Municipal Bond Monthly

Market Strategy

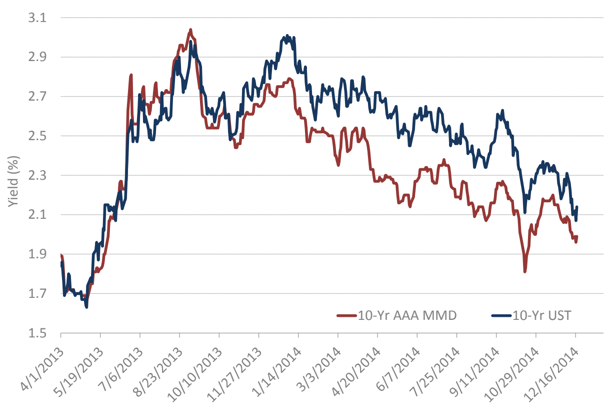
JOHN M DILLON
Managing Director
Morgan Stanley Wealth Management
John.Dillon2@morganstanley.com

MATTHEW GASTALL
Executive Director
Morgan Stanley Wealth Management
Matthew.Gastall@morganstanley.com

INVESTMENT THESIS

Investors should consider maintaining a barbell strategy that employs 7 to 12-year maturities paired with 20-year paper (for carry) while adding a modest allocation toward floating rate notes (FRNs). We continue to advocate modest credit curve extensions (A-rated for GOs and BBB rated for essential service revenue) but acknowledge that significant spread compression from this point may be a challenge. We continue to favor premium (5%) coupon structure and recommend periodic portfolio reviews to monitor credit and interest rate exposures. Please see our sector table on page 4 for granularity on credit selection.

Fig 1. Timeline of 10-Year US Treasury & AAA MMD Yields



Source: Morgan Stanley Wealth Management Investment Resources, Thomson Reuters Municipal Market Data as of 12/17/14

Year End Review & 2015 Outlook

As the municipal market prepares to bid farewell to what has been by most measures an impressive year for tax exempts, a growing list of external factors appears to be trumping, or at least tempering, otherwise strong domestic economic data. The resulting sentiment among market participants seems to be an exasperation-driven (or even frustrating) complacency after months of renewed market strength forced many to rethink and react amid a market that was clearly leaving them behind. It is with this perspective that we look forward to 2015 and acknowledge that the path to higher interest rates may remain opaque amid an unsettled global marketplace, even though our base case is still one of mildly higher yields.

In last year's Review & Outlook we opined that "*The case for tax-exempt municipal bonds remains strong*." In fact, it was even stronger than we had envisioned, posting a +9% total return year-to-date according to Barclays. Indeed, there were multiple drivers of such muni strength beyond the most obvious and primary driver of declining interest rates. Among them were 1) credit quality, which continued to generally improve throughout 2014, albeit at an uneven pace across the nation, driving credit spreads substantially tighter, 2) a stubborn absence of robust new issue supply, which appeared more egregious in the first half due to optics, but was generally a tailwind for performance throughout the year, 3) the comforting reality that tax-reform (which could adversely impact the municipal asset class) was unlikely to transpire during a mid-term election year, coupled with 4) the painful reality of the 2013 year's tax levy, which highlighted the value of the municipal bond tax exemption (including exemption from the 3.8% Medicare Surtax) and finally, 5) a masterful combination of outperformance and underperformance that enabled the municipal market to successfully navigate seasonal periods of supply/demand imbalances (the most recent example being the last few weeks, as the combination of a powerful UST-driven rally plus municipal underperformance resulted in a simply massive amount of well-placed issuance…hats off to the underwriting community on that one!).

During the year we saw the Detroit bankruptcy process unfold and conclude, with an outcome that was not great, but not terrible, either. Meanwhile, one of the market's largest issuers, Puerto Rico, successfully transitioned to the high yield (sub-investment grade) sector without triggering systemic risks. Importantly, the Fed's "taper" went quietly into the night (and the sun still rose the next day) while the US economy advanced and municipal credit quality generally improved. As highlighted by MMA on 12/15/14 "*Since Detroit, almost 18 months ago, no traditional local government has filed for chapter 9 bankruptcy protection. And, besides Detroit, no safe sector credits defaulted during the year*."

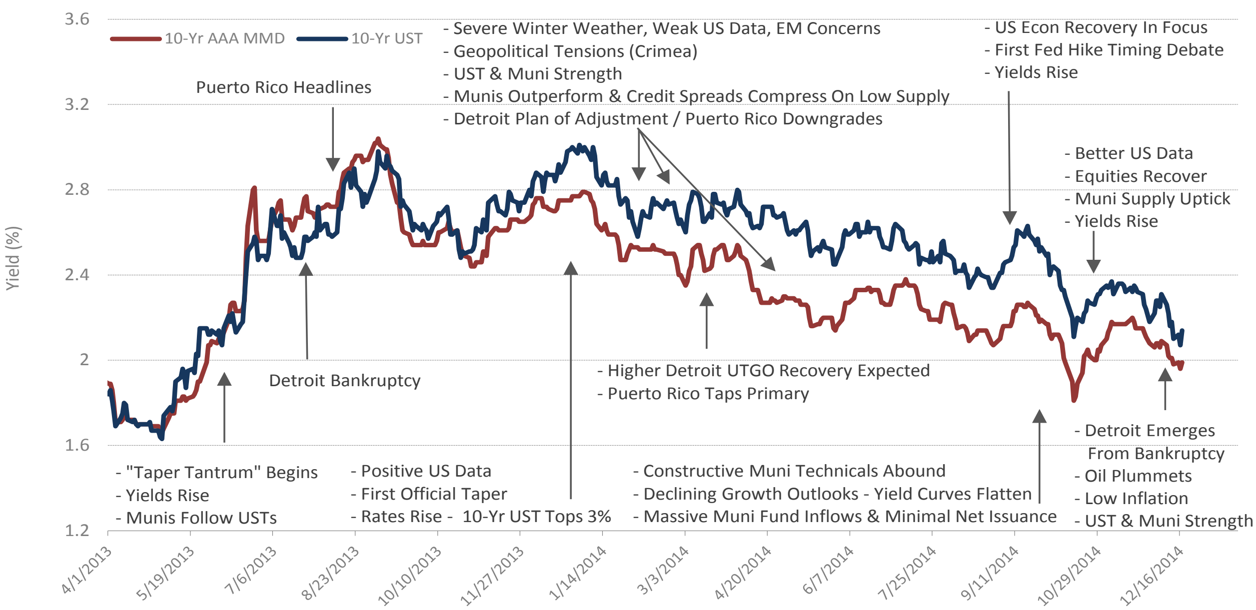
Relative value was also an interesting story this year. After opening the year in a weaker position (relative value ratios in the low-to-mid 90% range) munis subsequently outperformed in the second and third quarters…only to give it all back in the fourth quarter. This fortuitous timing, in conjunction with rallying USTs, helped new issue placement during peak volume weeks.

Looking forward, we anticipate more of a muddle-through market for 2015, as some of the aforementioned tailwinds convert to mild headwinds. Among the numerous potential challenges are 1) ongoing developments for Puerto Rico and related securities, 2) the prospect of renewed rhetoric or even legislation regarding adverse impacts to the municipal exemption in the context of tax reform, 3) court rulings regarding Illinois' pension reform (and implications for the rest of the nation), 4) the phase- in of new GASB accounting rules that worsen the optics of pension underfunding, 5) new issue volume that is likely higher than in 2014 (net supply also positive), 6) the slowing or "plateauing" of credit quality improvement (with related slowing/stalling of credit spread compression) that may challenge select states and municipalities, 7) a slowing or reversal of the consistent municipal mutual fund inflows enjoyed during 2014 and, 8) a greater focus on possible secondary impacts of lower oil (if sustained) upon the municipal landscape, though our initial take is that the positives generally outweigh the negatives, with transportation and toll roads being prime beneficiaries.

As is often the case, the trajectory of interest rates will likely call the tune for the municipal market, with the asset class underperforming or outperforming USTs depending on the aforementioned muni-specific factors. That said Morgan Stanley & Co. expects 2.2% annual GDP growth this year, a sustained pick-up to 2.9% for 2015 and a more modest increase of 2.3% in 2016. Accordingly, the firm anticipates the 10-year UST to reach 2.50% by April, 2.65% by the end of the second quarter and third quarters and a mild drift higher to 2.85% for the close of 2015.

Adding it all up, our strategy heading into 2015 continues to employ the use of a barbell, with a heavier weighting on maturities in the 7 to 12 year range and 20-year paper added for carry. Although rates have obviously declined a bit further since our initial advocacy of floating rate notes (FRNs), we continue to believe that the addition makes sense in the context of purchasing while expectations for rising rates are manageable (buying straw hats in the winter, so to speak). We continue to favor mild extensions on the credit curve into mid-A rated for GOs and mid-BBB for essential service revenue bonds, while remaining comfortable with all state-level general obligation bonds and state-level appropriated paper (watch for select opportunities in this space during 2015). Please see our sector table on page 4 for granularity on credit selection.

Fig 2. What A Year 2014 Has Been …



Source: Morgan Stanley Wealth Management Investment Resources, Thomson Reuters MMD as of 12/17/14

Market Metrics

One of the most telling stories of 2014 has been that of new-issue municipal bond supply…or, the lack thereof. From our perspective, the aforementioned drought in issuance was caused by two predominant factors. First, fiscal austerity continued its multi-year reign (since 2008) as a common theme throughout state and local government finance, as many municipalities remained wary of adding more debt to their fiscal profiles. Consequently, this year's par-value of *new-money* offerings is currently lower than 2013 by 9.3% year-to-date (YTD) year-over-year (YOY). Public initiatives such as infrastructure maintenance and new projects are being funded, albeit at a notably modest pace despite historically low borrowing costs. Secondly, deals issued for the sole purpose of refunding/refinancing outstanding debt began the year at an alarmingly slow pace (as low as -31% YTD YOY through June) as those issues eligible for refinancing in recent years were, in fact, refunded. This development has since changed, however, as more potential candidates have come "in the money," and has driven refundings higher by a marginal 7% YTD YOY. It is important to note that this dynamic did not change until very late in the year and, consequently, has had a notable impact on this year's market performance.

Total gross supply is currently running approximately 4% lower than 2013 YTD YOY, at nearly $295 billion. Analysing this data within a historical context, this year's volume is actually the 2nd lowest YTD metric posted throughout the last 13 years. Looking forward to 2015, Morgan Stanley's base case calls for an increase in annual gross issuance of approximately 15%, amounting to $354 billion. Importantly, we expect *net* supply to be positive in 2015, by approximately $46 billion.

From a market performance perspective, it has been quite a year. 2013 ended with investors staring at a multitude of bearish fixed-income signals. These included significantly stronger than anticipated economic data, the Fed's first official taper and the 10-year US Treasury yield's ascension to just over the psychologically important 3% threshold. However, 2014's much anticipated road to economic recovery and subsequently rising interest-rates has been (and likely will remain) long and winding, as bond prices actually advanced (and interest rates declined) throughout the majority of the year.

US Treasuries were initially bolstered by a variety of bond-friendly developments during the first half of 2014, which fueled a risk-off, "flight-to-quality" trade throughout the fixed-income markets. The aforementioned developments included weak domestic economic data (influenced by challenging weather) as well as the emergence of geopolitical tensions from both Crimea and Gaza. The resulting UST strength was further exacerbated by relatively benign inflation outlooks and continued institutional liability-driven investment (LDI) by select pension plans seeking to lock in prior gains while also "de-risking." This strength was prevalent throughout the remainder of the year (and even intensified in October amidst declining international growth outlooks), with the exception of some intermittent periods of weakness driven by rallying equity markets and strong domestic economic data. Consequently, yield-levels are currently lower on the 5-, 10-, and 30-year US Treasury by 14, 87 and 120 basis points (bps), respectively, since December 31, 2013. With longer-maturity securities benefiting from many of the developments discussed, the total slope of the UST yield curve flattened by a striking 130 bps, to 253 from 383.

Due to the inherent relationship between the two asset classes, municipals generally tracked the price-action of the broader US Treasury market. However, tax-exempts frequently outperformed UST strength due to an acute lack of supply in the new issue market. As discussed, both gross and net issuance (new supply less called and maturing bonds) have been disappointing this year, while many investors have held significant amounts of investment cash and inflows into municipal mutual funds have remained consistently strong.

This combination, in addition to slowly improving municipal credit quality, helped "A" rated municipal credit spreads to compress to 55 from 81 bps and "BBB" rated spreads to compress to 100 from 156 bps (as buyers ventured out on the credit curve in search of yield). The slope of the municipal bond yield-curve flattened and municipal benchmarks outperformed USTs throughout much of 2014 (until recently). For the year, yield-levels are currently lower on the 5-, 10-, and 30-year AAA MMD benchmarks by 2, 78 and 132 basis points (bps), respectively, and the slope of the municipal yield curve is flatter by 129 bps (at 274) since December 31, 2013. On a total return basis, the municipal market has more than made up for its negative 2.55% performance in 2013 by posting a YTD gain of over 9%.

Looking ahead to 2015, we expect limited spread compression from current levels after such an impressive year. On a relative value basis, the municipal outperformance enjoyed during much of 2014 may be difficult to repeat next year, as Republican control of Congress may reignite investor anxieties regarding the longevity of the full municipal bond tax exemption (a probability that has indeed risen, but still remains rather low). With 10-year maturity relative value ratios now at levels not seen since the start of 2014 (low to mid 90% range) following two weeks of peak new issuance and underperformance versus USTs, we view the current relationships as an opportunity for investment, but acknowledge that relative value ratios in the mid-80% range may be more difficult to come by next year. With regard to total return, Morgan Stanley anticipates a positive, but unspectacular performance next year of approximately 1.14%.

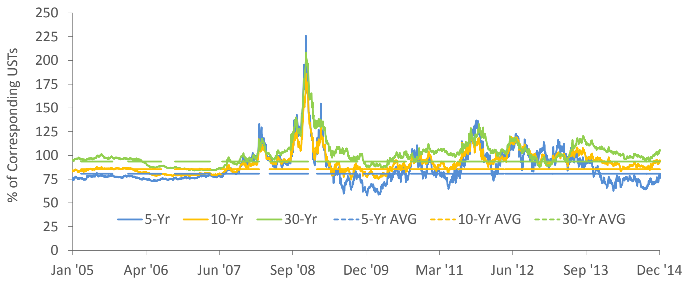
Happy Holidays,

JD

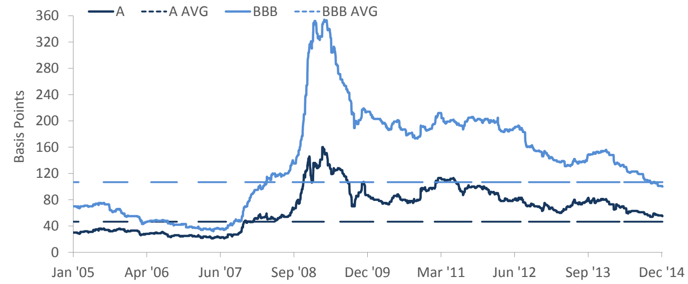
MG

Municipal Market Data

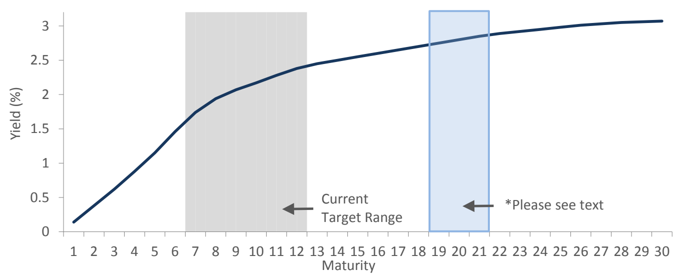
Relative-Value Ratios - (AAA GO Municipals as % of US Treasuries)



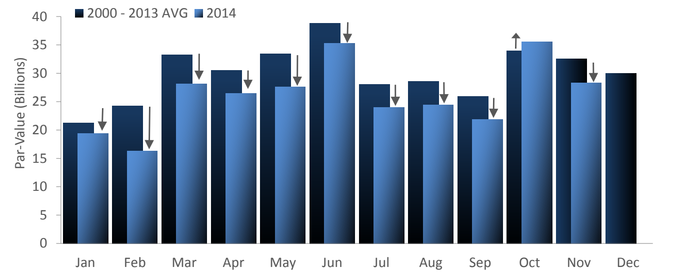
A Rated and BBB Rated Credit Spreads to AAA Securities



Our Current Target Maturity Range



YTD Gross New-Issue Supply 11.9% Below Historical YTD AVG



Source: Morgan Stanley Wealth Management Investment Resources, Thomson Reuters Municipal Market Data, *The Bond Buyer* as of 12/17/14

Morgan Stanley Wealth Management's Broad Municipal Sector Outlooks & Minimum Rating Parameters

Sector	Minimum Rating*	Commentary
State GO & State Appropriated	All	Political, deferred spending & pension challenges remain. Volatility, but market access likely protected long-term
Local GO	A2/A	Dependent upon housing & state-aid; pension challenges remain; we favor mid- to high- credit quality
Essential Service (Water & Sewer)	Baa2/BBB	Essential purpose beneficial, where applicable; water-scarcity & capital needs may create select challenges
US Public Power	Baa2/BBB	Favorable non-cyclicality of revenues; evolving power markets & increased regulation may create select challenges
State Housing Finance Agencies	A2/A	Directly exposed (positively or negatively) to housing market momentum; diversified business models
Higher Education	A2/A	We recommend higher-rated, well-established institutions due to student selectivity & price sensitivity
Transportation	A2/A	GDP growth & oil price decline supportive (upside may be limited); favor major tollways & metropolitan/hub airports
Not-for-Profit Hospitals	AA3/AA-	Major complex changes on horizon; we recommend larger systems as a conservative choice

*This table lists the *minimum* credit rating we are comfortable recommending. For example, buyers can consider the referenced rating and/or higher-rated (with a stable outlook) for investment. Tactical decisions or whether a bond is over/undervalued should be evaluated on a case-by-case basis.

Market Performance (Yield Level Changes in Basis Points)

		12/31/2013 Yields	Current	Difference
AAA	5 Year	1.24	1.22	-0.02
	10 Year	2.77	1.99	-0.78
	30 Year	4.19	2.87	-1.32
AA	5 Year	1.37	1.35	-0.02
	10 Year	3.00	2.20	-0.80
	30 Year	4.44	3.10	-1.34
A	5 Year	1.68	1.55	-0.13
	10 Year	3.57	2.54	-1.03
	30 Year	5.00	3.43	-1.57
BBB	5 Year	2.41	2.07	-0.34
	10 Year	4.31	2.99	-1.32
	30 Year	5.55	3.80	-1.75

*Please note: Yield increases represent price declines. Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Source: Morgan Stanley Wealth Management Investment Resources, Moody's, S&P, Thomson Reuters MMD as of 12/17/14

Fixed Income Risk Considerations

Call Risk - Some securities may be callable. If the security is called, the investor bears the risk of reinvesting the proceeds at a lower rate of return.

Credit Risk - The risk that the issuer might be unable to pay interest and/or principal on a timely basis. Widely recognized rating agencies, such as Moody's Investor Services and Standard & Poor's, offer their assessment of an issuer's creditworthiness. U.S. Treasury securities are considered the "safest" investment as they are backed by the "full faith and credit" of the U.S. Government. On the other end of the scale, high yield corporate bonds are considered to have the greatest credit risk.

Duration Risk - Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

Interest Rate Risk - The risk that the market value of securities might rise or fall, primarily due to changes in prevailing interest rates. All fixed income securities are susceptible to fluctuations in interest rates; generally, if interest rates rise, bond prices will fall, and vice versa.

Prepayment Risk - In a CMO or MBS, the risk that an investor's principal will be returned sooner than originally expected, due to principal prepayments made by homeowners on the underlying mortgage loans.

Reinvestment Risk - The risk that the income stream from the investment may be reinvested at a lower interest rate. This risk is especially evident during periods of falling interest rates where coupon payments are reinvested at a lower rate than the current instrument.

Secondary Market Risk - While a secondary market exists for most fixed income securities, there is no guarantee that a secondary market will exist for a particular fixed income security. Furthermore, if a security is sold prior to maturity, the price received may be more or less than face value, or the amount of the original investment.

Index data is based on index total return - Fixed income securities, including municipal bonds, are subject to certain risks including interest rate risk, credit risk, reinvestment and valuation risks. The value of fixed income securities will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. Information provided herein has been obtained from outside sources that are deemed to be reliable. However, Morgan Stanley Wealth Management has not independently verified them and we make no guarantees, express or implied, as to their accuracy or completeness or as to whether they are current. Past performance is not a guarantee of future performance. The indices are unmanaged and are shown for illustrative purposes only and do not represent the performance of any specific investment. Investors cannot invest directly in an index.

General and Asset Class Risk Considerations

Interest on **municipal bonds** is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Floating-rate securities The initial interest rate on a floating-rate security may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in the floating security's underlying reference rate. The reference rate could be an index or an interest rate. However, there can be no assurance that the reference rate will increase. Some floating-rate securities may be subject to call risk.

International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

A taxable equivalent yield is only one of many factors that should be considered when making an investment decision. Morgan Stanley Smith Barney LLC and its Financial Advisors do not offer tax advice; investors should consult their tax advisors before making any tax-related investment decisions.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies.

The **indices** are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

The indices selected by Morgan Stanley Wealth Management to measure performance are representative of broad asset classes. Morgan Stanley Wealth Management retains the right to change representative indices at any time.

Credit ratings are subject to change.

Disclosures

The author(s) (if any authors are noted) principally responsible for the preparation of this material receive compensation based upon various factors, including quality and accuracy of their work, firm revenues (including trading and capital markets revenues), client feedback and competitive factors. Morgan Stanley Wealth Management is involved in many businesses that may relate to companies, securities or instruments mentioned in this material.

This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security/instrument, or to participate in any trading strategy. Any such offer would be made only after a prospective investor had completed its own independent investigation of the securities, instruments or transactions, and received all information it required to make its own investment decision, including, where applicable, a review of any offering circular or memorandum describing such security or instrument. That information would contain material information not contained herein and to which prospective participants are referred. This material is based on public information as of the specified date, and may be stale thereafter. We have no obligation to tell you when information herein may change. We make no representation or warranty with respect to the accuracy or completeness of this material. Morgan Stanley Wealth Management has no obligation to provide updated information on the securities/instruments mentioned herein.

The securities/instruments discussed in this material may not be suitable for all investors. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Morgan Stanley Wealth Management recommends that investors independently evaluate specific investments and strategies, and encourages investors to seek the advice of a financial advisor. The value of and income from investments may vary because of changes in interest rates, foreign exchange rates, default rates, prepayment rates, securities/instruments prices, market indexes, operational or financial conditions of companies and other issuers or other factors. Estimates of future performance are based on assumptions that may not be realized. Actual events may differ from those assumed and changes to any assumptions may have a material impact on any projections or estimates. Other events not taken into account may occur and may significantly affect the projections or estimates. Certain assumptions may have been made for modeling purposes only to simplify the presentation and/or calculation of any projections or estimates, and Morgan Stanley Wealth Management does not represent that any such assumptions will reflect actual future events. Accordingly, there can be no assurance that estimated returns or projections will be realized or that actual returns or performance results will not materially differ from those estimated herein.

This material should not be viewed as advice or recommendations with respect to asset allocation or any particular investment. This information is not intended to, and should not, form a primary basis for any investment decisions that you may make. Morgan Stanley Wealth Management is not acting as a fiduciary under either the Employee Retirement Income Security Act of 1974, as amended or under section 4975 of the Internal Revenue Code of 1986 as amended in providing this material.

Morgan Stanley Smith Barney LLC, its affiliates and Morgan Stanley Financial Advisors do not provide legal or tax advice. Each client should always consult his/her personal tax and/or legal advisor for information concerning his/her individual situation and to learn about any potential tax or other implications that may result from acting on a particular recommendation.

This material is disseminated in Australia to "retail clients" within the meaning of the Australian Corporations Act by Morgan Stanley Wealth Management Australia Pty Ltd (A.B.N. 19 009 145 555, holder of Australian financial services license No. 240813).

Morgan Stanley Wealth Management is not incorporated under the People's Republic of China ("PRC") law and the material in relation to this report is conducted outside the PRC. This report will be distributed only upon request of a specific recipient. This report does not constitute an offer to sell or the solicitation of an offer to buy any securities in the PRC. PRC investors must have the relevant qualifications to invest in such securities and must be responsible for obtaining all relevant approvals, licenses, verifications and or registrations from PRC's relevant governmental authorities.

If your financial adviser is based in Australia, Dubai, Germany, Italy, Switzerland or the United Kingdom, then please be aware that this report is being distributed by the Morgan Stanley entity where your financial adviser is located, as follows: Australia: Morgan Stanley Wealth Management Australia Pty Ltd (ABN 19 009 145 555, AFSL No. 240813); Dubai: Morgan Stanley Private Wealth Management Limited (DIFC Branch), regulated by the Dubai Financial Services Authority (the DFSA), and is directed at Professional Clients only, as defined by the DFSA; Germany: Morgan Stanley Private Wealth Management Limited, Munich branch authorized by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Bundesanstalt fuer Finanzdienstleistungsaufsicht; Italy: Morgan Stanley Bank International Limited, Milan Branch, authorized by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, the Banca d'Italia and the Commissione Nazionale per Le Societa' E La Borsa; Switzerland: Bank Morgan Stanley AG regulated by the Swiss Financial Market Supervisory Authority; or United Kingdom: Morgan Stanley Private Wealth Management Ltd, authorized and regulated by the Financial Conduct Authority, approves for the purposes of section 21 of the Financial Services and Markets Act 2000 this material for distribution in the United Kingdom.

Morgan Stanley Wealth Management is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the “Municipal Advisor Rule”) and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning the Municipal Advisor Rule.

This material is disseminated in the United States of America by Morgan Stanley Smith Barney LLC.

Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data.