March 2020

Perspective from Franklin Templeton Fixed Income

Navigating the Muni Market in Today's Environment

As coronavirus-related market volatility expands into municipal bonds, the Franklin Municipal Bond Department explains how they are navigating an increasingly challenging muni-market environment. They also share reasons why they believe a longstanding preference for high-quality municipal bonds supports their efforts to turn volatility into opportunity.

As volatility due to the global coronavirus outbreak picked up across financial markets in late February and into early March, the municipal bond market seemed relatively impervious at first. Then, during the second week of March, the muni market experienced one of its worst single-day price declines over the last decade.[1]

In our view, it's premature to predict the full impact of the coronavirus outbreak on society and the US and global economies until the impacts of the COVID-19 pandemic are behind us. However, as the global market turmoil has carried over into munis—a unique corner of the US fixed income market—we wanted to highlight some of the key factors that have rapidly combined to create a much more volatile investment environment, one that we believe our strategies are relatively well-positioned to navigate.

In the United States, the recent selloff in municipals has felt similar to the global financial crisis just over a decade ago, with US Treasuries seemingly presenting the only safe haven in the minds of many investors.

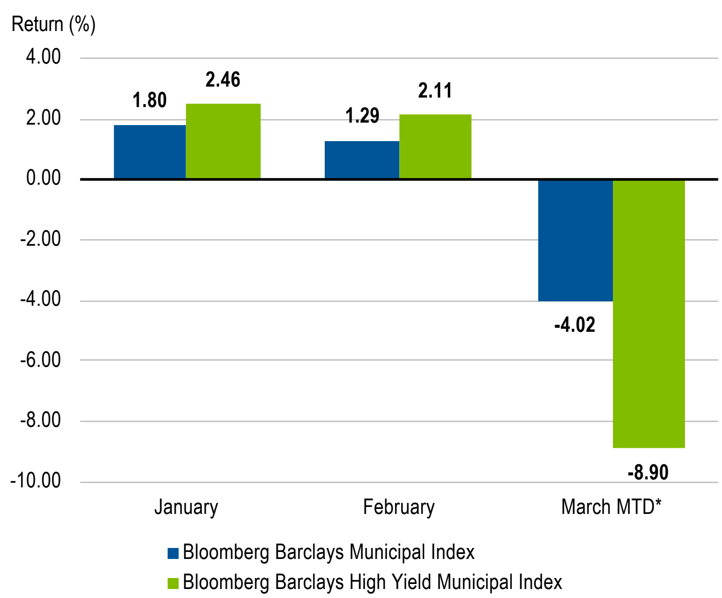
Although uncertainty related to the coronavirus outbreak has been the main reason for muni-market volatility, we have seen a number of other contributing factors as well.

For example, the oil shock that began to hit corporate bond markets in late February and has since gained steam, has started to play a more meaningful role in the municipal market. Another key factor contributing to the recent declines is the fact that the municipal market has recently transitioned to net redemptions after experiencing record cashflows in 2019 and the first two months of 2020. The entire municipal market has sold off, but this may be one reason why high yield has been hit hardest, a risk we highlighted in detail in a previous article in January.

After returning 4.62% for the year-to-date (YTD) through February, the Bloomberg Barclays High Yield Index returned -8.67% during the week of March 9, leaving YTD returns at -4.68% as of 3/13/20.[2]

Municipal Bond Market Sees Broad Selloff In March

As of March 13, 2020



Sources: Bloomberg Barclays Municipal Indexes, Morningstar Direct. *MTD as of March 13, 2020. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. For illustrative purposes only and not reflective of the performance or portfolio composition of any Franklin Templeton Fund. **Past performance is not an indicator or a guarantee of future results.**

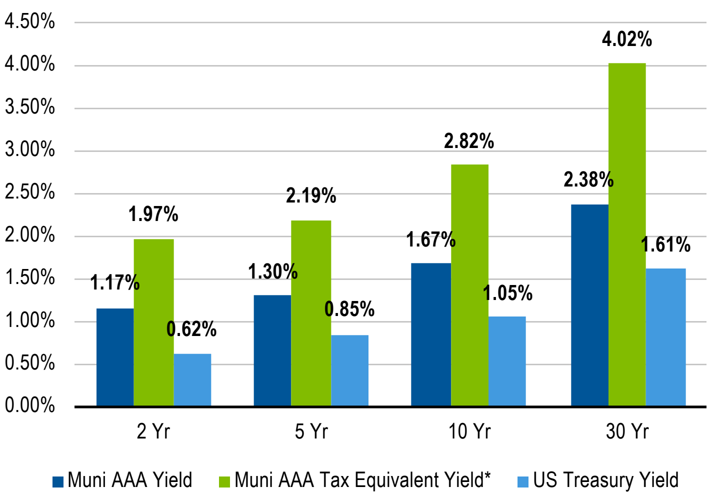
Implications for Municipal Investors

Although we believe certain credits and sectors are more likely to be negatively impacted by these factors than others, the recent selloff has been indiscriminate in nature, hitting broad swaths of the municipal market and creating attractive opportunities for some tax-sensitive investors.

We entered this downturn coming off a strong economy, and we think many state and local governments, as well as most municipal issuers, are fairly well-positioned heading into this crisis. After the recent selloff, even the highest-rated segment of the municipal bond market (AAA) far outyields US Treasuries across the yield curve, and short-term AAA munis are actually outyielding long-term Treasuries in some cases, as the chart below shows.[3] Depending on an investor's tax situation, the yield pick-up provided by municipal bonds versus Treasuries becomes incrementally more compelling.

AAA Municipal Bonds Meaningfully Outyield US Treasuries Across the Curve

As of March 13, 2020



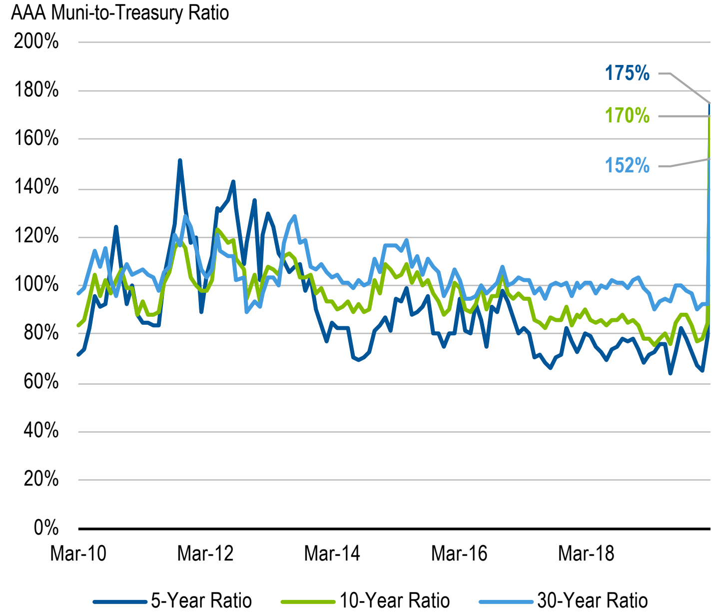
Source: Bloomberg. *Muni AAA Tax Equivalent Yield assumes a top federal tax rate of 40.80%. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed. For illustrative purposes only and not reflective of the performance or portfolio composition of any Franklin Templeton Fund. **Past performance is not an indicator or a guarantee of future results.**

A related measure of relative value to consider is the Municipal-to-Treasury ratio.[4] Muni yields are typically lower than those of Treasuries, as their tax-exempt benefits are priced in to some extent; however, as a ratio approaches and/or exceeds 100%, investors are theoretically able to capture the income tax benefit of municipal bonds at attractive valuations.

Given the magnitude of recent market moves, Muni/Treasury ratios have quickly shot up towards historical highs across the curve. Again, it's important to note that these charts only reflect yields for AAA-rated municipals and that yield potential is even higher when we consider the broader opportunity set.

Muni-Treasury Ratios Have Jumped to Long-Term Highs

As of March 13, 2020



Source: Bloomberg, as of March 13, 2020. For illustrative purposes only and not reflective of the performance or portfolio composition of any Franklin Templeton Fund. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed. **Past performance is not an indicator or a guarantee of future results.**

Franklin's Municipal Approach

As the market has started to show signs of distress amid extreme volatility, credit research will be critical for those looking to capitalize on opportunities created by the recent selloff. Existing portfolio composition will also determine one's ability to be nimble amid a rapidly changing environment, as we believe liquidity dynamics could be very challenging for those with levered positions and significant exposure to non-rated securities, especially if investor outflows persist.

For a number of reasons, we believe our approach to municipal investing is particularly well-suited for the volatile market environment. We have focused on purchasing high-quality bonds over the last several years, even in our high-yield portfolios, as quality spreads have been narrow. We have also maintained exposure to pre-refunded bonds over the past several years. Pre-refunded bonds are the most liquid high-quality bonds in the market, and roughly 11.8% of our investment-grade fund assets are pre-refunded.[5]

Across these investment-grade funds, over 80% of our bonds are rated AAA, AA or A.[6] The preference for quality is even apparent in our national high yield fund, which has an average credit quality of A and holds 15% in pre-refunded securities.[7] Our portfolios have low amounts of non-rated securities and do not use leverage.

Taken together, we believe these characteristics provide favorable liquidity dynamics across our municipal platform, allowing our portfolio managers to move quickly as indiscriminate selling often creates price dislocations for select credits and issuers. With respect to portfolio positioning, we will look to enhance book yields (and thus income distribution levels) in these market conditions, which often allow us to increase income potential without materially changing a portfolio's credit quality or duration profile. Capitalizing on these opportunities is much easier in portfolios with strong liquidity, especially as those with greater liquidity risks become forced sellers in order to meet redemptions.

Our seasoned team of analysts and portfolio managers have navigated very difficult times before, and we are using that knowledge to navigate through this panic. While we recognize that volatility is here to stay given the significant level of uncertainty that will continue to weigh on financial markets, we are confident in our ability to provide relative downside protection for tax-sensitive, income-oriented investors.

Endnotes

1. Source: Bloomberg Barclays Municipal Indexes, as of March 13, 2020. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**
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4. The muni/Treasury ratio is a popular relative value measure, dividing the yield of AAA municipal bonds vs. Treasury yields across the curve.
5. As of February 29, 2020, pre-refunded bonds represented approximately 11.8% of assets across 27 investment-grade funds. Holdings subject to change.
6. As of February 29, 2020, bonds rated AAA, AA or A represented over 80% of assets across 27 investment-grade funds. Holdings subject to change.
7. As of February 29, 2020, Franklin High Yield Tax-Free Income Fund held an average credit quality of A and held 15% in pre-refunded securities. Holdings subject to change.

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WHAT ARE THE RISKS?

Franklin High Yield Tax-Free Income Fund

All investments involve risks, including possible loss of principal. Because municipal bonds are sensitive to interest rate movements, the fund's yield and share price will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in the fund adjust to a rise in interest rates, the fund's share price may decline. Investments in lower-rated bonds include higher risk of default and loss of principal. Puerto Rico municipal bonds have been impacted by recent adverse economic and market changes, which may cause the fund's share price to decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. The fund may invest a significant part of its assets in municipal securities that finance similar types of projects, such as utilities, hospitals, higher education and transportation. A change that affects one project would likely affect all similar projects, thereby increasing market risk

For investors subject to the alternative minimum tax, a small portion of municipal bond fund dividends may be taxable. Distributions of capital gains are generally taxable

Federal and state laws and regulations are complex and subject to change, which can materially impact your results. Always consult your own independent financial professional, attorney or tax advisor for advice regarding your specific goals and individual situation.

Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. Download a prospectus, which contains this and other information. Please carefully read a prospectus before you invest or send money.

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