WEEKLY MARKET COMMENTARY

THE WEEK IN MUNILAND
MARCH 18, 2019

THE FED REMAINS ON THE SIDELINE

+ US inflation for February was a touch softer than expected, with core CPI rising 0.1% month over month and 2.1% year over year.

    - **Why it matters:** With the Fed already comfortably on hold, there is no near-term policy implication from this week's print. From a macro perspective, the biggest question remains whether a strong labor market will eventually feed through to higher inflation. That question remains unanswered, leaving us to await further information before drawing any conclusions. That's what the Fed is doing, and we think it's the right approach.

+ Year to date, record inflows into municipal mutual funds of $19.5 billion have caused munis to outperform treasuries. In fact, 10-year AAA municipals have returned 2.05% while comparable-maturity US Treasuries have returned 1.39%.

    - **Why it matters:** This outperformance has reduced the after-tax yield benefit of 10-year AAA municipals versus 10-year US Treasuries to just 0.51%, compared to the long-term average of 0.94%. This differential is just 0.09% away from putting 10-year munis at their most expensive levels in history. Investors should consider allocating a portion of their tax-exempt municipal allocation to 10-year US Treasuries until such time as the after-tax spread reverts toward normal.

IS NEW YORK CITY EDGING TOWARD BANKRUPTCY? NO, IT IS NOT.

+ The *New York Post* published an article late last week warning that "New York City is edging toward financial disaster." The author references long-term debt as one of the potential causes of bankruptcy.

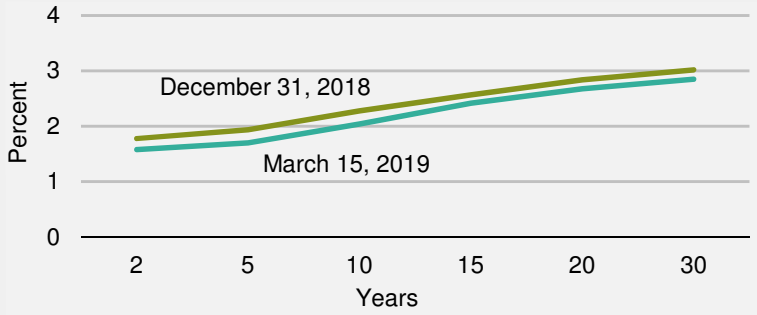
    - **Why it matters:** While the headline may startle some investors, many of the statements made by the author are misleading. Our research indicates the city is in a strong and stable financial position. While the reported debt burden looks high on an absolute basis, the city lacks any overlapping units of government, and thus serves the functions of a city, a county and a school district. When taking this into account, the city has ample revenues to support its debt burden. The city has also reduced its pension liability by contributing 30% more than the amount necessary to keep the liability unchanged. Consequently, the total net pension liability of the city has decreased from 6% to 5.3%. Furthermore, the city has best-in-class budget controls, as they are subject to state oversight if the city's ability to pay debt service or balance its budget is in question.

POSITIONING FOR TODAY'S MARKET

+ **Yield-Curve Risk:** Reduce concentrated maturity structure in favor of a combination of money market–eligible securities and longer-maturity municipals, as well as a small position in intermediate-maturity US Treasuries.
+ **Credit Risk:** Modest overweight. Investor demand for income remains strong, and economic growth is a credit positive for most mid-grade and high-yield municipal issuers.
+ **Taxable Bonds:** Modestly add US Treasury securities, as municipal bonds have become relatively expensive.

Displays of the Week: March 18, 2019

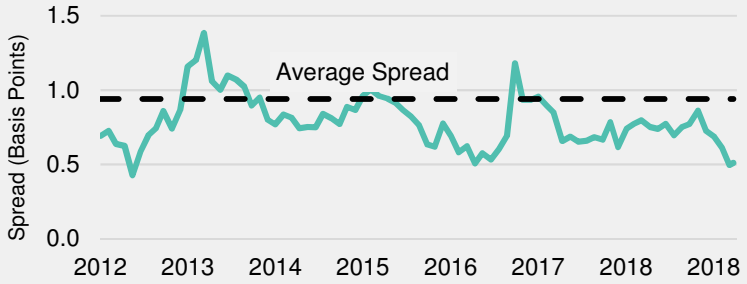
Display 1: AAA Municipal Yields



For 2019, the yield curve has steepened, with yields inside of 10 years down as much as 26 basis points and longer yields down only 17 b.p.

As of March 15, 2019
Source: Bloomberg and AllianceBernstein (AB)

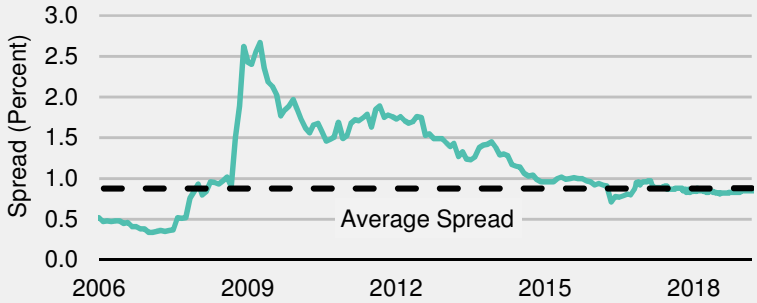
Display 2: Municipal/US Treasury After-Tax Spread



Investor demand for municipals has caused the after-tax yield advantage of 10-year AAA municipals to approach 0.50%. This is nearly as expensive as munis have ever been.

Through March 15, 2019
Historical analysis does not guarantee future results.
Chart shows the after-tax spread of a 10-year US Treasury vs. a 10-year AAA-rated municipal bond.
Source: Bloomberg and AB

Display 3: 10-Year AAA/BBB Muni Spreads

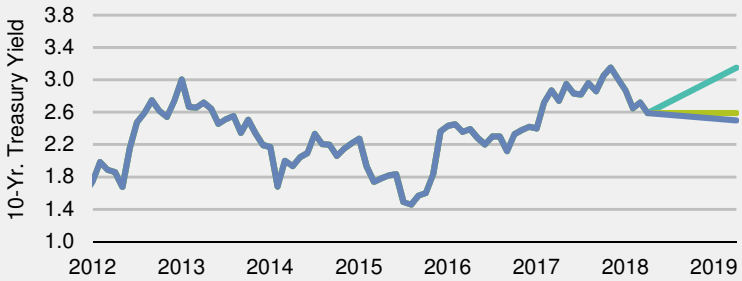


Assuming US economic growth continues at a modest pace, the extra income available for mid-grade and high-yield bonds relative to high-grades is attractive. Investors can pick up 0.85% in additional yield by investing in BBB-rated municipals.

Through March 15, 2019
Historical analysis does not guarantee future results.
Source: Municipal Market Data and AB

Display 4: Expected 12-Month Municipal Returns Scenario Analysis

10-Year US Treasury Yield (Percent)



10-Year Treasury, 3.15% → **1.68%**

10-Year Treasury, 2.59% → **3.30%**

10-Year Treasury, 2.50% → **3.56%**

As of March 15, 2019
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 3.15% over the next 12 months, remain the same or 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.

18-0090