Setting expectations for taxable clients in 2017

2017 Municipal bond outlook: Preparing for market volatility

2016 was arguably the year that political risk delivered on the potential for dark horse outcomes: think of the U.S. election and the U.K.'s Brexit referendum. In our view, 2017 will likely follow as the year dominated by policy risk. President-elect Trump's lack of policy track record, plus his stated goal of shaking up the status quo, will likely auger for increased market volatility, as the capital markets wait and see how the new Administration and legislators behave with one another.

For taxable investors, during the first half of 2017 it will be important to watch whether the broad fiscal stimulus and tax reforms/cuts that the market is currently pricing in (via record-setting equity index levels (S&P 500® Index as of Dec 19, 2016) and elevated interest rates) come to fruition. In the latter part of 2017 it will be important to watch how fundamental economic risk is developing, as the signs of a potential U.S. recession (or at least material slowdown) may begin to show. Here, President-elect Trump's fiscal stimulus, which is likely to pull future growth forward, could exacerbate a possible 2018 downturn for a U.S. economy whose expansion is already in the latter stages of its cycle.

Potential tax reform

Clearly, the near term dominant force impacting the municipal bond market is personal and corporate tax policy. Since this has featured prominently on both President-elect Trump's and the Republicans' agendas, we expect action in this space.
Municipal bond market performance outlook

The investment grade municipal bond market (as measured by the Bloomberg Barclays 1-15 Year Municipal Index) currently yields 2.4% (as of December 19, 2016). While downward pressure on prices may come from potentially higher interest rates, this may be offset by declining muni-to-treasury ratios, all of which leads to a base case nominal return of 2.0-2.4%. Downside risks to this estimate emanate from the potential for partial or full elimination of munis' tax exempt status plus a Federal Reserve hiking faster than expected due to an overheating economy. Upside to our estimate comes from the potential for increased municipal tax receipts from infrastructure stimulus, which would bolster states’ and localities’ fiscal positions.

We believe that the high yield municipal bond market should fare better than investment grade in 2017. High yield munis (Bloomberg Barclays Municipal High Yield Bond Index) came under extreme pressure in the last quarter of 2016 (as of Dec 19) on the back of outflows that started before the U.S. election. This appears unjustified as primary buyers here are funds and crossover investors and as such not given to extreme flow changes. With the current attractive levels that high yield munis represent versus taxable corporate bonds (Bloomberg Barclays U.S. Intermediate Credit Index), it's reasonable to assume demand will pick up in early 2017. The broad Bloomberg Barclays High Yield Municipal Index currently yields 6.5% (as of December 19, 2016), which should support returns of municipal bonds given the yield's relative attractiveness to corporate bonds on a tax-equivalent, default-adjusted basis. However, the Bloomberg Barclays High Yield Municipal Index currently has a longer duration than the Bloomberg Barclays U.S. Intermediate Credit Index. Hence, the muni market is more sensitive than corporate bonds to interest rate increases - particularly increases in long-term interest rates. Should long-term interest rates to increase in the range of 10-30 basis points in 2017, we see the potential for high yield municipal bonds to generate a 4-5% nominal total return in 2017.

We believe the Variable Rate Demand Notes (VRDN) includes some potential opportunities. These ultra-short-dated securities (rates typically re-set every seven days) currently have a nominal yield of 0.66% as of Dec 19 (SIFMA Municipal Swap Index). Should the Federal Reserve follow through on its projected two to three interest rate hikes in 2017, we believe VRDN nominal yields have the potential to increase to 1.1-1.4%. Given that these securities trade at par, their price doesn't suffer from interest rate increases, so we expect them to remain an important vehicle to manage both liquidity and interest rate risk over the next 12 months.

The bottom line

The potential for market volatility in 2017 is real, given the uncertainties surrounding President-elect Trump's policy plans. For taxable investors with commensurate risk tolerance, we believe that municipal bonds may offer attractive investment opportunities to help manage after-tax returns, liquidity and interest rate risk.

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The S&P 500® Index is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500® are those of large publicly held companies that trade on either of the two largest American stock market exchanges: the New York Stock Exchange and the NASDAQ.

Bloomberg Barclays 1-15 Year Municipal Index is a subset of the Barclays Municipal Bond Index that measures the performance of investment-grade issues with remaining maturities of one to 15 years.

Bloomberg Barclays Municipal High Yield Bond Index measures the non-investment grade and non-rated US dollar-denominated, fixed-rate, tax-exempt bond market within the 50 United States and four other qualifying regions (Washington DC, Puerto Rico, Guam and the Virgin Islands). The index allows state and local general obligation, revenue, insured, and pre-refunded bonds, however, historically the index has been comprised of mostly revenue bonds. The US Municipal High Yield Index is a stand-alone index with no crossover into other Barclays taxable indices, such as the US High Yield Index.

Bloomberg Barclays U.S. Intermediate Credit Index is the intermediate component of the U.S. Credit Index. The U.S. Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

SIFMA Municipal Swap Index is a 7-day high-grade market index comprised of tax-exempt VRDOs reset rates that are reported to the Municipal Securities Rule Making Board's (MSRB's) SHORT reporting system. The index is calculated on an actual/actual basis and is published every Wednesday by 4 p.m. Eastern Time.

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