Bond Market Perspectives

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Municipal Muddle-Through

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Highlights

We continue to find municipal bonds among the more attractive high-quality bond options in a low-yield world, despite seasonal challenges.

As April progresses, we expect a further reduction of the municipal bond market's mini supply-demand imbalance.

The municipal bond market continues to work its way through a difficult seasonal period of performance. A difficult month of March lived up to its traditional billing, before a rebound emerged in late March/early April. Internal demand from within the municipal bond market remains mixed at best, with spillover effects from recent Treasury market strength the primary driver of municipal bond stability.

Municipal bonds have improved recently but lagged Treasuries, leading to attractive valuations. Municipal-to-Treasury yield ratios are at their highest levels since September of last year [Figure 1]. Note that top-rated municipal bond yields have exceeded those of Treasuries since mid-March, implying that investors get the tax benefit for free, but yet the municipal bond market has failed to generate sufficient demand to outperform Treasuries and lower yield ratios in the process.

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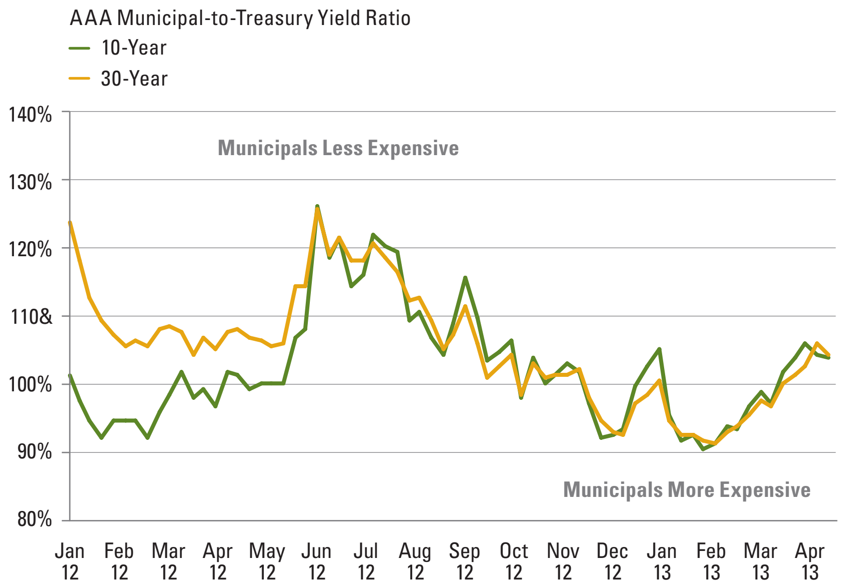
1 Municipal Valuations Remain Attractive



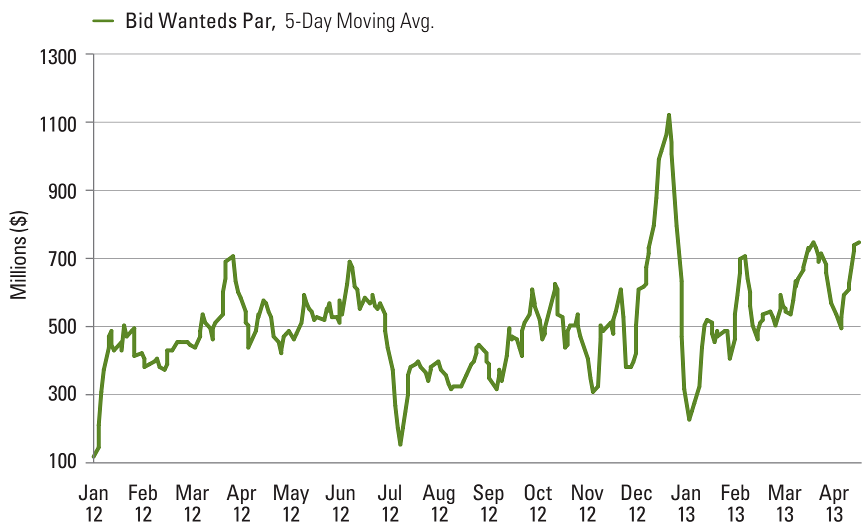
Source: MMA Data, LPL Financial 04/12/13

Ratio is a comparison of the expected yield of one bond to the expected yield of another. The average AAA Municipal is the average yield of all AAA-rated municipal bonds that come due in a particular year, and is maintained by municipal market advisors (MMA).

Municipal bonds are federally tax-free but other state and local taxes may apply. Interest income may be subject to the alternative minimum tax.

Still-heavy secondary market selling continues to weigh on the municipal bond market. The five-day rolling total of bonds looking to be sold (bid-wanteds) remains near a recent peak [Figure 2]. In mid-March 2013, that level of secondary market selling pressure coincided with the trough of municipal bond price weakness. Treasury-led bond market strength over the past few weeks has helped the municipal bond market absorb this pressure.

2 Heavy Secondary Selling Pressure Has Restrained Municipal Bonds



Source: Bloomberg, LPL Financial 04/12/13

Par is the dollar amount assigned to a security when first issued. In the case of bonds this is typically $1000.

Seasonal municipal bond weakness in March can often extend into early April.

As we highlighted in *Bond Market Perspectives – Waiting for the Spring*, February 27, 2013, seasonal municipal bond weakness in March can often extend into early April. Investors often sell municipal bond holdings to pay for taxes. Over the past two trading sessions (Friday, April 12, 2013 and Monday, April 15, 2013), secondary market pressure appears to be lessening, but a further reduction is likely needed to bolster prospects for further price improvement.

Low reinvestment demand in April is also restraining demand.

Low reinvestment demand in April is also restraining demand. April is one of the lightest months of the year in terms of maturing municipal bonds, a characteristic it shares with March. With few bonds maturing, investors' need to reinvest proceeds is reduced. May, June, and July bring improved reinvestment demand dynamics, but in the meantime the municipal bond market continues to experience demand in the primary, or new issue, market that as of yet has not spilled over into the secondary market.

Distractions

Two other stories continue to overhang the municipal market but have not had a widespread impact as of yet. These include:

- The threat of a 28% cap. Last week, the Obama Administration announced its 2014 fiscal year budget, which would begin on October 1, 2013. The budget included yet another proposal to cap the exemption of municipal bond interest income at 28%. Reducing the tax benefit of municipal bonds could spark a sell-off, but the proposed budget will very likely be rejected in Congress. We believe the 28% cap remains a low probability of actually being implemented over the near term. Furthermore, IRS data reveal that roughly half of individual municipal bond investors would not be impacted by a cap, as their gross income would be too low to be subject to the cap, a factor that may limit any potential market impact. Over the longer term, the concept of a 28% cap is likely to linger, but enactment is more likely to be part of broader tax reform if at all. As of yet, there are no viable options besides traditional tax-exempt municipal bonds to facilitate state and local government finance. A cap could lead to higher borrowing costs for states and municipalities, and be detrimental in the long run.
- Puerto Rico. Puerto Rico rivals some of the largest U.S. states in terms of size in the municipal bond market. During the first quarter of 2013, general obligation bonds from the commonwealth of Puerto Rico were downgraded to the last rung of investment-grade ratings. Another downgrade could push Puerto Rico debt into "junk" territory and force indiscriminate selling by investors unable to hold low-rated debt. Puerto Rico bonds would likely bear the brunt of weakness under such a scenario, but given its sheer size, there would likely be negative ramifications for the broader municipal bond market. Puerto Rico has taken steps to address its large pension liabilities in order to stave off further downgrades but remains a risk worth watching in coming months.

Light at the End of the Tunnel

Despite the longer-term challenges above, we continue to find municipal bonds among the more attractive high-quality bond options in a low-yield world. The passage of tax day (April 15) and gradual easing of secondary market selling pressure may motivate investors to refocus on the attractive valuations of municipal bonds. The mini supply-demand imbalance of March is slowly dissipating, and as April progresses, we expect a further reduction of these pressures. At that point, primary market strength may better support the municipal bond market. It is worth noting, that despite ongoing challenges municipal bonds have still managed to outperform Treasuries year-to-date through April 15, 2013, according to Barclays Index data. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Yield is the income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Bonds given an investment grade rating indicate a relatively low risk of default.

AAA is the highest possible rating assigned to the bonds of an issuer by credit rating agencies. An issuer that is rated AAA has an exceptional degree of creditworthiness and can easily meet its financial commitments.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax free, but other state and local taxes may apply.

Treasuries are marketable, fixed-interest U.S. government debt securities. Treasury bonds make interest payments semi-annually, and the income that holders receive is only taxed at the federal level.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features.

A municipal bond backed by the credit and "taxing power" of the issuing jurisdiction rather than the revenue from a given project.

INDEX DESCRIPTIONS

The Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The Barclays Treasury index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include t-bills (due to the maturity constraint), zero coupon bonds (Strips), or Treasury Inflation Protected Securities (TIPS).

The Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

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