Municipal Bond Monthly

NORTH AMERICA

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Our thoughts and prayers are with everyone affected by Hurricane Florence and Typhoon Mangkhut.

Strategy:

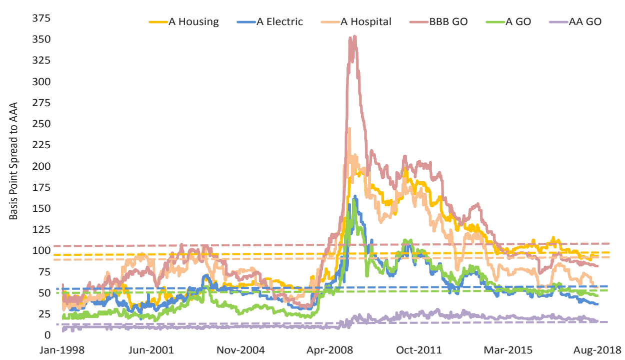
- Continue to Monitor USTs for Leadership
- Consider Swapping to Strengthen Positioning
- Quality, Front-End Focus (Taxable and Tax-Exempt)

Credit Quality: High (Refer to our Sector Outlooks Table)

Coupon Structure: Above-Market

Spotlight: Turn Toward High Quality

Fig 1. Turn to Quality—Low Compensation for Credit Risk



Source: Morgan Stanley Wealth Management Municipal Research, Bloomberg, Thomson Reuters Municipal Market Data (MMD) as of 9/18/18

To Everything Turn

"To everything turn, turn, turn … " While some changes are peaceful and others are quite eventful, weren't the Byrds right when reiterating that there's an appropriate time and purpose for just about everything in life? Yet here we are in the midst of another transition when the days are shorter, temperatures change, and those daily calls of never-ending responsibilities begin to chime. We're turning once again .... Though as we've discussed since March, this year has been a different one for our market. The environment is slightly calmer, slightly quieter, and, upon further analysis, appears to be in good condition. If anything, investors can utilize the current period to improve portfolio positioning.

It was just two years ago when we wrote about the market's reception of the largest monthly new-issue volume since 1986, a dynamic inspired by a post-Labor Day rush to issue debt ahead of the 2016 elections. At the time, many differing opinions existed about how the markets would respond to two notably divergent styles of national leadership, and many state and local governments decided to act ahead of what could be (and was) an eventful and volatile response to that outcome. Turning the calendar forward one year, the theme of last August's publication, *Imperfectly Perfect*, centered on concerns that financial markets were benefiting from "Goldilocks" conditions in which asset values appeared so perfectly priced, they were actually imperfectly positioned to withstand a number of fixed income threats. These included the potential passage of tax reform, details of the Fed's balance sheet unwind, transitioning global monetary policy, and others. Sure enough, these catalysts proved sufficient to elicit a considerable market response, and global equities rallied while US Treasuries (USTs) weakened at year end.

This year's "turn" has been quite different. As always, we must pay close attention to a number of important events that loom on the horizon, such as this year's FOMC decisions, current trade tensions, and the midterm elections; however, the tone of the market has been comparably less eventful for municipals. Though we needed to maintain a very different focus throughout the last two autumns, we believe that not only is the current environment "not bad," it's actually good.

Taking a look at some of the market's vital signs may help to explain why current conditions support a welcome respite from recent years. Primary market volume is one of the first dynamics that comes to mind. Despite issuance hovering nearly 8% below the year-to-date historical average, this September's supply has been quite healthy, and appears to be competing for the month's second largest volume in seven years, sitting behind 2016's anomalous pre-election rush. Taking one step further, the summer's substantial redemption-driven reinvestment backdrop (comfortably over $100 billion) has helped to bolster a strong primary setting where supply has been met well by prospective investors. Finally, as discussed in last month's publication, we can add low muni volatility, a flatter yield curve, healthy trading volumes, and benign credit conditions to the mix. The market appears healthy, but we must always look forward.

Combining the aforementioned dynamics, we recommend focusing on three objectives as we journey toward yet another turn: (1) continue to monitor USTs for leadership; (2) consider swapping to strengthen positioning; (3) retain a household focus on high-quality, front-end securities (taxable and tax-exempt).

We discussed our first objective thoroughly last month. Since our market has encountered a number of constructive developments, bond prices have advanced, driving yield levels and relative-value ratios lower in their outperformance. Should USTs continue to weaken and interest rates rise, our market may breach thresholds where crossover investors will likely sell tax-exempt securities to increase their exposure to taxable ones, particularly on the short end of the curve where ratios trade below historical averages. Consequently, municipal investors must pay even closer attention to macroeconomic developments that may incite UST weakness. These include any above-consensus economic progress, concerns of foreign ownership of UST debt, transitioning inflationary expectations, and changes to global monetary policy (next week's Fed meeting), among others.

Our second objective represents the completion of the advocacy that we've reviewed since July. Though we often caution against aggressively completing "clean-up" trades while liquidity is weak during the summer, we often find the period to be beneficial to complete portfolio reviews when activity is slower. Now that liquidity appears to be improving, investors may wish to consider executing swaps to strengthen positioning within the coming months (be careful with recent rate volatility), but remember to consider tax consequences and transaction costs, among other factors, when acting. Some of the most imperative items featured in July's Portfolio Review Checklist include swapping to improve credit quality, yield curve positioning, coupon structure, tax exposure, and sector/state diversification. Tight credit spreads and a flatter yield curve suggest that the current period continues to be one of the most advantageous times in the last 10 years to upgrade quality and/or shorten final maturities.

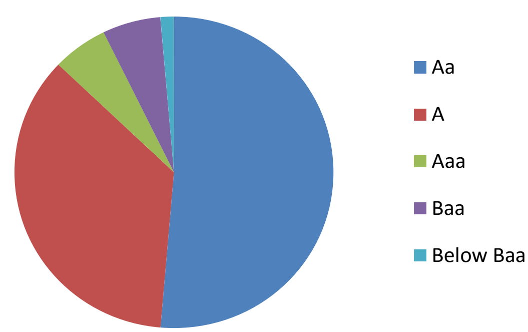
Consistent with the recommendations of Morgan Stanley Wealth Management's Global Investment Committee, we continue to favor a front-end, high-quality focus for household investors at this time. Though we must be mindful of how future Fed decisions may impact yields on the short end of the curve, it's important to stress that household investors are often less concerned with interim price fluctuations with securities that are likely "bought and held" until earlier maturity dates. Importantly, the additional compensation offered for taking interest-rate risk continues to be very modest. Despite recent curve steepening, muni 2s/10s, 10s/30s and 2s/30s still hover within striking distance of 10-year lows. Participants should also maintain the appropriate exposures to cash and look to blend high-quality taxable counterparts in the very shortest maturities where yields have risen in USTs more than municipals. Recognizing that the economic cycle continues to progress, we decided to highlight the importance of credit quality in our Monthly Spotlight below. Overall, our strategy may be achieved by focusing on high-quality securities (diversified throughout the sectors listed on the next page) with above-market coupons, evenly distributed call options, and final maturities laddered under 11 years.

"To everything turn … " Here we are in the midst of yet another transition, but this year's turn is different for our market. Though slightly calmer, slightly quieter, the market appears to have a foundation that investors can utilize to improve positioning.

Monthly Spotlight – Turn Toward High Quality

Investing in (or swapping for) high-quality municipals likely becomes increasingly important as the economic cycle progresses. Working within the guidance of the sector parameters featured on the next page, our credit-quality preference is predicated upon three important factors. First, tight credit spreads indicate that the additional yields offered for investing in weaker-rated credits reside near 10-year lows, which suggests that investors are now receiving some of the most minimal levels of risk-taking compensation earned since 2008. Second, keep in mind that spreads tend to increase (or widen) during periods of economic stress when investors shy away from risk. In essence, the prices of lower-rated bonds may soon decline if the economy is in a late cycle. Third, recall that stronger entities often have the ability and willingness to tackle hurdles when they surface, and should be more likely to avoid challenges. We continue to favor exposure to high-quality municipal securities and remain cautious on high yield at this time.

Fig 2. High-Quality Market Majority



Source: Morgan Stanley Wealth Management Municipal Research, Bloomberg, Moody's as of 9/18/18. Credit rating breakdown calculated by number of CUSIPs.

Municipal Market Data

Fig 3. Relative Value — Continue to Watch USTs Following Outperformance

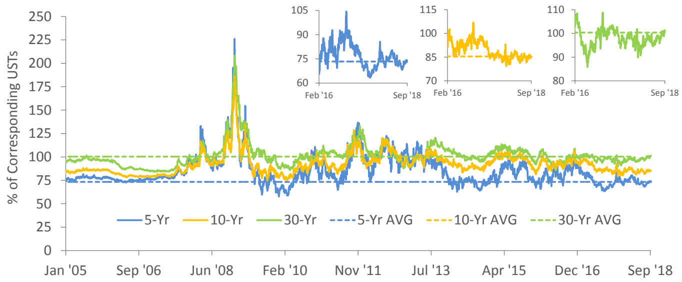


Fig 4. Credit Spreads — Still Low Compensation for Credit Risk

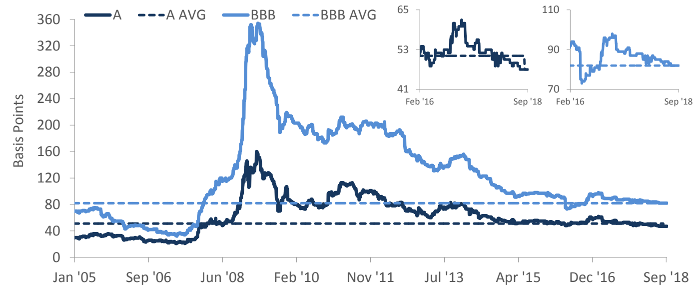


Fig 5. Muni Yields Mostly Range Bound in 2018

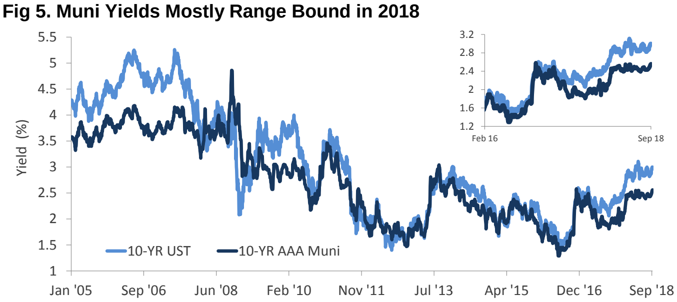


Fig 6. Yield-Curve — Flat Curve, Low Compensation for Interest Rate Risk

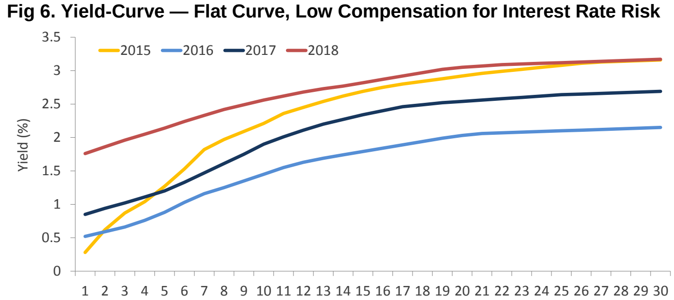


Fig 7. Monthly Supply — August Issuance Surprises to the Upside

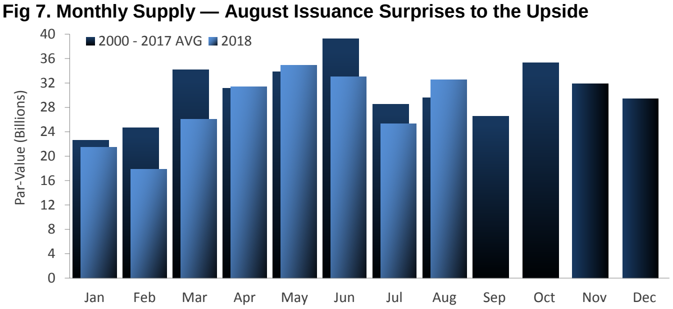
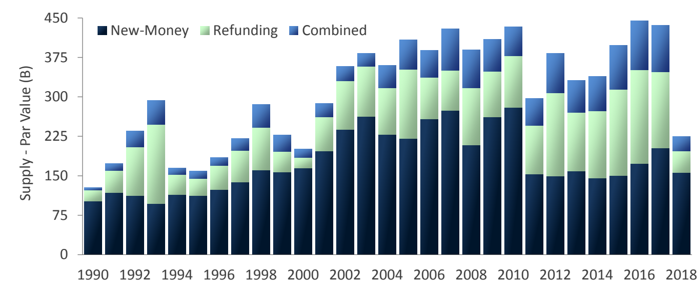


Fig 8. Annual Supply — Still Lower YTD Supply Following Tax Reform



Source: Morgan Stanley Wealth Management Municipal Research and Strategy, Thomson Reuters MMD, Bloomberg, The Bond Buyer as of 9/18/18

Fig 9. Sector Outlooks Table 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 economic growth and manageable 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.

Source: Morgan Stanley Wealth Management Municipal Research and Strategy

*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 **August 31, 2018**)

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	CEF Coverage Universe		Investment Banking Clients (IBC)		
Closed-End Fund (CEF) Rating Category	**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%	

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