Muni Bonds: Making every basis point matter

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OVERVIEW

In an investment environment characterized by low rates and volatility, municipal bonds remain an excellent source of tax-free income, total return potential and diversification.

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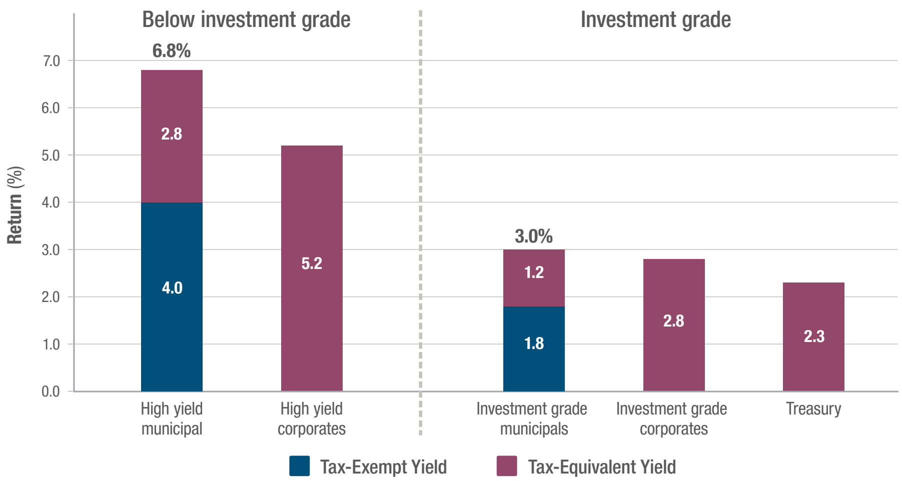
As tailwinds from the country's new tax code (the 2017 Tax Cuts and Jobs Act "TCJA") and low interest rates persisted in 2019, municipal bond funds experienced strong flows and solid performance. Heading into 2020, there are clear and distinct reasons why the asset class remains an attractive solution for investors.

Compelling tax-equivalent yields

With yields touching all-time lows, capturing a reasonable income stream is harder than ever. The fact remains that municipal bonds are still a very popular source of tax-free income, helping investors keep more of the income they earn. When factoring in the benefit of this tax-exempt feature, both investment grade municipal bonds and high yield municipal bonds have delivered compelling income, relative to corporates and treasurys.



Source: Bloomberg Barclays, 12/31/19. Yield is represented by yield to worst (YTW), as of 12/31/19. YTW is the lowest potential yield that can be received on a bond without the issuer actually defaulting and is calculated by making worst-case scenario assumptions on the issue by calculating the return that would be received if the issuer uses provisions, including prepayments, calls or sinking funds. Tax equivalent yield assumes the highest federal income tax rate for single filers, 37%, as well as the 3.8% Medicare surcharge, for a total of 40.8%. High Yield Municipals: Bloomberg Barclays High Yield Municipal Index; High Yield Corporates: Bloomberg Barclays U.S. High Yield Index; Investment Grade Municipals: Bloomberg Barclays Municipal Index; Investment Grade Corporates: Bloomberg Barclays U.S. Corporate Index; Treasuries: Bloomberg Barclays U.S. Aggregate Index. It is not possible to invest directly in an index. Past performance is no guarantee of future results, which will vary.

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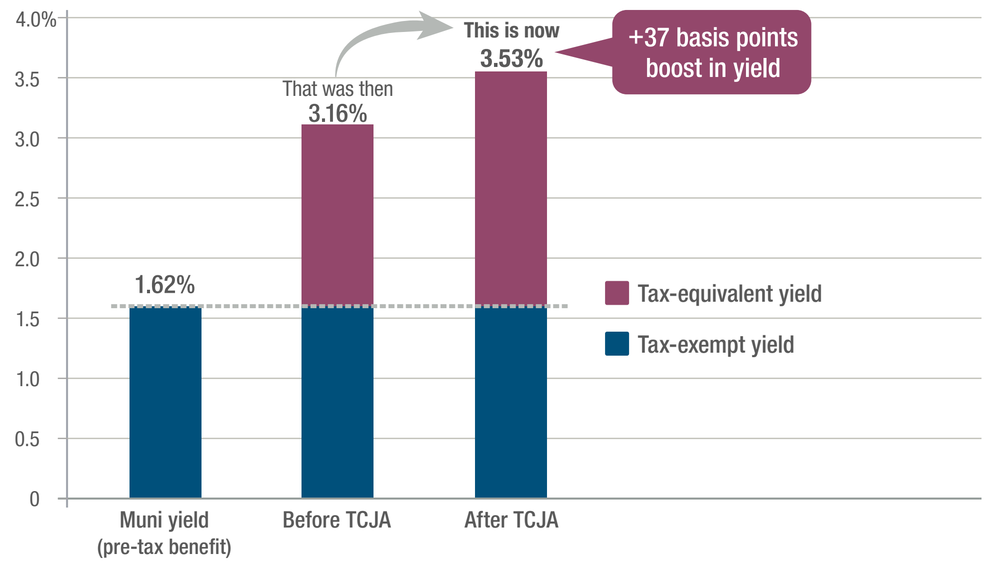
With the impact of TCJA factored in, this benefit is now even more appealing, especially for investors in higher tax brackets and in high tax states. To demonstrate the impact, let's compare the tax-equivalent yield of a muni bond for a California investor, both before TCJA and after. In light of the State and Local Tax Deduction (SALT) cap of $10,000 instituted in 2018, the tax-exempt benefit of a municipal bond provided for a boost in yield of 37 basis points. Thinking about this in terms of dollars— it's clear that every basis point matters. Assuming a $1,000,000 hypothetical investment, this equates to a pickup in annual income of $3,700 dollars.

Every basis point matters



Hypothetical Investment for a California Investor	
Principal	$1,000,000
Annual yield	1.62%
Annual coupon income (tax exempt)	$16,200
Pre TCJA taxable equivalent income	$31,600
Post TCJA taxable equivalent income	$35,300
Tax equivalent income boost	**$3,700**

Source: Bloomberg Barclays, 12/31/19. Yield is represented by yield to worst (YTW), as of 12/31/19. YTW is the lowest potential yield that can be received on a bond without the issuer actually defaulting and is calculated by making worst-case scenario assumptions on the issue by calculating the return that would be received if the issuer uses provisions, including prepayments, calls or sinking funds. Tax equivalent yield assumes the highest federal income tax rate for single filers, 37%, the highest California state tax rate of 13.3%, and the 3.8% Medicare surcharge, for a total of 54.1%. California Municipals: Bloomberg Barclays California Municipal Bond Index. It is not possible to invest directly in an index. Past performance is no guarantee of future results, which will vary.

Diversification for the long-term

Since Q4 2018, we've seen a remarkable u-turn in interest rate expectations. Compounded with future uncertainties, some investors may consider straying from long-term goals in an attempt to time market fluctuations with short-term investment decisions. When it comes to municipal bonds, we don't view an allocation as a tactical trade but rather as a dedicated part of a complete asset allocation to offer diversification benefits over time, regardless of the interest rate environment.

Municipal bonds are not highly correlated to rates

Price movements in the municipal bond market do not move in lockstep with U.S. Treasuries. Over the trailing 10-year period from 12/31/2009 to 12/31/2019, there were three periods when the 10-year U.S. Treasury rose by 100 bps or more. During these timeframes, investment grade municipal bond returns had low correlations to U.S. Treasury rate increases.

Bloomberg Barclays Municipal Bond Index correlations to the Bloomberg Barclays U.S. Treasury Index during rising rate periods of 100 bps or more

12/31/2009–12/31/2019

	10/11/10-2/8/11	7/25/12-12/31/13	7/8/16-11/8/18	Average
10-Year U.S. Treasury Yield Increase	+134 bps	+161 bps	+187 bps	+161 bps
Municipal Bonds Daily Correlation to U.S. Treasuries	0.37	0.56	0.62	0.52

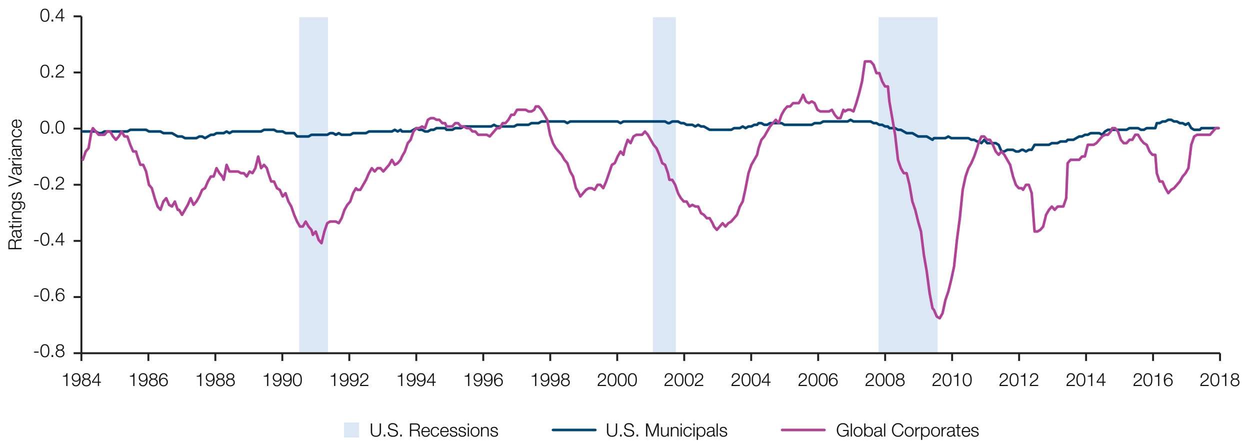
Source: Bloomberg Barclays, 12/31/19. Average monthly total returns are for Bloomberg Barclays Municipal Index. Correlation present, in a table format, whether or not "different" investments will move at the same time for the same reason and in the same direction. If true, they have a correlation of plus 1. If, on the other hand, they were to move in exactly opposite direction they would have a negative correlation of minus 1. It is not possible to invest directly in an index. Past performance is no guarantee of future results, which will vary.

A port in the storm

We are late in the economic and market cycle. For investors worried about the economy, a potential recession, or credit quality issues—now may be a time to consider de-risking your portfolio. In fact, historically, municipal bonds have had higher credit quality and fewer downgrades and defaults than investment grade corporates, even during recessions.[1] One key reason for this is municipal bond issuers are often tied to inelastic services—such as water, sewer, education—foundational needs that tend to be recession-resistant. As a result, municipal bonds offer an opportunity for investors to add a level of stability to their portfolios.

Municipal bond credit ratings have held up well, even during recessions

Moody's rating drift 1984–2018[1]



1. Rating drift measures the net average number of notches a credit changes over the study period. It is defined as the average upgraded notches per issuer minus the average downgraded notches per issuer. Source: Moody's US Municipal Bond Defaults and Recoveries 1970 – 2018; Moody's Trends in Global Corporates Rating Transitions 1983 – 2018.

Municipal bonds have always been attractive to income-oriented investors, but today they make more sense than ever. In an investment environment characterized by low rates and volatility, municipal bonds remain an excellent source of tax-free income, total return potential and diversification, and should represent a strategic portion of an investor's portfolio.

For more information, including regular updates and insights about the municipal markets, visit **muni360.com**

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Municipal bond risks include the ability of the issuer to repay the obligation, the relative lack of information about certain issuers, and the possibility of future tax and legislative changes, which could affect the market for and value of municipal securities. A portion of a fund's income may be subject to state and local taxes or the alternative minimum tax. Income from municipal bonds held by a fund could be declared taxable because of unfavorable changes in tax law, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. High-yield municipal bonds may be subject to increased liquidity risk as compared to other high-yield debt securities. Bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner.

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