LPL RESEARCH

BOND MARKET PERSPECTIVES

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STATE OF THE STATES

Anthony Valeri, CFA *Fixed Income & Investment Strategist, LPL Financial*
Shawn Doty *Senior Analyst, LPL Financial*

KEY TAKEAWAYS

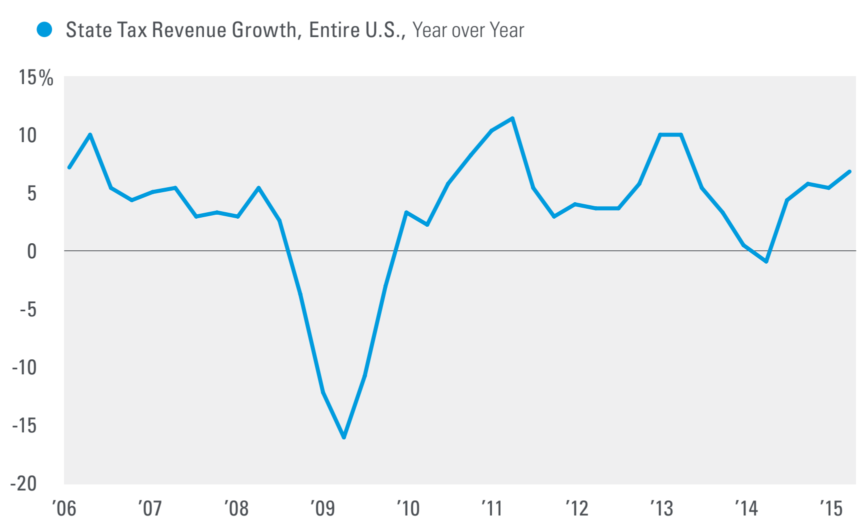
Growth in state tax revenue, which has been a positive for municipal credit quality in recent years, is slowing — meaning the bulk of credit quality improvements may be behind us.

Though problem areas like Puerto Rico continue to make headlines, municipal defaults remain very low.

With the deadline approaching, taxes are front and center in the minds of investors. No one likes paying taxes, but they are of utmost importance to the financial well-being of state and local governments. Higher tax revenue has been a key driver of improving (in most cases) state and local government credit quality metrics by firming the financial standing of municipal government debt issuers. However, growth in state and local government tax revenue may be poised to slow, lessening the positive impact behind municipal credit quality.

The United States Census Bureau tracks quarterly tax revenue data for each state, and Figure 1 shows the year-over-year growth in tax receipts through the second quarter of 2015 (the most recent data available). Gains have been strong since the Great Recession, with rare exceptions. However, despite an impressive more than 5% growth rate through the second quarter of 2015, preliminary reports covering more recent quarters indicate slowing growth in tax revenue. States' own projections have also started to become more pessimistic, with many expecting slower growth for 2016 and extending into 2017.

1 GROWTH IN STATE TAX RECEIPTS HAS BEEN CONSISTENT IN RECENT YEARS



Source: LPL Research, Haver Analytics, United States Census Bureau 04/06/16

Past performance is no guarantee of future results.

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The deceleration isn't related to one specific revenue source either. The Rockefeller Institute publishes estimates about one quarter ahead of the U.S. Census, and these estimates showed a slowing growth rate in both personal income taxes (4.5% average in 2016 and 2017 versus 8.3% in fiscal year 2015), and sales taxes (3.7% average in 2016 and 2017, versus 4.8% in fiscal year 2015.) Slower revenue growth means less money for states to cover expenses, which include debt service payments. A decrease in tax receipts could lead investors to require more compensation for risk in the form of higher yield spreads for general obligation bonds, which are typically backed by taxing revenue.

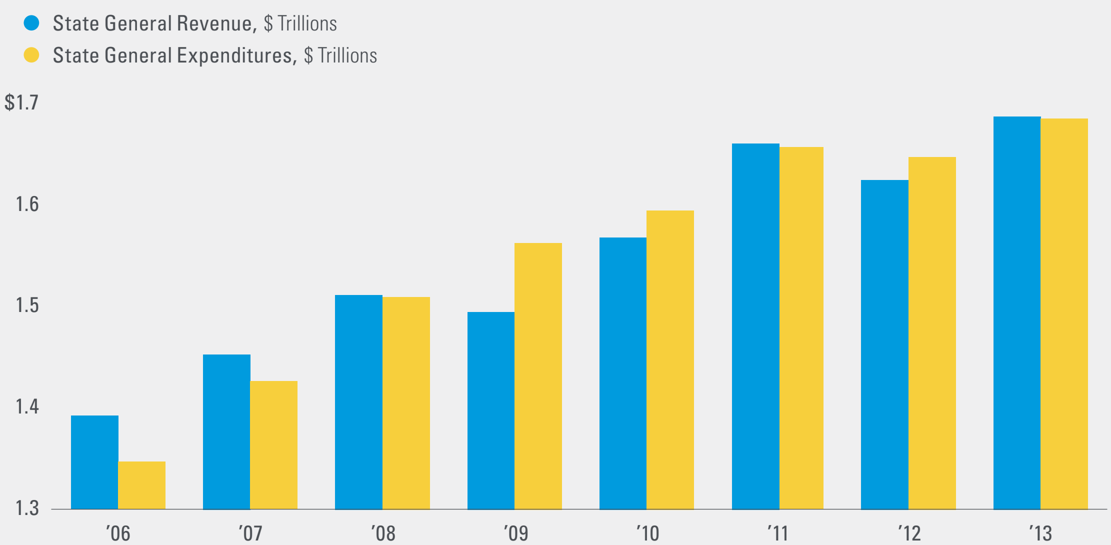
STATES RESIST ADDITIONAL DEBT

State revenue has generally trailed expenditures in the years since the financial crisis [Figure 2], which is why revenue gains of the past several years have failed to translate into even better financial standing. The reality is that despite revenue gains, budgets remain very tight and have left states with little appetite for taking on additional debt.

The relatively slow rate of growth in debt levels has generally been supportive of the municipal bond market by keeping overall market growth close to zero. This has fostered a favorable supply-demand balance and may have been one factor that helped municipal bonds power through a traditionally weak seasonal period in March 2016, with a positive return of 0.3% for the Barclays Municipal Bond Index, the best March return since 2008.

Over the past year, however, budget battles have intensified in places like Illinois, which still doesn't have a 2016 budget, and Pennsylvania, which just recently passed its 2016 fiscal budget nearly nine months after the deadline. Pennsylvania's budget was achieved without tax increases but the state will likely face a tax hike debate in the next budget

2 **GROWTH IN STATE REVENUE HAS GENERALLY TRAILED GROWTH IN EXPENDITURES SINCE THE FINANCIAL CRISIS**



Source: LPL Research, Haver Analytics, United States Census Bureau 04/06/16

Latest data the U.S. Census has officially released is for fiscal year 2013.

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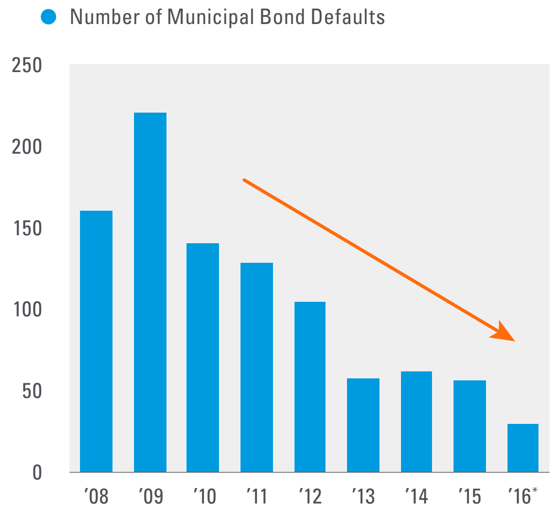
discussion. The city of Chicago recently passed a large tax increase to help cover pension shortfalls and may be forced to do so again, as an attempt to cut pension costs in order to lower expenses was overturned by the state's Supreme Court.

The threat of higher tax rates remains despite revenue gains of the past few years. Higher tax rates improve the attractiveness of tax-exempt municipal bonds broadly and may boost their allure. With budgets expected to remain tight, the supply of municipal bonds will likely remain constrained relative to demand, and the potential for tax increases will also likely stay on the table—both of which are longer-term positives for municipal bonds.

3 DEFAULTS REMAIN LOW IN THE MUNICIPAL BOND MARKET



Source: LPL Research, Municipal Market Analytics 04/06/16

*2016 is an estimate for full year based on year-to-date data as of March 24, 2016.

Past performance is no guarantee of future results.

The estimates set forth in the presentation may not develop as predicted.

DEFAULTS REMAIN LOW

Despite highly publicized budget skirmishes and trouble spots like Puerto Rico, municipal defaults remain isolated. Figure 3 shows the deceleration and continued low number of defaults in the municipal bond market in recent years, giving little evidence that the weakness of these well-known problem areas is spilling over into the broader municipal market.

CONCLUSION

Though growth in state tax receipts may slow, the fundamental picture for municipal bonds remains positive and the prospects of higher taxes in future years may enhance their allure. Valuations also remain attractive with 10- and 30-year municipal bond ratios at 95% and 100%, respectively, meaning investors are able to receive nearly the same yield as similar maturity Treasuries, while also enjoying the tax benefits. Although certain issuers will struggle with the prospects of declining revenue, we believe these issuers may continue to be isolated cases.

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.

General obligation (GO) bonds are municipal bonds backed by the credit and “taxing power” of the issuing jurisdiction rather than the revenue from a given project.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

INDEX DESCRIPTIONS

The Barclays U.S. Municipal Index covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

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