

WITH A SPOTLIGHT ON INTEREST RATES AND EQUITIES, WHAT'S NEXT FOR MUNIS?

NAVIGATING ROUGHER WATERS

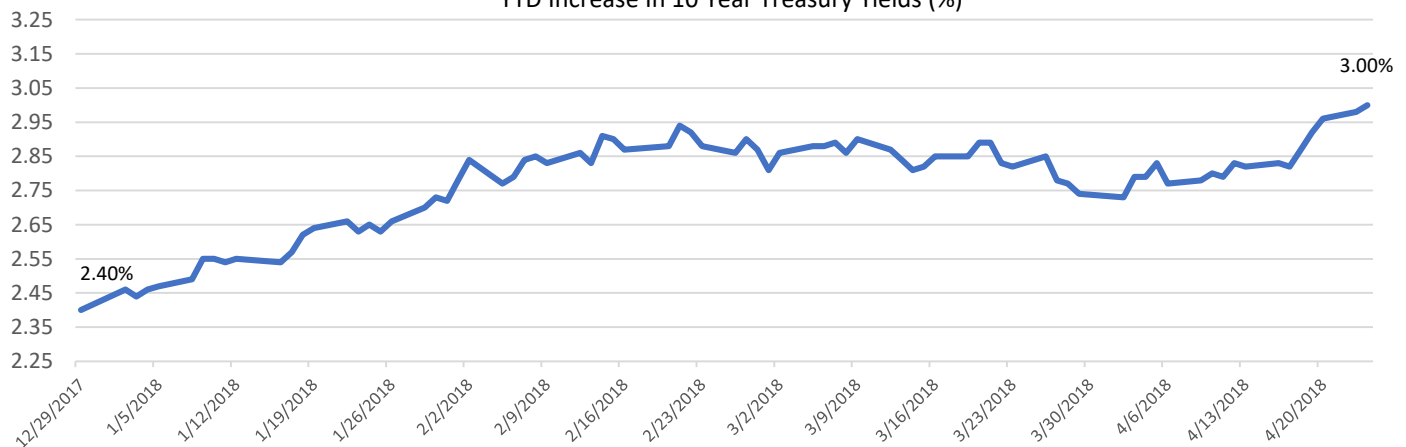
The first quarter of 2018 ended a period of unusual tranquility in the capital markets. History tells us that volatility, while unsettling, is the norm, not an aberration. In an average year, the US equity market experiences 50 trading days with a >1% move in either direction, and 10 days with a >2% move. By contrast, 2017 brought zero >2 % days and only eight of >1%. Until recently, the Treasury market had largely also reflected a benign environment, with modest, steady economic growth and a muted inflation outlook anchoring the 10Yr, which ended 2017 at 2.40%.

In a few short months a great deal has changed. 2018 has introduced a number of economic and policy risks, among them sporadic inflation concerns, soaring budget deficits, lingering trade war fears, and speculation about how quickly Federal Reserve monetary policy normalization will proceed.

Against this backdrop, investors are grappling with a disconcerting rise in Treasury yields and volatile equity markets.

The 10Yr Treasury breached 3.00% on April 24th, a psychologically important level not seen since January of 2014. What comes next is inherently uncertain, although Treasury prices are hardly being helped by Federal fiscal policy. Austerity has seemingly gone by the wayside in Congress, and The Committee for a Responsible Federal Budget now anticipates that the deficit will exceed \$1 trillion by 2019, a record level for a time of low unemployment. Over the past six months alone, outstanding US Treasury debt has increased by \$1.2 trillion, thereby putting more pressure on Treasuries and creating another risk factor for equities.

YTD Increase In 10 Year Treasury Yields (%)



Source: Bloomberg; data as of 4/24/18

EYES ON THE FED

So, where will the Fed go from here and how might this impact the bond markets? As we reported a few weeks ago, the recently concluded March Fed meeting bumped up the Fed Funds target rate to 1.50 – 1.75%, with an accelerated pace of increases anticipated. Median Fed Governor's expectations now call for a Fed Funds rate of 2.10% by the end of 2018, 2.90% by the end of 2019, and 3.40% at year-end 2020. However, it should be emphasized that such policy decisions are highly data dependent and subject to change. We will be closely monitoring developments.

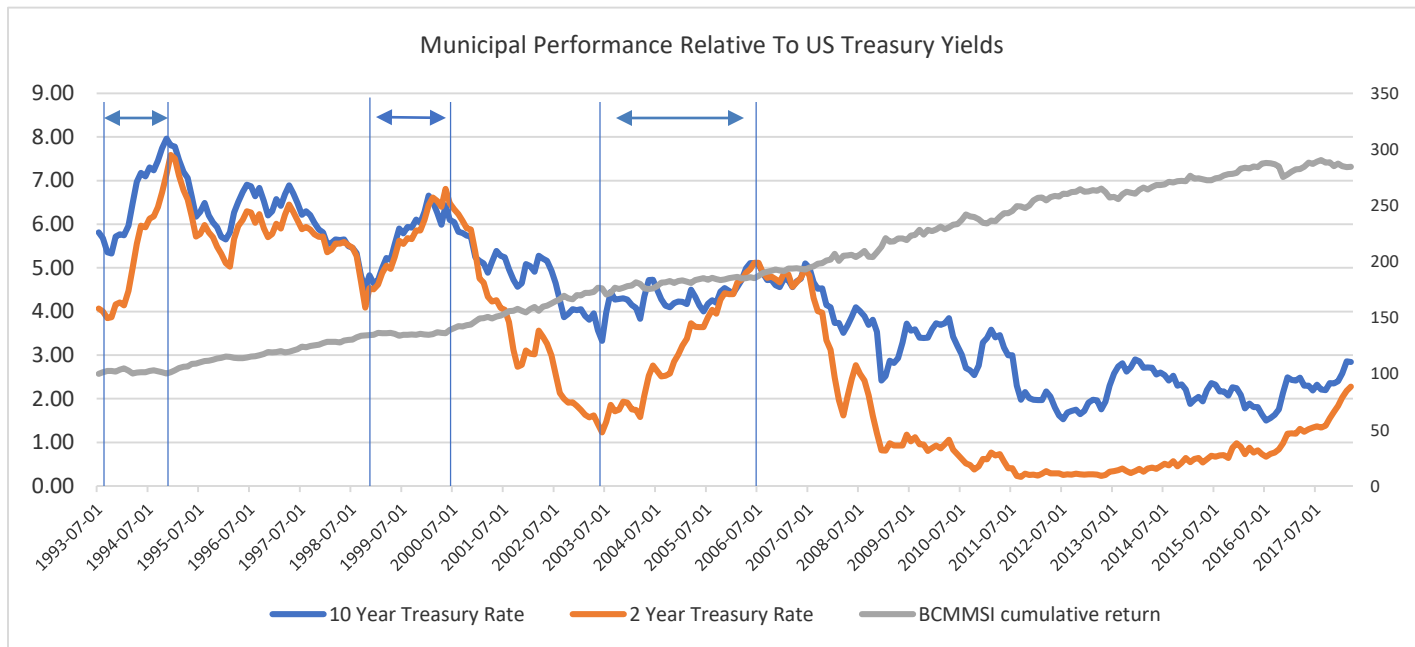
After accounting for the March increase, **our base case still calls for one or two additional 0.25% hikes in 2018, not more.** We are not in the camp that anticipates more hawkish Fed action, particularly given unnerving equity markets, a slight slowing in first quarter global growth, and considerable debate as to whether inflation is truly picking up on a sustained basis.

In the face of these uncertainties, how might advisors counsel skittish bond investors considering tax-efficient diversified asset allocation strategies? **Let's take a closer look at municipals and the historic relationship of this asset class to interest rates and equities.**

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WHAT CAN WE LEARN FROM HISTORY?

Should Treasury yields move higher in the coming months, how might municipals respond? Each market cycle is unique, as they are driven by specific economic, fiscal, and monetary factors. Nonetheless, the prospects for high quality intermediate term municipals in an environment of upward rate pressure appears promising. As detailed in the accompanying chart, **municipals have historically held up well during periods marked by significant increases in Treasury yields.**



Source: Federal Reserve Bank of St. Louis. US Treasury Yields are expressed in % terms as per the scale to the left of the graph. Municipal returns reflect the performance of the Bloomberg Barclays Managed Money Short/Intermediate (1-10 Years) Index and are expressed as cumulative return beginning on 7/31/93.

ROOTS OF INTEREST RATE RESILIENCE

Several attributes of actively managed municipal portfolios can help explain these dynamics, offering some comfort to investors fearing higher interest rates.

- **Higher yields typically provide an ability to reinvest a growing stream of tax-exempt income.** Despite the likelihood of initial price declines, increased coupon cash flow derived from higher yields may add significant value to investor portfolios over time.
- **Municipal supply is often constrained in rising rate periods** given a lack of issuer refinancing, thereby providing a degree of pricing support. This dynamic has been exacerbated by the recent tax law changes, including the elimination of advance refunding bonds, and a late 2017 acceleration of private activity borrower issuance that prompted a much slower pace of 2018 offerings.
- **Tactical flexibility in liquid, high grade markets may prove valuable,** as it generally enables separate account managers to tailor the maturity of individual bonds and the portfolio at large, while also targeting pockets of value along the yield curve as market conditions change. This speaks to the value we have always placed on liquidity in security selection.

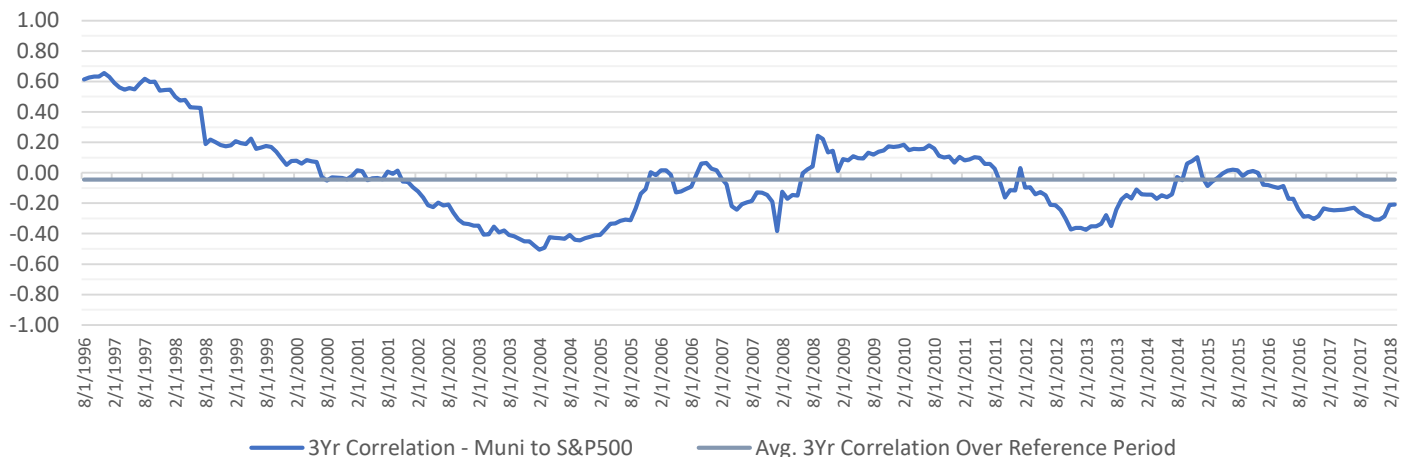
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AN ASSET ALLOCATION RESOURCE

An important attribute of municipal portfolios lies in an ability to complement riskier asset classes in the context of a well structured asset allocation strategy. With this in mind, the relationship between municipals and equities is revealing.

While many variables impact common stock and other risk asset valuations, thereby potentially altering past patterns, **municipals have historically demonstrated a low correlation to equities**. This attribute may hold considerable appeal given the aforementioned increase in equity volatility in what may be an aging bull market.

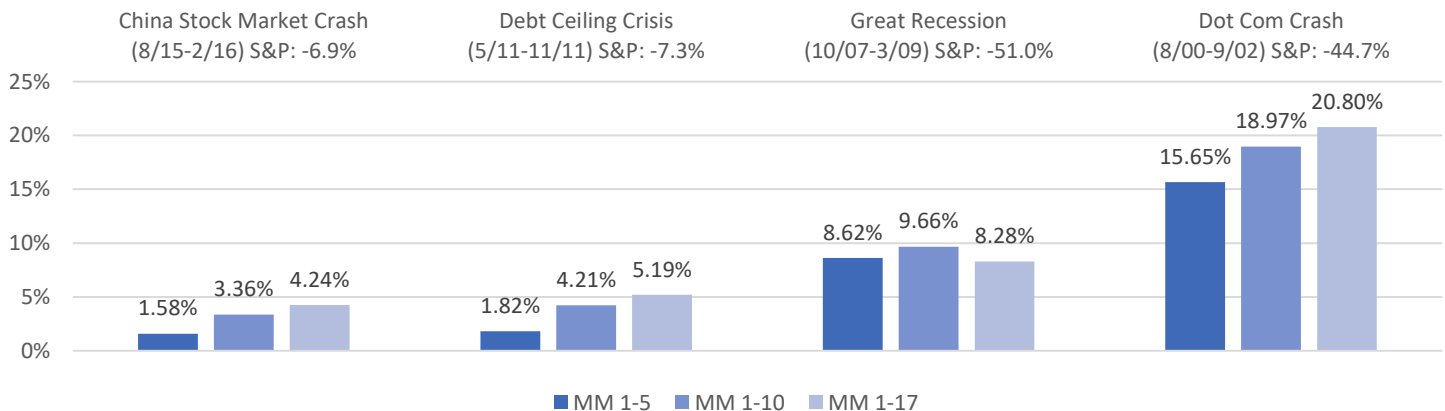
Correlation Between High Grade Intermediate Municipals and the S&P 500
7/31/1996 to 3/31/2018



Source: Bloomberg. Municipal returns used in correlation analysis reflect the performance of the Bloomberg Barclays Managed Money Short/Intermediate (1-10 Years) Index from its inception on 7/31/93.

The portfolio efficiency value demonstrated above is reinforced by municipal market performance during periods of equity weakness. Despite a strong overall upward trend, there have been four major equity market corrections over the past 25 years. Although circumstances differ, **municipals delivered positive performance in each downturn, generating income while hedging equity exposure**.

Municipal Performance in Equity Market Downturns



Source: Bloomberg, API. Indices are the Bloomberg Barclays Managed Money series ordered by average maturity; the Short (1-5 years), the Short/Inter (1-10 years), and the Intermediate (1-17 years).

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GUIDANCE AMID UNCERTAINTY

Headlines introduce risks of their own, as investor reaction may not prove beneficial over the long term. As advisors and their clients weigh investment decisions, several summary points are worth reinforcing:

- municipals have traditionally held up well during rising rate cycles and equity market downturns, thereby potentially enhancing their value in client portfolios, particularly for high income investors
- municipals may also offer investors an ability to diversify their equity exposure and mitigate some of the associated volatility given the relatively low historical correlation of these asset classes
- reinvestment at higher nominal yield levels can have a significantly positive impact over time on portfolio income

Regardless of environment, we will continue to rely on fundamental analysis, macroeconomic research, careful security selection, and tailoring portfolios to specific investor needs. By emphasizing liquidity in high-grade markets, we intend to maintain the flexibility needed to help investors capitalize on credit specific, economic and market developments.

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Source: Bloomberg, API. Indices are the Bloomberg Barclays Managed Money series ordered by average maturity; the Short (1-5 years), the Short/Inter (1-10 years), and the Intermediate (1-17 years).

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