WEEKLY MARKET COMMENTARY

THE WEEK IN MUNILAND
DECEMBER 10, 2018

BONDS RALLY AND CURVE INVERTS

+ This week's stock market volatility, spurred by uncertainty around US–China trade relations, resulted in a risk-off trade and a rally in bonds.
    - **Why it matters:** With the S&P down 4.6% for the week, muni bonds did their job—which is to hold their value in volatile markets—and rallied 0.73%. Muni yields declined anywhere from 6 to 13 basis points across the yield curve, with the longer end realizing the larger declines.

+ The flight to quality caused the US Treasury yield curve to flatten and the short end to become slightly inverted.
    - **Why it matters:** The shape of the yield curve is an imperfect forecaster of recessions. The market is looking for signs of a recession even though economic indicators are strong and point to further growth. The inversion between two- and five-year US Treasuries is a technical inversion and not an indication of a pending recession. The two- to ten-year spread has narrowed to 14 b.p. and will likely continue to flatten over the coming months.

THE MOTOR CITY'S TRIUMPHANT RETURN

+ Detroit returned to the new-issue market with a general obligation bond secured solely by its full faith and credit and its taxing power for the first time since the city's 2013 bankruptcy.
    - **Why it matters:** The deal, rated Ba3 by Moody's and B+ by S&P, was well received by the market, as it was seven to 11 times oversubscribed, depending on maturity. At issue, the 10-year bond came at a 202-b.p. spread to a AAA muni and quickly tightened to 181 b.p. The new-issue spread was fair given the external ratings, although our internal assessment is a low-investment-grade rating. With Detroit's low fixed costs through 2024, better-than-anticipated financial results and stable population, we believe there is a bit more upside to the city's credit quality and ultimate rating.

+ As the market has recently become increasingly volatile, investors need to be cautious when realizing capital losses.

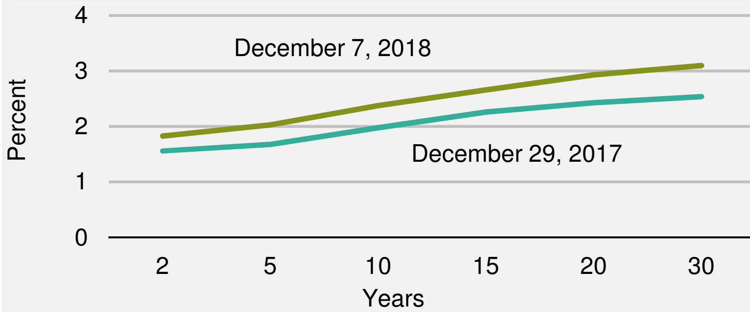
- **Why it matters:** Volatile markets increase the risk when harvesting capital losses. The risk to an investor is that he might realize the loss, forgo income by sitting in cash for too long and have the market move against him enough to overwhelm the tax benefit. Ideally, an investor would swap immediately into a new bond, but that is difficult in choppy markets. Harvesting losses throughout the year, rather than waiting until year-end, is the most efficient way to "rotate" portfolios into higher-yielding bonds.

POSITIONING FOR TODAY'S MARKET

+ **Yield-Curve Risk:** Move toward a more concentrated maturity structure. The spread between short- and long-term municipal bond yields is still narrow by historical standards.
+ **Credit Risk:** Modest overweight. Investor demand for income remains strong, and economic growth is positive for most mid-grade and high-yield municipal issuers.

Displays of the Week: December 10, 2018

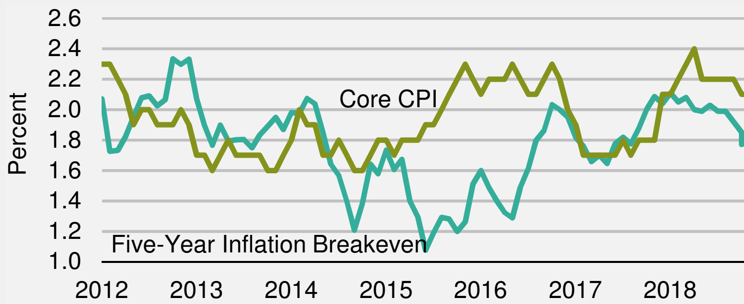
Display 1: AAA Municipal Yields



As of December 7, 2018
Source: Bloomberg and AB

Across the municipal yield curve, short-term yields have risen 0.27% and long-term yields have risen 0.56%. Now that yields are higher, bond portfolios are more insulated against future rate hikes.

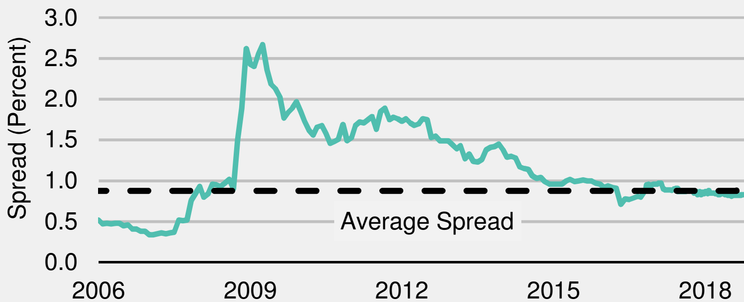
Display 2: Core CPI vs. Five-Year Inflation Breakeven



CPI as of October 31, 2018; breakeven as of December 6, 2018
Source: Bloomberg and AB

Breakeven inflation rates fell with oil and equity prices last week as investors worried about slower global growth.

Display 3: 10-Year AAA/BBB Muni Spreads

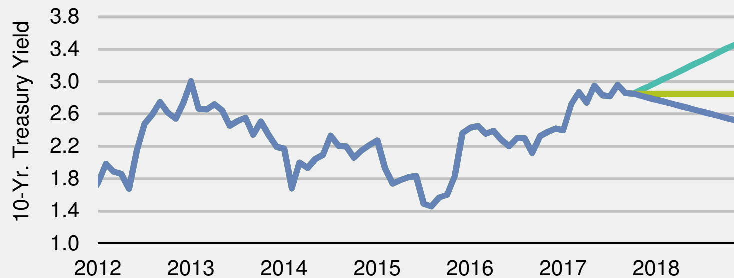


As of December 7, 2018
Historical analysis does not guarantee future results.
Source: Municipal Market Data and AB

Assuming economic growth continues, the extra income available for mid-grade and high-yield bonds relative to high-grades is attractive. Investors can pick up 0.83% in additional yield by investing in BBB-rated municipals.

Display 4: Expected 12-Month Municipal Returns Scenario Analysis

10-Year US Treasury Yield (Percent)



10-Year Treasury, 3.50% → **1.50%**

10-Year Treasury, 2.85% → **3.38%**

10-Year Treasury, 2.50% → **4.40 %**

As of December 7, 2018
Historical analysis does not guarantee future results.
Display reflects expected return of a 5.40-year-duration intermediate municipal portfolio under three scenarios: 10-year Treasury yields rise to 3.50% over the next 12 months, remain the same and decline to 2.50% over the next 12 months.
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.

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