Municipal Bond Monthly

NORTH AMERICA

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

Strategy:

- Watch for Pre-Reform Supply "Priced to Move"
- Tax-Loss Selling Should Be Completed
- Enjoy the Holidays

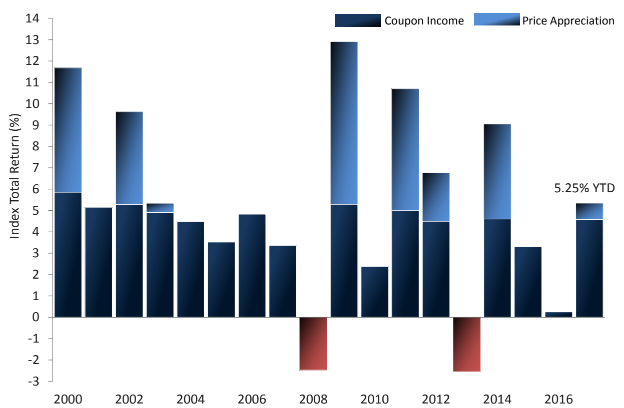
Credit Quality: High

Favored Sectors: See our Sector Outlooks Table

Duration: Short/Low-to-Neutral

Coupon Structure: 4.5% or Higher

Fig 1. A Good Year for Municipal Performance



Source: Morgan Stanley Wealth Management Municipal Research and Strategy, Thomson-Reuters TM3, Bloomberg Barclays Municipal Index as of 12/19/17

Encore

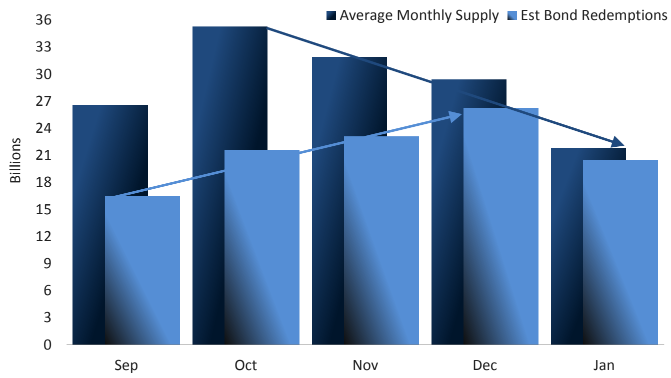
"The end of labor is to gain leisure." Aristotle's timeless advice seems particularly comforting this year, especially when considering the many uncertainties we've encountered throughout 2017. Though as we've discussed in past publications, the only real constant that markets tend to deal with is change, with just the last ten years bringing us a thriving real-estate setting, an inverted US Treasury yield curve, "too big to fail," three elections, rallying equities, Brexit, Grexit, one fiscal cliff and a taper tantrum … to name a few. Overall, we can now state that municipal bond investors have navigated yet another year quite well, with the Bloomberg Barclays Municipal Index currently posting a 5.25% total return year to date (YTD).

Keeping with the theme that we've often discussed this fall, there are times for action and times for patience when it comes to bond investing, and this year's labor is now approaching its end as the period for holiday patience begins … well, sort of. Looking back, we can now state that last summer was an advantageous period to complete portfolio maintenance (and to clean up positions from a credit and/or interest rate perspective) while the last two months were more beneficial for adding exposure as municipal investors sat awash with cash. In fact, tax-exempts experienced a bit of an "encore" during the twilight of this year, as yield levels quickly rose on apprehension that the proposed elimination of the tax-exemption for advance refundings and private-activity bonds (PABs) would intensify December's year-end supply rush. Not surprisingly, this increase was met with open arms by those investors with cash to spend, particularly while the market anticipated the beginning of next year's "January effect" (when new-issue supply typically declines as redemption-driven reinvestment demand increases). Consequently, the market completed a round-trip and settled back at the same yield levels from which it began. Most investors who added exposure in early autumn have benefited from months of earned interest while their bonds' prices have returned to where they started from. For those investors who carefully added exposure during the volatility and before the subsequent rally, the performance was likely even better. As we will elaborate upon shortly, we're now returning to the seasonal period where patience may be beneficial; however, we highlight a handful of modest opportunities for those participants still looking to invest.

Before reviewing our three investment objectives, we believe it's important to provide another brief update about tax reform and its potential repercussions on the municipal bond market. Though we discussed this topic last month, the proposed legislation's importance still holds our primary focus at this juncture.

Consistent with last month's discussion, many of the plan's final takeaways remain mostly unchanged, but we are now placing an increased emphasis on the possibility that institutional demand may wane as proposed corporate tax reductions are more significant than the market's original anticipations. Keep in mind that this dynamic may primarily affect intermediate-to-long maturity municipals and may even be mitigated by HQLA legislation. Conversely, the bill's potentially positive impacts on price action remain intact. These include the possibility for lower outstanding supply if the exemption is excluded for future advance refundings (the exemption for PABs may now be spared), the unchanged treatment for the broader municipal tax-exemption, and the suggestions for federal income tax reductions that appear manageable for tax-exempt bond demand. The market may also experience an increased appetite for tax-sheltered investments issued by high-tax states that tax outside debt if the state and local government tax (SALT) deduction is limited. Please see our Tax Reform Breakdown Table on the next page for additional details.

Fig 2. A Textbook "January Effect"



Source: Morgan Stanley Wealth Management Municipal Research and Strategy, Thomson-Reuters, Bond Buyer, ICE Data Services as of 12/19/17

Combining the aforementioned dynamics, we would focus on three objectives as we finish the year: (1) watch for pre-reform primary issuance or supply overhang "priced to move" before year-end; (2) finish any necessary tax-loss selling as soon as appropriately possible; (3) enjoy the holidays.

First, committed investors may wish to watch for any primary market issuance or supply overhang that is "priced to move" following the recent rush to raise capital before proposed reform changes were implemented. Though we typically don't advocate adding exposure at year-end, this December's supply has been anomalously heavy due to reform, and both issuers and underwriters may be actively searching for investors before 2018. Additionally, January's already low levels of supply may be exacerbated by issuer efforts to upsize or pull deals forward into 2017 (though we may have some residual volume to manage next year). This dynamic, coupled with already increasing redemption-driven reinvestment demand, may create one of the more constructive *latter* stages of the January effect we've experienced in some time. In essence, demand may continue to be strong while primary supply declines.

Consistent with the recommendations of Morgan Stanley Wealth Management's Global Investment Committee, we continue to favor high-quality municipal securities with short-to-neutral duration for those participants still looking to invest. Our two primary reasons for advocating high-quality continue to be: (1) investors are currently compensated less for taking credit risk due to tight credit spreads; and (2) lower-rated credits may experience challenges if the US economy is, in fact, in a late cycle. We recommend a diversified blend of the sectors listed at the bottom of page 4. For yield-curve positioning, short-to-neutral duration securities will likely hold their value more effectively than securities with longer final maturities if interest rates rise. It's also important to stress that 76% of the yield curve is captured by year 12. In summary, we feel that employing a bond ladder strategy of short-to-neutral duration municipal bonds can function as an effective intermediary between earning yield without taking excessive interest rate risk for buy-and-hold investors.

Second, we'd look to finish any necessary tax-loss selling as soon as appropriately possible. As discussed last month, this strategy can be advantageous if clients can offset gains while cleaning up bond positions at the same time. Though some investors have postponed such trades until the details of reform are finalized, others may need to complete these transactions by year-end, regardless of the bill's outcome. As liquidity tends to weaken and balance-sheet protection is evident at year-end (particularly after this month's supply has been so robust), we advocate that clients finish any leftover trades sooner rather than later.

Lastly, we'd recommend that the objectives above are completed in moderation and would like to wish everyone a happy holiday season. We hope that buyers were able to utilize the most recent period of volatility to add exposure, especially when considering that we're likely on the verge of another constructive January. After finishing any final tax-loss selling while watching for attractively-priced primary issuance, we would try to avoid forcing any last minute trades while bid-ask spreads widen and trading becomes lethargic. Once again, we're moving toward a time for patience ... Furthermore, we remain cautious that interest rates may still rise in 2018 if fiscal stimulus is inflationary or financed through the issuance of US Treasuries, particularly if bank and insurance company demand wanes due to corporate income tax reductions.

"The end of labor is to gain leisure"— Cheers to another very good year for municipal bond market performance. As we put pen to paper, the Bloomberg Barclays Municipal Index currently posts a 5.25% YTD total return. We'll take it … As we bid adieu to 2017, it's time to transition our focus toward leisure and to some of life's more important aspects. Happy Holidays!

Monthly Spotlight - Updated Tax Reform Breakdown Table

<table>
<tr><th>Potential Positives (+)</th><th>Considerations (-)</th></tr>
<tr><td>▪ Lower outstanding supply if the future exemption is excluded for advance refundings
▪ The exemption for future private activity bond (PABs) may now be preserved</td><td>▪ Bank and insurance company demand may wane due to corporate income tax reductions (which may be mitigated by the resurgence of HQLA)
▪ This dynamic may primarily impact intermediate-to-long maturity municipals</td></tr>
<tr><td>▪ No material changes to the municipal bond tax-exemption were proposed</td><td>▪ Interest rates may rise if stimulus is inflationary and/or financed through the issuance of government debt</td></tr>
<tr><td>▪ Federal income tax reductions appear demand-neutral
▪ Recall that personal income tax changes have not historically had a considerable impact on demand since municipals offer benefits aside from tax efficiency
▪ Wealth preservation, current income, others</td><td>▪ High-tax governments may encounter fiscal challenges if the elimination of the SALT deduction causes population loss and/or adds political pressure to reduce taxes, spending, and borrowing</td></tr>
<tr><td>▪ Increased demand for bonds issued in high-tax states that tax out-of-state debt if the SALT deduction is limited
▪ Please see considerations column as well</td><th>Summary</th></tr>
<tr><td>▪ Outstanding pre-refunded bonds may outperform if the exemption is excluded for future advance refundings
▪ The exemption for future private activity bond (PABs) may now be preserved</td><td rowspan="2">▪ We still see little at this juncture which conflicts with our current investment strategy. We recommend that buy-and-hold investors continue to focus on high-quality municipal securities with short-to-neutral duration to consistently earn interest (carry).</td></tr>
<tr><td>▪ Outstanding alternative minimum tax (AMT) securities may underperform in the short-term, but outperform versus long-term historical averages if the tax is limited, but not eliminated</td></tr>
</table>

Source: Morgan Stanley Wealth Management Municipal Research and Strategy

Municipal Market Data

Fig 3. Municipals Return to Historical Averages Versus US Treasuries

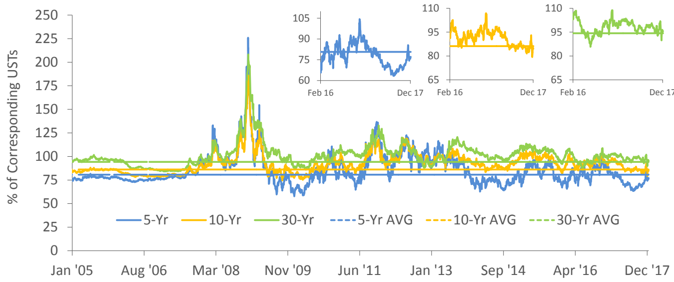


Fig 4. Credit Spreads—Tight Spreads Support Our High Quality Advocacy

Fig 5. Nominal Yield Levels Closer to Post-Elections Highs

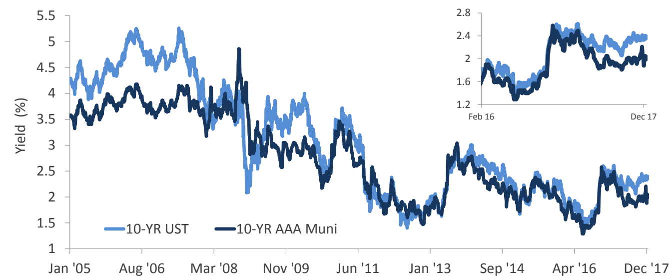


Fig 6. We Advocate Short-to-Neutral Duration Due to Flatter "Long-End"

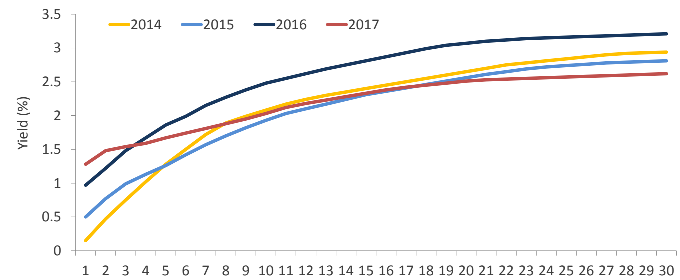


Fig 7. Monthly Supply Averages Vs. 2017

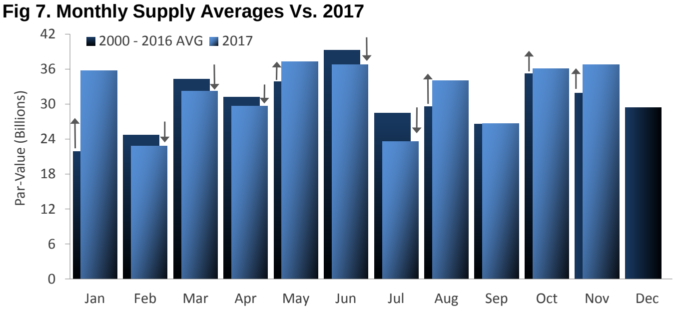
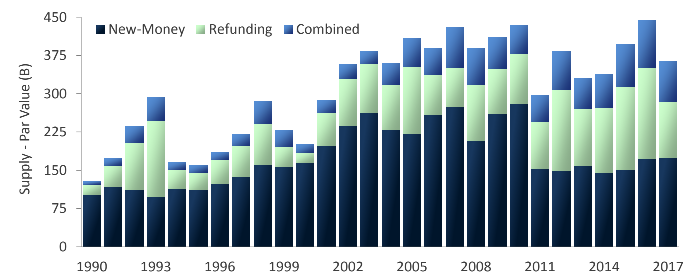


Fig 8. Gross Supply Healthy, Bolstered By Tax-Reform



Source: Morgan Stanley Wealth Management Municipal Research and Strategy, Thomson Reuters MMD, Bloomberg, The Bond Buyer a/o 12/14/17

Fig 9. Sector Outlooks and Recommended Rating Parameters

Sector	Minimum Rating*	Commentary
State GO & State Appropriated	A1/A+	Pension/OPEB challenges. SALT debate may 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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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.

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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(as of date **November 30, 2017**)

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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%		16	45.7%	45.7%
Equal-weight/Hold	43	44.3%		13	37.1%	30.2%
Underweight/Sell	19	19.6%		6	17.2%	31.6%
Total	97	100.0%		35	100.0%	

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