FRANKLIN TEMPLETON

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Outlook for US Municipal Bond Investing

Focused on Income, Prepared for Volatility

"Moving into 2020, we believe municipal bonds can continue to provide a number of benefits for tax-sensitive investors. However, following the strong results in 2019, we expect total return potential to be muted in 2020, with income largely driving performance in the asset class. Additionally, as the US presidential election approaches, we anticipate increased volatility that could provide attractive opportunities for our active, income-focused investment approach."

Sheila Amoroso
Senior Vice President
Director, Municipal Bond Department
Franklin Templeton Fixed Income Group®

Municipal Market Technicals Remain Favorable…

Municipal bond supply and investor demand continue to represent important factors in the context of the municipal bond market. In terms of supply, several themes have emerged following the elimination of tax-exempt advance refundings, a component of the 2017 tax reform legislation that has led to the reduced supply of tax-exempt bonds in 2018 and 2019. Meanwhile, the market has seen a significant increase in the supply of taxable municipal bonds, as issuers have turned to them for opportunities to refinance through advance refunding higher coupon tax-exempt bonds thanks to attractive fundamentals versus similarly rated investment-grade corporate bonds. While taxable issuance is likely to remain elevated in 2020, the net issuance of tax-exempt municipal bonds—which continue to represent the vast majority of the overall market—is likely to remain low, in our view.

At the same time, municipal bonds have continued to see strong investor demand, with 2019 expected to break historical records for inflows. Although we believe municipal market performance potential will likely be more muted over the next 12 months, we expect investor demand to remain strong given the variety of benefits that municipal bonds can provide within a broader investment portfolio, particularly their tax-exempt status.

…But the Potential for Volatility Remains

Unfunded pension liabilities continue to be an overhang for municipalities in general, but particularly for local governments. Over the past several decades, due largely to inadequate funding, pension programs have seen ever increasing liabilities, causing significant budget stress as these expenses have grown faster than revenues. Despite legislative efforts in some areas to increase funding, contributions to retirement programs remain below levels needed to meet obligations in many places. In certain instances, we feel that the market and rating agencies have underestimated the burden that these liabilities pose to local and state governments.

To the extent we experience a deterioration in economic conditions in 2020, the impact on state and local governments would likely be disparate, potentially leading to credit downgrades and increased yield spreads for heavily burdened issuers. Our robust credit research process looks to identify those issuers that have superior financial positions and thus should continue to perform well under these circumstances, ideally providing downside protection for our clients.

Going into 2020, we also recognize that volatility could increase as we move toward the presidential election. Current candidates have a wide variety of views on areas that can impact the municipal bond market, including potential changes to tax legislation, budget deficits and health care reforms. In our view, any changes to federal tax law that could significantly affect municipal market technicals are unlikely at this point in time, but we will continue to monitor political developments across national, state and local levels closely throughout the year.

Focusing on Higher Income Levels

In summary, we believe municipal bonds will continue to be attractive for many investors seeking tax-free income, but we also expect their performance potential to be much more muted compared to 2019 given the general level of interest rates and tighter yield spreads, particularly for lower-rated segments of the municipal market.

As a result, we believe a consistent focus on prudently managing our portfolios toward higher income levels through a nimble investment approach will be key to success in 2020. To the extent volatility creates opportunity, we will remain at the ready to deploy capital and position our portfolios accordingly.

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. 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.

IMPORTANT LEGAL INFORMATION

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