September 18, 2018

Changing Municipal Guidance—Crossover and Pre-Refunded

George Rusnak, CFA
Co-Head Global Fixed Income Strategy

☑ **Guidance change**
☐ Allocation change
☐ Forecast change

Key takeaways

» *We have moved our tactical guidance on pre-refunded municipals to favorable (from most favorable), due to valuation and limited supply. We continue to view pre-refunded securities as a consideration as an investment choice within a diversified fixed-income portfolio.*

» *We have changed our guidance on crossover strategies to neutral (from favorable). August brought a tightening of spreads that corporate bonds had had over municipals on the short end of the yield curve (1-5 years). This change signaled that future investment opportunities between taxable securities and municipals were neutrally weighted (rather than favorable).*

What it may mean for investors

» *We have a favorable view of municipal securities overall, and believe that any market weakness could offer a buying opportunity for long-term investors.*

» *We continue to view pre-refunded municipals favorably. We are neutral on crossover strategies. Instead, we generally favor retaining legacy, existing allocations.*

We recently changed our guidance on pre-refunded municipals to favorable, from most favorable. We also have changed our guidance to neutral from favorable on municipal crossover strategies. These changes are summarized in the table below and outlined in this report.

Table 1. Wells Fargo Investment Institute fixed income guidance changes

	New guidance	Previous guidance
Pre-refunded Municipal	Favorable	Most favorable
Municipal Crossover Opportunity	Neutral	Favorable

Source: Wells Fargo Investment Institute, September 17, 2018. A pre-refunded municipal bond is issued to fund a callable bond that are escrowed to their call date typically in Treasury obligations that are backed by the full faith and credit of the U.S. government. When the original municipal bond reaches its call date, the Treasury bond proceeds are used to repay the earlier bondholders.

© 2018 Wells Fargo Investment Institute. All rights reserved.

Pre-refunded municipal securities—moved to favorable from most favorable

We have adjusted our tactical guidance on pre-refunded securities to favorable from most favorable. Our rationale is detailed below:

- Initially, index changes and weakness on the short part of the yield curve presented an opportunity for most favorable guidance for pre-refunded municipals.[1]
- Early in September, pre-refunded municipals were fairly priced relative to non-refunded municipals. The recent increase in short-term municipal yields has slightly improved the ratio of pre-refunded municipal yields to Treasury yields. The larger issue is that tax reform has ended the pre-refunding of outstanding municipal issues, leaving a shrinking pool of pre-refunded bonds in the marketplace. Consequently, existing pre-refunded bonds likely will be in high demand while they remain outstanding.
- Although we still believe pre-refunded municipal securities are attractive and offer compelling valuations relative to historical norms, the magnitude of the opportunity has diminished. This explains the change in tactical guidance to favorable from most favorable.

Crossover opportunities—changed to neutral from favorable

We adjusted our guidance on crossover opportunities (between taxable securities and municipals) from favorable to neutral this month. Our rationale is detailed below:

- August had brought a tightening of the spreads that corporate bonds had over municipals on the short end of the yield curve (1-5 years).
- Yield-spread tightening, particularly between taxable and municipal securities on both 2- and 5-year issues, suggests that future opportunities are more neutrally weighted going forward (rather than favorable).
- Although current yield spreads are above average, based on a one-year horizon, the yield advantage has diminished. This suggests a neutral stance.

As noted, the metrics that we monitor for crossover opportunities are now in the neutral range. Consequently, this is not an opportunity to allocate new money to the crossover strategy. Instead, we favor retaining legacy, existing allocations.

Investment implications

We continue to retain a favorable tactical view of municipal securities within a well-diversified fixed income portfolio. We favor selectivity, higher quality, and essential service revenue bonds with dedicated revenue streams today. Municipals have outperformed other fixed income classes year to date. This outperformance, combined with a seasonal supply increase, may result in market pressure between now and year-end. We would view any municipal-market weakness as a buying opportunity for longer-term investors.

[1] Non-rated pre-refunded/Escrowed to Maturity bonds now qualify for inclusion in the Bloomberg Barclays U.S. Municipal Index, which had increased demand for these securities. These are the index changes referenced above.

© 2018 Wells Fargo Investment Institute. All rights reserved.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **Municipal** bonds offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR 0918-02490

© 2018 Wells Fargo Investment Institute. All rights reserved.