March 31 2015

MUNICIPAL SUPPLY SURGE

Anthony Valeri, CFA *Fixed Income & Investment Strategist, LPL Financial*
Colin Allen *Senior Research Analyst, LPL Financial*

KEY TAKEAWAYS

The sharp increase in new municipal issuance has been driven by issuers refinancing existing debt, making the recent surge far less of a risk to the market.

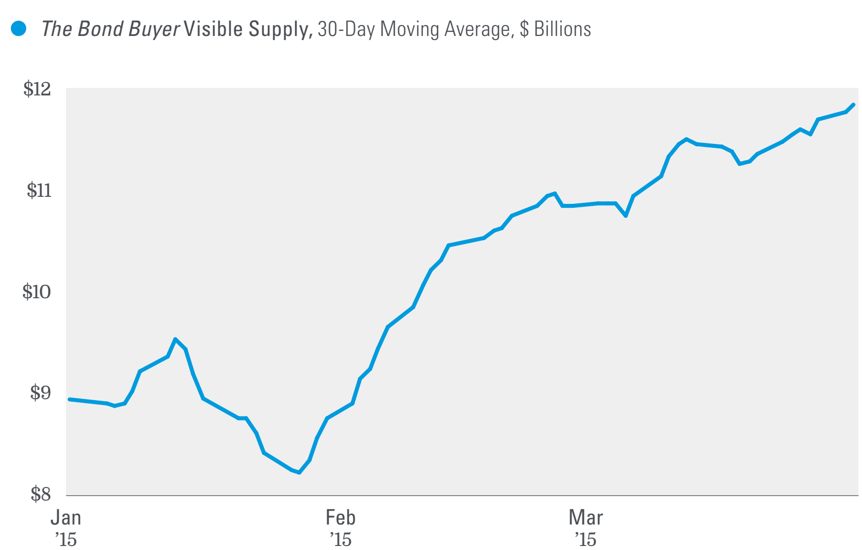
We do not see recent new issuance changing the favorable supply-demand underpinning the municipal bond market.

March 2015 is shaping up to be the biggest month for new municipal bond issuance since June 2012 (and prior to that, late 2010, when a supply surge exerted significant downward pressure on municipal bond prices). Another $9 billion is slated to come to market this week, March 30, 2015, which would put the first three months of 2015 on pace to witness approximately 60% more new issuance than the same period in 2014 [Figure 1].

The supply surge comes at a difficult time of the year when buying interest typically fades due to the approaching April 15 tax deadline. Investors often redeem municipal bonds to pay for capital gains taxes ahead of the filing deadline. For the week ending March 18, 2015, municipal bond mutual fund inflows declined for the fourth consecutive week and tallied only a modest $190 million, according to ICI data, down from a robust $1 billion in late February. On a positive note, flows still remain positive, but the decline has raised concerns as to whether increasing supply may be a headwind for investors and pose a threat to the favorable supply-demand balance that has underpinned municipal bonds over the past 18 months.

Because over 70% of municipal bonds are held by individual investors, either individually or through mutual funds, supply can have a much greater impact

1 MUNICIPAL BOND NEW ISSUANCE HAS MARCHED STEADILY HIGHER IN 2015



Source: LPL Research, *The Bond Buyer* 03/30/15 on municipal bond prices relative to other sectors of the taxable bond market. The investor base in the taxable bond market is much more diverse and is dominated by institutional investors, many of whom have mandates to remain fully invested despite market ups and downs, making supply changes less impactful.

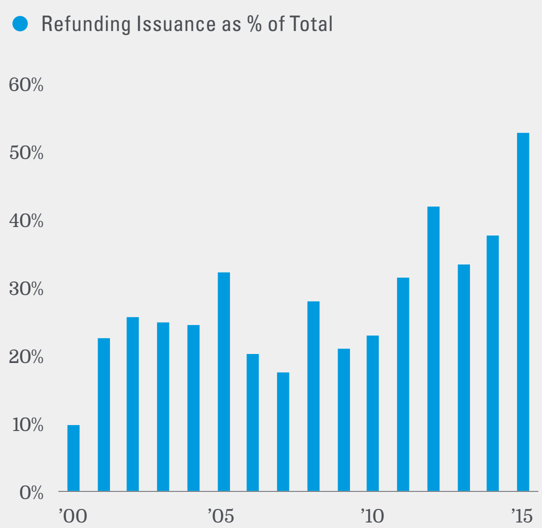
A CLOSER LOOK

A deeper look into new issue supply reveals the surge in supply may not be sustainable. The bulk of new issuance is "refunding" related as municipal issuers take advantage of low interest rates and refinance higher interest rate debt. Year to date through March 27, 2015, refunding related volume is running at the highest level of the past 15 years, easily surpassing the 2012 level [Figure 2]. In fact, the past two weeks have witnessed refunding issuances comprise a staggering 70% of new volume. Refundings typically do not increase overall market supply and may be met with firm demand as investors look to redeploy redeemed bond proceeds.

A surge in what is called "new money" issuance could be more troublesome for the market as it represents new debt growth and may have a greater influence on the overall size of the outstanding municipal bond market. The percentage of new money issuance remains relatively low by historical standards, reflecting still tight state and local budgets. State revenue has improved notably in recent years but has also been met with increased expenses. Local revenue, which is less volatile, is showing only very modest growth. Although the needs for new infrastructure and longer-term projects remain great, state and local budgets are constrained in their ability to take on such new projects.

The headwind of higher new issuance has led to cheaper municipal valuations [Figure 3]. Average AAA municipal-to-Treasury yield ratios remain

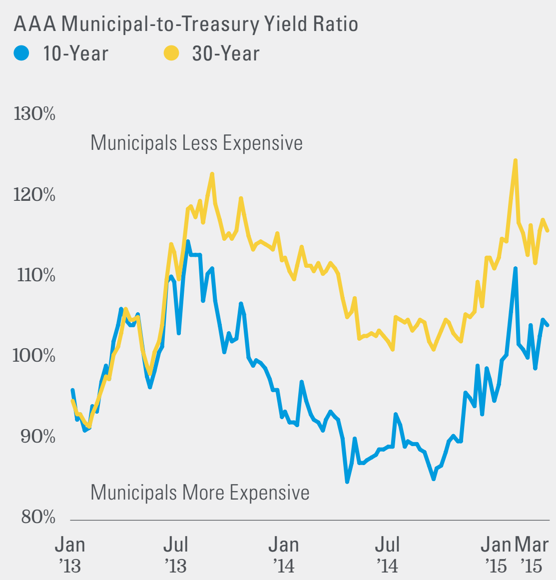
2 REFINANCING IS RUNNING WELL ABOVE NORMAL



Source: LPL Research, *The Bond Buyer* 03/27/15

The 2015 bar data are through 3/27/15.

3 NEW ISSUE HEADWINDS HAVE PLAYED A ROLE IN ATTRACTIVE VALUATIONS



Source: LPL Research, Municipal Market Advisors 03/30/15

Member FINRA/SIPC

LPL Financial

elevated, a sign of better relative value, and near their highest point of the past 18 months. The cheaper valuation is offset by very low yields, but relative to government bonds we find municipal bonds attractive in what is a challenging environment for fixed income investors overall.

A closer look into the increase in municipal bond issuance reveals the surge may not be threatening. The outstanding supply of municipal bonds has gradually declined since peaking in early 2010 and the increase in new issuance overall may reverse that trend. However, until new money issuance plays a far larger role in municipal bond issuance, meaningful debt growth is likely to remain elusive. The favorable supply-demand balance backing the municipal bond market may remain intact. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

DEFINITIONS

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETF), and unit investment trusts (UIT).

Different agencies employ different rating scales for credit quality. Standard & Poors (S&P) and Fitch both use scales from AAA (highest) through AA, A, BBB, BB, B, CCC, CC, C to D (lowest). Moody's uses a scale from Aaa (highest) through Aa, A, Baa, Ba, B, Caa, Ca to C (lowest).

This research material has been prepared by LPL Financial.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit

RES 5029 0315 | Tracking #1-368692 (Exp. 03/16)