WEEKLY MARKET COMMENTARY

THE WEEK IN MUNILAND

FEBRUARY 3, 2020

FEELS LIKE GROUNDHOG DAY

+ Munis continued their rally this week with shorter maturity yields down 2 basis points (b.p.), while long yields fell as much as 8 b.p. For the month of January, the Bloomberg Barclays Municipal Index was up 1.77%. With an estimated $38 billion of cash expected to enter the municipal market in February due to maturities and coupon payments and only $13 billion set to be issued, we expect municipal bond prices to continue to grind higher.

    - **Why it matters:** Investors have enjoyed the rally in their muni bond portfolios so far this year. However, at current valuations, owning US Treasuries in portfolios can provide protection against a backup in muni yields or an economic recession. We have been advocating a modest position in 10-year-maturity US Treasuries and one- to two-year investment-grade corporate bonds for those mandates that permit such investments.

+ The overall message from this week's Fed meeting was that they are comfortable with the current stance of monetary policy and are happy to watch and wait to see how the situation evolves before deciding what their next move is. The only meaningful change to the statement was an indication that the committee wants inflation to return "to" the symmetric 2% target rather than "near" the 2% target.

    Why it matters: Chair Powell indicated that this change was designed to make clear that the committee is not comfortable with inflation running consistently below the target—they want inflation to go up. We don't think it will take much evidence of economic weakness to trigger a rate cut, but a hike remains a distant prospect. We expect inflation breakevens to increase over time as well. Breakevens remain well-below CPI, as depicted in *Display 1.* We recommend investors take advantage of this cheapness through CPI swaps or Treasury Inflation-Protected Securities (TIPS).

+ US GDP rose 2.1% on a quarter-over-quarter annualized basis in the fourth quarter, roughly in line with the 2.0% market forecast. The basic picture is of an economy that has settled into a 2% growth rate. Each of the last three quarters has been either 2.0% or 2.1%.

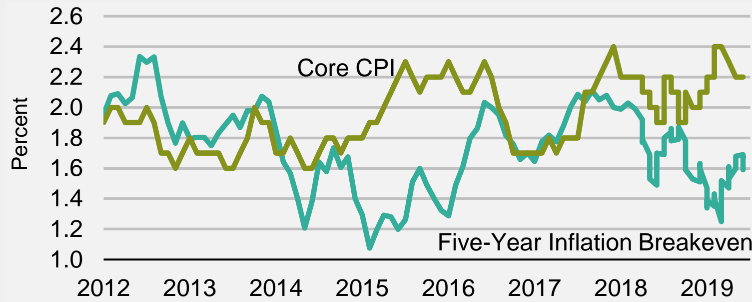
    - **Why it matters:** 2.0% is strong enough to avoid being too close to recession but not so strong as to suggest overheating. If we think of the economy as being roughly in equilibrium, the natural question is what it would take to shock the system. For the moment, negative risks are more likely than positive ones, but with the economy as stable as it is, it would take a very large shock to materially alter the economy's basic trajectory. With the economy continuing to expand, yields low and demand high, the conditions for these higher-yielding "credit" bonds to outperform high-credit-quality bonds are favorable.

POSITIONING FOR TODAY'S MARKET

+ **Credit Risk:** Modest overweight. Investor demand for income remains strong. Economic growth and better-than-expected tax revenues are a credit positive for most mid-grade and high-yield municipal issuers.
+ **Taxable Bonds:** Long maturity and very short maturity municipal bonds remain relatively expensive—consider adding a position in US Treasuries until municipals are more attractively priced.
+ **Inflation Protection:** Inflation protection remains extremely cheap, as shown in *Display 1*. We are investing in inflation hedges in our portfolios with the expectation that breakevens will rise over time.

Displays of the Week: February 3, 2020

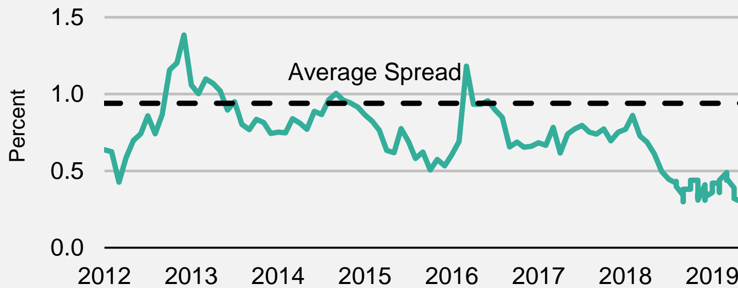
Display 1: Core CPI vs. Five-Year Inflation Breakeven



Break-even inflation rates have increased recently but remain cheap.

CPI through December 31, 2019; breakeven through January 30, 2020
Source: Federal Reserve Bank of St. Louis and AllianceBernstein (AB)

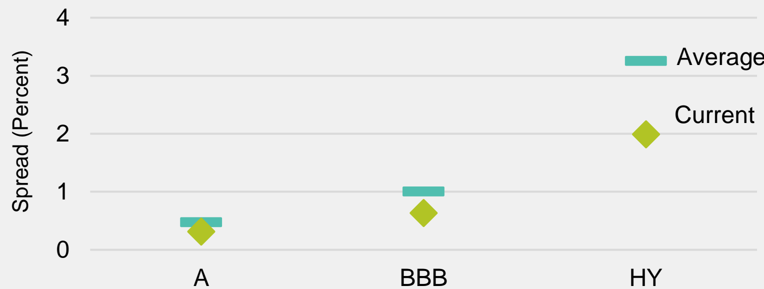
Display 2: Municipal/US Treasury After-Tax Spread



Limited supply and steady demand have led to municipals outperforming US Treasuries over the past year.

Display shows the after-tax spread of a 10-year AAA-rated municipal bond vs. a 10-year US Treasury.
Through January 31, 2020
Source: Bloomberg and AB

Display 3: Municipal Credit Spreads

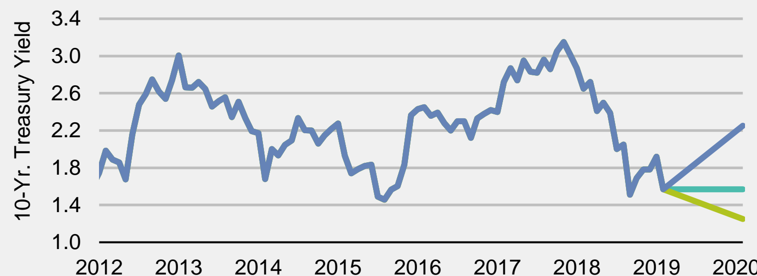


High-yield (HY) credit spreads are further through their long-term average.

As of January 31, 2020
Source: Bloomberg, Municipal Market Data and AB

Display 4: Expected 12-Month Municipal Returns Scenario Analysis

10-Year US Treasury Yield (Percent)



10-Year Treasury, 2.25% → **0.50%**

10-Year Treasury, 1.57% → **2.44%**

10-Year Treasury, 1.25% → **3.37%**

Historical analysis does not guarantee future results.

Display reflects expected return of a 5.4-year-duration intermediate municipal portfolio under three scenarios: 10-year Treasury yields rise to 2.25%, remain the same or decline to 1.25% over the next 12 months
As of January 31, 2020
Source: Bloomberg and AB

A Word About Risk

Market Risk: The market values of the Portfolio's holdings rise and fall from day to day, so investments may lose value. **Interest-Rate Risk:** Fixed-income securities may lose value if interest rates rise or fall—long-term securities tend to rise and fall more than short-term securities. The values of mortgage-related and asset-backed securities are particularly sensitive to changes in interest rates due to prepayment risk. **Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or principal—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered and the bond's value may decline. **Inflation Risk:** Prices for goods and services tend to rise over time, which may erode the purchasing power of investments. **Foreign (Non-US) Risk:** Investing in non-US securities may be more volatile because of the political, regulatory, market and economic uncertainties associated with such securities. These risks are magnified in securities of emerging or developing markets. **Currency Risk:** If a non-US security's trading currency weakens versus the US dollar, its value may be negatively affected when translated back into US-dollar terms. **Diversification Risk:** Portfolios that hold a smaller number of securities may be more volatile than more diversified portfolios, since the gains or losses from each security will have a greater impact on the portfolio's overall value. **Derivatives Risk:** Investments in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments and may be more volatile, especially in a down market. **Leverage Risk:** Trying to enhance investment returns by borrowing money or using other leverage tools magnifies both gains and losses, resulting in greater volatility. **Municipal Market Risk:** Debt securities issued by state or local governments may be subject to special political, legal, economic and market factors that can have a significant effect on the Portfolio's yield or value. An investor cannot invest directly in an index. **Investment and Insurance Products:** Not FDIC insured I Not a bank deposit I Not insured by any federal government agency I No bank guarantee I May lose value

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