THE MUNICIPAL BOND MARKET: THE SAME ... YET DIFFERENT

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Point of View With Peter Hayes

The municipal bond market continues to blaze a new path. Despite traveling a fairly rough road in 2013, many of the attributes that have long defined the asset class, including its high quality and income-oriented nature, remain firmly intact. But the market is also evolving. BlackRock's Peter Hayes offers insight into where the market may be headed, along with recommendations for investors. A few of his key observations:

- **Munis trade as a credit market.** Munis traditionally vied for investor attention vs. rate-centric Treasuries. Today, they are competing with and often outyielding investment-grade corporate bonds and other credit sectors.
- **The market is shrinking.** A continued aversion to debt could mean supply in the market continues to decrease. Low supply could be a positive for muni prices, particularly if crossover and non-traditional investors maintain interest.
- **Fundamentals are their strongest in five years.** The recession was painful, but it forced state and local governments to address some challenges (including pensions), which is leading to rising revenues, spending restraint and greater fiscal stability.

The municipal market hit a rough patch in 2013. What drove the volatility?

The volatility was largely about interest rates. It started with Fed Chairman Bernanke's testimony before Congress in May, at the first utterance of "taper," and then ramped up at the FOMC meeting and press conference in June.

Ten-year municipal bond yields rose 94 basis points between April 30 and June 21, resulting in a 4.38% loss for the Barclays Municipal Bond Index. The market was stunned by the swiftness and magnitude of the move. It's not typical in the muni space. As a result, investors became more conscious of the duration in their portfolios and began shedding interest rate risk. That, in turn, drove fund flows out of the asset class and left the market seeking a more stable demand base, which perpetuates the volatility.

Some people believe credit risk was to blame, citing Detroit and Puerto Rico. I think it was a lot less about credit and a lot more about interest rates. As rates go up, demand goes down, and that's the perfect recipe for volatility.

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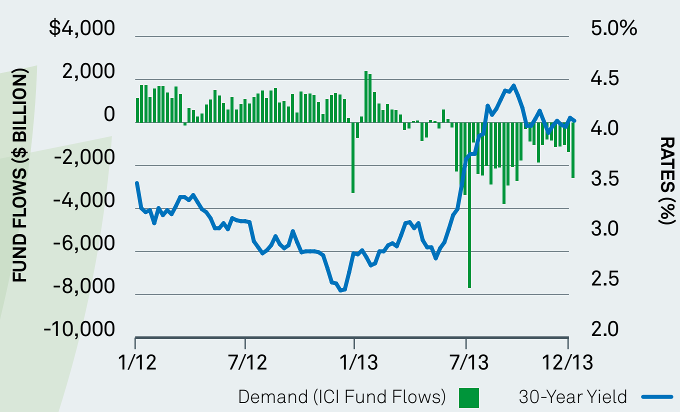
Will munis return to their low-volatility roots or are we in a new normal?

I think we'll exist in a world of greater volatility, and there are a few reasons for that. First is the increase in regulation that has banks and other dealers using less of their balance sheet and, therefore, providing less liquidity to the market. Second is the fact that we're still in an environment of fairly

AS RATES GO UP, DEMAND GOES DOWN

Fund Flows and 30-Year AAA Muni Yields, 2012 and 2013



Sources: ICI and Thomson Reuters; as of Dec. 11, 2013.

low absolute rates, with the most likely long-term path being up. Investors shouldn't expect the inevitable rise in rates to be a smooth ride. Third is the changing investor base in the muni market. The market has diversified away from its heavily retail roots. In the past few years, it's actually been banks, insurance companies and even hedge funds that are increasing their ownership in municipal bonds. That's because the asset class, post-crisis, has behaved more like a credit market. Munis compete day in and day out with other fixed income asset classes and, because of that, they will experience volatility. These crossover and non-traditional buyers also have shorter investment time horizons than typical buy-and-hold retail investors. The offset to all of this is dwindling supply. At some point, when we get to a very low level of supply, that in itself would mute volatility.

What is the outlook for supply/demand?

We're still in a deleveraging world that is averse to debt, and that means a good chance supply continues to shrink. Issuance in 2013 was down roughly 15% from 2012, and it could be down modestly again in 2014. That may bode well for market performance. Constrained supply helps the price action of any asset or commodity.

On the demand side, robust retail interest may not materialize until investors understand what the removal of quantitative easing (taper) means for rates. I also think there's going to be a big realization around tax time. In March and April, people will begin to see what it meant to pay higher taxes. And what are they going to do to offset that and shelter some income? Munis are the obvious answer, especially after the 2013 selloff and reset in value.

Munis have been outyielding Treasuries and corporates before tax. Can this continue?

It's interesting, because this had not been the nature of the asset class prior to the financial crisis. But it has been the norm since, and that may well continue. Here's why: Despite the rates-induced correction over the summer, the municipal market is not the rates market it once was, but rather, a credit market. It's become a source for incremental income, much like corporate bonds always have been. Because of that, the market needs to maintain high ratios. It needs to stay at yields that are at or above Treasuries and investment-grade corporate bonds in order to continue to attract those non-traditional buyers until the retail base returns (and there's no clear indication that it will). For that reason, I think ratios remain elevated, at least for a while.

You mentioned Detroit earlier. What are the implications of its bankruptcy filing?

Detroit's bankruptcy filing, despite being the largest in history, wasn't a big market mover. Detroit has been rated non-investment grade since 2009, so the filing itself wasn't necessarily a surprise. The bigger factors may be the precedents that come out of the bankruptcy proceedings. In approving the city's Chapter 9 petition in December, the judge ruled that pension contracts are fair game for negotiation. That ruling at the federal level supersedes state protections and, as such, it may have implications for further pension reform down the road. Ultimately, that's a positive for fiscally strapped state and local governments.

We are also watching the court's treatment of general obligation (GO) debt. Detroit has proposed treating GOs as unsecured debt (generally GO bonds are viewed as the highest priority payment). If the city's plan is upheld, and GOs take a significant haircut, then we might see a bifurcation in the market where high-grade municipals trade very well compared to lower-rated names. It's a longer-term story, but one worth watching.

Are there other "Detroits" that threaten to unnerve the market?

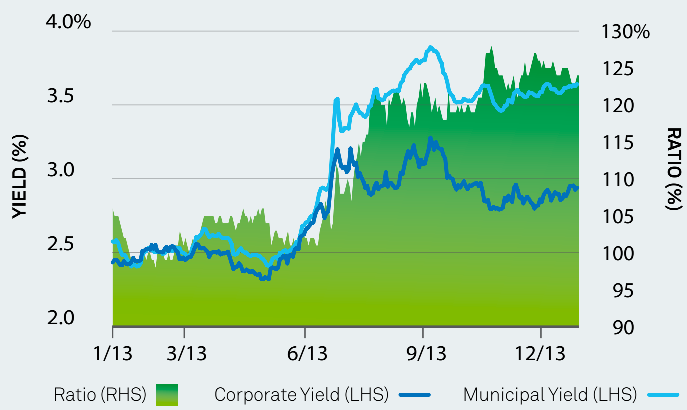
We are not seeing any. There are only 34 names that are rated below investment grade by Moody's (out of 7,500), and those tend to be very small. Detroit, meanwhile, is the only big city that is fiscally insolvent. We don't see any others like it on the horizon. Our credit research team maps areas of vulnerability and opportunity across the country, and tracks changes throughout the year. The trend we're seeing is clearly headed in the right direction: areas of strength increasingly outnumber areas of weakness.

Puerto Rico is another headline maker. What is your outlook there?

The island faces extraordinary economic and fiscal challenges; and because Puerto Rico bonds are exempt from federal, state and local taxes in all 50 states, they are very

MUNI YIELDS COMPARE FAVORABLY

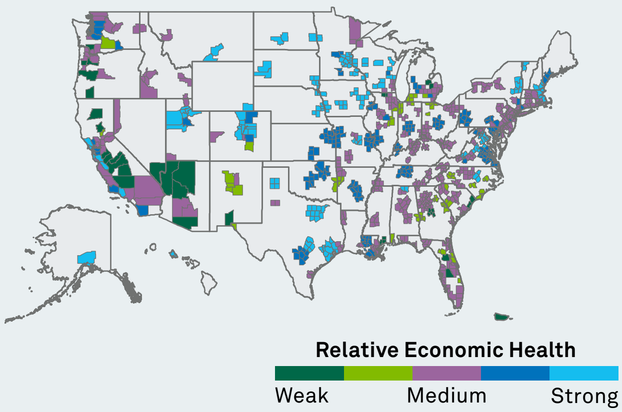
BBB Munis vs. BBB Corporates



Source: Barclays; as of Dec. 31, 2013.

AREAS OF VULNERABILITY AND OPPORTUNITY

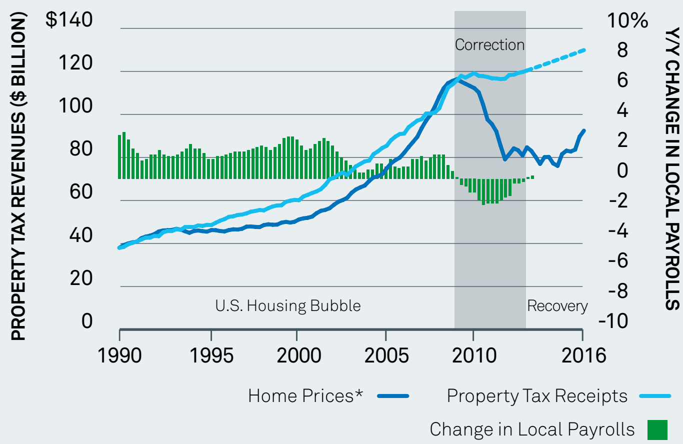
Metropolitan Statistical Area (MSA) Analysis



Sources: BlackRock, U.S. Census, Federal Housing Finance Agency and Bureau of Labor Statistics. Areas of vulnerability as assessed by BlackRock and based on unemployment rates, change in home valuations, poverty levels and relative per-capita wealth, as of December 31, 2013. Uncolored areas not part of MSA.

THINGS ARE LOOKING UP FOR LOCALS

Property Tax Collections Stable, Spending Contained



Sources: BlackRock, U.S. Census, Case-Shiller, Bureau of Labor Statistics; as of Nov. 30, 2013. * Home prices are represented by the Case-Shiller Index and indexed to property taxes. Case-Shiller Home Price Index data was pulled forward to reflect the typical lag of property tax collections vs. actual home prices.

widely held. Puerto Rico has been in a recession for roughly seven years and the pension pain is severe. It has deep debt and is simply running out of money to pay its bills.

To its credit, the administration in Puerto Rico has been taking steps to better the situation. Policymakers have made changes to the pension system, raised existing taxes and created new ones to the tune of potential billions in future revenues. They've recently bought themselves some time with some short-term bridge financing from banks. But it may be a case of too little too late. A lot of the island's debt is trading in the 9% range (market participants are demanding these high rates to compensate them for the risk). The question is whether Puerto Rico can afford to continue borrowing at that level given the state of its finances. It does not appear likely. Unless the economy was to improve quickly and in dramatic fashion, debt restructuring becomes a more likely outcome.

Outside these anomalies, you've said creditworthiness in the muni market is the strongest in five years. How so?

At the state level, revenues are up for 15 consecutive quarters. Expenses are also well contained. States are not borrowing as much, which tends to be a good theme in terms of credit fundamentals (but a bad theme in terms of not having enough issuance available in the market).

At the local level, the housing market was stronger than most expected last year. Some of the areas hardest hit in the housing bust have seen big upturns in median home prices. Tax collections also are improving. Overall, we see the fiscal picture strengthening at the local level for a few key reasons: Payrolls and other spending were cut; property tax rates were raised to offset declining home values; and, more recently, home prices have rebounded. (See graph above, right.)

Do pension liabilities threaten to break state and local finances?

We do not believe pensions are priming to break the market. In fact, we're more optimistic on this front than we have been in some time given greater awareness of the problem and increased pension reform in the past few years. Illinois is a case in point. It has the lowest pension funded ratio among the 50 states and was among the last to approve reform. We think that's an important development in regards to pension reform and what it means for state and local governments. Illinois' success, along with the federal judge's ruling on pension contracts in Detroit, may have implications for reform elsewhere. So, the momentum is moving in the right direction. We are more encouraged now than we were a year or two ago.

Why the penchant for pension reform now?

Pensions are a long-term liability, but there's a growing realization that the burden to pay looms larger as the asset pools shrink (i.e., funded levels fall). There's also an awareness that the obligation to pensioners is growing larger and longer as life expectancies increase. BlackRock has talked a lot about the need for individuals to plan for longevity, and the same is true of companies and governments that provide retirement benefits.

Pragmatically speaking, the impetus for the reforms has been ratings action. Since the recession, the agencies have been penalizing states for inaction on their pensions. They are acknowledging the fact that this significant long-term liability could potentially impair states' ability to repay current debt. Illinois is a good example. The agencies lowered Illinois' rating, citing its pension problems. A low rating means high borrowing costs, and that tends to bring legislators to action. So, more than ever before, ratings agencies and market spreads are factoring in a state's pension status. And that is leading to reforms that, ultimately, should help bolster states' long-term fiscal health.

Is now the time to buy munis?

Based on the long-term outlook, I'd offer an emphatic yes. The mid-year market selloff restored value in the asset class. We haven't seen such attractive levels since 2011. In the short-term, however, it makes sense to keep an eye on the Fed and interest rates, as the market needs time to digest and understand the implications of tapering.

Any advice for investors as we start 2014?

We'd urge investors to approach the market with proper perspective. That means looking beyond the headlines and interest rate action to see what is really a very appealing proposition on an after-tax basis. I think fears about interest rates were so great in 2013 that investors forgot about the concept of taxable-equivalent yield—the fact that muni income is tax-exempt. I believe that will get greater focus in 2014. Proper perspective also means resetting expectations and remembering that munis are, first and foremost, an income vehicle. They are not designed to generate total return, although that's been a fringe benefit in many years.

If you look back at the average performance of the Barclays Muni Index, you'll find 5- and 20-year average returns of 5.89% and 5.85%. 2013 came in at -2.5%. Those who believe in mean reversion might expect 2014 to produce a return of 7%+, but that's a highly unlikely outcome. It would require a fall in interest rates, and that's not what the consensus is calling for. Bottom line: Returns are likely to be modest, but if you look at taxable-equivalent yields, munis are an excellent option for maximizing income.

Are potential tax policy changes a risk?

The two parties are so far apart in Washington, D.C., that coming to meaningful tax reform will be very difficult. So I don't think that's a risk at all. It may not be a real factor until 2016, assuming there's more unified thinking in Congress.

How should investors position their muni allocations for 2014?

We're very likely in for "low for longer" rates. Against this backdrop, some allocation to high yield probably makes sense in 2014, but balanced with high quality for liquidity and trading flexibility.

We recommend waiting for the early-year volatility to subside as the market digests Fed action, and then looking to lock in yields longer term. Once investors realize the long-feared taper is not particularly meaningful from a big-picture perspective (overall policy is still accommodative, the economy is in decent shape and the supply of Treasuries and other fixed income assets is shrinking), the markets will probably snap back in a fairly short period of time. Certainly we do not expect a repeat of 2013's reaction.

We would also caution investors to avoid the pitfalls of 2011 and 2012 when rates were very low: Extending too far out on the curve and/or taking on excessive credit risk. At the same time, don't go too defensive. Some investors are going as far as exiting the market and holding cash. There's no value in cash.

Importantly, credit research is an absolute necessity. It's at the core of our process here at BlackRock. In addition to referencing the agencies' ratings, we assign an internal rating to every credit and issuer before considering it for inclusion in our portfolios. We're cognizant that avoiding the wrong credits is as important as owning the right ones.

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