FIXED INCOME

The Case for Municipal Bonds in a Rising-Rate Environment

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Municipal bond yields moved higher in 2018 and seem likely to continue moving up in 2019 if market expectations for further interest-rate increases play out. Sheila Amoroso, director of Franklin Templeton Fixed Income Group's Municipal Bond Department, makes a case for munis within a rising-rate environment. She says there could actually be more demand for munis ahead as a source of tax-free income.

During 2018 we saw some volatility in the municipal bond market for the first time since the fourth quarter of 2016. Municipal bond yields moved higher across the yield curve throughout the year with the yield curve steepening, unlike the US Treasury market, which has seen a flattening of the yield curve.

Given the expected path for US Federal Reserve rate hikes and underlying macroeconomic fundamentals in the United States, we expect broader interest rates to continue moving higher during 2019, along with municipal bond yields. However, we do expect the moves to be more gradual, as opposed to sizable short-term increases.

Because of the higher yields available in the market, there is a greater opportunity to earn tax-free income in the municipal bond asset class. It is important to remember that as municipal bond yields move higher, the taxable equivalent yield moves exponentially higher, particularly for higher-tax states. This new higher base of tax-free income available in the market could help spur demand for the asset class in 2019.

US Tax Reform Impacts

The impacts of the tax reform bill that was passed at the end of 2017 will be felt more directly by investors in 2019. Specifically, with the cap on SALT (state and local tax) deductions at $10,000, we expect demand to increase for municipal bonds, particularly from higher tax states. While we haven't experienced a material increase in such demand as of this writing, we tend to see a shift in demand only after the impact is felt during the tax period by investors. Therefore, we believe a pickup is likely after the impact of the cap is fully felt in early 2019 during the tax preparation season. We also expect that if we were to see such increased demand, it would help to lower yield volatility in a general up-trending yield environment.

Mid-Term Election Impacts

Now that the US midterm elections are behind us, we believe that the likelihood for gridlock in Congress has increased. While the election did not produce any material surprises, there was a shift in power within the House of Representatives, decreasing the prospects for broader, more sweeping legislation in 2019. We therefore believe comprehensive health care reform will be less likely, which may be a net positive for the sector as those entities gain a higher level of certainty for a period of time. Additionally, any further material tax-reform changes are less likely. While it is also questionable whether substantial progress can be made on infrastructure reform, we retain the belief that the municipal bond market would play a material role in the financing of any broad infrastructure plan.

One area we are watching closely is the ability for issuers to advance refund municipal issues on a tax-exempt basis. While this is currently prohibited, there have been some initial discussions around allowing this again in the future by members in the new Democrat-controlled House of Representatives. We would be supportive of such a change as we don't feel the revenue gains from this prohibition have matched expectations, while issuers would benefit from that flexibility.

Concerns and Opportunities

As we advised our clients during 2018, we believe now is an important time to take a hard look at the municipal market because old norms may not hold true going forward. More specifically, we believe the increasing financial pressures being placed on state and local governments demand a shift in how these municipal bond credits are analyzed. We have seen an increase in the likelihood of issuers choosing to harm bondholders' interests, rather than make tough financial and political decisions. This is a departure from the historical norm, in which there was much more of a willingness negotiate and compromise with bondholders during periods of stress.

Today, similar actions seem to be much less likely, requiring a rethinking of how best to manage municipal bond portfolios. In 2019, we will remain focused on the overall health of pensions and pension-related financial matters when it comes to analyzing municipal issuers. Specifically, we believe the best way to manage this risk is to avoid altogether those issuers who appear to have unsustainable budget situations. This also highlights the ongoing importance of independent credit analysis when investing in the municipal market. We expect to remain cautious of local government debt in 2019 given the more limited financial flexibility for those issuers versus states.

In terms of opportunities, the recent market volatility driven by yields moving higher and mutual funds experiencing redemptions has created opportunities to invest at valuations we consider more attractive. In broad terms, we entered 2018 with our portfolios more conservatively positioned, which allowed us to be active and opportunistic during the year's bouts of volatility. As we move into 2019, we will continue to be opportunistic with an eye toward using periods of volatility to potentially enhance the income profile of our portfolios while maintaining discipline when it comes to issuer selection.

Important Legal Information

What are the Risks?

All investments involve risks, including possible loss of principal. Because municipal bonds are sensitive to interest rate movements, a municipal bond portfolio's yield and value will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the portfolio's value may decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value.