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Municipal Bond Perspective: Approach High Yield with Caution in 2020

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As we head into 2020, municipal bonds will likely remain attractive for many tax-sensitive investors, but their performance potential could prove to be relatively muted compared to 2019, according to Sheila Amoroso, director of our Municipal Bond Department. She and her team say this is due to the general level of interest rates and tighter yield spreads, particularly for lower-rated segments of the municipal market. They believe that while now may be a good time to consider a more cautious approach, they still see potential for high levels of tax-exempt income.

Municipal Market Nuances in a High-Yield Context

The municipal bond market presents a number of unique features and characteristics that set it apart from traditional asset classes, and, as one moves further down the credit ratings scale, we believe these nuances become increasingly important for investors to consider.

For example, the municipal market itself is relatively fragmented in nature, with bond inventories spread out across a vast network of dealers and buyers. Trading in the market tends to be limited, and those bonds that do trade typically do so in a decentralized, over-the-counter (OTC) market, presenting challenges for retail investors with regard to market access and price transparency. Liquidity dynamics tend to become even more challenging for lower quality segments of the market.

Only around 10% of the municipal market would be considered below investment grade, based on the traditional breakdown of credit ratings (i.e., bonds rated BB and below). Due to the small size and limited diversity of bonds with these ratings, many BBB issues are considered high yield in the context of the municipal bond market. This is one reason why many high-yield municipal bond funds typically hold meaningful exposure to the BBB segment, which can also provide a valuable source of liquidity compared to even lower quality and non-rated bonds.

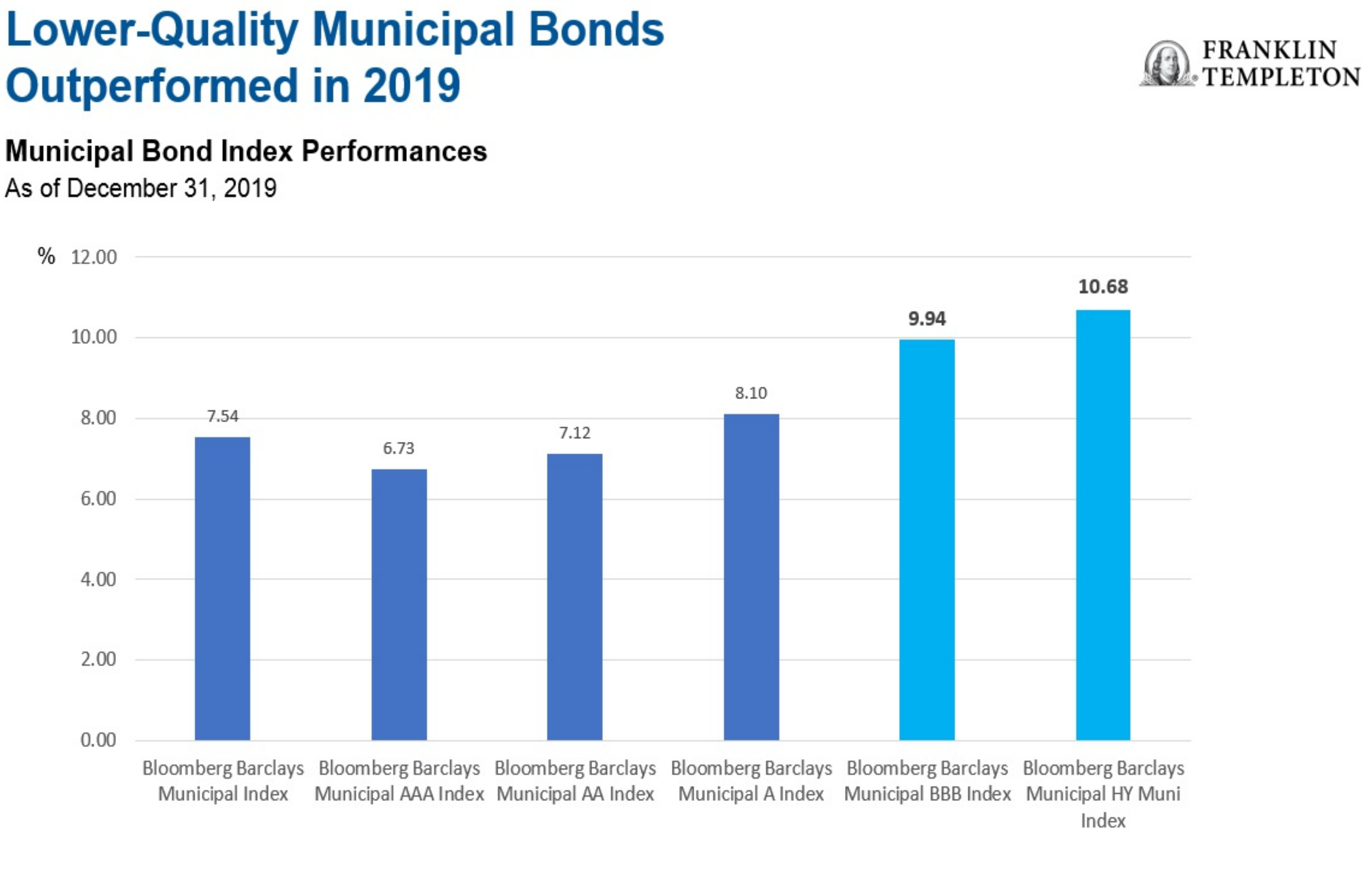
These themes have meaningful implications in a market where almost 2/3 of bonds are held by retail investors, either directly or through investments in mutual funds.[1] With over a million unique securities from more than 50,000 issuers available, many investors simply lack the expertise and resources required to navigate an increasingly complex and fragmented market.

We believe this ownership structure makes the market susceptible to investment decisions that may be driven by emotions, market headlines or other similar factors, further contributing to the market’s inefficiencies.

We also believe this ownership structure contributes to the importance of market technicals, which consistently exert meaningful impacts on municipal market performance—as we observed in 2019—particularly for lower-quality segments of the municipal bond market.

High-Yield Municipal Bonds: Recapping Key Performance Trends from 2019

The municipal bond market performed quite well in 2019, and lower-quality segments of the market posted especially strong results. From our perspective, a key driver was the record-setting levels of demand, as investors continued their search for yield in a low-interest-rate environment.



For illustrative purposes only and not representative of the performance or portfolio composition of any Franklin Templeton Funds.

Source: Bloomberg Barclays Municipal Indexes, as of 12/31/19. Indexes are unmanaged and one cannot directly invest in them. They do not Include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results**.

Against this backdrop, high yield municipal bond funds were a clear beneficiary, bringing in roughly $18.6 billion in net flows for the calendar year, shattering previous records, based on Morningstar flow data.[2]

Throughout 2019, such significant inflows presented favorable tailwinds for the BBB and high-yield municipal indexes, driving significant contributions from price returns for both indexes. This has had a material effect on valuations, which in our view warrants increased caution from investors going forward.

Calendar Year 2019 Set a New Record for High-Yield Municipal Bond Fund Flows

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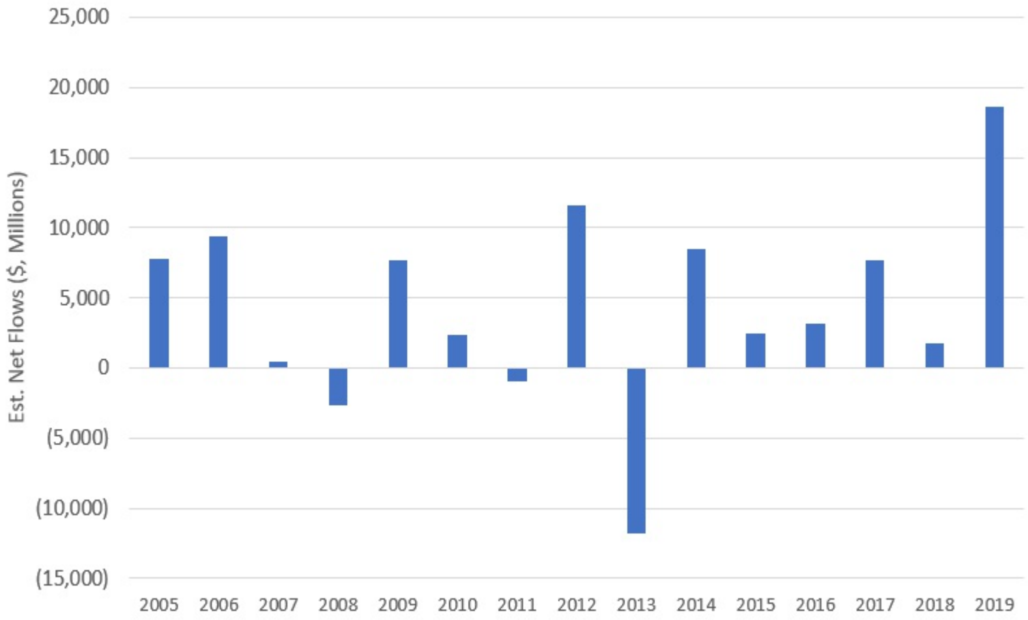
Estimated Net Inflows

As of December 31, 2019



Source: Morningstar Direct, as of 12/31/19.

There is no assurance that any estimate, forecast or projection will be realized.

Historically, wider spread levels have provided opportunities for credit selection to drive incremental upside results, given the potential for spread compression amid improving fundamentals. However, spreads have narrowed significantly in recent years and are well below long-term averages, not only limiting the likelihood for continued price returns going forward but potentially exposing some investors to increased downside risks, should any number of market factors cause spreads to widen.

It's worth noting the mean-reverting nature of price returns, which consistently average out over time.

For example, when we isolate the price returns for the BBB and high-yield municipal indexes since 2007, we observe average price returns of -0.35% and -0.19%, respectively.[3] Meanwhile, we observe average coupon returns (interest payments) of 4.91% and 6.07% for the BBB and high-yield municipal indexes, respectively.[4]

High-Yield Municipal Bond Index Price Returns Over the Last 10 Years

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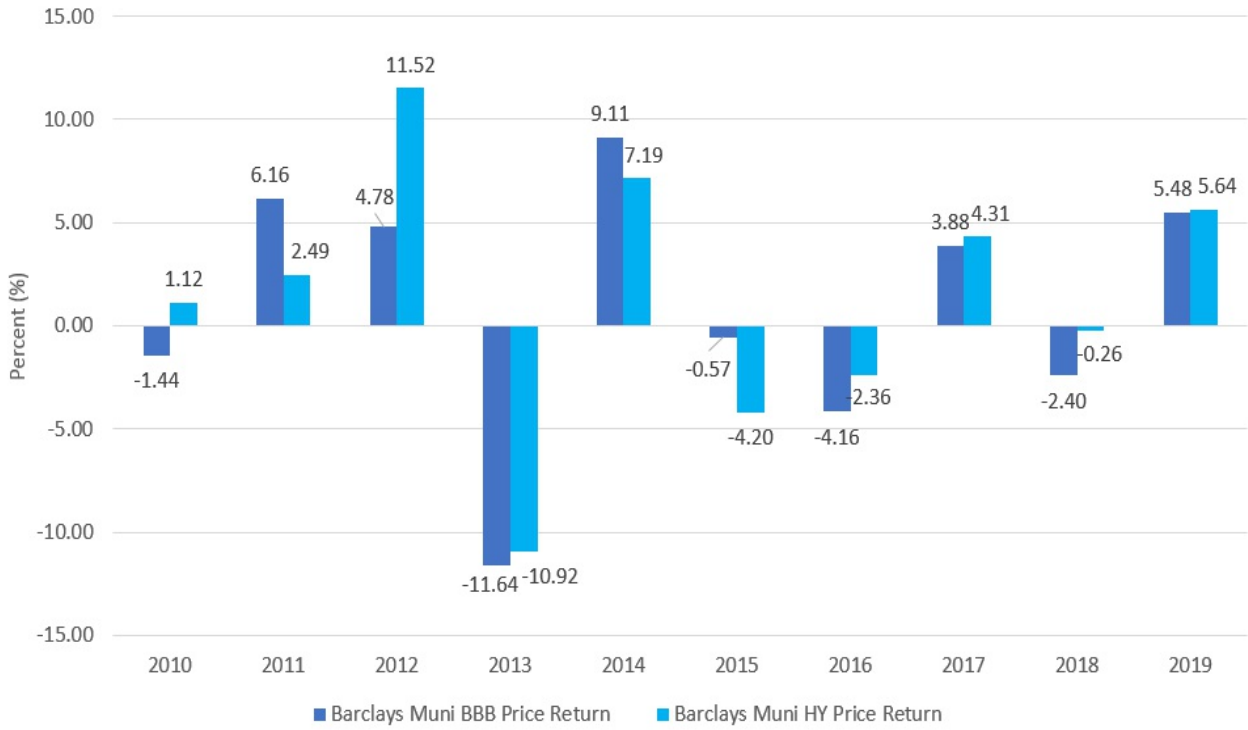
Municipal Bond Index Price Returns

As of December 31, 2019



Sources: Franklin Templeton Capital Market Insights Group, Federal Reserve, NBER (National Bureau of Economic Research) Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

We strongly believe that income returns represent the primary driver of municipal bond performance over time, and, while it’s impossible to predict for any given year, our outlook leads us to believe that a focus on income generation and downside protection will be keys to success for high-yield municipal investors in 2020, especially when we consider risk and return dynamics at this point in time.

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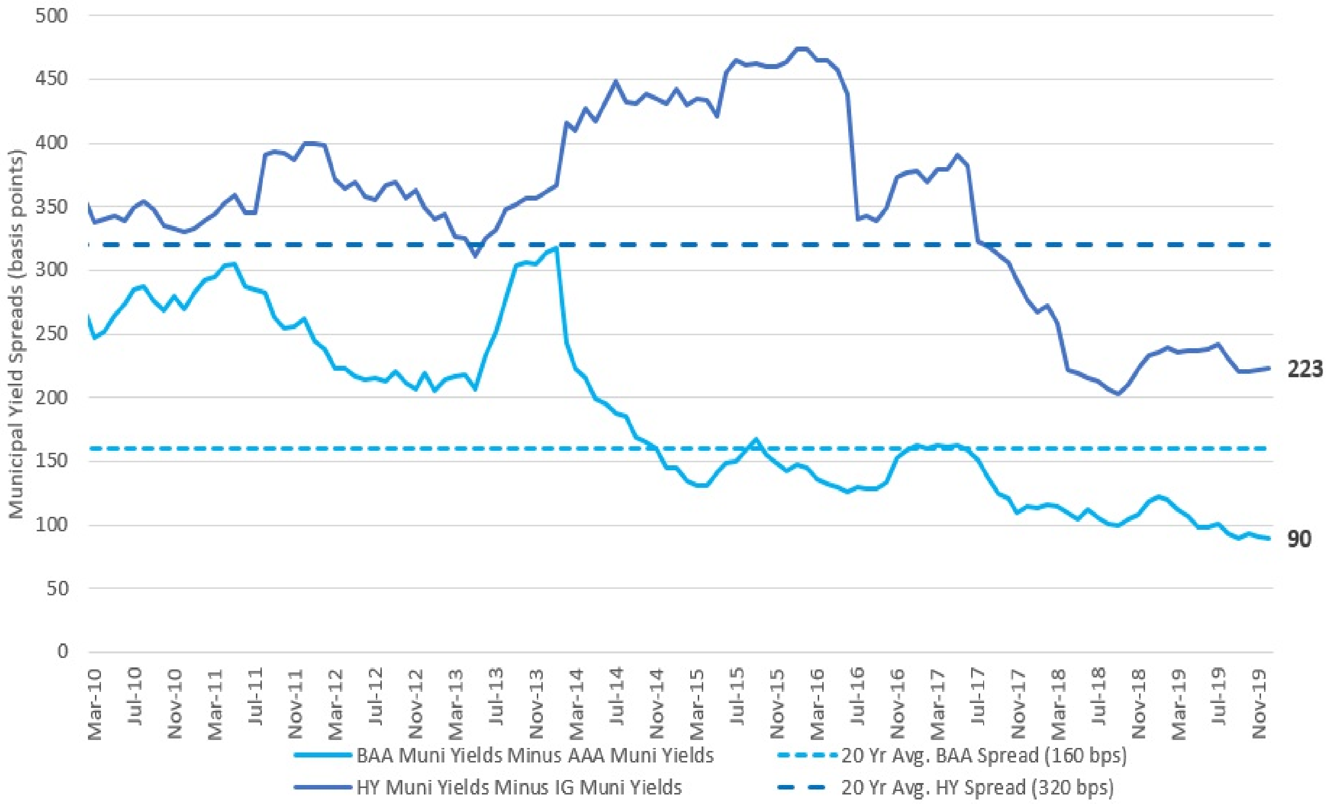
BBB and High-Yield Municipal Index Spreads Are Well Below Long-Term Averages

Municipal Bond Index Spreads

As of December 31, 2019



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Source: Bloomberg, as of 12/31/19. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results**.

Franklin's Approach: Focused on High Income, Not High Risk

Against a backdrop of tighter spreads and lower rates, we also see several factors that could lead to increased bouts of volatility for municipal bonds in 2020, as noted in our annual outlook. To the extent we experience a slowing of economic conditions in 2020, the impact to state and local governments would likely be disparate, leading to potential credit downgrades and increased yield spreads for heavily burdened issuers. In certain instances, we feel that the market and rating agencies have underestimated the burden that these liabilities pose to local and state governments.

Of course, we also recognize that volatility could increase as we move closer to the US presidential election, an event that has previously marked the high-yield municipal market's most recent major decline, when the index returned -4.65% in the last two months of 2016 alone.

In any case, our robust credit research process looks to identify those issuers that appear to have superior financial positions and thus should continue to perform well under these circumstances, ideally providing downside protection for our clients.

We also believe that our consistent achievement of high levels of tax-free income, without overly aggressive allocations to lower-quality segments, reflects our balanced approach to income and risk.

For example, for some time we have not favored lower-quality and non-rated buckets in our portfolios, where liquidity risks often become more meaningful in addition to credit risks. This positioning also enhances our ability to be nimble and opportunistic amid market dislocations, which is when our trading activity typically accelerates.

In such instances, we selectively initiate or add to existing positions in bonds that have unfairly sold off, allowing us to capitalize on opportunities that present higher book yields without requiring the excessive risk-taking at the portfolio level. Over time, such trading activity is one of the key reasons why we can provide above-average levels of tax-exempt income without emphasizing lower-quality bonds or using leverage, practices that aren't uncommon for many high-yield municipal funds.

On the contrary, we generally hold on to our positions when the market is performing well, and, in many cases, we continue to hold legacy positions that were initiated in previous market selloffs. Some of these holdings result in exposure to bonds that have been advance refunded, a segment that has generally underperformed versus lower-quality segments of the market, due to naturally lower price-return contributions.

As we consider risk and return dynamics at this point in time, we think these bonds could continue to provide more incrementally attractive income streams while potentially reducing credit risks. As such, it would be difficult for us to justify trading out of such bonds in favor of others with lower yields and higher credit risks given current valuations. In addition, advance refunded bonds are typically more liquid, further supporting our efforts to capitalize on opportunities amid future periods of distress in the high-yield municipal bond market, whenever they should occur.

Time for a Cautious Approach

We recognize the strong levels of total return observed across lower-quality segments of the municipal bond market in 2019. However, given the general level of interest rates and tighter spreads for high-yield municipal bonds, we believe that now may be a good time to consider a more cautious approach, particularly one that still offers the potential for high levels of tax-exempt income.

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. Investments in lower-rated bonds include higher risk of default and loss of principal. 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.

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1. Source: Municipal Securities Rulemaking Board (MSRB), March 2019.

2. Source: Morningstar Direct, as of December 31, 2019.

3. Source: Bloomberg Barclays, as of December 31, 2019. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.

4. Source: Bloomberg Barclays, as of December 31, 2019.