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As Interest Rates Rise, Muni Bonds' Unique Characteristics Matter More

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By:

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This year, the Federal Reserve (Fed) is likely to raise interest rates at least three times. The current rate-hike cycle is the first in nearly a decade and after all those years of zero-bound rate policy, some investors may feel as though this is a step into uncharted territory. Standish, however, has managed municipal bond portfolios through many similar interest rate tightening cycles and our analysis of how various asset classes have performed during previous periods of rising rates makes us confident that opportunities may exist for investors to earn attractive yields while also reducing portfolio risk amid the ongoing normalization of monetary policy.

RISING RATES AREN'T NECESSARILY BAD NEWS FOR BONDS

Though bond prices move in the opposite direction of yields, moves in fixed income markets may be driven less by the mere fact of higher rates than by whether or not investors expect rate hikes. Expected rate increases are typically priced into current valuations and markets typically respond to them with modest volatility. A slow and steady tightening by two or three increases per year is largely priced into the fed funds futures market already, so interest-rate policy is likely to have a limited impact on muni bond prices, barring an abrupt policy change.

Rising rates also hold little threat for investors who hold bonds until they mature, as changing rates and yields do not affect the investor's total return. These investors receive regular interest income as well as the value of the bond at maturity. Rather than posing a threat, rising rates offer bond investors of this sort the opportunity to reinvest the income their bonds yield at maturity into newly issued, higher-yielding bonds.

Not FDIC-Insured. Not Bank-Guaranteed. May Lose Value.

HOW MUNI BONDS HAVE BEHAVED DURING PREVIOUS RATE-HIKE CYCLES

While past performance does not predict future results, munis have delivered higher returns and lower volatility than Treasury securities of comparable maturities during the three most recent periods of rising rates.* Between January 1994 and February 1995, the central bank raised the fed funds rate by 300 basis points. From June 1999 through May 2000, the Fed raised the rate by 175 basis points. From June 1, 2004 through June 30, 2006, the Fed raised rates by 425 basis points in a series of 17 rate hikes of 25 basis points each. We expect the current tightening cycle to resemble that of 2004-06 in that it will be steady and gradual, likely playing out in two or three hikes per year until rates reach 3%.

During each of those periods, municipal bond yields fluctuated less than did Treasury yields. Standish research shows that over 3-year rolling periods, yields on 10-year municipal bonds have historically exhibited only 60% as much volatility as 10-year Treasuries have shown. Using history as a guide, a 100-basis-point rise in 10-year Treasury yields, reflecting a 100-basis-point rise in interest rates would likely be accompanied by a 60-basis-point rise in municipal bond yields. While future yields could deviate from historical averages, we expect that the lower volatility of municipal bonds will help offset the negative impact of rising interest rates on a variety of categories of bonds, particularly other liquid fixed income asset classes such as Treasuries. We expect muni bonds with longer maturities, particularly those greater than 10 years, to show significantly less volatility than 10-year Treasuries.

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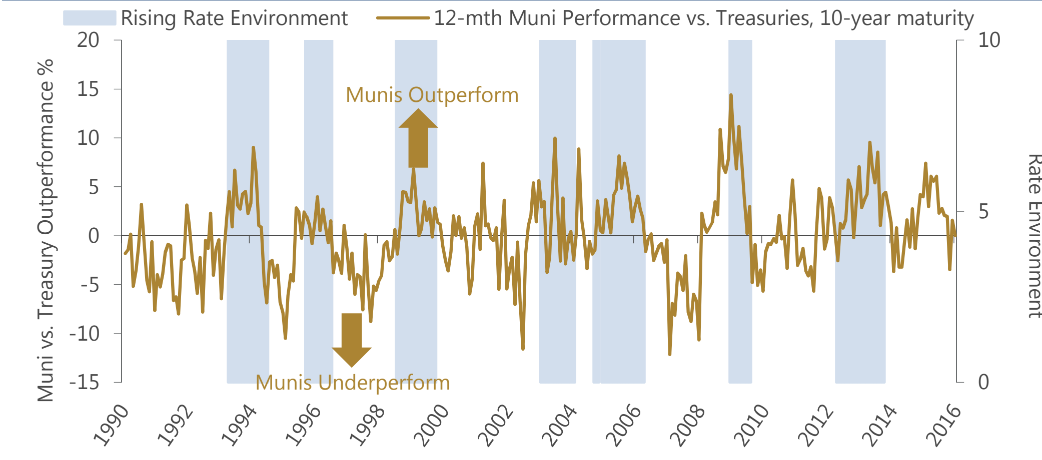
*Returns series shown is 12-month rolling total return difference between munis and Treasuries. Treasury data based on Bloomberg Barclays 10-year Treasury Bellwether benchmark. Muni data based on 10-year Thomson Reuters MMD scale. Sources: Bloomberg Barclays, Thomson Reuters, Standish as of December 31, 2016. Volatility is based on average of 1994 and 1999 experience. Time period reflects environment of significant spike in federal funds rate over relatively short time period (12 to 14 months). Sources: U.S. Federal Reserve, Bloomberg, Standish as of May 25, 2016.

Munis Have Outperformed Treasuries When Rates Rise



Returns series shown is 12-month rolling total return difference between munis and Treasuries. Treasury data based on Bloomberg Barclays 10-Year Treasury Bellwether Index. Muni data based on 10-year Thomson Reuters MMD scale. Sources: Bloomberg Barclays, Thomson Reuters, Standish as of December 31, 2016. Charts are provided for illustrative purposes only and are not indicative of the past or future performance of any Dreyfus product.

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The relative steadiness of muni bonds reflects the unique intrinsic characteristics of the bonds themselves. Many municipal bond investors in the U.S. own these securities for the tax-free income they provide and tend to hold the bonds to maturity, which reduces concern about the impact of rising and falling markets on the value of capital invested in a fixed income portfolio. As Fed policy becomes gradually less accommodative, many investors will begin to look for more of their total return from income as equity markets cool and will reallocate their portfolios accordingly. The tax-exempt income that muni bonds offer becomes more attractive to investors as rates rise. At the same time, higher rates may reduce cities' and states' interest in refinancing their debt at higher rates, which reduces the supply of bonds in the market, also helping to push up prices.

These dynamics help make the municipal bond market less volatile than other fixed income markets when rates are on the way up. Municipal bonds tend to be relatively immune to Fed moves for a variety of reasons. Muni valuations reflect the level of demand from these bonds from the individual investors who own more than two-thirds of the entire muni bond market, either directly or through mutual funds. These investors often hold municipal bonds chiefly as sources of income. They may buy more bonds as rising interest rates create opportunities for them to lock in higher yields. And the value from receiving tax-exempt income is typically greater for investors as lower-yielding bonds are replaced by higher-yielding ones.

Supply conditions also contribute to muni bonds' defensive characteristics. When rates rise sharply, issuers often lose their ability to refinance existing debt by issuing refunding bonds. By choking off refunding activity, higher rates can reduce new issuance by as much as 30%, creating relative scarcity and tempering the price declines caused by rising interest rates.

These unique characteristics enable U.S. municipal bonds to offer investors opportunities to reduce portfolio risk while also providing compelling yields amid the ongoing normalization of monetary policy.

Risks

Bonds are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. **Municipal income** may be subject to state and local taxes. Some income may be subject to the federal alternative minimum tax for certain investors. Capital gains, if any, are taxable.

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Bloomberg Barclays 10-Year U.S. Treasury Bellwether Index - The Bloomberg Barclays 10-Year U.S. Treasury Bellwether Index is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments.

The **Thomson Reuters Municipal Market Data (MMD) AAA Curve** is a proprietary yield curve that provides the offer side of "AAA"-rated state general obligation bonds, as determined by the MMD analyst team. The "AAA" scale (MMD Scale) is published by Municipal Market Data every day at 3:00 p.m. Eastern Time with earlier indications of market movement provided throughout the trading day. The MMD AAA curve represents the MMD analyst team's opinion of AAA valuation, based on institutional block size ($2 million+) market activity in both the primary and secondary municipal bond market. In the interest of transparency, MMD publishes extensive yield curve assumptions relating to various structural criteria which are used in filtering market information for the purpose of benchmark yield curve creation.

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