Municipal bonds have been under a cloud amid political noise about potentially lowering U.S. personal income tax rates and limiting the amount of muni interest that’s tax exempt. Investors are also weighing the potential impact of future infrastructure spending on new issuance, another potential headwind for the asset class.

We believe long-term investors should take advantage of any market weakness, rather than exiting the asset class. Even if tax rates come down, muni after-tax yields still have the potential to outpace those on U.S. Treasuries. In addition, muni investors have exposure to a differentiated source of income with little volatility.

**Lower taxes ahead?**

Although personal tax rates in the U.S. may come down, potentially reducing the value of municipal bonds, historically the municipal bond market has been able to digest similar changes. In fact, even after a significant reduction of personal tax rates, municipal bonds might still offer attractive after-tax yields (Figure 1). Furthermore, weaker demand from individual investors in higher tax brackets may be offset by a reduction in corporate issuance should interest deductibility, one of the proposals for the new tax plan, be eliminated in exchange for overall lower corporate taxes.

**Summary**

Possible future tax reform, both on the individual and corporate level has led some investors to question the value and role municipal bonds play in their portfolio.

We think the case for municipal bonds remains intact given the market’s resilience, recently attractive risk-adjusted yields and low correlations.

We remain constructive on the asset class over the longer term and look for attractive entry points into the muni market.

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**Figure 1. The potential impact of lower taxes:**

*Before and after tax yields*

Sources: BlackRock, Thomson Reuters, and Bloomberg, as of February 10, 2017.

Notes: Current municipal yield is from Thomson Reuters Municipal Market Data, an amalgamation of U.S. municipal bond data, and is before tax. TEY (or Tax Equivalent Yield) figures show the yield offered by the municipal bond after factoring in a high tax rate of 43.4% and the hypothetical TEY with the proposed new high tax rates of 33% and 28%. The TEY is the pretax yield that a taxable bond needs to yield to be equal to a tax-free municipal bond. This information should not be relied upon as research, investment advice or a recommendation regarding the Funds or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. Past performance is no guarantee of future results.
Potentially attractive source of income

The risk-adjusted yield relative to other fixed income assets also makes municipal bonds appear attractive. Municipal bonds have exhibited volatility similar to U.S. Treasuries but have offered a yield closer to that of investment grade credit (Figure 2). Additionally, the AAA muni-Treasury ratio, a common measure of valuations, has trended upward (~80% to ~96%) since 2008 as the market has demanded a higher yield to account for the credit and liquidity risk of municipal bonds.1 That said, the relative value of municipal bonds has structurally improved.

Diversification

U.S. Treasuries have long played an essential role in portfolio diversification. Although long-maturity government bonds still have a part to play, low yields and rising rates are undermining their traditional role as portfolio diversifiers. Meanwhile, as expectations of Fed tightening rise, investors are pivoting to corporate bonds which tend to be highly correlated to equities. Municipal bonds sit in the middle. They not only provide a potential for an attractive income stream but are less correlated to equities than either high yield or investment grade credit, making them a good candidate for diversification in a portfolio.

Conclusion

Despite headwinds from political uncertainly and recent volatility, we believe the market resilience, attractive risk-adjusted yield and low correlation relative to equities of municipal bonds create a compelling long-term case for the asset class. We would look for attractive entry points to build a position in the municipal bond market.

1. Source: Bloomberg, 2/23/2017. Notes: The muni-Treasury ratio is a comparison of the current yield of a municipal bond to U.S. Treasuries. A ratio above 100% means municipal bonds are yielding more than Treasuries, which could be a bullish sign. The historical average of this ratio is 80%.

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