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Municipal Bond Monthly

NORTH AMERICA

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

Strategy:

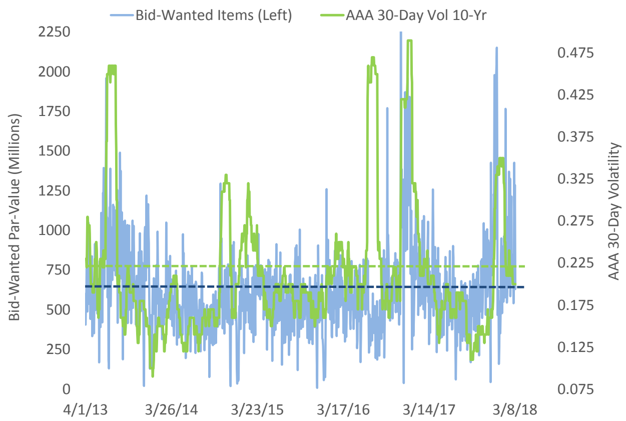
- Consider Current and Spring Entry Points
- Watch USTs; Systematically Add Exposure
- Favor High-Quality

Credit Quality: High

Favored Sectors: Please see our Sector Outlooks Table

Coupon Structure: 4.5% or Higher

Fig 1. The Seasons Change—Volatility Subsides …



Source: Morgan Stanley Wealth Management Municipal Research and Strategy, Bloomberg, Thomson Reuters TM3 as of 3/13/18

Rain or Shine

"Spring is the time of plans and projects." We've likely all acknowledged the thought at one time or another, but Leo Tolstoy first noted it in his famous nineteenth century work *Anna Karenina*. Confusing as the season can be, opening with winter storms and ending in warm "beach days," the important message is this: Winter is over and summer is now just around the corner. Though the weather may be fickle and the transition challenging, we know there's work to do … rain or shine.

This message seems particularly relevant this year. After navigating our way through tax reform, rising commodity prices, a weakening US dollar, transitioning inflationary expectations, ECB tapering anxieties, stimulus anticipations (infrastructure) and more, we can now state that this winter has been an eventful one. As discussed in January's **Back Home Again,** the combination of a relieved municipal bond market (as the federal tax-exemption was left unchanged during reform) with the seasonal transition toward lower supply and heavier reinvestment demand created a "rich" tax-exempt arena that had little choice but to follow US Treasuries (USTs) as they weakened. Had they not, crossover investors were positioned to sell tax-free securities to switch their exposure to taxable ones. This relationship has balanced dislocations between the two markets for decades. Consequently, municipal investors had little choice but to monitor global dynamics to better understand what was occurring throughout their own asset class, patiently awaiting a period of stability to add exposure. This **follow the leader** dynamic reinforced our advocacy for caution, and has now been evident in an over 60-basis-point (bp) rise in the 10-year muni space. It's been quite a winter, and we believe the time of plans and projects is here … rain or shine.

Three important dynamics help us to reach this conclusion. First, the long-awaited period of fixed-income stability appears to have finally settled in. Since we last put pen to paper, volatility metrics have subsided and the 10-year AAA MMD and UST have traded within a 4 to 6 bp range. Though this period may be fleeting (last week's Employment Situation Report served as a stark reminder), we'd be remiss not to mention that current yield-levels hover near the highest thresholds offered in nearly a year. Importantly, we may have reached a period where future rate weakness is unlikely to offset the value of "carry"—simply being invested to continuously earn interest. Such a period of stability, coupled with higher nominal rates, may be hard to pass up … particularly when considering that summer is just around the corner.

Second, municipals may soon exhibit a tendency to underperform USTs as seasonals change and laggard investors respond to the recent interest rate increase. Recall that primary activity should continue to accelerate while redemption-driven reinvestment demand wanes as we venture into the spring. It's also important to stress that over 79% of this year's primary volume has been for new-money efforts instead of refinancings, a dynamic caused by the elimination of the tax-exemption for future advance refundings during reform. Though a significant amount of supply was pulled into December, the "big picture" is that a considerable portion of this year's issuance may remain outstanding for a longer period of time, rather than helping to call issued debt to complete refinancings. Additionally, such bearish developments may also be exacerbated by laggard investors selling securities in a delayed response to the recent interest-rate increase. In summary, an increase in outstanding supply combined with weaker reinvestment demand may create minor pockets of underperformance and opportunity.

Third, the summer is now only three months away. Winter, spring, summer … seems like it's all happening so fast, right? Trading typically becomes lethargic as the market tightens during the summer months. This development is often apparent as investor focus transitions and new-issue volume declines. Though opportunities can (and do) arise throughout the summer, they're not always in an abundance following the July 4th holiday.

Combining the aforementioned dynamics, we would focus on three objectives at this time: (1) consider current entry points as seasonals shift now that stability has ensued; (2) watch USTs for leadership and systematically add exposure; (3) favor high-quality securities with short-to-neutral duration (for household investors).

We believe investors should carefully consider entry points both now and as we venture into the spring. As previously discussed, both USTs and municipals have exhibited stability and yield-levels currently hover near some of their highest offerings in over one year. An acceleration in primary market volume, coupled with weaker reinvestment demand, should also help to unearth pockets of opportunity this spring. Additionally, we may have reached the period where it's unlikely that future rate weakness will offset the value of carry.

Furthermore, we still believe investors should watch US Treasuries for leadership and enter the market systematically by dollar-cost averaging. Though recent price stability is encouraging, the follow the leader dynamic discussed last month is still in play. This "cocktail" of recent interest-rate weakness and relative municipal strength suggests that tax-exempts may have little choice but to follow USTs should they continue to decline again. As catalysts for future rate weakness remain, we encourage that participants add exposure before the summer, but do so by dollar-cost averaging both now and throughout the spring.

Lastly, our positioning strategy remains unchanged at this time. Consistent with the recommendations of Morgan Stanley's Global Investment Committee, we continue to recommend that household investors favor exposure to high-quality municipal securities with short/low-to-neutral duration at this juncture. Tight spreads suggest that investors are earning less for taking credit risk, while only 24 bps of additional yield is currently offered between the 16- and 30-year maturities due to the flatter curve (and nearly 86% of all the yield available is captured by year 12). Additionally, interim price fluctuations for bonds with shorter maturities caused by transitioning Fed rate hike expectations are often of lesser importance to buy-and-hold investors seeking earlier redemption dates. In summary, a high-quality, short-to-neutral duration bond ladder diversified throughout the sectors listed in our Outlooks table on the next page should function as an effective strategy for household investors in the current market.

"Spring is the time of plans and projects …" Though the transition may be challenging, winter is over and summer is now just around the corner. Rain or shine, there's work to do…

Monthly Spotlight – The State of New Jersey

As discussed in our most recent **Synopsis** report, New Jersey's fiscal position has benefited from improved tax collections and the passages of legislation that mandate quarterly pension contributions and dedicate lottery revenues toward its pension systems. Importantly, the state's constitution mandates neither caps on raising revenues nor spending levels in its inherent control over one of the nation's largest and most affluent taxpayer bases. However, the state has not fully leveraged the economic recovery to tackle its considerable debt burden and sizeable unfunded pension liabilities. Additionally, New Jersey's operating budget will likely be negatively impacted by Chapter 57's tax reductions while the recent limitation of the SALT (state and local government tax) deduction could hinder its fiscal flexibility at a period when the economy may be in a late cycle.

Overall, the state's fiscal position is currently stable due to the recovering economic backdrop and the passages of the aforementioned legislation. Moving forward, we believe the limitation of the SALT deduction could inhibit the state's financial profile as it may hinder its political appetite to further raise revenues (taxation) on a taxpayer base that already has a high cost of living and doing business. (Additionally, even minor population loss of certain affluent entities can impact the state's health.) This limitation, coupled with the possibility that the economy may be in a late cycle, will likely challenge the state as it seeks to increase pension contributions over the next five years. We believe the current period of stability is an appropriate time for investors to simply complete any overdue portfolio maintenance and review allocations for size and suitability, remaining mindful that other forms of debt are also impacted by the state (TTFA, state-appropriated EDA, and others). Importantly, states generally possess very strong, sovereign authorities (versus locals) to reduce expenditures, raise revenues, bond, and utilize interfund borrowings to bolster their profiles, and New Jersey holds an inherent control over one of the nation's most affluent taxpayer bases; however, we believe governance action (pension reform) is currently necessary.

Municipal Market Data

Fig 2. Relative Value—Muni Strength Relative to USTs Continues

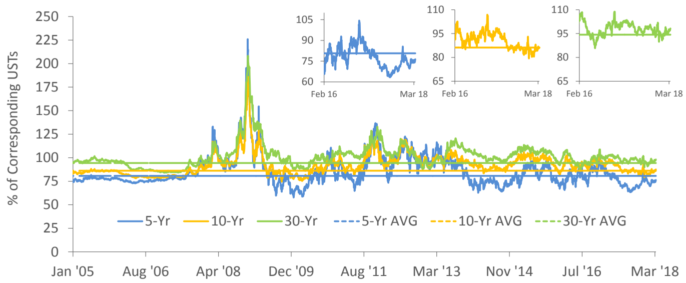


Fig 3. Credit Spreads—Still Favor High Quality Due to Tight Spreads

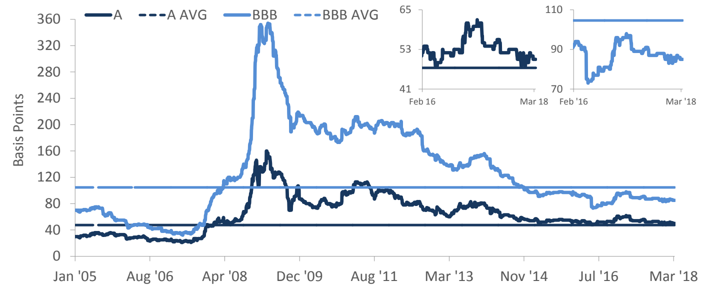


Fig 4. Systematically Add Exposure Due to Stability and Higher Nominals

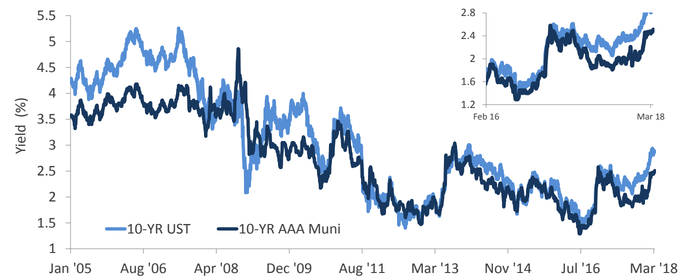


Fig 5. Flat Yield-Curve Encourages Short-to-Neutral Duration for Households

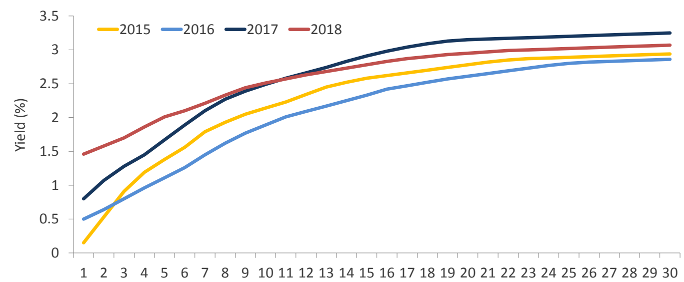


Fig 6. Tax-Reform Anxieties Pull January and February Supply Into 2017

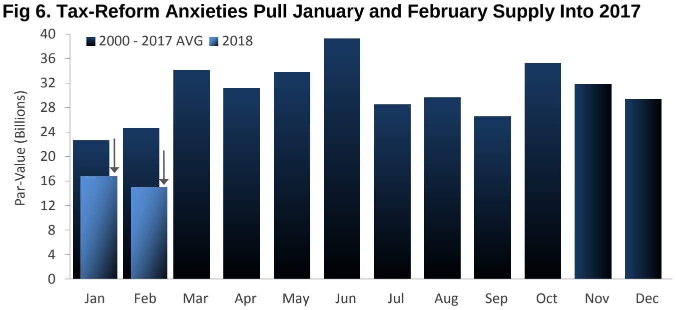
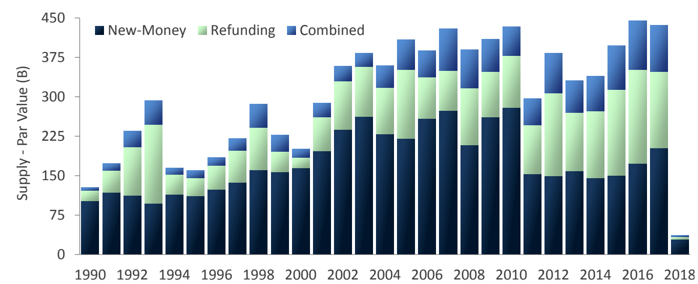


Fig 7. Slow Primary Market Start Following 2017's Reform Anxieties



Source: Morgan Stanley Wealth Management Municipal Research and Strategy, Thomson Reuters MMD, Bloomberg, The Bond Buyer a/o 3/13/18

Fig 8. 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 still lower oil prices. Some recession risk
Not-for-Profit Hospitals	Aa3/AA-	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.

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Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following:
http://www.morganstanleyfa.com/public/projectfiles/id.pdf

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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.

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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.

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Equal-weight/Hold	43	44.3%		13	38.2%	30.2%
Underweight/Sell	19	19.6%		8	23.6%	42.1%
Total	97	100.0%		34	100.0%	

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