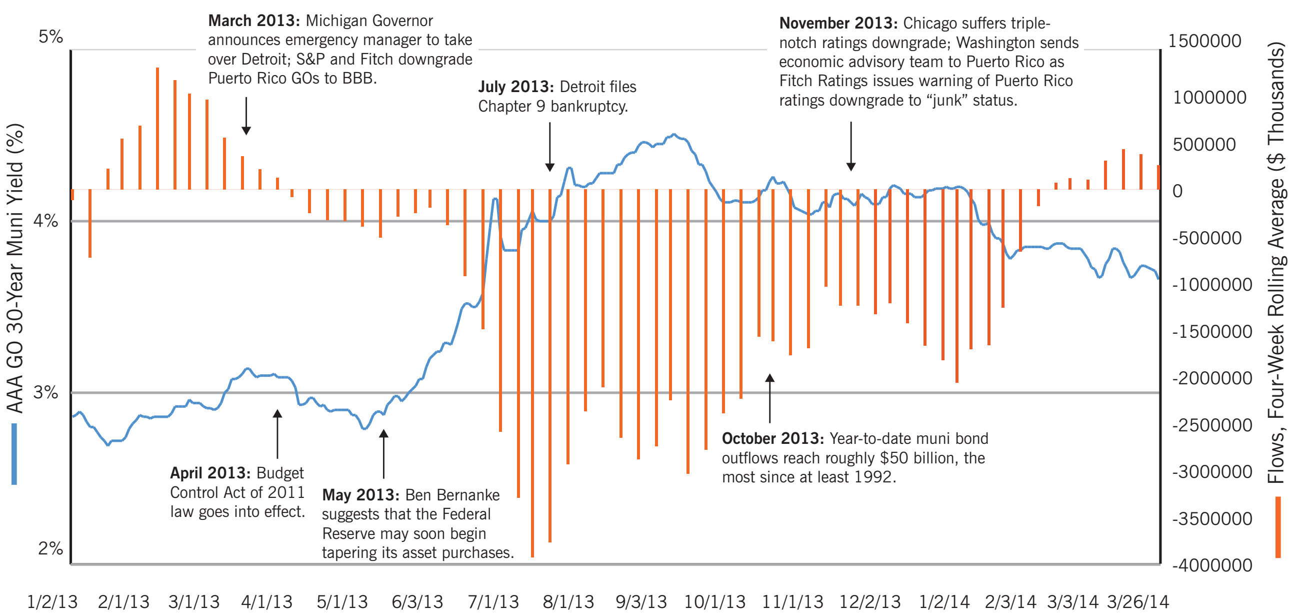
# Attractiveness of municipal bonds should not be overlooked in 2014

**Municipal Insight Committee**
The Municipal Insight Committee is composed of Eaton Vance thought leaders in the municipal bond market.

After a challenging year for the municipal bond (muni) market in 2013, we believe the underlying strength of munis has improved, making the asset class an attractive proposition. In our view, challenges and headwinds will continue in 2014; however, more palatable yields and the relative attractiveness of munis versus other taxable alternatives may help investors limit the volatility and downside witnessed over the past year.

Looking back on 2013, retail investor fear generated by negative headlines on select muni issuers combined with worry that the Federal Reserve (Fed) would taper its quantitative easing (QE) led to a migration out of munis starting in June. Fund outflows stubbornly persisted in the second half of the year due to fear and uncertainty over a handful of issuers, and muni investors were handed their worst yearly return since 2008. Indeed, external forces were the primary driver of performance in the muni market for most of 2013. The timeline below highlights several of these forces.

**Negative headlines in 2013 contributed to large muni bond fund net outflows.**




Sources: BofA/Merrill Lynch, Thomson Reuters, Lipper Analytical Services as of March 31, 2014.

**At Eaton Vance, we value independent thinking.**
In our experience, clients benefit from a range of distinctive, strongly argued perspectives.
That's why we encourage our independent investment teams and strategists to share their views on pressing issues–even when they run counter to conventional wisdom or the opinions of other investment managers.
**Timely Thinking. Timeless Values.**

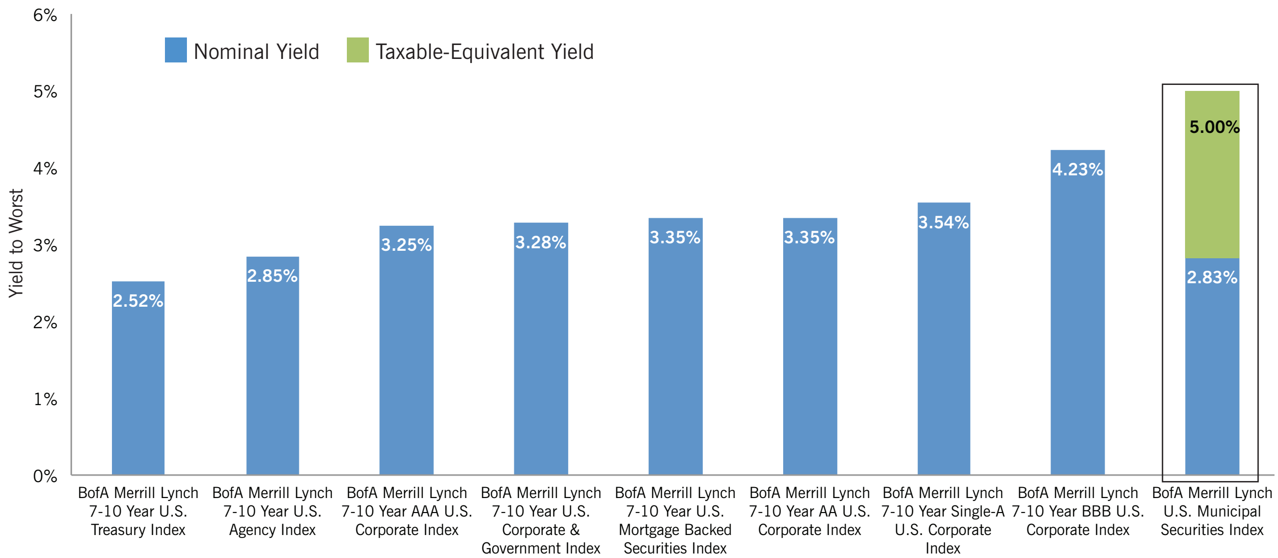
Despite recent negative headlines, which we have written about extensively over the past several months, we think that investors are overlooking four reasons that munis remain compelling:

- The impact of higher taxes has not been fully recognized.
- A steep muni yield curve has historically resulted in outperformance for intermediate- and long-term bonds.
- A steeper yield curve may help increase the total return potential in a rising interest-rate environment by "rolling down" the yield curve.[1]
- Patient muni investors have historically been rewarded in the year after a period of heavy outflows. However, past performance is no guarantee of future results.
- High-yield muni bonds may offer attractive income potential for investors searching for yield.

We begin our outlook for 2014 with a closer look at how the realization of higher tax rates may increase the attractiveness of muni bonds in the coming months.

## 1. Higher tax rates will shine a light on tax-exempt munis in 2014.

**Higher tax rates make municipals attractive relative to other taxable bond sectors.**



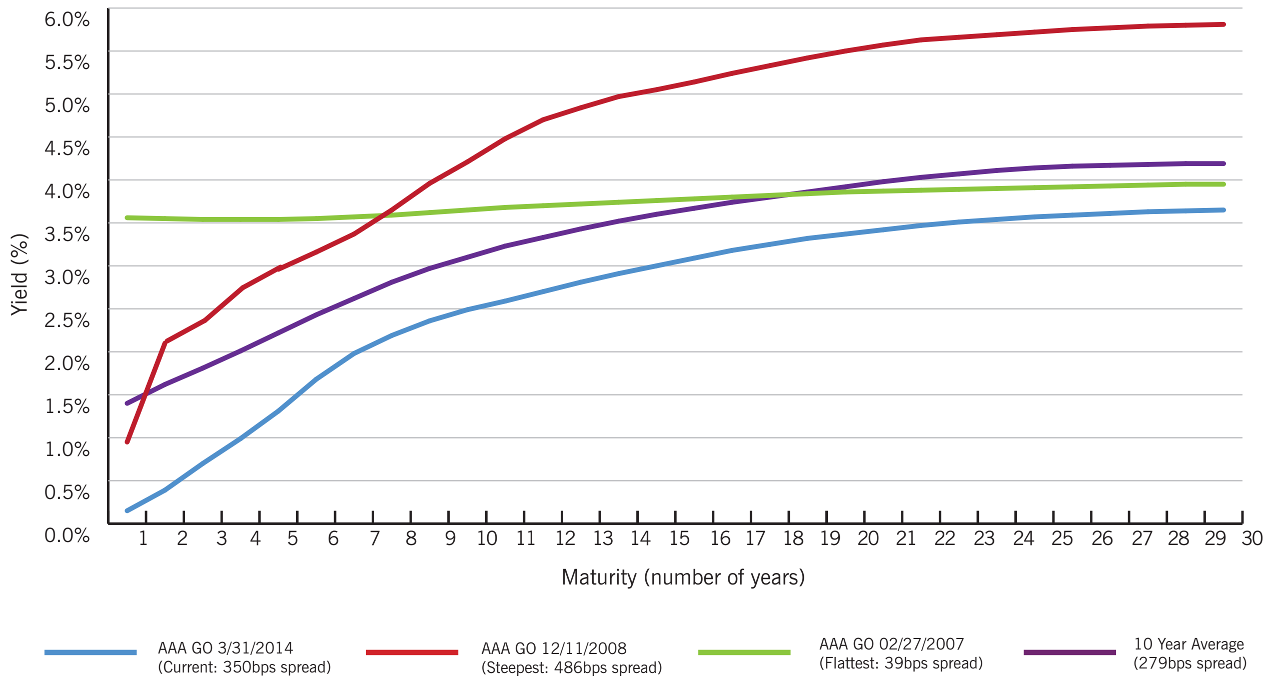

Source: BofA Merrill Lynch as of 3/31/2014. Yield to Worst is a measure that reflects the lowest potential yield earned on a bond without the issuer defaulting. Taxable-equivalent yield refers to the yield an investor in a particular tax bracket would have to earn on a taxable investment to have the same after-tax yield as on a given tax-free security such as a municipal bond. Assumes the new 2013 maximum rate of 43.4%. A portion of income may be subject to federal income and/or alternative minimum tax. The after-tax return for the investor may be even higher when the municipal exemption from state taxes is also included. Please refer to the end of this Insight for important disclosures and index definitions. The broader muni index was chosen because of similar duration and average maturity to the other indexes.

- The realization of higher tax rates effective in 2013 after the April 15 tax deadline will likely bring positive attention to tax-exempt munis as a potential tax management tool. Given the increase in tax rates in 2013, munis appear to be attractive on a tax-adjusted basis compared to other fixed-income alternatives, as the chart above illustrates.
- As of March 31, 2014, munis (as measured by the BofA Merrill Lynch U.S. Municipal Securities Index) were yielding 2.83% on a pretax basis. Under the 2012 maximum tax rate of 35%, that is equivalent to a 4.35% taxable instrument. But under the new 2013 maximum rate of 43.4%, which includes the new tax from the Affordable Care Act, the taxable-equivalent rate jumps to 5.00%. It is rare in the investing world to receive an extra benefit without also boosting risk, but that is the case here, courtesy of rising tax rates.
- AAA-rated municipals on the long end of the curve yield over 100% of similar-maturity Treasury securities (as of March 31, 2014). Historically, when investors have purchased municipal bonds at high ratios, they have experienced outperformance. Past performance is no guarantee of future results.
- We think there is a decreased probability of comprehensive tax reform in 2014, which would keep the tax-exempt status of munis intact for the foreseeable future.

[1]"Rolling down" the yield curve refers to a bond's increase in price as the bond moves closer to its maturity date, all other factors being equal.

## 2. Intermediate- and long-term bonds may outperform if the yield curve flattens.

**As of March 31, 2014, the muni yield curve is nearly as steep as during the credit crisis in December 2008.**

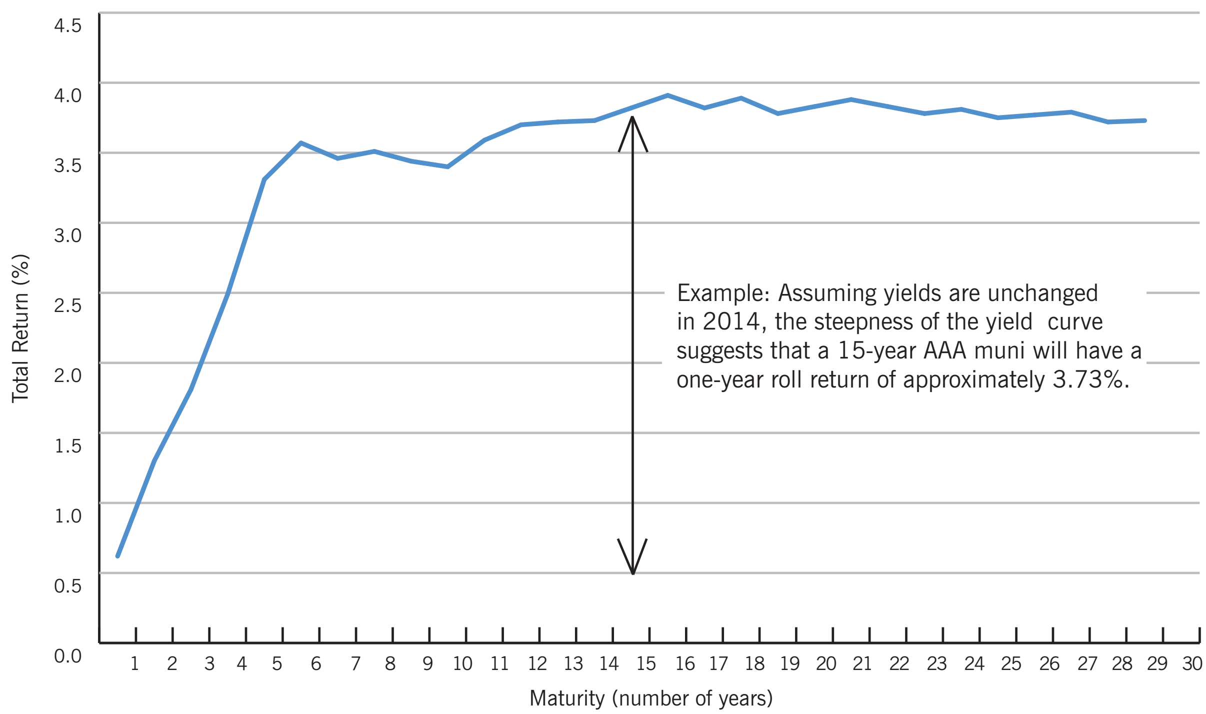



Source: Thompson Reuters, Municipal Market Data as of 3/31/2014.

- The municipal yield curve steepened in 2013, a result of a declining preference for longer-dated bonds and short-term rates anchored near zero. The first quarter of 2014 with the spread between AAA 2- and 30-year bonds at 350 basis points (bps), 100bps wider compared to the start of 2013 and only 136 basis points from the widest spread in 2008.
- Historically, the yield curve flattens when the economy improves. Though we believe it is unlikely that the Fed will raise the fed funds rate in 2014, we feel that with an improving economy, ultimately a flattening of the yield curve will occur. In this possible scenario, intermediate-and long-term bonds may outperform short-term bonds.
- It is important to remember that, historically, muni credit improves as the economy strengthens. Indeed, Moody's revised its broad 2014 outlook for U.S. local governments to stable from negative as housing markets continue to stabilize and municipalities' fund balances remain stable. In addition, revenues are higher and balance sheets are improving. Despite the headlines involving Detroit's record bankruptcy filing, the muni default rate for 2013 remained low at 0.23%, according to Municipal Market Advisors.
- The aforementioned steeper yield curve increases the total return potential associated with simply "rolling down" the yield curve. This may be attractive to investors in a rising interest-rate environment.

## 3. A steeper yield curve enhances yield curve roll opportunities.

**Looking at the one-year roll return, the long end of the curve appears to show the most value (as of March 31, 2014).**

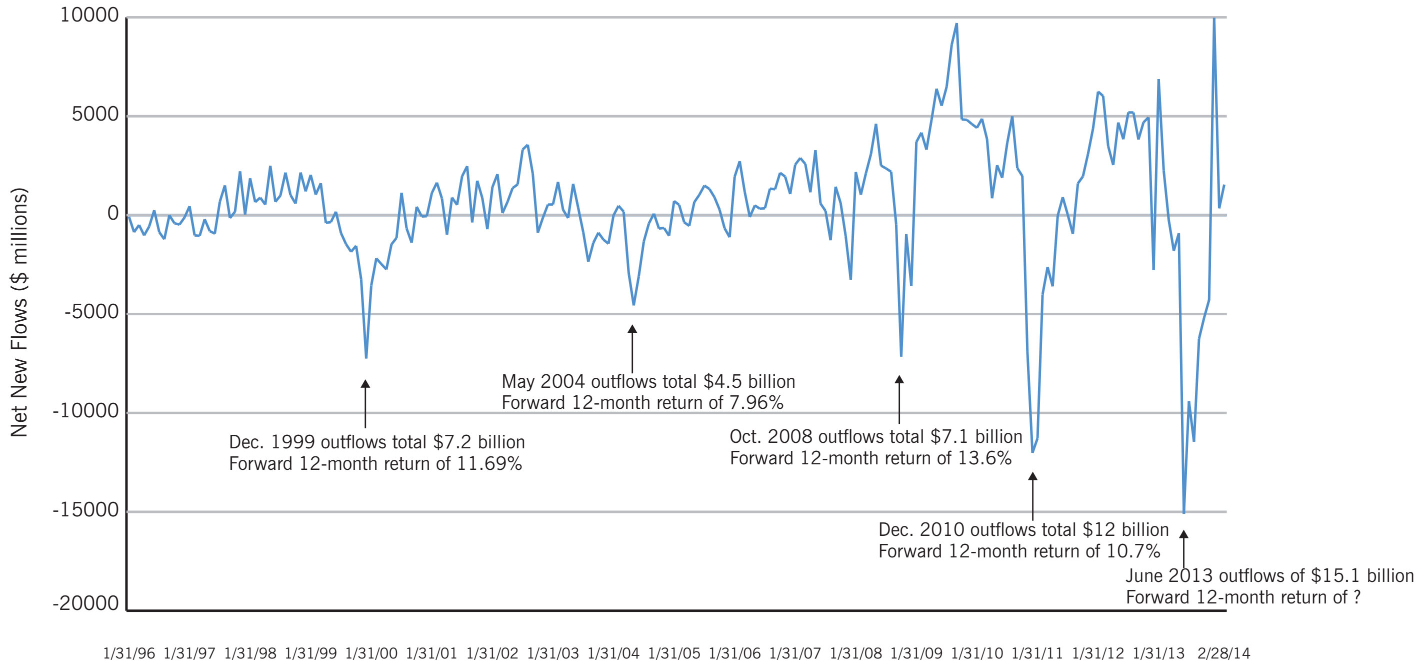



Sources: Thompson Reuters, Municipal Market Data as of 3/31/2014. For illustrative purposes only and is not to be construed as a recommendation of any security or investment.

- As of March 31, 2014, the longer end of the yield curve may offer the greatest roll return potential. As the chart above shows, in a flat-to-modestly higher yield environment, bonds with maturities of 7+ years may offer better returns than those with shorter maturities.
- Unlike most other major asset classes, demand for municipal bonds historically has been driven largely by individual retail investors, who comprise approximately 70% of the muni market, making the asset class very susceptible to negative headlines. We believe that this type of volatility in the muni market can drive investors to make a bad decision at the wrong time.

## 4. Munis have historically had positive returns after periods of heavy outflows[2].

**Periods of heavy muni outflows have been followed historically with positives returns for the asset class.**



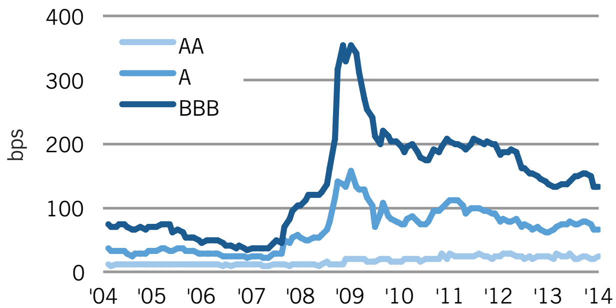

Sources: Investment Company Institute, Barclays Capital as of 3/31/2014. Returns are represented by the Barclays Capital Municipals Bond Index, an unmanaged index of municipal bonds traded in the U.S. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

- In 2013, fear from negative headlines on select muni issuers combined with worry that the Fed would taper its QE, elevating concerns about downside risk in muni portfolios. Investors began to question their existing muni exposures and found it hard to justify any new allocation to the asset class, leading to outflows.
- In recent history, outsized outflows from the asset class have been followed by positive returns, rewarding patient investors. However, past performance is no guarantee of future results. In a balanced asset allocation, we believe investors should consider having exposure to tax-exempt munis.

[2]Past performance is no guarantee of future results.

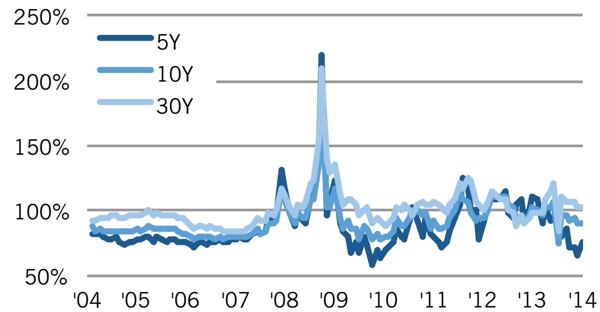
## 5. High-yield muni bonds offer higher tax-exempt income and attractive valuations.

**Credit quality spreads vs. AAA**




| | AA | A | BBB |
|---|---|---|---|
| **Current** | 23 | 68 | 132 |
| **Average** | 17 | 65 | 137 |
| **Median** | 17 | 68 | 138 |
| **High** | 32 | 160 | 354 |
| **Low** | 8 | 21 | 32 |

**AAA muni-to-Treasury yield ratios (%)**




| | 5Y | 10Y | 30Y |
|---|---|---|---|
| **Current** | 76 | 91 | 103 |
| **Average** | 88 | 92 | 102 |
| **Median** | 81 | 89 | 99 |
| **High** | 220 | 187 | 209 |
| **Low** | 59 | 75 | 84 |

Source: Barclays Capital as of 3/31/2014. Data provided are for informational use only. Past performance is no guarantee of future results. Please see the end of this Insight for important additional information.

- High-yield munis may be an attractive option for investors to consider. Compared to high-quality muni bonds, high-yield munis have generally less interest-rate sensitivity, higher tax-exempt income and valuations suggesting a potential opportunity (as of 3/31/2014).

- The Fed continues to taper its asset purchases, which is moving up expectations for higher interest rates. In this environment, income investors remain focused on the triple challenge of low yields, a rising tax bite and the potential threat to bond values brought on by higher rates.

- As the chart above shows, BBB-rated muni spreads remain significantly wider than the lows of the last cycle. Discounted valuations may translate to potential upside opportunity. The highest income potential appears to lie in longer-dated, BBB-rated munis.

**The importance of professional management in 2014.**

Thanks to an improving U.S. economy, the credit outlook for the majority of muni issuers is optimistic. Issuer revenues are higher and balance sheets are improving. These positive trends contributed to a current muni default rate of 0.23%, putting munis in good standing in early 2014.

While conditions in the U.S. economy are generally improving, given the size and the disparity of the muni bond market, credit research remains paramount. With more than 60,000 different issuers, over one million CUSIPs and about $3.7 trillion outstanding, making generalizations about the broad muni market's outlook is challenging, if not impossible. As we have cautioned in the past, there are likely to be one-off situations in which a particular muni issuer incurs credit stress. Individual investors need to be mindful of these potential land mines among the vast number of muni issuers. Detroit's record bankruptcy during the past year is one example. In our view, these investors may benefit from skilled professional management and credit research.

## Index definitions

**BofA Merrill Lynch 7-10 Year AA U.S. Corporate Index** is an unmanaged index that tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market with a remaining term to final maturity greater than or equal to 7 years and less than 10 years and rated AA1 through AA3, inclusive.

**BofA Merrill Lynch 7-10 Year AAA U.S. Corporate Index** is an unmanaged index that tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market with a remaining term to final maturity greater than or equal to 7 years and less than 10 years and rated AAA.

**BofA Merrill Lynch 7-10 Year BBB U.S. Corporate Index** is an unmanaged index that tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market with a remaining term to final maturity greater than or equal to 7 years and less than 10 years and rated BBB1 through BBB3, inclusive.

**BofA Merrill Lynch 7-10 Year Single-A U.S. Corporate Index** is an unmanaged index that tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market with a remaining term to final maturity greater than or equal to 7 years and less than 10 years and rated A1 through A3, inclusive.

**BofA Merrill Lynch 7-10 Year U.S. Agency Index** is an unmanaged index that tracks the performance of U.S. dollar-denominated U.S. agency senior debt issued in the U.S. domestic market with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.

**BofA Merrill Lynch 7-10 Year U.S. Corporate & Government Index** is an unmanaged index that tracks the performance of U.S. dollar-denominated investment-grade debt publicly issued in the U.S. domestic market, including U.S. Treasury, U.S. agency, foreign government, supranational and corporate securities with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.

**BofA Merrill Lynch 7-10 Year U.S. Mortgage Backed Securities Index** is an unmanaged index that tracks the performance of U.S. dollar-denominated fixed-rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market with an average life greater than or equal to 7 years and less than 10 years.

**BofA Merrill Lynch U.S. Municipal Securities Index** is an unmanaged index that tracks the performance of U.S. dollar-denominated investment-grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market.

**BofA Merrill Lynch 7-10 Year U.S. Treasury Index** tracks the performance of U.S. dollar-denominated sovereign debt publicly issued by the U.S. government in its domestic market with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.

## About Asset Class Comparisons

Elements of this report include comparisons of different asset classes, each of which has distinct risk and return characteristics. Every investment carries risk, and principal values and performance will fluctuate with all asset classes shown, sometimes substantially. Asset classes shown are not insured by the FDIC and are not deposits or other obligations of, or guaranteed by, any depository institution. All asset classes shown are subject to risks, including possible loss of principal invested. The principal risks involved with investing in the asset classes shown are interest-rate risk, credit risk and liquidity risk, with each asset class shown offering a distinct combination of these risks. Generally, considered along a spectrum of risks and return potential, U.S. Treasury securities (which are guaranteed as to the payment of principal and interest by the U.S. government) offer lower credit risk, higher levels of liquidity, higher interest-rate risk and lower return potential, whereas asset classes such as high-yield corporate bonds and emerging-market bonds offer higher credit risk, lower levels of liquidity, lower interest-rate risk and higher return potential. Other asset classes shown carry different levels of each of these risk and return characteristics, and as a result generally fall varying degrees along the risk/return spectrum. Costs and expenses associated with investing in asset classes shown will vary, sometimes substantially, depending upon specific investment vehicles chosen. No investment in the asset classes shown is insured or guaranteed, unless explicitly stated for a specific investment vehicle. Interest income earned on asset classes shown is subject to ordinary federal, state and local income taxes, except U.S. Treasury securities (exempt from state and local income taxes) and municipal securities (exempt from federal income taxes, with certain securities exempt from federal, state and local income taxes). In addition, federal and/or state capital gains taxes may apply to investments that are sold at a profit. Eaton Vance does not provide tax or legal advice. Prospective investors should consult with a tax or legal advisor before making any investment decision.

## Disclosure

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**About Risk:** An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. As interest rates rise, the value of certain income investments is likely to decline. Longer-term bonds typically are more sensitive to interest-rate changes than shorter-term bonds. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. A portion of municipal bond income may be subject to alternative minimum tax. Income may be subject to state and local tax.

**Before investing, investors should consider carefully the investment objectives, risks, charges and expenses of a mutual fund. This and other important information is contained in the prospectus and summary prospectus, which can be obtained from a financial advisor. Prospective investors should read the prospectus carefully before investing.**

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Municipal Insight Committee

**Payson Swaffield, CFA**
Chief Income Investment Officer

**Cindy Clemson**
Co-Director of Municipal Investments

**William Delahunty, CFA**
Director of Municipal Research

**Craig Brandon, CFA**
Co-Director of Municipal Investments

**Tom Metzold, CFA**
Senior Portfolio Advisor

**James Evans, CFA**
Director of Tax-Advantaged Bond Strategies

**Michael Sullivan, CFA**
Institutional Portfolio Manager

**Jonathan Rocafort**
Municipal Portfolio Manager