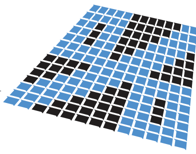


JANUARY 2016 TIMELY THINKING

Municipal bonds in 2016: Stay the course

After two years of outperformance, what's next for muni bonds?

SUMMARY

- Municipal bonds outperformed nearly all other asset classes in 2015, despite challenges presented by Puerto Rico.
- Entering 2016, we think investors should continue to consider municipal bonds as an anchor of their portfolio.
- We think municipal bond investors should continue to focus on tax-equivalent yields, valuations, credit quality and supply/demand dynamics.

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

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.**

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

In the world of fixed income, boring is the new exciting. Given the volatility and credit concerns over the past year in areas like high-yield corporate debt, municipal (muni) bonds enjoyed a notable-yet-uneventful year in 2015. On one hand, muni bonds remarkably outperformed nearly every asset class last year, including U.S. Treasurys and many other fixed-income asset classes. On the other hand, muni bonds' modest return of 3.30% came without the volatility and turmoil experienced in the equity market and other areas of fixed income. Despite negative headlines over Puerto Rico's debt challenges, the muni bond market behaved exactly as we expected: a source of diversification and volatility reduction.

One year ago, we wrote in our 2015 outlook that it would be unlikely for muni bonds to experience the same kind of price appreciation we saw in 2014, when the asset class returned 9.05%. Indeed, the muni market in general behaved as expected last year: stable tax-exempt income and lower price volatility relative to other asset classes. Muni investors clipped their coupon and enjoyed lower volatility relative to other asset classes.

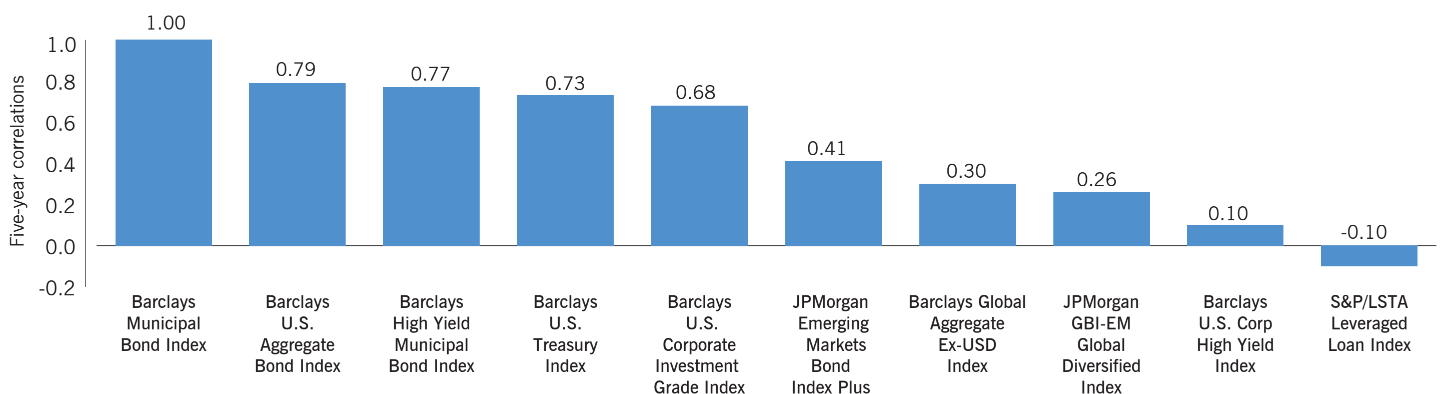
So what's next for municipal bond investors after back-to-back years of outperformance? When considering the asset class in the context of an entire investment portfolio, the case for muni bonds in 2016 remains strong thanks to:

- Income that may be exempt from federal and state taxes.
- Diversification[1] benefits based on low correlations to other asset classes (Exhibit A).
- Generally stable-to-improving credit quality.
- Greater potential of inefficiencies due to the opaque nature of the $3.7 trillion market.

However, credit spreads in the municipal marketplace are relatively tight and valuations are not as compelling as they were a year ago. Despite the current market environment for muni bonds – tight spreads, low rates and rich valuations – we think the muni market is in for a repeat year of investors clipping their coupons. Importantly, we expect muni bonds to provide investor portfolios with diversification benefits, which may be helpful, as volatility is likely to persist in the broader fixed-income market.

In this Insight, we offer our justification for that view by examining our outlook for rates, the muni yield curve, credit quality of muni bond issuers and current valuations, as well as exploring the risks to our outlook for the muni market in 2016. We begin first with a view on rates.

Exhibit A **Munis have low correlation to other fixed-income asset classes.**



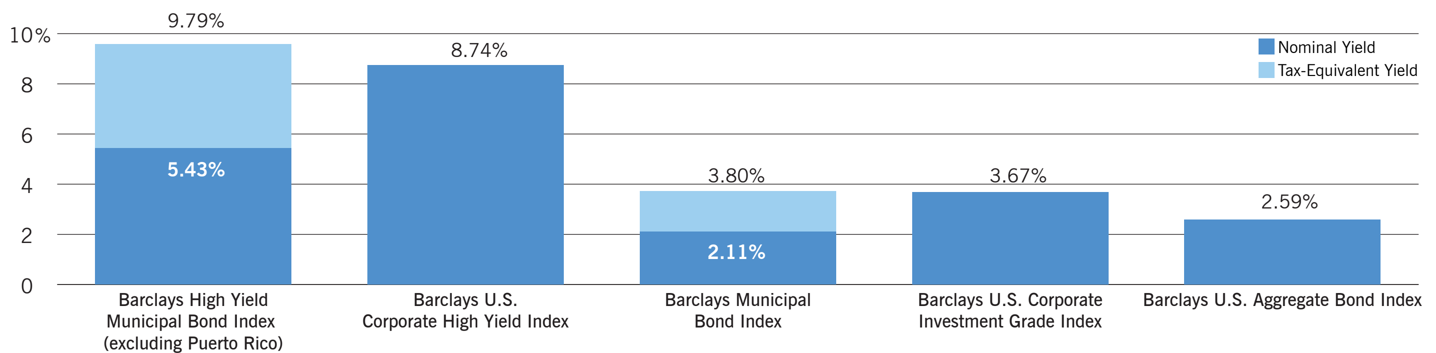
Sources: Barclays, JPMorgan and S&P/LSTA as of 12/31/15. Data provided are for informational use only. Past performance is no guarantee of future results. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Correlation measures how closely the performance of one asset tracks that of another. See end of this Insight for important additional information.

[1]Diversification cannot ensure a profit or eliminate the risk of loss.

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

How quickly will interest rates rise in 2016?

Exhibit B **On a tax-equivalent basis, high-yield municipal bonds provided more income than other fixed-income sectors.**



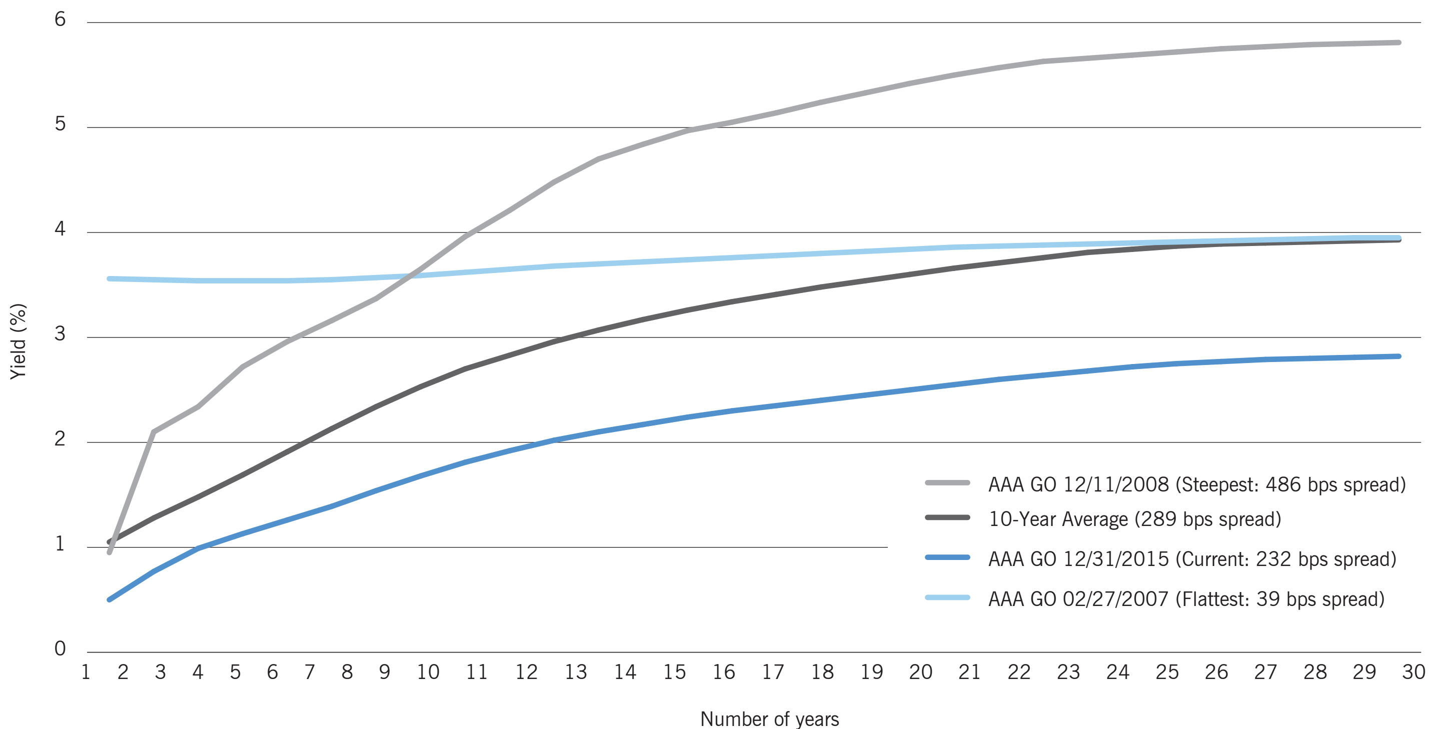
Source: Barclays as of 12/31/2015. Index returns are not managed and it is not possible to invest directly in an index. Past performance is no guarantee of future results. Yield to worst is a measure that reflects the lowest potential yield earned on a bond without the issuer defaulting. Tax-equivalent 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 a maximum rate of 44.59%. 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. See end of this Insight for important additional information. We exclude Puerto Rico from the Barclays High Yield Municipal Bond Index as it represented 23.6% of the Index as of 12/31/2015. As Puerto Rico debt had an average yield of 12.1% as of 12/31/2015, we believe that excluding Puerto Rico from the Index may give investors a more accurate representation of the high-yield municipal bond market.

- Short-term rates rose in 2015 in anticipation of the Fed's December rate increase, but longer-term rates held steady as inflation and growth remained subdued in the U.S.
- Looking ahead, we believe it will continue to be a low-rate environment, as the Fed will not raise the fed funds rate substantially in 2016. Given our outlook of a continued low rate environment, investors who need income may want to consider muni bonds as a source of yield.
- As of December 31, 2015, munis (as measured by the Barclays Municipal Bond Index) were yielding 2.11% on a pretax basis. Under the current maximum rate of 44.59%, which includes the tax from the Affordable Care Act and itemized deduction limitations, the tax-equivalent rate climbs to 3.80%.
- With high tax rates still in effect for the 2016 tax year, we think munis continue to be attractive on a tax-adjusted basis compared to other fixed-income alternatives, as the Exhibit above illustrates.
- Given our view of a generally favorable rate environment, the higher income potential from high-yield muni bonds may be most attractive despite the additional credit risk. That said, we believe that high-yield munis should be a piece of your muni bond exposure, not an entire allocation.
- Additionally, a laddered approach[2] to muni bonds should be considered for a reliable source of income and as a way to protect against a potential rise in interest rates.

[2]A rules-based, equal-weighted approach to municipal bond investing.

Will the muni yield curve flatten?

Exhibit C **The current muni yield curve is flatter than the 10-year average.**



Sources: Thompson Reuters, Municipal Market Data. Data provided are for informational use only. Past performance is no guarantee of future results. All spreads are in basis points. As measured by 1-Year AAA Municipal Market Data (MMD) Index vs. 30-Year AAA Municipal Market Data (MMD) Index, which is an index of AAA-rated general obligation bonds. It is not possible to invest directly in an Index. See end of this Insight for important additional information.

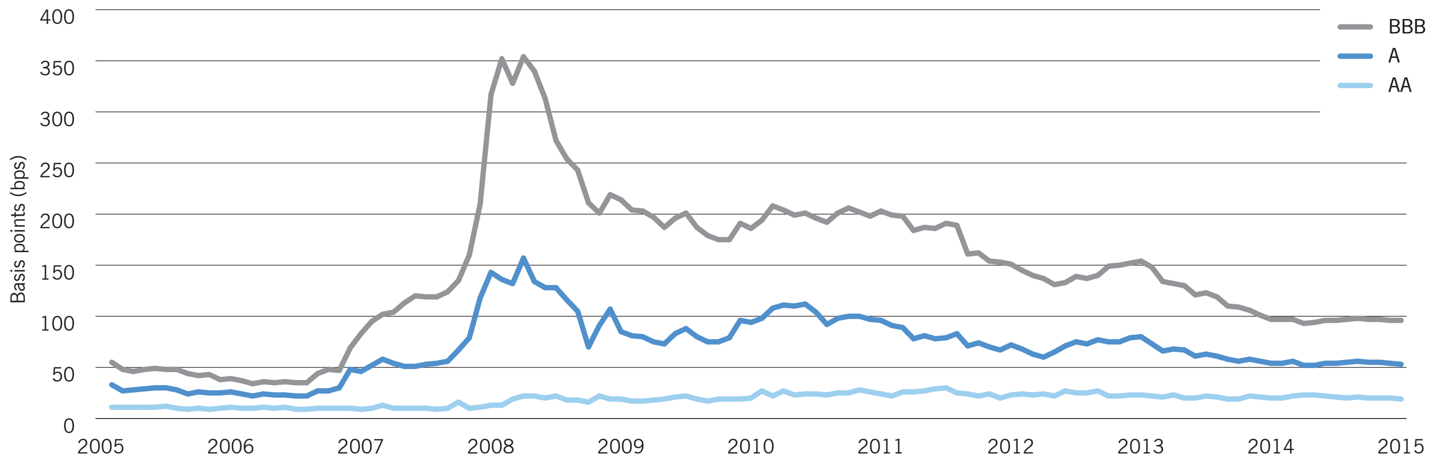
- We saw a slight flattening of the muni yield curve in 2015. At the end of the year, the spread between AAA one- and 30-year bonds was at 232 basis points (bps), slightly below the 10-year average, but still wide of the narrowest spread in 2007.
- As we mentioned, we do not believe that the Fed will raise short-term rates significantly in 2016. Additionally, we think that long bonds could rally due to uncertainty over global growth, which would result in a further flattening of the yield curve.
- Muni bond yields tend to move with U.S. Treasury yields. So, in the possible scenario of a flattening yield curve with short-term rates rising slightly and long-term rates flat-to-falling, we think intermediate- and long-term bonds may outperform short-term bonds.
- Rather than targeting a specific part of the muni yield curve, investors may want to consider an opportunistic, flexible approach to the muni bond market that can adapt to a changing curve.
- As a complement to an opportunistic approach, an equal-weighted muni bond ladder may offer attractive “roll return”[3] as well as potential for outperformance in a continuing flattening scenario.

[3]The roll refers to a bond’s natural movement down a positively sloped yield curve over time.

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

Will muni credit quality continue to improve?

Exhibit D **Muni spreads are narrow, signaling need for selectivity.**



	Current	1 month ago	12 months ago	Median
AA	19	20	20	20
A	53	54	54	68
BBB	96	96	97	138

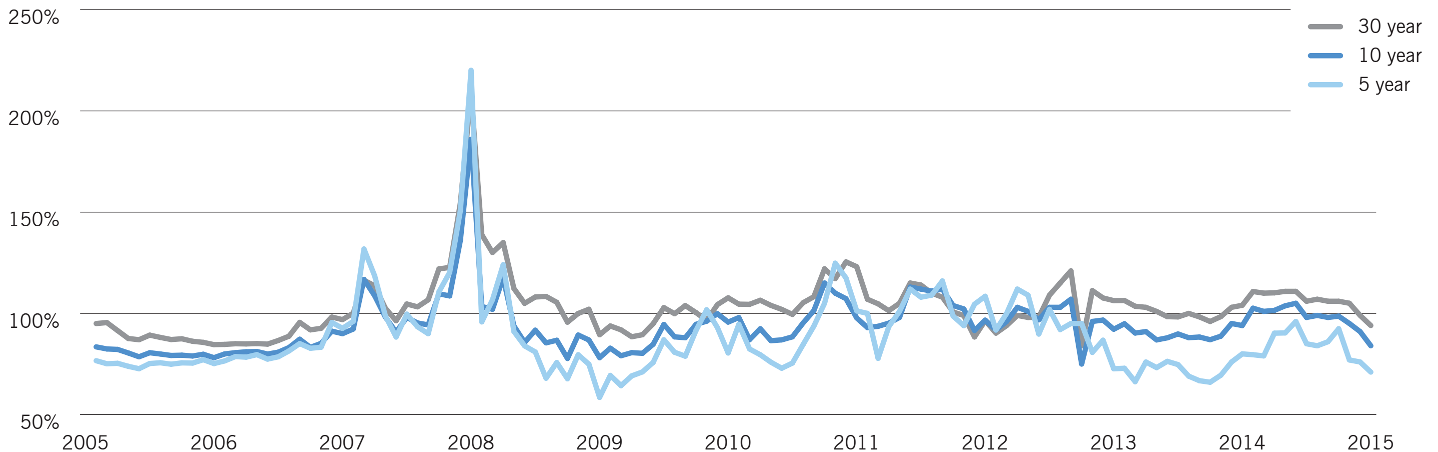
Source: Barclays as of 12/31/15. Data provided are for informational use only. Past performance is no guarantee of future results. See end of this Insight for important additional information. All spreads are in basis points and measure option-adjusted yield spread relative to comparable maturity U.S. Treasurys.

- Thanks to an improving U.S. economy, the credit outlook for the majority of muni issuers is positive. Historically, muni credit has generally improved as the economy has strengthened.
- We think muni issuers' strong credit quality reflects their resiliency in the midst of broader economic themes, which may be a negative for certain other asset classes (e.g., the impact of oil price declines on high-yield debt and equity prices).
- On a year-over-year basis, state tax revenues have increased in 20 out of the last 22 quarters (according to the Rockefeller Institute) thanks to increases in sales and personal income taxes. For 12 straight quarters, S&P Ratings has reported that upgrades have outpaced downgrades.
- Defaults in the muni bond space continue to decline. The positive U.S. economic environment has contributed to a current muni default rate of 0.4%, according to Municipal Market Advisors (MMA). We note that in 2015, unique municipal defaults fell for the fifth straight year, while corporate issuer defaults climbed to the highest level since 2009, also per MMA.
- That said, credit spreads in the muni market are tight. And while it appears that credit is generally improving, the muni space requires careful navigation. Investors may want to consider utilizing an experienced, active manager in order to uncover value, while also avoiding potential landmines.

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

Are muni valuations still compelling?

Exhibit E **AAA muni-to-Treasury yield ratios have fallen over the past year.**



	Current	1 month ago	12 months ago	Median
5 year	71	76	80	83
10 year	84	91	94	92
30 year	94	99	104	102

Source: Barclays as of 12/31/15. Data provided are for informational use only. Past performance is no guarantee of future results. See end of this Insight for important additional information. All spreads are in basis points and measure option-adjusted yield spread relative to comparable maturity U.S. Treasurys.

- After back-to-back years of relative outperformance, AAA-rated municipal-to-Treasury ratios have dropped to levels that indicate muni bonds are not as cheap as they were to begin 2015.
- Similar to our view on tight credit spreads, we think that lower muni-to-Treasury yield ratios highlight the need for active management in 2016.
- Additionally, we think muni-to-Treasury ratios may still have to adjust to a new world of higher tax rates. With higher tax rates on investment income, we think that the muni-to-Treasury ratio would have to be lower than than a range of 85% to 90% in order for 30-year munis to be considered rich.

Risks to our outlook in 2016

Puerto Rico

- It was reassuring to us that despite Puerto Rico debt issues, money flowed into the muni bond market in 2015. That said, we haven't seen a default yet on Puerto Rico's general obligation (GO) bonds. If a default on GO debt occurs, we do not know what impact that will have on the broader market.
- Puerto Rico's fiscal situation continues to deteriorate, as revenue estimates for the fiscal year ending June 30, 2016, have been revised down (from $9.8 billion to $9.2 billion) and the Commonwealth's cash flow forecast now shows that it is expected to end the fiscal year with negative $775 million in liquidity.
- If a default by a Puerto Rico issuer disrupts the broader muni market, we would consider any price volatility as an opportunity.

Heading into 2016, key events for Puerto Rico include:

- Issuance of a restructuring proposal to creditors in January.
- Finalizing a restructuring agreement between PREPA (Puerto Rico Electric Power Authority) and its creditors and bond insurers.
- The federal government's response to the crisis (potential Chapter 9 access or financial assistance).
- Significant debt service payments of $400 million in May 2016 and $1.9 billion in July 2016.

Liquidity in the muni market

- Declining broker-dealer inventories have also increased the challenges for individual investors. Due to increased regulations, dealers are allocating less capital to municipal bond holdings, leaving the market without a key stabilizing force during periods of stress and volatility.
- With the potential for increased volatility due to lower liquidity in the muni bond market, we think that active institutional management may provide the opportunity to take advantage of any mispricings in the market.

Supply/demand dynamics

- Over the past few years, a decline in muni bond issuance has been a positive tail wind. We did see an uptick in issuance in 2015, although the supply was easily absorbed by the market. We view this as a positive sign.
- State and local budgets have improved as the financial crisis moves further back in the rearview mirror. These dynamics could help drive muni bond issuance in the future; that greater supply could become a headwind for the market. That said, historically, there has been a long lead time before new issues are brought to market, so we do not anticipate outsized issuance in 2016.
- Demand for tax-exempt income remains strong and broad-based. We believe the prospect for sustained muni bond fund inflows in 2016 is high given the likelihood of low inflation keeping yields lower for longer.

Stay the course

We think it is likely that muni bonds will experience the same "clip-your-coupon" year we experienced in 2015. Given this view – as well as two consecutive years of outperformance – investors may ask why they should stay the course with their muni bond allocation. We believe the basic tenets of holding munis have not changed. We think muni bonds should be an anchor of a portfolio, and the reasons are clear:

- They provide income that is exempt from federal taxes.
- The credit quality of most muni issuers is stable.
- Muni bonds may provide diversification and volatility reduction to an overall portfolio.

With volatility in the bond markets expected to increase in 2016, we think investors should consider muni bonds as part of their overall asset allocation. However, credit research remains very important. With more than 60,000 issuers, over one million CUSIPs and about $3.7 trillion outstanding, we believe skilled professional management and credit research are absolutely necessary to sort through the diverse muni landscape.

In addition, for 2016, we think that there are several timely reasons why investors should favor muni bonds now:

- On a tax-adjusted basis, muni bonds today are among the most attractive fixed-income areas when comparing like credits and maturities.
- With overall credit conditions improving as well as narrow credit spreads, we believe active management can add value and help individual investors navigate the market.
- In terms of relative valuations, muni bonds are not overly rich and may have room for further outperformance as ratios adjust to a new world of higher tax rates.

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

Index Definitions

Barclays Global Aggregate Ex-USD Index is a broad-based measure of global investment-grade fixed-rate debt investments, excluding USD-denominated debt.

Barclays High Yield Municipal Bond Index is an unmanaged index of noninvestment-grade municipal bonds traded in the U.S.

Barclays Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

Barclays U.S. Aggregate Bond Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities.

Barclays U.S. Corporate High Yield Index measures USD-denominated, noninvestment-grade corporate securities.

Barclays U.S. Corporate Investment Grade Index is an unmanaged index that measures the performance of investment-grade corporate securities within the Barclays U.S. Aggregate Bond Index.

Barclays U.S. Treasury Index measures public debt instruments issued by the U.S. Treasury.

JPMorgan Emerging Markets Bond Index Plus (EMBI+) is a market cap-weighted index that measures USD-denominated Brady Bonds, Eurobonds and traded loans issued by sovereign entities.

JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified is an unmanaged index of local currency bonds with maturities of more than one year issued by emerging-market governments.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

Not FDIC Insured | Not Bank Guaranteed | May Lose Value

About Eaton Vance

Eaton Vance is a leading global asset manager whose history dates to 1924. With offices in North America, Europe, Asia and Australia, Eaton Vance and its affiliates offer individuals and institutions a broad array of investment strategies and wealth management solutions. The Company's long record of providing exemplary service, timely innovation and attractive returns through a variety of market conditions has made Eaton Vance the investment manager of choice for many of today's most discerning investors. For more information about Eaton Vance, visit eatonvance.com

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.

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.

Disclosure

Ratings are based on Moody's, S&P or Fitch, as applicable. If securities are rated differently by the ratings agencies, the higher rating is applied. Ratings, which are subject to change, apply to the creditworthiness of the issuers of the underlying securities and not to the Fund or its shares. Credit ratings measure the quality of a bond based on the issuer's creditworthiness, with ratings ranging from AAA, being the highest, to D, being the lowest based on S&P's measures. Ratings of BBB or higher by Standard and Poor's or Fitch (Baa or higher by Moody's) are considered to be investment-grade quality. Credit ratings are based largely on the ratings agency's analysis at the time of rating. The rating assigned to any particular security is not necessarily a reflection of the issuer's current financial condition and does not necessarily reflect its assessment of the volatility of a security's market value or of the liquidity of an investment in the security. Holdings designated as "Not Rated" are not rated by the national ratings agencies stated above.

Laddered Muni Interest Rate Scenario Tool

While rising rates are generally negative for fixed-income investments, laddered portfolios allow investors to take advantage of those rising interest rates by reinvesting proceeds from maturing bonds at higher rates. The result can be positive income and total return even in rapidly rising rate environments. The Laddered Muni Interest Rate Scenario Tool provides customizable fields for initial investment, ladder range, credit quality, interest-rate change and time period.

Visit eatonvance.com/munirladder to get started.
Follow these six steps to understand how laddered municipal portfolios perform in rising interest-rate environments.

1 Enter Initial Investment.
2 Select Minimum Credit Quality.
3 Select Maturity Range.
4 Select National or State Specific.
5 Enter Interest-Rate Increase.
6 Enter Time Period.

ENTER YOUR STARTING INVESTMENT: – $1,000,000 +

SELECT MINIMUM CREDIT RATING: AA | A | BBB

CHOOSE MATURITY START AND END YEAR: 5 – 15

Tax-Free Yield: 1.92%

SELECT STATE: National

TAXABLE INCOME*: Maximum
☑ Or Maximum For All Tax Brackets

Your Tax Rate Summary				
Federal†	State†1	Health Care†2	Deduction Limitations†	Top Tax Rate On Investment Income†3
39.60%	0.00%	3.80%	1.19%	44.59%

Taxable Equivalent Yield: 3.46%

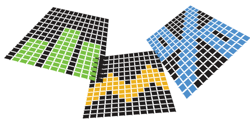
Input Your Rising Rate Scenario

Rates rising – 0.00 % + over – 5 yrs + (0.00% per year)

VIEW CUMULATIVE RETURN DATA OVER: 5 Year | 10 Year

Cumulative Data	Your Ladder: 5 - 15 years	1 - 8 years	1 - 14 years	5 - 15 years	10 - 20 years
Yield at Inception	1.92%	1.13%	1.54%	1.92%	2.33%
Tax-Equivalent Yield at Inception[4]	3.46%	2.04%	2.78%	3.46%	4.21%
5-year Cumulative Coupon Income	$103,766	$72,384	$89,495	$103,766	$122,158
5-year Total Return Cumulative | Annualized	14.42% | 2.73%	9.24% | 1.78%	11.75% | 2.25%	14.42% | 2.73%	16.96% | 3.18%
5-year Tax-Equivalent Total Return Cumulative | Annualized	23.56% | 4.32%	15.33% | 2.89%	19.45% | 3.62%	23.56% | 4.32%	27.97% | 5.06%

The information presented in the scenario tool is for hypothetical and illustrative purposes only. Results may not represent the experience of individual investors, and should not be construed as tax or legal advice. An investor should consult a financial and/or tax professional concerning his or her specific situation before making any financial decisions. The use of tools cannot guarantee performance. Any references to future returns should not be construed as an estimate of the results a client portfolio may achieve. Yields, cumulative income and total return shown do not reflect the effect of fees imposed by an investment manager nor does it reflect the impact of taxes. Fees and taxes will reduce the value of a client's portfolio. Past performance is no guarantee of future results. The simulations presented do not represent the results that any particular investor actually attained. The information presented is based, in part, on hypothetical assumptions entered by the user. No representation or warranty is made as to the reasonableness of the assumptions made or that all the assumptions used in achieving the returns have been stated or fully considered. Simulated results have many inherent limitations and no representation is made that any account will or is likely to profit similar to those shown in the scenarios. Actual performance results may differ, and may differ substantially, from the simulations. Changes in the assumptions may have a material impact on the hypothetical results presented.



Income | Volatility | Taxes
Strategies. For times like these.

Eaton Vance offers strategies to help meet three of today's most important investment challenges—Income, Volatility and Taxes. Explore our broad range of strategies to address these issues at **eatonvance.com/IVT.**

For more information visit **eatonvance.com/munis**

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

Adam Weigold, CFA
Senior Municipal Portfolio Manager

Evan Rouke, CFA
Municipal Portfolio Manager

James Evans, CFA
Director of Tax-Advantaged Bond Strategies

Jonathan Rocafort
Municipal Portfolio Manager

Michael Sullivan, CFA
Institutional Portfolio Manager

The views expressed in this insight are those of the authors and are current only through the date stated at the top of this page. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance fund. Eaton Vance does not provide legal or tax advice. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness. Individuals should consult their own legal and tax counsel as to matters discussed.

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.

©2016 Eaton Vance Distributors, Inc. | Member FINRA/SIPC | Two International Place, Boston, MA 02110 | 800.836.2414 | eatonvance.com