LPL RESEARCH
BOND MARKET PERSPECTIVES

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HIGH-YIELD MUNICIPALS: DOES RISK OUTWEIGH REWARD?

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KEY TAKEAWAYS

High-yield municipal bonds have started to recover following the November 2016 sell-off.

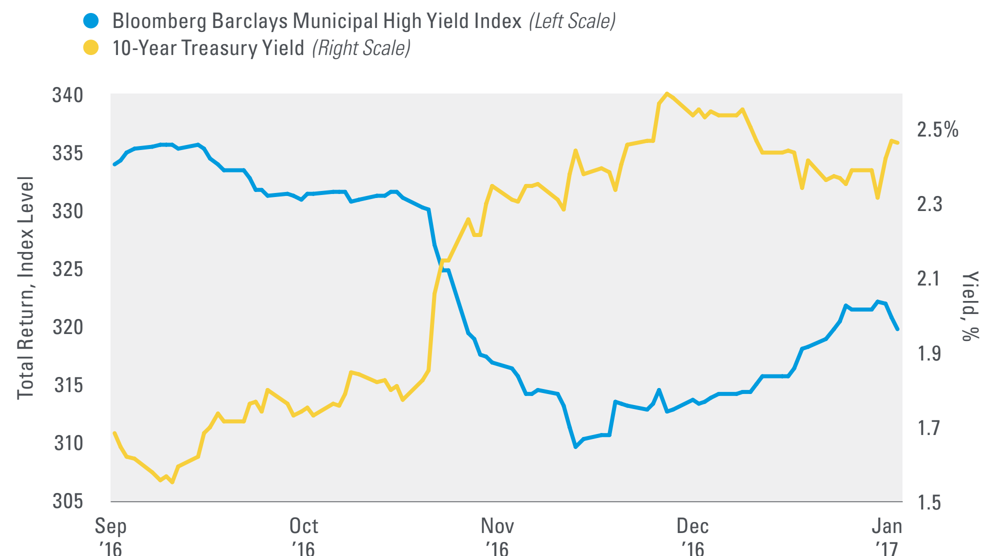
Prices are up, presenting investors with a favorable opportunity to trim longer duration municipal high-yield in favor of shorter duration high-yield municipal bonds or funds.

Taxable equivalent yields are compelling compared with high-yield corporate bonds, BBB-rated municipals, and 30-year U.S. Treasuries.

Municipal high-yield default rates are lower than comparable corporate bonds, with problem issuers remaining isolated.

With a positive return of 1.93% for December 2016, followed by month-to-date (January) returns of 1.27% (as of 1/20/2017), the Bloomberg Barclays Municipal High Yield Index has recovered dramatically. This improvement comes after a post-election sell-off resulting in a -5.95% return in November 2016. Benefiting from lower supply and a technically favorable month where coupon payments, maturities, and refinancing cash flows tend to be reinvested back into the market, January may have investors looking at high-yield municipals once again to seek additional yield. We remain neutral on high-yield municipal bonds because of the longer maturity profile and greater price sensitivity in rising rate environments [Figure 1]. Additionally, the sector comprises lower-rated issues, with exposure to riskier securitized bonds like tobacco, corporate-backed, project financed, and hospital bonds — a sector that could be impacted by changes to the Affordable Care Act. On a positive note, yields are compelling, and default risk, a key variable in determining price volatility, remains subdued and unlikely to pose a notable risk in 2017. The recent recovery may also offer an opportunity for suitable investors to take advantage of the higher prices to reduce longer exposure in favor of shorter duration.

1 HIGH-YIELD MUNICIPAL BONDS EXPERIENCED A PULLBACK AS RATES MOVED HIGHER POST-ELECTION



Source: LPL Research, FactSet, Bloomberg 01/20/17

Indexes are unmanaged and cannot be invested into directly. Past performance is not indicative of future results.

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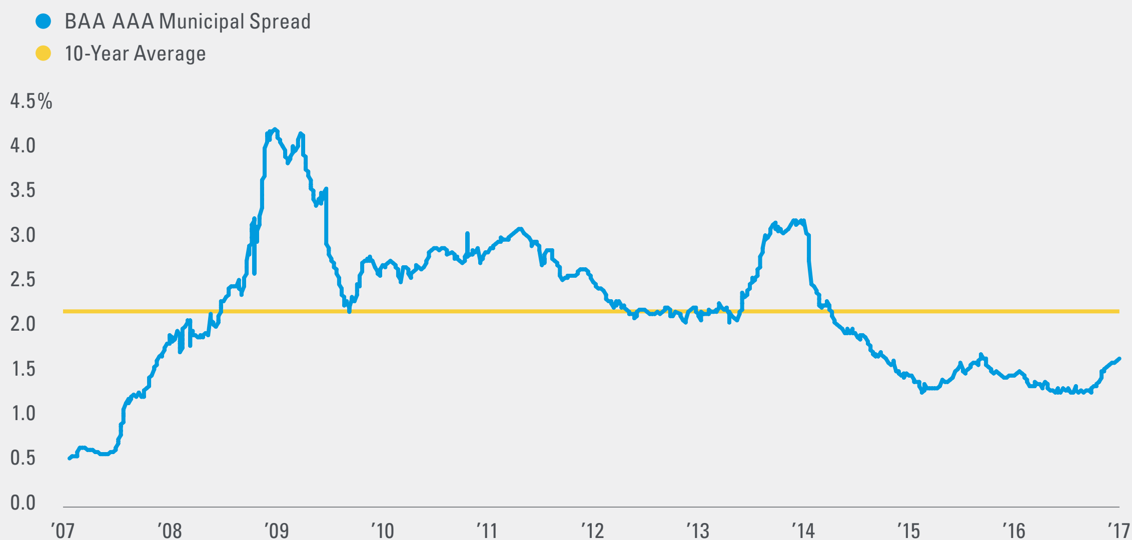
INTEREST RATE SENSITIVITY

The Bloomberg Barclays High Yield Municipal Bond Index, a leading benchmark for this sector, has an average maturity of 20 years, which makes prices very sensitive to interest rate movements and explains the losses experienced in November 2016. By comparison, the average maturity of the Barclays High Yield Corporate Bond Index is 6.3 years. Generally, the longer the maturity and duration, the more sensitive the bond's price is to interest rate changes. The duration of the high-yield index is 8.6 years. Therefore, if interest rates rise by 1%, the price of the index would be expected to decline by approximately 8.6%, assuming no other changes. The longer the duration of the bond, the higher the yield should be as investors need compensation for the additional time it takes to recover their principal investment. Historically, short-term bonds perform better in rising rate environments, since investors can recover their principal sooner and reinvest at higher interest rates.

Prior to October 2016, as interest rates moved lower, investors piled into lower rated municipals in search of higher yields. As a result, average yield spreads between top-quality AAA-rated general obligation (GO) bonds and BBB-rated GO bonds fell to post-recession lows of 1.25% in August 2016 [Figure 2]. Increased supply then came into the market during October and November as issuers pushed forward deals in hopes of getting ahead of the U.S. election and a well telegraphed Federal Reserve (Fed) rate hike in December. This caused spreads to move higher (cheaper for BBB bonds) entering into December 2016. Although spreads widened to more attractive levels, it is important to remember that technical conditions tend to weigh heavily on municipals entering into the May through August periods. With interest rates still historically low and the Fed signaling two to three additional rate hikes this year, issuers may come to market with more supply, which could negatively impact spreads.

2 **THE AAA TO BBB MUNICIPAL BOND YIELD SPREAD HAS INCREASED, THOUGH REMAINS ON THE EXPENSIVE SIDE OF ITS 10-YEAR AVERAGE**



Source: LPL Research, Bloomberg 01/20/17

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The credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade.

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COMPELLING YIELD

Proposed tax rate reductions discussed by the Trump administration have investors wondering if the tax-exempt benefit in the municipal bond market will be negatively impacted. At current prices, high-yield municipals appear to have a large enough after-tax advantage to mitigate the risk of lower tax rates. For example, the yield of the Bloomberg Barclays Municipal High Yield Index is 6.34% (as of 1/20/2017), with a taxable equivalent yield of 10.5% (assuming a 39.6% tax rate) [Figure 3]. In comparison, the yield on the Barclays High Yield Corporate Index is 5.87%. A comparably priced high-yield municipal bond offers more yield even before factoring in the tax advantage, which makes sense given that investors demand more yield for longer duration securities. Even if the tax rate moves lower to 25%, the municipals would still offer more tax-adjusted yield than the corporate bond at 8.95% after-tax yield. In short, on an after-tax basis, high-yield municipals appear to offer a more compelling yield than corporate high-yield bonds at this time, though the longer duration of high-yield municipal bonds may be a headwind if rates rise. Keep in mind that Puerto Rico bonds can be found in some high-yield funds, adding to the yield. Investors should be aware of this risk and be comfortable owning non-investment grade credits before buying high-yield municipals.

3 HIGH-YIELD MUNICIPAL BONDS OFFER COMPELLING TAXABLE EQUIVALENT YIELDS

Tax Rate	Taxable Equivalent Yield*
10%	7.04%
15%	7.46%
25%	8.45%
28%	8.81%
33%	9.46%
35%	9.75%
39.6%	10.50%

Source: LPL Research, IRS Personal Tax Brackets, Bloomberg 01/20/17

*Based on a yield of 6.34% as of 01/20/17.

This is a hypothetical example and is not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing.

LOWER DEFAULT RATES

Historically, compared with taxable corporate bonds, municipal bonds have had a very low default rate. Municipal general obligation bonds are backed by the full faith and credit of the issuing municipality, which has the authority to raise taxes to make payments on the bonds. Revenue bonds are backed by the income stream of the project. Corporate-backed bonds, on the other hand, rely on the issuing company's credit strength. In addition, municipal high-yield has very little exposure to oil and commodities, whereas these are present in most corporate bond indexes.

Large municipal defaults have occurred in recent years, including Puerto Rico, Detroit, and Jefferson County Alabama, but the problems exhibited in these situations were years in the making and forecast well in advance of the defaults. These type of credit issues remain isolated, and can be minimized through proper diversification across several different municipal high-yield sectors.

As mentioned in our *Outlook 2017: Gauging Market Milestones*, we expect the 10-year Treasury yield to end the year in the 2.25% to 2.75% range, with the potential to reach 3% if meaningful fiscal stimulus is enacted. We also don't expect deterioration in the economy, which could pressure lower-rated states and municipalities leading to

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not ensure against market risk.

default. That said, it is important to realize that an allocation to states that are experiencing pension liability funding issues such as Illinois, New Jersey, and Puerto Rico, can be found in the in many high-yield funds. Investors should shy away from funds with excessive exposure (greater than 20%) to CCC and non-rated bonds.

CONCLUSION

We remain neutral on high-yield municipal bonds overall. The asset class should remain sought after in 2017, as the yield advantage and lower default rates make this sector attractive. However, based on history supply tends to become a headwind moving into February and March, and investors should understand the interest rate risk involved. November 2016, when high-yield municipals lost 5.60%, should serve as a reminder of the potential volatility within high-yield investing. Although sell-offs of that magnitude are rare in fixed income markets, it is important for investors to remain diligent in their asset allocation choices. Well diversified portfolios, with a shorter duration profile and allocation across various sectors and asset classes, may help to protect investors from additional volatility. ■

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 reference 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.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

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.

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 rates rise. Interest income may be subject to the alternative minimum tax. Federally tax free but other state and local taxes may apply.

INDEX DEFINITIONS

The Bloomberg Barclays Municipal Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year.

The Bloomberg Barclays Municipal High Yield Bond Index is comprised of bonds with maturities greater than one year, having a par value of at least $3 million issued as part of a transaction size greater than $20 million, and rated no higher than 'BB+' or equivalent by any of the three principal rating agencies. (The long and the short are subindexes of the Municipal Bond Index, based on duration length.)

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