Municipal securities
closed-end fund commentary

Executive summary

- For the second quarter, the Bloomberg Barclays Municipal Bond Index gained 1.96%, outperforming the overall taxable bond market.
- Supporting the municipal market were generally positive underlying fundamentals, declining long-term yields and overall solid investor demand.
- In Western Asset Management’s (“Western”) view, while municipal yields have fallen and spreads have tightened, they feel there’s the potential for spreads to grind tighter as the year progresses.
- Within the muni market, Western continues to favor revenue bonds over general obligation bonds. In particular, they remain focused on finding value in A-rated revenue bonds and BBB-rated securities.

Market recap†

The U.S. Treasury yield curve flattened during the second quarter as short-term yields moved higher, whereas longer-term yields declined (yields and prices move in the opposite direction). During the second quarter as a whole, the overall U.S. bond market generated a modest gain and spread sector (non-U.S. Treasuries) total returns generally outperformed equal-duration Treasuries.

Looking at the U.S. economy, the Commerce Department reported that first quarter 2017 Gross Domestic Product (GDP) growth was 1.4%. In contrast, the economy expanded 2.1% during the fourth quarter of 2016. The deceleration in growth reflected downturns in private inventory investment and personal consumption expenditures, along with more modest state and local government spending. The preliminary estimate for second-quarter GDP will be released on July 28.

As widely expected, the Federal Reserve Board (“Fed”) raised rates, for a second time this year, at its meeting in June. This was the Fed’s fourth rate hike since December 2015. The Fed also said that it planned to begin reducing its balance sheet, saying “The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee currently expects to begin implementing a balance sheet normalization program this year, provided that the economy evolves broadly as anticipated.”

The municipal (“muni”) market posted a positive return and outperformed the overall taxable bond market during the second quarter. This was driven by a number of factors, including generally positive underlying fundamentals, declining long-term yields and overall solid investor demand. All told, the Bloomberg Barclays Municipal Bond Index (the “Index”) gained 1.96% during the second quarter. Over the same period, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, returned 1.45%. Within the muni market for the quarter, longer-term securities outperformed short-term securities and lower-quality issues outperformed their higher-quality counterparts.

Portfolio positioning and outlook

Our view of a continuing moderate pace of U.S. growth and an improving global backdrop suggests Fed policy will stay on course. We expect the Fed to tighten once more by the end of the year and continue this process of inching up the fed funds rate. Lastly, we would point out the enormity of the change in expectations for fiscal policy. Excitement about the possibility of tax cuts, deregulation and infrastructure spending characterized the consensus earlier this year. Presently, however, the enormous political turmoil in Washington has left investors very doubtful that any meaningful fiscal thrust will be accomplished. Our view is that this is too pessimistic. The prospects for tax cuts to emerge from a Republican-controlled House, Senate and presidency are meaningful. In our view, market sentiment on the political front has swung too far toward pessimism.

Turning to the muni market, in our view fundamentals remained solid overall during the second quarter. While muni yields have fallen and spreads have tightened, we feel there’s the potential for spreads to grind tighter as the year progresses. This could be driven by a supportive technical environment. Net new issuance was relatively flat during the first six months of 2017. We’ve also seen strong overall demand from both individual and institutional investors. That being said, demand trends could shift, and we continue to closely monitor this situation.
Within the muni market, we continue to favor revenue bonds over general obligation (GO) bonds. In particular, we remain focused on finding value in A-rated revenue bonds and BBB-rated securities. In most portfolios, we favor benchmark-like durations, given the current market backdrop and the flattening of the yield curve that occurred over the first half of the year.

Investment risks

All investments are subject to risks, including the possible loss of principal. Investments in bonds are subject to credit risk, inflation risk and interest rate risk. As interest rates rise, bond prices fall, reducing the value of a fund’s share price. Investments in lower-rated high-yield bonds are subject to greater credit risk (risk of default) than higher-rated obligations. Derivatives, such as options and futures, can be illiquid, may disproportionately increase losses, and have a potentially large impact on fund performance. Certain investors may be subject to the federal Alternative Minimum Tax (AMT), and state and local taxes may apply. Distributions are not guaranteed and are subject to change.

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Glossary
A revenue bond is a type of municipal bond distinguished by its guarantee of repayment solely from revenues generated by a specified revenue-generating entity, rather than from a tax.

A general obligation bond (GO bond) is a type of municipal bond that is secured by a state or local government's pledge to use available resources, including tax revenues, to repay bond holders.

The Bloomberg Barclays Municipal Bond Index is a market value-weighted index of investment-grade municipal bonds with maturities of one year or more. Investors cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

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Duration is a measure of the price sensitivity of a fixed-income security to an interest rate change of 100 basis points. It is calculated as the weighted average of the present values for all cash flows.

The U.S. Treasury Department is responsible for issuing all Treasury bonds, notes and bills; it is responsible for the revenue of the U.S. government.

The yield curve shows the relationship between yields and maturity dates for a similar class of bonds.