Municipals and Rising Rates: A Potential Opportunity for Fixed Income Investors

Executive Summary

- For investors concerned about the prospect of rising interest rates, U.S. municipal bonds may be a good opportunity
- U.S. municipal bonds can be a high quality, low volatility complement to an overall asset allocation
- The diversification benefits of U.S. municipal bonds may enhance the overall risk-and-return profile of an investment portfolio

Municipal Bonds Defensive Behavior During Rising Rates

While it's generally true that there is an inverse relationship between interest rate movements and bond prices, investors should be aware that not all fixed income asset classes are created equal when it comes to the magnitude of price sensitivity to rate changes. At Standish, our research has shown that over the long-term, municipal bond yields tend to exhibit lower volatility than Treasury yields. We have observed 10-year municipal bonds move approximately 60% as much as 10-year Treasuries (beta) over 3-year rolling periods.

As an example, assuming the historical 60% beta relationship holds, for a 100 basis point increase in 10-year Treasury yields we would expect municipal bond yields to rise by about 60 basis points, translating to a price change of -4.9% versus Treasuries at -8.9%. While the beta experience in the future could vary from the historical average, it is reasonable to expect that the lower volatility characteristics of municipal bonds will help mitigate negative price effects of rising interest rates, particularly versus other liquid fixed income asset classes such as Treasuries.
The chart below shows the defensive behavior of municipal bonds going back to 1990. In each highlighted period of rising rates, municipal bond total returns (pre-tax) were higher than comparable Treasuries. The magnitude of outperformance increases further when tax rates are considered. Volatility and beta are consistently lower in the municipal bond market than Treasuries, over long and short time horizons.

**Munis Have Outperformed Treasuries When Rates Rise**

Muni yields tended to rise less than those of comparable Treasury securities as monetary policy turned from accommodative-to-restrictive.

**How Municipals Fared During Fed Rate Hike Regimes**

Municipals have also demonstrated more defensive characteristics when the Fed has hiked rates markedly over a relatively short span. Muni yields tended to rise less than those of comparable Treasury securities as monetary policy turned from accommodative-to-restrictive. As seen in the chart below, covering the last two brief tightening regimes (January 1994 through February 1995, when the Fed Funds rate was raised by 300 basis points, and June 1999 through May 2000, when the rate was raised by 175 basis points), municipal yields exhibited considerably lower sensitivity to the Fed’s interest rate actions than did Treasury yields. The lower sensitivity to Fed rate hikes also increased out the yield curve, particularly at 10-year maturities and beyond.

**Historical Muni Beta Yield Change to Fed Rate Hikes**

Based on average of 1994 and 1999 experience. Time period reflects environment of significant spike in Fed funds rate over relative short time period (12-14 months). Source: Federal Reserve, Bloomberg, Standish as of May 25, 2016
Why the Low Muni Bond Beta?

Certain features of the municipal bond market help explain this observed defensiveness of municipals when the Fed is tightening. First, municipal bond valuations tend to respond to demand trends among individuals and households, who together own over two-thirds of all municipals, either directly or through funds. These investors often hold municipal bonds chiefly as a source of income, and may step up their buying as rising interest rates create opportunities to lock in higher yields. And the value from receiving tax-exempt income is typically greater for investors as lower-coupon bonds roll off and are replaced by higher-coupon bonds.

Supply conditions also support the defensiveness noted above. Often when rates rise sharply, issuers lose the ability to refinance existing debt by issuing refunding bonds. Choking off refunding activity can cut new issuance by as much as 30%, creating relative scarcity and tempering the price declines caused by rising interest rates.

Municipal bond returns have a low correlation with other asset classes, while delivering comparable levels of income versus similar quality-and-maturity global fixed income alternatives.

Scarcity of High Quality Global Fixed Income Assets

Municipal bond yields compare favorably versus other high-quality sovereign bonds. A somewhat diminished supply of high grade AAA-rated sovereign and quasi-sovereign credits, make municipals an attractive fixed income vehicle in view of relative yield and strong credit quality.

Moody’s AAA-rated - Sovereign 10-year Yields

* Rated AA1/AA+/AAA (DBRS)
Source: Bloomberg, Standish as of May 9, 2016. These states/sovereigns were chosen based on comparable quality. For illustrative purposes only.
Diversification Benefits

U.S. municipal bonds can be attractive to non-taxpaying investors as a mechanism to increase risk-adjusted returns. Municipal bond returns have a low correlation with other asset classes, while delivering comparable levels of income versus similar quality-and-maturity global fixed income alternatives.

Conclusions

Fixed income bond investors may be able to cushion against future unrealized losses from rising interest rates by holding a core position in intermediate high-grade municipals. These bonds can offer several positive characteristics, including attractive income, a lower volatility profile which contributes to diversification benefits, defensiveness against Federal Reserve rate hikes and high credit quality, all of which can help preserve investment income while further dampening the negative price impact of higher interest rates.

Correlation Matrix Based on Total Returns - Since January 1, 1997

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<tr>
<th></th>
<th>Barclays Muni Index</th>
<th>Barclays Treasury Index</th>
<th>Barclays Corporate Index</th>
<th>BofA Merrill Lynch World Sovereign Bond Index</th>
<th>S&amp;P 500</th>
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Source: Barclays, Merrill Lynch, Bloomberg as of April 30, 2016