodity prices, a hawkish European Central Bank (ECB), concerns of reduced UST investment from China and, importantly, the potential return of the “reflation trade” if explicit details of a federal infrastructure package emerge. Indeed, a stimulus package has the potential to reverse short-term investor sentiment, increase inflationary expectations, elevate federal debt levels, and even foster anxieties about US deficit spending—all of which could cause interest rates to rise.

Combining the aforementioned dynamics, we would focus on three objectives as we begin the year: (1) exercise caution in the current period of low relative value and interest rate weakness; (2) cautiously consider entry points once present UST weakness stabilizes; and (3) favor high-quality securities and keep some powder dry.

First, though absolute yield levels hover near the appealing levels we’ve experienced since October, low relative-value ratios hint that the muni market may have little choice but to follow US Treasuries if they continue to weaken. Consequently, investors should exercise caution in the coming weeks. Since we elaborated upon this dynamic earlier, we can swiftly transition this discussion to our second focus: Moving forward, we believe investors can carefully consider adding exposure once the current period of weakness stabilizes. Though we would by no means cannonball in, higher absolute yield levels suggest that prudently adding some exposure for carry (earning interest) may be beneficial; however, waiting for UST stability with ratios as low as they are should help investors to heed the old adage of not catching a falling knife.

Lastly, we continue to advocate that investors focus on high-quality municipal securities at this time. Though we discuss this topic often, we believe this advocacy supports a proper balance between risk and reward as: (1) investors are currently compensated less for taking credit risk due to tight spreads; while (2) lower-rated credits may experience challenges and/or spread widening if the economy is in a late cycle. Consistent with the recommendations of Morgan Stanley Wealth Management’s Global Investment Committee, we also favor bonds with short/low-to-neutral duration for buy-and-hold investors. Tactical investors may wish to consider higher durations, but private clients should note that 83% of the yield curve is currently captured by the 12-year maturity. As discussed last month, we feel that employing a bond ladder strategy of high-quality, short-to-neutral duration municipal securities can function as an effective intermediary between earning yield and taking excessive interest rate risk. Finally, we'd stress that investors leave some dry powder for the possibility of any future rate weakness due to the aforementioned catalysts.

After receiving some clarity about the municipal bond tax exemption and federal income tax reductions, our market seems to be home again for the first time in nearly eight years. Though the setting is familiar, the journey will still be a different one moving forward … as it always is.

Monthly Spotlight – State of New York (Credit Update)

As discussed in last February’s publication, the state’s credit strengths include its inherent dominion over one of the nation’s largest economies, which is bolstered by the productivity of the New York metropolitan area. The state has also embraced disciplined managerial practices in recent years, apparent in expenditure restraint and multi-year revenue forecasting/financial planning. Additionally, New York’s taxpayer base is populous and affluent as per-capita income metrics handily surpass national averages. However, the state now faces a considerable budget deficit as a result of revenue growth that has fallen below expectations. This challenge will likely be exacerbated by the recent loss of some federal health care funding and the limitation of the SALT (state and local tax) deduction, which may cause population loss and/or add political pressure to reduce taxes, spending, and borrowing. New York’s progressive income tax structure also creates a dependence upon the state’s top earners and the financial services sector. This reliance exposes its position to cyclical downturns. Though net-tax-supported debt per capita has declined, the state’s debt burden is also high.

Overall, New York has made significant progress in recent years as the state has leveraged the recovery to strengthen its profile; however, the state faces fiscal challenges moving forward. We advocate that investors monitor New York’s management of the aforementioned challenges, as well as macroeconomic developments and their repercussions on the financial services sector (NYC) when evaluating creditworthiness. Investors should anticipate volatility moving forward, but we believe the state’s position is of very strong credit quality at this time.

Municipal Market Data

Fig 3. Home Again—Muni Ratios Return to Historical Averages Versus USTs

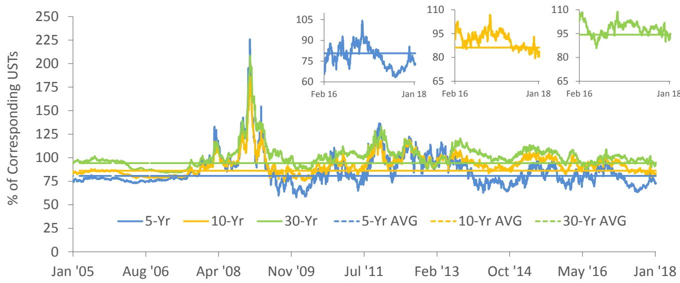


Fig 4. Credit Spreads—Favor High Quality On "Tight" Spreads

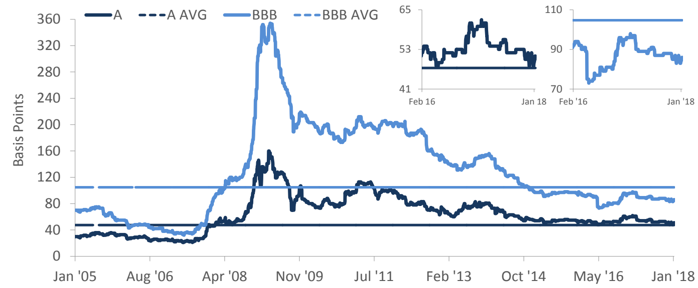


Fig 5. Nominal Yields Rise; Wait for Stability

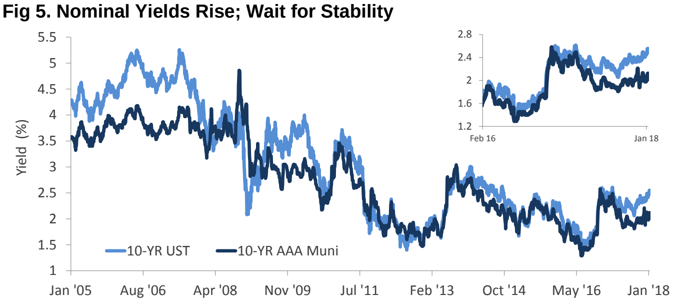


Fig 6. Flat Long End Supports Our Short-to-Neutral Duration Preference

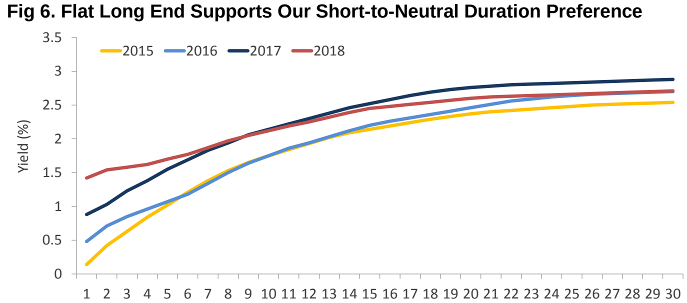


Fig 7. Pre-Reform Supply Rush Sets December Record

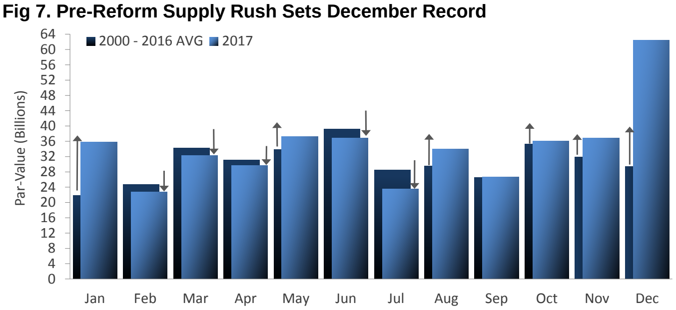
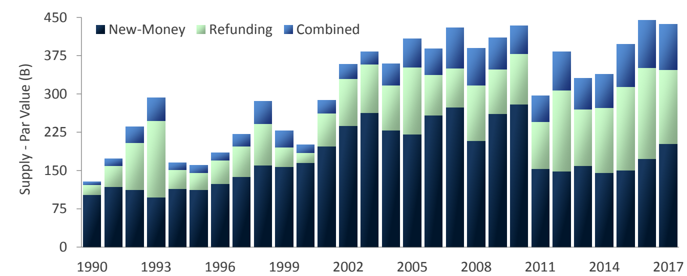


Fig 8. Bolstered by Tax-Reform, 2017 Gross Supply Healthy



Source: Morgan Stanley Wealth Management Municipal Research and Strategy, Thomson Reuters MMD, Bloomberg, The Bond Buyer as of 1/16/18

Fig 9. Sector Outlooks and Recommended Rating Parameters

Sector	Minimum Rating*	Commentary
State GO & State Appropriated	A1/A+	Pension/OPEB challenges. SALT debate should challenge high-tax states. Volatility/downgrades continue. Be selective
Local GO	Aa1/AA+	State aid, pension challenges, and SALT challenges apparent. We strongly advocate selectivity and high credit quality
Essential Service (Water & Sewer)	A2/A	Essential purpose beneficial, where applicable; capital needs may create select challenges
US Public Power	A2/A	Favorable non-cyclicality of revenues; evolving power markets and regulation may create select challenges
State Housing Finance Agencies	A2/A	Directly exposed (positively or negatively) to housing market momentum; diversified business models
Higher Education	A1/A+	We recommend higher-rated, well-established institutions due to student selectivity and price sensitivity
Transportation	A2/A	Bolstered by modest economic growth and lower oil prices. Some recession risk
Not-for-Profit Hospitals	Aa3/AA-	Recommend larger systems as a conservative choice. The future of the ACA still unclear
Tax-Secured / Dedicated-Tax	A1/A+	Generally less political risk. We prefer high-quality income, sales, and utility tax bonds with no commingling of revenues

*Table lists *minimum* credit rating recommended for buy-and-hold investors. (Please consider referenced rating with a stable outlook and/or higher rating.) Tactical decisions or whether a bond is over/undervalued should be evaluated on a case-by-case basis.

Moody’s and S&P Ratings Scale

	Moody’s	S&P
Investment Grade	Aaa	AAA
	Aa1	AA+
	Aa2	AA
	Aa3	AA-
	A1	A+
	A2	A
	A3	A-
	Baa1	BBB+
	Baa2	BBB
	Baa3	BBB-
High Yield	Ba1	BB+
	Ba2	BB
	Ba3	BB-
	B1	B+
	B2	B
	B3	B-
	Caa1	CCC+
	Caa2	CCC
	Caa3	CCC-
	Ca	CC
	C	C
	WR	D
	NR	NR

Source: Bloomberg

Credit ratings throughout this report are cited from Standard & Poor’s and Moody’s given they are two of the most widely followed credit agencies in the fixed income markets.

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Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Interest on **municipal bonds** is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Also, municipal bonds acquired in the secondary market at a discount may be subject to the market discount tax provisions, and therefore could give rise to taxable income. Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies.

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Equal-weight/Hold	43	44.3%		13	35.1%	30.2%
Underweight/Sell	19	19.6%		7	19.0%	36.8%
Total	97	100.0%		37	100.0%	

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