Q1 2016

Contagion Could Drive Opportunity in Municipal High Yield

Christine Todd, CFA
President of Standish
Head of Tax-Sensitive and Insurance Strategies

Daniel Rabasco, CFA
Chief Investment Officer
Tax-Sensitive Strategies

Jeffrey Burger, CFA
Senior Portfolio Manager

Thomas Casey
Senior Portfolio Manager

Daniel Marques, CFA
Senior Portfolio Manager

David Mann, CFA
Junior Research Analyst

Corporate High Yield Market Conditions

As we entered the final weeks of 2015, the US high yield (HY) market struggled with destabilizing undercurrents, including: the downbeat OPEC meeting, which drove oil prices to new 5-year lows; the Federal Reserve's recent rate increase, which created uncertainty; and recent news of liquidating distressed hedge funds and freezing mutual funds, which exacerbated concerns about trading liquidity. As the corporate high yield market seeks to establish fair valuation and orderly trading, we expect price erosion to abate, particularly with HY yields currently trading near 9%. In prior periods of rising rates, HY spreads have tended to trade tighter within the ensuing six months; we would expect this trend to persist. Nevertheless, the Energy and other commodity linked sectors are likely to see default rates rise to around 4.0%, which is an increase from 2.5% in 2015, but still lower than the historical average rate of 4.7%. We expect energy will continue to be a drag this year, currently trading at approximately 14% yields, with dollar prices generally hovering in the mid $60s.

Historically, municipal high yield bond valuations have moved largely in concert with corporate HY, but in this recent bout of volatility, muni HY has been spared. Since 1995, the correlation between muni HY and corporate HY has been 67%, and in the second half of 2015, has been the converse. As a result, year to date Barclays Corporate HY Index returns are (4.5)%, and Barclays Municipal HY Index is positive at 1.9%[1]. A combination of favorable technical and fundamental factors has supported muni HY valuations. However, relatively small changes in market conditions could tip the market's fragile balance. We feel that a normalization of the historical relationship between muni and corporate HY would likely manifest itself in a significant cheapening of the muni HY market, therefore creating an attractive buying opportunity.

[1]Source Barclays as of November 30, 2015

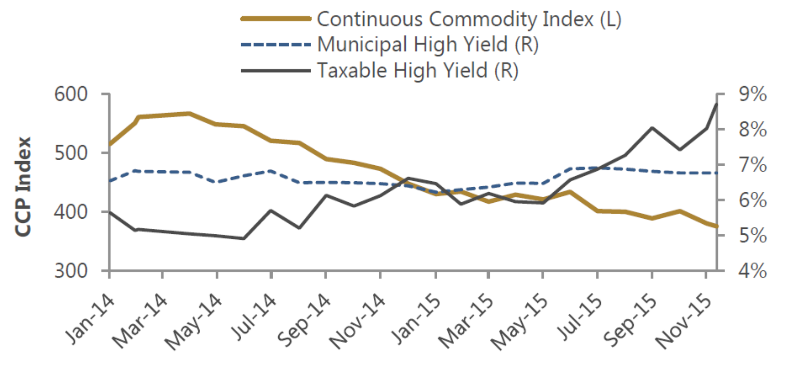
Municipal High Yield Has Been Sheltered From the Commodity Price Storm

Commodity prices have very little direct impact on the creditworthiness of the largest muni HY sectors. While some credits within the industrial development subsector are hurt by the decline in commodities, other sectors such as airlines, toll roads and tobacco will directly or indirectly benefit. An estimated 65% of muni HY is not energy related; 5% of muni HY is negatively impacted by lower commodity prices[1]. For corporate HY, 17% of the Bank of America/Merrill Lynch High Yield Index is comprised of energy, metals and mining credits that are highly leveraged to commodity prices. Consequently, the change in commodity prices explains 88% of the movement in corporate HY yields, and only 1% of the change in muni yields[2]. While muni HY may serve as a safe haven amid volatile commodity markets, the muni HY market is vulnerable to the liquidity contagion in corporate HY.

Commodity price declines have driven corporate HY yields higher, and municipal HY yields have remained steady thus far.

As evidenced by the chart below, commodity price declines have driven corporate HY yields higher, while municipal HY yields have remained steady thus far.

Commodity Prices vs. HY Yields



Source: Barclays, Bloomberg as of December 11, 2015

Fundamentals and Fund Flows Have Further Supported Muni HY

In addition to the buffer from commodity price swings, muni HY credit quality is generally more stable than that in corporate HY. The greater factor impacting municipal credit quality is US GDP growth, which has been anemic, but positive since the financial crisis. Income, sales and property taxes have recovered to their pre-recession levels, positively impacting overall municipal credit quality. Specific to high yield, a Moody's study reveals that the default rate of speculative grade municipal bonds has been 7.5%. In contrast, 32.4% of speculative grade corporates have defaulted. In the case of default, median recovery rate for municipals is $75[3]; median recovery for below investment grade senior unsecured corporates is $38[4].

Retail investors' insatiable reach for yield has supported demand for muni HY. Since 2013, muni HY mutual funds have grown 34.1%, while taxable HY mutual fund assets have declined –8.6%[5]. Year to date, municipal HY mutual funds have had nearly 4 times the net positive flows as corporate HY mutual funds, $1.8 billion in muni HY, and 0.5 in taxable HY[6]

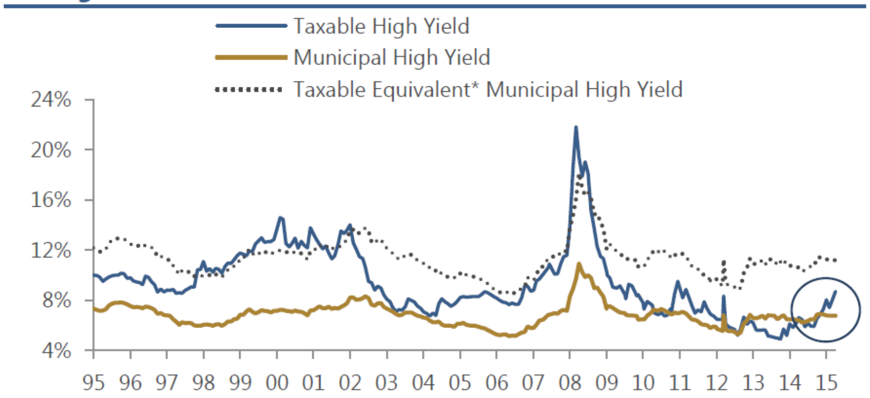
[1]Source: Barclays, Standish
[2]Source: Barclays, Standish, Bloomberg 1/1/14 - 11/30/15
[3]Source: Moody's as of July 24, 2014
[4]Source: Moody's as of March 4, 2015
[5]Source: Morningstar as of November 30, 2015
[6]Source: Simfund MF/Morningstar category as of November 2015

Municipal and Corporate High Yield Valuations Have Diverged

Credit spreads in corporate HY have widened dramatically, currently hovering at over two standard deviations from the mean since 2010. In contrast, Muni HY credit spreads (normalized, ex- PR bonds which joined the HY Index in 2014) have plummeted to 1.5 standard deviations below the mean[7]. This year's strong relative performance of muni HY could motivate selling from taxable HY strategies that have crossed over to muni HY, and need to meet redemptions.

Though tax equivalent muni HY yields exceed those of corporate HY, nominal yields in the corporate HY market have retaken their dominant position. Climbing corporate HY yields could potentially attract investment flows from yield seeking buyers, potentially at the expense of muni HY funds. Our research shows a 70% correlation between muni high yield net mutual fund flows and total return since 2003[8], making muni HY valuations vulnerable to retail behavior and psychology.

Divergence of HY Yields



Source: Barclays Corporate and Municipal High Yield Index, ex PR as of December 11, 2015
*Maximum tax rate of 39.6%

A repricing of muni HY could be simply driven by a reversion to the historical relationship between the two HY asset classes.

A Tale of Two Sectors

For the coming year, we expect corporate HY to stabilize, based on our sanguine view of the US economy, bottoming commodity prices, accommodative Fed, and moderately higher default rates due to commodities. Technical demand could also support valuations, as corporate HY closes in on the 9% yield bogie that previously attracted capital into the asset class. Leverage ratios have been stable through 2015, and interest coverage near historic highs, providing cushion in facing top-line revenue declines. In sectors less correlated with commodities, we anticipate more balance sheet-friendly activities in a rising interest rate environment. To the extent that corporate HY fundamentals are stable, volatility should decline and liquidity should improve.

While corporate HY finds more solid footing, municipal market liquidity concerns, a wane in retail demand or a major municipal market credit crisis are some events that could contribute to a relative cheapening of the muni HY market. As liquidity in the corporate HY market is stressed, there is potential for muni HY to be sold by taxable HY strategies that had crossed over to the municipal market and are now facing redemptions. A repricing of muni HY could be simply driven by a reversion to the historical relationship between the two HY asset clases. We believe wider spreads and higher yields in muni HY could present a compelling investment opportunity in the coming year.

[7]Source: Barclays, Standish
[8]Source: Barclays, Standish, Lipper

For additional information please visit our website at www.standish.com

or

email at us at: info@standish.com

STANDISH
A BNY MELLON COMPANY[SM]

Standish Mellon Asset Management Company LLC
Boston • Pittsburgh • San Francisco

Standish Mellon Asset Management (UK) Limited

Standish Mellon Asset Management (Singapore) Pte. Limited

www.standish.com • info@standish.com

@StandishIM

WP/MUNIHY/121715/BR

BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited

金融商品取引業者：関東財務局長（金商）第 406 号
〔加入協会〕一般社団法人　投資信託協会
　　　　　　一般社団法人　日本投資顧問業協会