Post-Election Outlook for Municipal Bonds

Assessing Risks and Opportunities

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In the months since the election, the municipal market has witnessed greater price volatility than other fixed income sectors. Yields on longer dated Municipals initially rose over 100 basis points, causing sharp declines in price of 10% or more, before paring back some of their losses. So where do we head from here? In this Portfolio Strategy update, we recap the shifts in municipal bonds' relative value, examine the reasons behind them, and present our thoughts on the investment case going forward.

A Brief Muni Market Recap

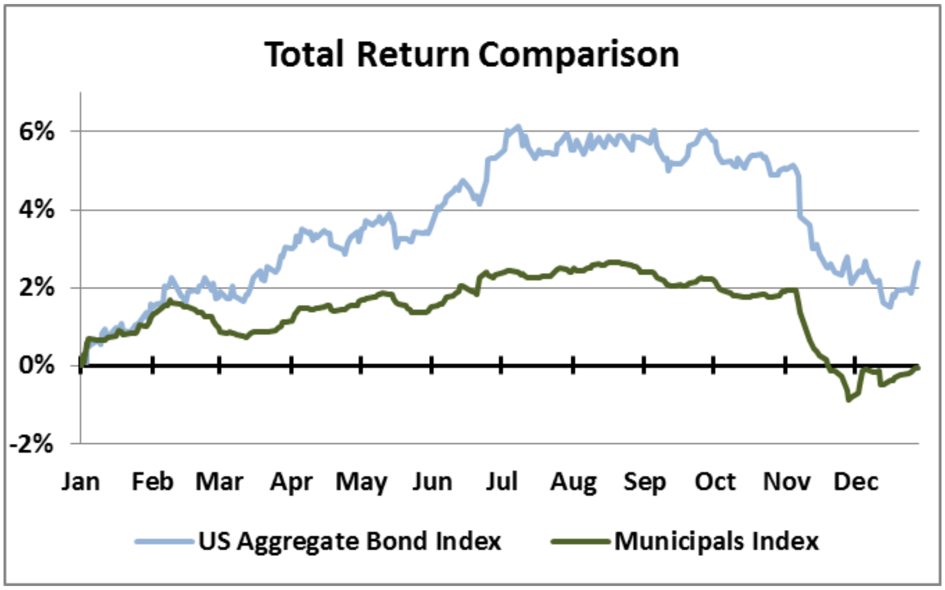
In the weeks following Election Day, domestic Treasury yields shot up significantly, increasing by 50-60 basis points for maturities 3 years and out. Municipals witnessed even greater increases, with yields on longer maturities rising 10-30 basis points more than comparable Treasuries. In the past several weeks, both municipals and Treasuries have rallied somewhat, but yields generally remain 40-50 basis points above their pre-election levels. Since yields move in the opposite direction of prices, the value of existing bonds has suffered accordingly.

Muni/Treasury yield ratios, which reflect the relative value of municipals to Treasuries (higher ratios signal municipals are cheap, and vice versa), have whipsawed considerably during this time.

Maturity	Range of Post-Election Muni/Treasury Ratios
3 Year	85.6% - 99.9%
5 Year	80.4% - 101.7%
10 Year	89.9% - 107.6%
30 Year	94.4% - 109.7%

Source: Bloomberg. Range covers period from 11/12/16 - 1/12/17

Although municipals had lagged the broader bond market throughout the year, post-election developments have served to highlight this relative underperformance. The 2016 total return of the municipal benchmark dipped into negative territory following the election, and ultimately finished on the wrong side of the zero bound at -5 basis points for the year. On the other hand, while the broader bond market certainly sold off in concert with Treasuries, it nonetheless retained a 2016 total return comfortably over 2%.



Source: Municipals Index = BofA Merrill Lynch 1-10 Year AAA-A Municipal Securites Index
US Aggregate Bond Index = Bloomberg Barclays US Aggregate Total Return Index

Different segments of the municipal market have suffered outsized declines. In particular, those who relaxed their discipline and reached for yield in longer dated maturities have been saddled with significant losses. Consider the following 3 long-term maturities from an August 2016 issuance of New York City General Obligation bonds. These bonds are the same in almost every respect – including credit exposure and maturity – except for their coupons. Holding all else equal, lower coupons lead to larger fluctuations in a bond's price when prevailing interest rates change.

Here the buyers of 3% coupon bonds accepted more interest rate risk, and as compensation received an additional 31 basis points of yield versus 5% coupon bonds. However, that 31 basis points cushion has since evaporated, as the price of the 3% coupon bond has declined by a stunning 15.8% at the height of the post-election rout. The corresponding 7.0% drop in the price of the 5% coupon bonds, while also painful, was far more palatable in comparison. Although the losses have been somewhat pared back since then, they are still significant and noticeably larger in the lower-coupon maturities.

Final Maturity	Coupon	Price at Original Issue	Estimated Price as of 12/9/16	% Change in Price vs. Original	Estimated Price as of 1/11/17	% Change in Price vs. Original
2036	3%	$101.90	$85.78	-15.8%	$89.97	-11.7%
2036	4%	$111.37	$101.897	-8.5%	$103.21	-7.3%
2037	5%	$122.20	$113.67	-7.0%	$116.17	-4.9%

Source: Bloomberg. CUSIPs analyzed are 64966MFF1, 64966MFR5, and 64966MFG9. All maturities include a 2026 par call option
Estimated price/yields are Bloomberg Estimates as of 12/9/16 and 1/11/17

What's Driving Muni Underperformance?

Post-election policy uncertainty has led to shifts in investor attitudes towards many asset classes, both positive and negative. For municipals, the market thus far seems focused on two negative possibilities:

Probability of Lower Personal and Corporate Tax Rates. Lower income tax rates reduce the benefit investors receive from holding tax-exempt securities like municipals vs. fully taxable alternatives. Furthermore, any reduction in municipals' after-tax relative value would likely result in less demand for them going forward, further pressuring prices.

Threats to the Municipal Tax Exemption. The municipal tax exemption, although longstanding and powerfully rooted, is nonetheless still a federal policy that can be revised at any time. Potential scenarios range from partial limitations to its value, such as a cap on tax free income earned per investor, to full removal of the tax exemption on municipal income at the extreme.

Importantly, the relative probabilities of these two key concerns are not equal. President-Elect Trump and Congressional Republicans have clearly indicated their intent to reduce personal and corporate tax rates by some degree. On the other hand, neither the President-Elect, nor his campaign platform, nor any public campaign materials have made any specific mention of municipal bonds or their tax exemption.

Just How Valuable is the Tax Exemption?

Much of the value in municipal bonds derives from their status as a tax-advantaged security. Their interest income and discounts from par are typically fully exempt from federal taxes, and in certain circumstances state and local taxes as well. The benefit an investor receives from the tax exemption is tied to their marginal tax rate – the higher your tax rate, the greater the benefit.

Calculating a taxable equivalent yield (TEY) – the yield a fully taxable bond must offer an investor to generate the same after-tax value - demonstrates this relationship. Imagine an investor in the highest federal tax bracket, currently 39.6%. To match a 3.00% after-tax yield on a municipal bond, a comparable taxable bond must feature a 4.97% pre-tax yield. Any taxable bond with a yield below 4.97% offers less net value than the 3.00% municipal, and vice versa.

Tax-Exempt Yield	Taxable-Equivalent Yield (39.6% Rate)
3.00%	4.97%

Reducing marginal tax rates or capping the exemption reduces the relative value of municipals. For example, assume that the interest income exemption for municipals is now capped at 28% - the equivalent of having only a 28% marginal tax rate. In that case, the TEY for a municipal bond yielding 3.00% is reduced from 4.97% to 4.17%.

Tax-Exempt Yield	Taxable-Equivalent Yield (28% Rate)
3.00%	4.17%

Outlook For Municipals – The Good, the Bad, and the Murky

Going forward, what does this new policy landscape mean for the municipal market? In short, nobody knows for certain. The lack of any specific details from key officials and policy papers leaves a wide range of possibilities. Much remains uncertain, including whether current municipal bondholders are ultimately helped, harmed, or unaffected.

At first glance, the risks of lower tax rates and capping/removing the tax exemption both appear unambiguously harmful for investors. However, as always "the devil lies in the details," and there are scenarios in which current municipal bondholders may actually benefit. For example, consider the possibility that the value of the tax exemption is indeed removed or capped, but only for new municipal bond issues – that is to say, currently outstanding municipal bonds are "grandfathered" from this change, and continue to benefit from the promise of full tax exemption in place at the time of their creation. In that case, existing municipal bonds may actually <u>increase</u> in value, as the supply of these tax-advantaged securities would now be limited while demand likely remains robust.

> ***"Much remains uncertain, including whether current municipal bondholders are ultimately helped, harmed, or unaffected."***

Of course, this can cut both ways, and a reduction in the tax exemption without a grandfather clause for pre-existing municipal investors represents a serious negative threat. The important takeaway from these hypotheticals is that in the absence of new laws, there are credible "bull" and "bear" cases for the relative value of municipals.

Another positive factor is that, unlike more questionable federal tax preferences and "loopholes", the municipal tax exemption has a strong political case for full or partial preservation. From an accounting perspective, it represents a fairly minor federal tax preference (much smaller than the impact of allowing deductions for state and local income and property taxes), and its elimination would add little new revenue towards closing the deficit. Tax-exempt financing also has a long history of efficiently supporting a majority of the existing infrastructure building and maintenance programs throughout the country. With the incoming Administration clearly signaling that infrastructure projects will be a priority, tinkering with the municipal tax exemption would create new obstacles to achieving its ambitious objectives. Last but not least, any retroactive reductions in the tax exemption would probably be perceived as a breach of investors' trust in the federal government's good faith, a factor which could lead lawmakers to fear a popular backlash from constituents.

Conclusion

Taking everything into consideration, we believe the prospect of forthcoming tax cuts does present a headwind to municipal bond values, and will help set a tighter spread to muni/Treasury ratios. However, we also believe that changes to the municipal tax exemption (if they happen at all) are likely to spare current municipal bondholders from catastrophic harm – for example, with a full or partial grandfather clause.

As a result, we believe municipal bonds remain a suitable investment for clients subject to income taxes. Combined with the spike in absolute yields, the current municipal underperformance represents an opportunity to add high-quality municipals at relatively undervalued prices that haven't been possible in several years. We have been increasing exposures in client portfolios where appropriate, and will continue to search for new bonds with attractive risk-adjusted yields.