

# Municipal Bond Monthly

## NORTH AMERICA

**MATTHEW GASTALL**

Executive Director

Morgan Stanley Wealth Management

Matthew.Gastall@morganstanley.com

+1 212 296-2602

### Strategy:

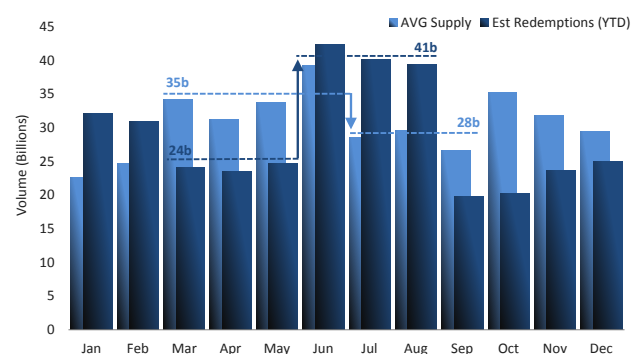
- Consider Pre-Summer Entry Points
- Favor High-Quality; Front-End Curve Focus
- Systematically Add Exposure; Maintain Allocations

**Credit Quality:** High

**Favored Sectors:** Please see our Sector Outlooks Table

**Coupon Structure:** 4.5% or Higher

**Fig 1. Blue-Sky Forecast**



Source: Morgan Stanley Wealth Management Municipal Research and Strategy, The Bond Buyer, Bloomberg, ICE Data, Thomson Reuters Municipal Market Data as of 4/17/18

## Blue Skies

*“Blue days ... all of them gone.”* Though they may not last forever, Irving Berlin’s sanguine composition reminds us to enjoy the “Blue Skies” whenever we can. Vivacious, optimistic ... just plain fun ... renditions of the song were later completed by Ella Fitzgerald, Benny Goodman, Willie Nelson, and many others. Turning to our own focus, the similarities now seem readily apparent. Though we know that current events will inevitably change, we see blue skies for municipals as the seasons change and we journey toward the summer.

As many of our readers will attest to, the first quarter of this year was a challenging one for municipal bond price action. As we discussed in our January and February publications, however, this storyline was shaped less by public finance developments and more by geopolitical dynamics that impacted the entire fixed income landscape. The aforementioned included rising commodity prices, a weakening US dollar, transitioning inflationary expectations, ECB taper anxieties, the passage of tax reform, and anticipations of future stimulus (infrastructure)—a confluence of factors that caused interest rates to rise and bond prices to decline. Conversely, developments specific to the public finance arena, namely the preservation of the tax exemption during reform and this year’s low supply, were so constructive that state and local government bond prices had little choice but to **“Follow the Leader,”** the US Treasury (UST) market, downward. Had they not, municipals risked becoming *too expensive* and would have likely been sold by crossover investors seeking higher yields elsewhere. Due to this longstanding relationship between the two asset classes, tax-exempts finished last quarter with a  $-1.11\%$  year-to-date (YTD) total return, according to the Bloomberg Barclays Municipal Bond Index. (Recall that buy-and-hold investors are often less concerned with interim price fluctuations as they generally hold the securities until maturity.) This being said, it’s now refreshing to state that the weather is improving, temperatures are rising, and the short-term outlook for the municipal market appears bright at this juncture.

As discussed last month in **Rain or Shine**, a number of dynamics lead us to believe that we may encounter blue skies in the coming months. First, the now two-month period of interest rate stability continues as we put pen to paper. Volatility metrics have subsided and the 10-year AAA MMD and UST have traded within a 13- and 21-basis-point (bp) range, respectively, since February 21. The longevity of this period following the approximate 60 bp interest rate increase reiterates that fixed income markets may now have less “room to run” (decline) and have settled into a new range. (Importantly, this development may also indicate that any near-term rate weakness is unlikely to offset the value of carry—simply being invested to continuously earn interest.)

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Complementing this period of stability, last quarter's new issue volume finished nearly 23% below the primary market's YTD historical average. As many of our readers will recall, this dynamic surfaced as the result of limitations placed on advance refundings following the passage of tax reform. Consequently, only 12% of this year's gross supply has been for refinancings (advance *and* crossover), where such deals have accounted for roughly 34% of all volume since 2009. Though this spring's supply influx should create minor pockets of underperformance during which to add exposure, we believe the combination of rate stability and less YTD issuance creates a mostly constructive, blue-sky setting for municipals as we journey toward the summer.

Considering the aforementioned dynamics, we would focus on three objectives at this time: (1) consider entry points as shifting seasonals create pockets of underperformance this spring; (2) exercise a front-end focus when targeting high-quality municipal securities with short/low-to-neutral duration; (3) systematically add exposure and maintain appropriate asset allocations.

First, we believe investors should consider entry points this spring, particularly if shifting seasonals create modest pockets of underperformance. As interest rates rose to more enticing levels last quarter, we advocated that market participants exercise caution and wait for a sustained period of stability before committing capital. That period now appears to be here. Not only have USTs and tax-exempt securities exhibited stability, but 1- to 5-yr municipals are currently yielding their highest levels in nearly 10 years (and 10-yr yields reside near one-year highs). Complementing this dynamic, this spring's seasonal supply acceleration, which generally occurs in tandem with weaker redemption-driven reinvestment demand, may help to create modest pockets of underperformance during which investors may wish to systematically add exposure. Such an exercise may be beneficial before the summer doldrums set in.

### Monthly Spotlight — States versus Locals; Sector Diversification

It's basic, yet often overlooked. Investors can increase portfolio credit quality, vary exposure, reduce volatility, and even increase yield by diversifying between public finance sectors and even states. This strategy encourages investment in a diversified blend of general obligation, revenue, and dedicated tax structures impacted by different geographic and economic variables.

One topic we discuss often is the differentiation between state and local government fiscal profiles. It's important to note that the revenue compositions of most states are bolstered by personal income and sales tax collections, both of which have exhibited improvement during the recovery. However, local government profiles are different, as they typically rely heavily upon state aid and ad valorem property tax collections (lagging and dependent upon housing). Importantly, states often enjoy an enhanced degree of flexibility with reducing expenditures, raising revenue, cutting aid, utilizing inter-fund borrowing, bonding, and even passing liabilities down to local governments. Consequently, we prefer

Consistent with the recommendations of Morgan Stanley Wealth Management's Global Investment Committee (most recently cited in [The GIC Weekly](#)), we believe household investors should embrace a "front-end" focus of the municipal bond yield curve at this time. As previously alluded to, the combination of Fed rate hike expectations and seasonal tax-time fund outflows has helped yields on shorter maturity securities to rise, causing the slope of the municipal bond yield curve to flatten. In fact, the yield differences between 2- and 10-yr (2s/10s) and 2- and 30-yr (2s/30s) AAA MMD maturities now stand at their second lowest readings since 2008. As we often discuss in our work, nearly 80% of the curve is now captured by year 9. Consequently, a bond ladder of short-to-neutral duration securities (with a current front-end focus) should function as an effective intermediary between earning yield without taking excessive interest rate risk. Turning to credit, recall that "tight" spreads indicate that lower-rated issuers offer investors less compensation for risk. Please see our Monthly Spotlight below and reference the Sector Outlooks on the next page for more information.

Lastly, the still-lingering presence of catalysts that may incite fixed income weakness suggests that participants should systematically add exposure to the market, preferably throughout periodic intervals of underperformance this spring. Though recent stability is encouraging, many of the aforementioned global dynamics may cause interest rates to rise again. Investors may wish to add exposure before the doldrums of the summer, but we believe should do so in a methodical fashion and remain mindful of asset allocations (the appropriate proportions of cash, fixed income, and/or equities).

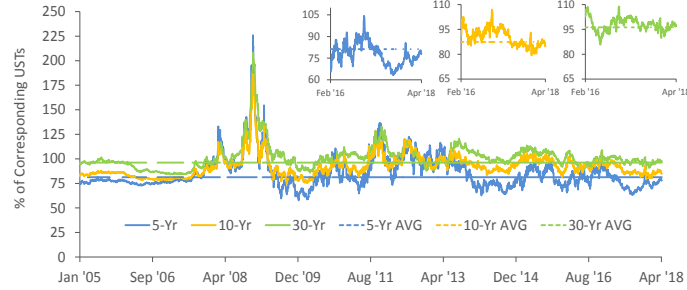
*"Blue days ... all of them gone"* Though markets are inherently ever changing, outlooks can appear bright in the short term. We see blue skies for municipals this spring and believe this period is an opportunity to prudently add exposure.

state GO/appropriated securities over local governments at this time; however, we advocate investors closely monitor developments relevant to New Jersey, Illinois, and Connecticut.

As revenue bonds are often secured by fares, tolls, or fees generated by dedicated systems/projects, their issuers are impacted by different variables. These include macroeconomic dynamics, demographic trends, and others. Additionally, investors should watch for systems that heavily depend upon appropriations received from, or where they are required to make payments to, a "parent" government. Should a parent encounter fiscal stress, the profile of any associated, or coterminous, entity may also be impacted. Thus, a state's challenges can have a multiplier effect on some of its revenue systems or local governments. Consequently, investing in only one state can also subject an investor to the same economic, political, and technical sensitivities. Please see our Sector Outlooks table on the next page for more information.

**Municipal Market Data**

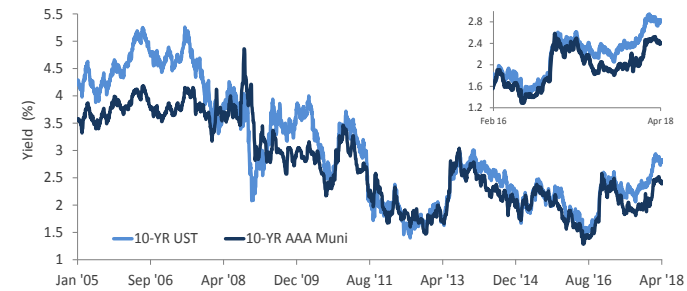
**Fig 2. Relative Value — Still “Rich” Relative Levels (Post 2008)**



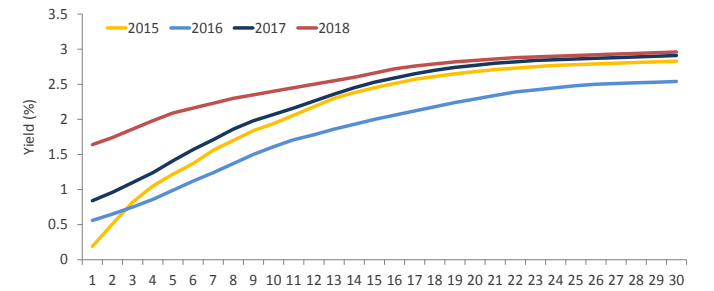
**Fig 3. Credit Spreads—A and BBB Yield Historically Less to AAA Benchmark**



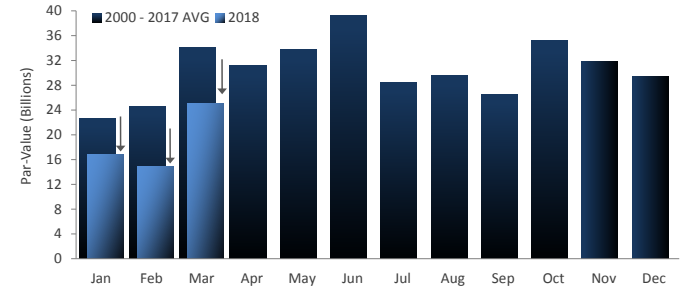
**Fig 4. Stability Apparent; Nominal-Yields Near One-Year High**



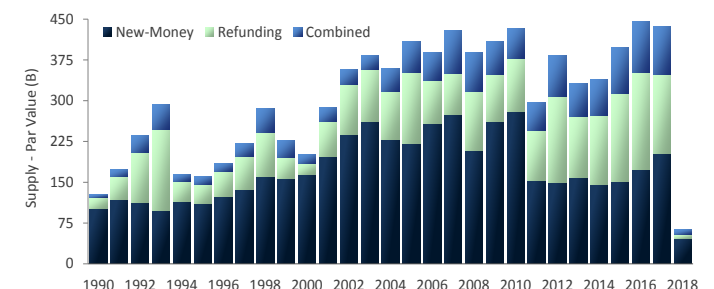
**Fig 5. Yield Curve Continues to Flatten; Focus on Short-Neutral Duration**



**Fig 6. Monthly Supply — Spring Increase Anticipated (Potentially Modest)**



**Fig 7. Annual Supply — Low YTD Metrics Following Tax Reform**



Source: Morgan Stanley Wealth Management Municipal Research and Strategy, Thomson Reuters MMD, Bloomberg, The Bond Buyer a/o 4/17/18

**Fig 8. Sector Outlooks and Recommended Rating Parameters**

Sector	Minimum Rating*	Commentary
State GO & State Appropriated	A1/A+	Pension/OPEB challenges exist. SALT debate challenges 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	Aa2/AA	Exposed to housing market momentum; diversified business models; recession risk; SALT challenges in high-tax states.
Higher Education	Aa3/AA-	We recommend higher-rated, well-established institutions due to student selectivity and price sensitivity.
Transportation	A2/A	Bolstered by modest economic growth and still relatively low oil prices. Recession risk exists.
Not-for-Profit Hospitals	Aa2/AA	We recommend larger systems as a conservative choice. The future of the ACA is 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.

Credit quality is a measure of a bond issuer's creditworthiness, or ability to repay interest and principal to bondholders in a timely manner. The credit ratings shown throughout this report are based on each issuer's security rating as provided by Standard & Poor's and Moody's, as applicable. The credit quality of the issuers listed in this report **does not represent the stability or safety of the bonds**. Credit ratings shown range from AAA, being the highest, to D, being the lowest based on S&P's classification (the equivalent of Aaa and C, respectively, by Moody's). Ratings of BBB or higher by S&P (Baa or higher by Moody's) are considered to be investment grade-quality securities. Within Moody's classification, "WR" stands for "withdrawn rating." Reasons for withdrawals include: debt maturity, e.g., calls, puts, conversions, etc.; and business reasons, e.g., change in the size of a debt issue or the issuer defaults. "NR" stands for "not rated" by the agencies.

## Risk Considerations

**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.

**Yields** are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

**Credit ratings** are subject to change.

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(as of date **March 31, 2018**)

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Closed-End Fund (CEF) Rating Category	CEF Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	35	36.1%	13	38.2%	37.1%
Equal-weight/Hold	43	44.3%	14	41.2%	32.6%
Underweight/Sell	19	19.6%	7	20.6%	36.8%
Total	97	100.0%	34	100.0%	

Data includes CEFs currently assigned ratings. An investor's decision to buy or sell a fund should depend on individual circumstances (such as an investor's existing holdings) and other considerations.

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