VOLATILITY IN THE BOND MARKETS HIGHLIGHTS ADVANTAGES FOR MUNICIPAL BONDS

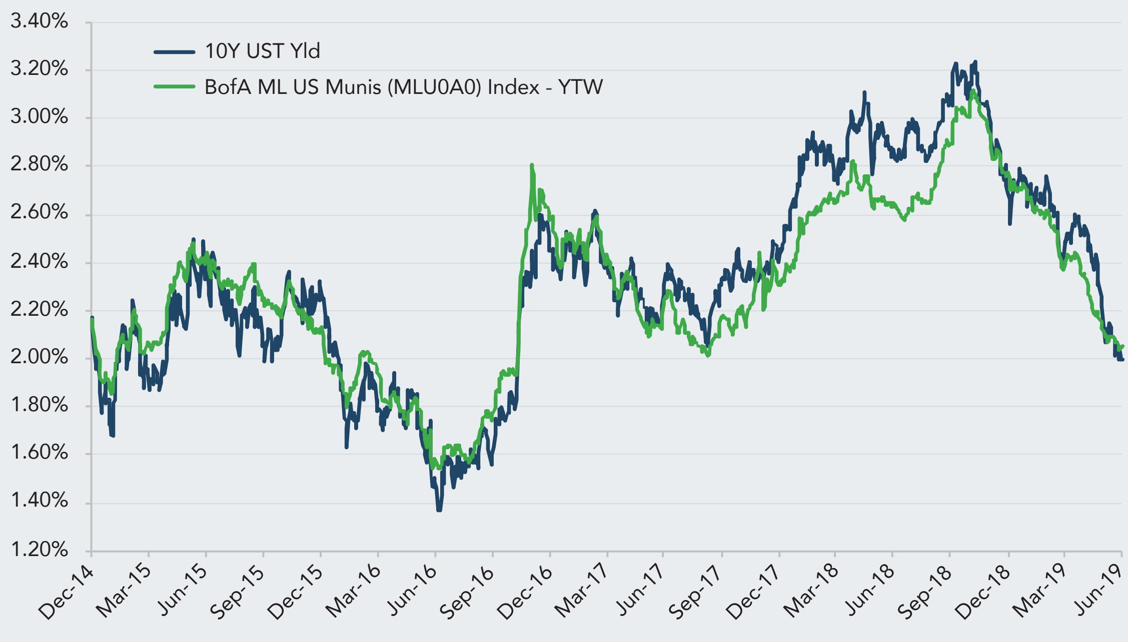
This white paper discusses historical trends in the municipal bond markets. However, there is no guarantee that markets will perform similarly in the future.

Municipal bonds have demonstrated in previous periods of volatility and rising interest rates to have an advantage over other fixed income sectors. The resilience of municipal bond pricing in a rising interest rate environment may be a surprise as there has been an extended period of time since the Federal Open Market Committee (FOMC) raised Federal Fund Rates. Volatility in fixed income investments has investors nervous about potential negative returns and future pricing. While headline news carries a fear factor in order to increase readership, the current move in interest rates and subsequent volatility, has not reached levels experienced in 1994 or 2004, the last two periods of time when the Federal Open Market Committee raised Federal Funds rates. The 1994 and 2004 periods of volatility may be a distant memory to current investors, so sharing a little history may help place our current situation into perspective.

In 1994, the FOMC held interest rates at a then low level around 3.00 percent following the Savings and Loan crisis. From February 1994 to June 1995, the Federal Funds rate moved higher by 300 basis points.
In 2004, the FOMC had eased Federal Funds rates due to the dot com bubble, 9/11 and the first Iraq War. Federal Funds rate was a low 1.00 percent. From June 2004 through June 2006, the Federal Funds rate moved higher by 425 basis points.

In comparison, beginning December 2015, the FOMC have raised Federal Funds rates 25 basis points nine times for a total of 225 basis points as of December 31, 2018. The recent increases by the FOMC have been subdued compared to 1994 or 2004.

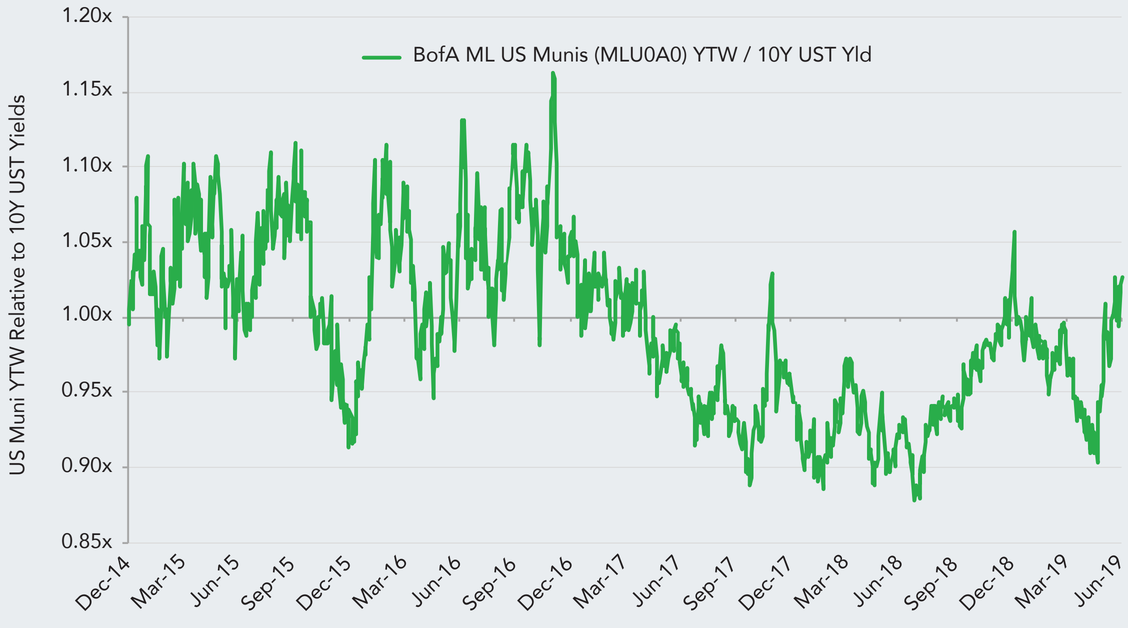
The 10 year Treasury has risen from an intraday low on July 3, 2016 of 1.38 percent, closing near a historical low of 1.42 percent to a high of 3.24 percent November 8, 2018.



Source: FactSet

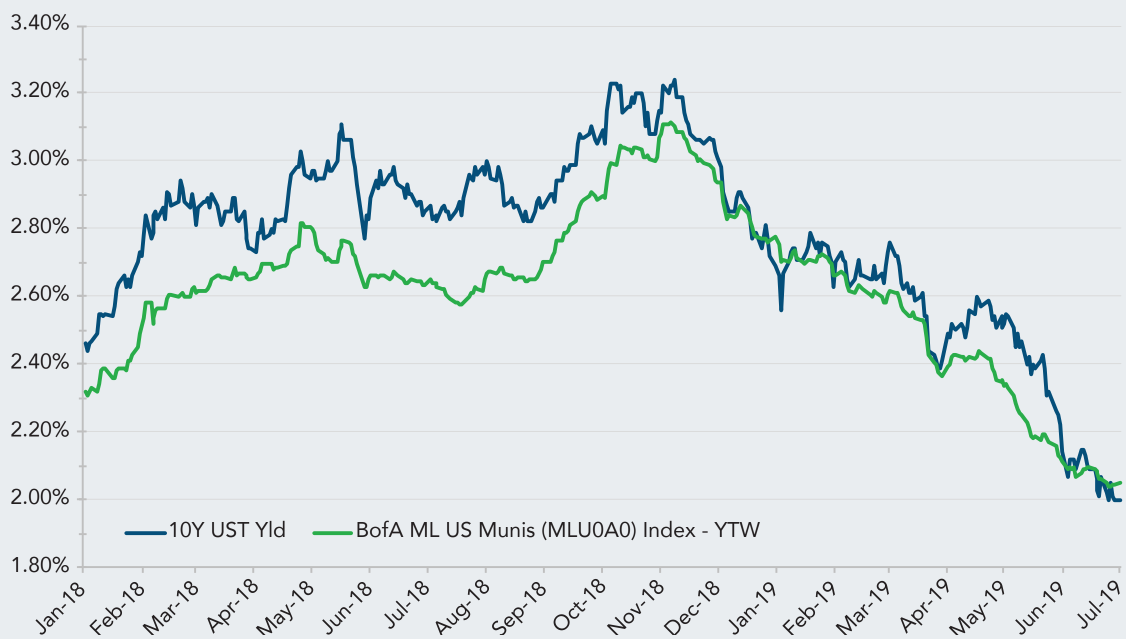
Historically, municipal bond yields have averaged 85 percent of Treasury yields. Since the Great Recession began, the municipal bond yield to Treasury ratios have risen to extreme levels for an extended period of time. This disconnect from the historical ratio between municipal bonds and Treasury has made municipal bonds an absolute best sector to invest for the income portion of asset allocation. This ratio corrected in 1H19 only to reverse back to favoring municipal bonds in May 2019. Occurrence of volatility has increased in the current environment.

Volatility in the Bond Markets Highlights Advantages for Municipal Bonds



Source: FactSet

Interest rate movement on the 10 year Treasury and municipal bond index show yields rising faster on the Treasury than municipal bonds. This also occurred during the interest rate increases in 1994 and 2004 making municipal bonds a preferred holding over other fixed income sectors in a rising interest rate environment. Municipal bonds are currently outperforming other fixed income sectors just as they did in 1994 and 2004.

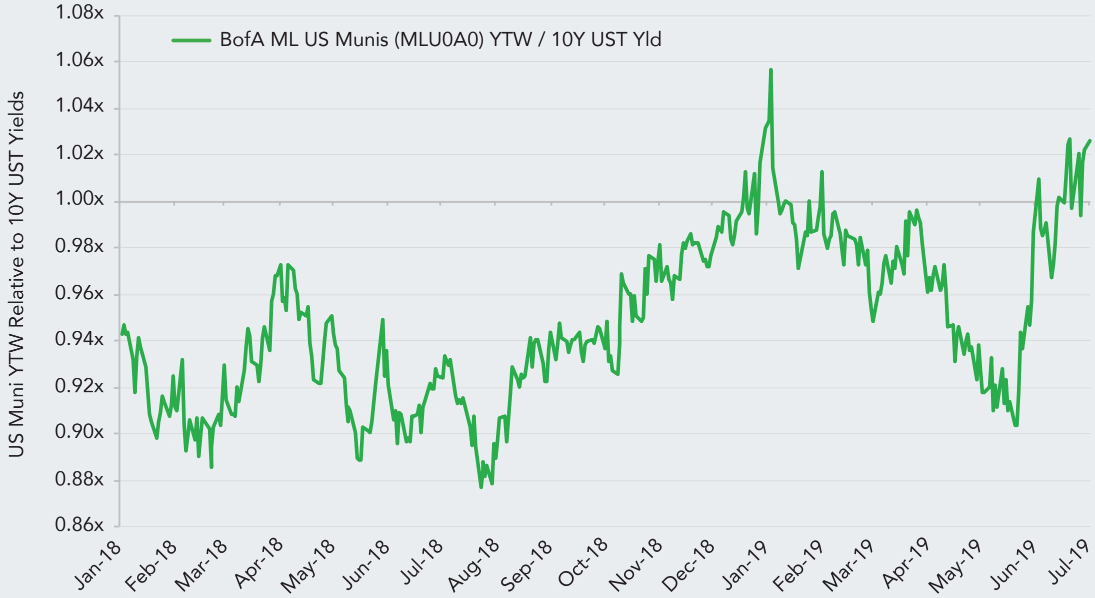


Source: FactSet

Volatility in municipal bond yields, as compared to Treasury yields, has been amplified since the beginning of 2018 and had remained above the historical spread to Treasuries. The first five months of 2019 showed yield to worst on municipal bonds declining relative to 10 Year Treasury yields as municipal bond investors aggressively purchased bonds at an advanced pace. Volatility reversed the downtrend of municipal bond yields when compared to 10 Year Treasuries back into higher territory between May and the end of 2Q19 as Treasury prices increased faster than municipal bonds.

Municipal bonds outperformed other fixed income sectors in 1994 and 2004 under more extreme conditions in terms of the FOMC increasing Federal Funds rates over a shorter period of time as they have outperformed in the current rising rate environment since 2014. In 1994, municipal bond volatility was only 64 percent of Treasuries while in 2004 the volatility to Treasuries was just 52 percent. Many future factors still exist that can alter the current status of municipal bonds outperforming other fixed income sectors but if history is repeatable, municipal bonds may hold an advantage for individuals, Trusts and certain business entities that are in the higher tax brackets. With interest rates declining in the 1H19, volatility shifts back to favor a shorter duration to reduce risk.

Past performance does not guarantee future results. Investing in municipal bonds involves risks including, but not limited to, interest rate risk (the value of a bond will drop if interest rates rise) and credit risk (the risk that the bond issuer may be unable to pay interest and repay principal as agreed).



Source: FactSet

About Crossmark's 30 Year History

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