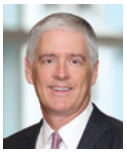
MUNICIPAL MARKET UPDATE

MAY 2018

Munis had a taxing month, but summer usually brings relief



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Highlights

- Rising rates and seasonal selling led to negative muni market returns in April.
- Short-term munis are offering better potential reward for a low level of risk.
- We expect favorable supply-and-demand dynamics to help buffer rate risk.

Market overview

The S&P Municipal Bond Index edged down -0.35% in April as the market took cues from rising interest rates (bond prices fall as rates rise). Firm economic data, expectations for stronger growth, and a more muted geopolitical backdrop pushed the 10-year U.S. Treasury yield above 3% for the first time since 2014.

Throughout the month, municipal supply normalized a bit from the extremely depressed levels of the first quarter, but remained below historical norms. Demand weakened, as expected, in the few weeks leading up to tax day. Seasonal outflows from municipal mutual funds, mostly short-term, were particularly heavy this year as investors sought to offset strong gains on equity positions in 2017. While we anticipate a reversion to continued strong inflows in the coming weeks, the recent swift rise in interest rates presents some risk.

Shorter-term municipals have become increasingly attractive as yields have moved higher on the front end of the curve and, due to the flatness of the yield curve, investors can now achieve a comparable level of income as that offered by longer-term bonds at a fraction of the risk.

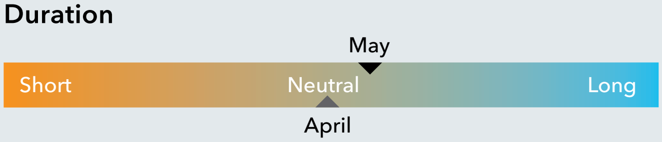
Some of the market's riskier segments generated positive returns in April. Tobacco bonds experienced strong demand driven by refinancing activity in the sector, notably the $3.2 billion New Jersey Tobacco refunding deal, while Puerto Rico bonds benefited from multiple fiscal plan revisions, each of which increased the projected primary surplus.

The historically favorable summer months are just around the corner. We expect to see an increased level of reinvestment of calls, coupons and matured bonds that outstrips gross supply, providing a positive tailwind for the muni market.

Strategy and outlook

We maintain a generally neutral stance on duration (interest rate sensitivity) and a barbell yield curve strategy as we expect favorable supply-and-demand dynamics in municipals to help buffer rising rate risk. We prefer A-rated issues for their potential to outperform during market downturns, and we are neutral on high yield given tight valuations.

Duration



Yield curve

Barbell strategy, preferring 0-2 and 20+ years

Overweights

- State tax-backed and essential-service bonds, particularly in the Northwest, Sun Belt and Plains
- School districts

Underweights

- U.S. territories and their authorities
- States and locals with poorly funded pensions (IL, NJ, KY, PA, CT) or high oil dependence (AK, NM, ND, OK, WY)
- Single-site hospitals in Medicaid expansion states

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Credit update

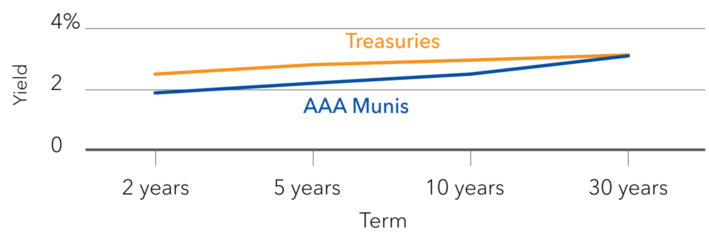
State and local tax collections surged in the fourth quarter of 2017 due largely to prepayments of state income and local property tax as high-income taxpayers sought to take advantage of tax deductions expiring in 2018 under the new tax law, according to the Rockefeller Institute of Government. Total state government tax revenue increased 9.4%, exceeding the average quarterly growth rate of 2.7%. Local government tax revenue rose 8.9%, substantially higher than the 3.5% average growth in the previous four quarters. While preliminary data also indicate robust growth in personal income tax collections for January and February 2018, the Institute warns of a "high level of fiscal uncertainty for states" in the remaining months of fiscal year 2018 and in fiscal year 2019.

The state of Connecticut was downgraded by Standard & Poor's to an A credit rating (from A+) as a result of its increasing debt burden. The agency noted that given current levels of economic growth, recent population declines, and large unfunded pension and other post-employment benefit liabilities, Connecticut's debt load is likely to remain well above average for the state sector. Meanwhile, Connecticut reached an agreement with the city of Hartford, its capital, under which the state will assume responsibility for over $500 million of the city's outstanding debt obligations. Hartford had previously announced its intention to seek a debt restructuring or bankruptcy as a result of significant financial pressure and a constrained budgetary environment. S&P upgraded Hartford to A (from CCC) and Moody's upgraded Hartford to A2 (from Caa3) upon announcement of the deal.

Monthly change in yields

	AAA Muni yield (%)		Treasury yield (%)	
Term	3/31/18	4/30/18	3/31/18	4/30/18
2 years	1.65	1.87	2.27	2.49
5 years	2.04	2.19	2.56	2.80
10 years	2.42	2.49	2.74	2.95
30 years	2.95	3.09	2.97	3.12

Municipal and Treasury curves as of 4/30/18



Sources: BlackRock; Bloomberg.

Municipal performance analysis

	APR 2018	YTD 2018
S&P Municipal Bond Index	-0.35	-1.26
Long maturities (20+ yrs.)	-0.42	-1.63
Intermediate maturities (3-14 yrs.)	-0.36	-1.44
Short maturities (6 mos.-3 yrs.)	-0.21	0.03
High yield	0.52	1.82
High yield (ex-Puerto Rico)	0.33	0.76
General obligation (GO) bonds	-0.41	-1.59
California	-0.36	-1.37
New Jersey	-0.26	-1.09
New York	-0.39	-1.45
Pennsylvania	-0.35	-1.37
Puerto Rico	2.35	11.66

Source: S&P Indexes.

Investment involves risk. *The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. There may be less information available on the financial condition of issuers of municipal securities than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. A portion of the income may be taxable. Some investors may be subject to Alternative Minimum Tax (AMT). Capital gains distributions, if any, are taxable.* ***Index performance is shown for illustrative purposes only. You cannot invest directly in an index. Past performance is no guarantee of future results.***

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