

DEUTSCHE STRATEGIC MUNICIPAL INCOME TRUST
Form N-CSR
February 05, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM N-CSR

Investment Company Act file number: 811-05767

Deutsche Strategic Municipal Income Trust
(Exact Name of Registrant as Specified in Charter)

345 Park Avenue
New York, NY 10154-0004
(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, including Area Code: (212) 250-3220

Paul Schubert
60 Wall Street
New York, NY 10005
(Name and Address of Agent for Service)

Date of fiscal year end: 11/30

Date of reporting period: 11/30/2014

ITEM 1. REPORT TO STOCKHOLDERS

November 30, 2014

Annual Report

to Shareholders

Deutsche Strategic Municipal Income Trust
(formerly DWS Strategic Municipal Income Trust)

Ticker Symbol: KSM

Contents

4 Portfolio Management Review

10 Performance Summary

12 Investment Portfolio

24 Statement of Assets and Liabilities

<u>25</u>	Statement of Operations
<u>26</u>	Statement of Cash Flows
<u>27</u>	Statement of Changes in Net Assets
<u>28</u>	Financial Highlights
<u>30</u>	Notes to Financial Statements
<u>39</u>	Report of Independent Registered Public Accounting Firm
<u>40</u>	Tax Information
<u>40</u>	Other Information
<u>41</u>	Shareholder Meeting Results
<u>42</u>	Dividend Reinvestment and Cash Purchase Plan
<u>45</u>	Advisory Agreement Board Considerations and Fee Evaluation
<u>49</u>	Board Members and Officers
<u>54</u>	Additional Information

The fund's investment objective is to provide a high level of current income exempt from federal income tax.

Closed-end funds, unlike open-end funds, are not continuously offered. There is a one time public offering and once issued, shares of closed-end funds are sold in the open market through a stock exchange. Shares of closed-end funds frequently trade at a discount to net asset value. The price of the fund's shares is determined by a number of factors, several of which are beyond the control of the fund. Therefore, the fund cannot predict whether its shares will trade at, below or above net asset value.

Bond investments are subject to interest-rate, credit, liquidity and market risks to varying degrees. When interest rates rise, bond prices generally fall. Credit risk refers to the ability of an issuer to make timely payments of principal and interest. Investing in derivatives entails special risks relating to liquidity, leverage and credit that may reduce returns and/or increase volatility. Leverage results in additional risks and can magnify the effect of any gains or losses. Although the fund seeks income that is exempt from federal income taxes, a portion of the fund's distributions may be subject to federal, state and local taxes, including the alternative minimum tax.

Deutsche Asset & Wealth Management represents the asset management and wealth management activities conducted by Deutsche Bank AG or any of its subsidiaries, including the Advisor and DeAWM Distributors, Inc.

NOT FDIC/NCUA INSURED NO BANK GUARANTEE MAY LOSE VALUE NOT A DEPOSIT NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY

Portfolio Management Review (Unaudited)

Market Overview and Fund Performance

All performance information below is historical and does not guarantee future results. Investment return and principal fluctuate, so your shares may be worth more or less when sold. Current performance may differ from performance data shown. Please visit deutschefunds.com for the fund's most recent month-end performance. Fund performance includes reinvestment of all distributions. Please refer to pages 10 through 11 for more complete performance information.

Investment Process

The fund's investment objective is to provide a high level of current income exempt from federal income tax. The fund will invest at least 50% of its assets in investment-grade or unrated municipal securities of comparable quality and may invest up to 50% of its assets in high-yield municipal securities that are below investment grade. The lowest-quality municipal securities in which the fund will invest are those rated B by Moody's Investors

Service, Inc. or B- by Standard & Poor's Corporation or unrated municipal securities, which, in the opinion of the fund's investment advisor, have credit characteristics equivalent to, and will be of comparable quality to, such B or B- rated municipal securities.

Deutsche Strategic Municipal Income Trust returned 13.80% based on net asset value for the annual period ended November 30, 2014, while the fund's benchmark, the unmanaged, unleveraged Barclays Municipal Bond Index, returned 8.23% for the 12-month period. Municipals overall outperformed the broad taxable bond market, as measured by the Barclays Aggregate Bond Index, which returned 5.27% for the same period. The fund's return based on market price was 16.96%. Over the period, the fund's traded shares went from a discount of 2.48% to a premium of 0.23%. The fund maintained its monthly dividend of 7.7 cents per share through the fiscal period.

While bond issuance picked up over the last few months, supply overall was manageable for the 12-month period ending November 30, 2014. The picture was also supportive on the demand side as mutual funds, a major source of demand for municipal markets, experienced consistent strong inflows. Early in the period, with municipals at relatively inexpensive levels, there was significant demand from both retail investors and institutional investors traditionally more focused on the taxable market.

"The municipal yield curve flattened over the period, mostly via rate declines on longer-term issues."

With inflation remaining moderate and ongoing concerns over the subpar employment picture, the U.S. Federal Reserve Board (the Fed) kept the target for its benchmark short-term interest rate between 0% and 0.25% for the entire period ending November 30, 2014. While the Fed tapered and eventually ended its purchases of government bonds during the period, markets took this in stride and long-term interest rates declined over the 12 months. With short-term rates anchored by the Fed, the municipal yield curve flattened over the period, mostly via rate declines on longer-term issues. (When the yield curve is steep, it means that longer-term bonds provide a greater yield advantage vs. short-term bonds.) For the full 12 months ended November 30, 2014, yields on two-year municipal issues rose by 5 basis points, from 0.33% to 0.38%, while bonds with 30-year maturities experienced a yield decrease of 109 basis points, from 4.10% to 3.01%, resulting in a flattening of 114 basis points between two and 30 years. (100 basis points equals one percentage point.) See the graph below for municipal bond yield changes from the beginning to the end of the period.

AAA Municipal Bond Yield Curve (as of 11/30/14 and 11/30/13)

Source: Thompson Reuters as of 11/30/14.

Chart is for illustrative purposes only and does not represent any Deutsche AWM product.

For the 12 months ending November 30, 2014, most municipal market credit spreads — the incremental yield offered by lower-quality issues vs. AAA-rated issues — narrowed, as investors sought sources of higher yields in a low-rate environment.

Positive and Negative Contributors to Performance

The fund has the ability to leverage returns to shareholders through the issuance of preferred shares for which dividend rates are generally tied to short-term interest rates. With the Fed anchoring short-term rates near zero, the fund's cost of borrowing remained low for the 12 months ended November 30, 2014. The use of leverage was a positive for total return given rising municipal prices over the period.

Given a meaningfully steep yield curve, the fund has maintained significant exposure to bonds with remaining maturities in the 20-to-30-year range. This helped relative performance, as longer-term issues benefited the most from falling interest rates and rising bond prices.

The fund had significant exposure to bonds in the A- and BBB-quality ranges. This positioning was a positive for performance as credit spreads narrowed overall during the period. The fund's overweighting of hospital, airport revenue and transportation bonds was helpful, as these sectors outperformed. Exposure to Puerto Rico issues detracted from relative performance, as headlines concerning the territory's fiscal challenges led to volatility in those credits.

Relative to its Morningstar peer group, the fund had a higher-quality bias and less exposure to below-investment-grade issues, which acted as a constraint on returns. In particular, the fund has had less exposure to tobacco, as well as to industrial and pollution control revenue bonds, sectors which strongly outperformed.

Outlook and Positioning

Municipal yields on an absolute basis are quite low, but remain attractive vs. taxable alternatives. At the end of November 2014, the 10-year municipal yield of 2.08% was 95% of the 2.20% yield on comparable maturity U.S. Treasuries, as compared to a ratio of 96% twelve months earlier. While the municipal yield curve has flattened considerably, there remains meaningful incremental yield to be gained out on the curve, and we continue to see value in the 20-to-25-year maturity range. With respect to credit spreads, we see selective valuation opportunities among bonds in the AA-quality range, while viewing spreads for most bonds in the A and BBB range as relatively tight.

State and local governments have continued to show progress in stabilizing their finances. State tax receipts have increased for four consecutive fiscal years, and many states have passed pension reform legislation to address unfunded liabilities. Nonetheless, there are also significant uncertainties with respect to the global economic backdrop and the U.S. political environment with the potential to weaken the outlook. In addition, there remain pockets of significant credit stress for municipal governments that have experienced secular economic decline or mismanagement, and smaller and less diverse municipalities with less flexibility to support struggling enterprises. Accordingly, intensive research into individual credits continues to be an important part of the fund's approach.

Portfolio Management Team

Effective October 1, 2014, the fund's portfolio management team is as follows:

Ashton P. Goodfield, CFA, Managing Director

Co-Lead Portfolio Manager of the fund. Began managing the fund in 2014.

— Joined Deutsche Asset & Wealth Management in 1986.

— Co-Head of Municipal Bonds.

— BA, Duke University.

Rebecca L. Flinn, Director

Co-Lead Portfolio Manager of the fund. Began managing the fund in 1998.

— Joined Deutsche Asset & Wealth Management in 1986.

— BA, University of Redlands, California.

A. Gene Caponi, CFA, Managing Director

Portfolio Manager of the fund. Began managing the fund in 2009.

— Joined Deutsche Asset & Wealth Management in 1998.

— BS, State University of New York, Oswego; MBA, State University of New York at Albany.

Carol L. Flynn, CFA, Managing Director

Portfolio Manager of the fund. Began managing the fund in 2014.

— Joined Deutsche Asset & Wealth Management in 1994.

— Co-Head of Municipal Bonds.

— BS, Duke University; MBA, University of Connecticut.

The views expressed reflect those of the portfolio management team only through the end of the period of the report as stated on the cover. The management team's views are subject to change at any time based on market and other conditions and should not be construed as a recommendation. Past performance is no guarantee of future results. Current and future portfolio holdings are subject to risk.

Terms to Know

The unmanaged, unleveraged Barclays Municipal Bond Index covers the U.S.-dollar-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

The Barclays Aggregate Bond Index is an unmanaged, unleveraged index representing domestic taxable investment-grade bonds, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities with average maturities of one year or more.

Index returns do not reflect any fees or expenses and it is not possible to invest directly into an index.

The yield curve is a graphical representation of how yields on bonds of different maturities compare. Normally, yield curves slant up, as bonds with longer maturities typically offer higher yields than short-term bonds.

Credit spread is the additional yield provided by municipal bonds rated AA and below vs. municipals rated AAA with comparable effective maturity.

Leverage is the use of various financial instruments or borrowed capital, such as margin, to increase an investment's potential return.

Overweight means the fund holds a higher weighting in a given sector or security than the benchmark. Underweight means the fund holds a lower weighting.

Credit quality measures a bond issuer's ability to repay interest and principal in a timely manner. Rating agencies assign letter designations, such as AAA, AA and so forth. The lower the rating, the higher the probability of default.

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Credit quality does not remove market risk and is subject to change.

Performance Summary November 30, 2014 (Unaudited)

Performance is historical, assumes reinvestment of all dividend and capital gain distributions, and does not guarantee future results. Investment return and principal value fluctuate with changing market conditions so that, when sold, shares may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Please visit deutschefunds.com for the Fund's most recent month-end performance.

Fund specific data and performance are provided for informational purposes only and are not intended for trading purposes.

Average Annual Total Returns as of 11/30/14

Deutsche Strategic Municipal Income Trust	1-Year	5-Year	10-Year
Based on Net Asset Value(a)	13.80%	9.67%	8.04%
Based on Market Price(a)	16.96%	9.15%	7.96%
Barclays Municipal Bond Index(b)	8.23%	5.12%	4.81%
Morningstar Closed-End High-Yield Municipal Funds Category(c)	15.90%	9.87%	6.44%

(a) Total return based on net asset value reflects changes in the Fund's net asset value during each period. Total return based on market price reflects changes in market price. Each figure assumes that dividend and capital gain distributions, if any, were reinvested. These figures will differ depending upon the level of any discount from or premium to net asset value at which the Fund's shares traded during the period. Expenses of the Fund include management fee, interest expense and other fund expenses. Total returns shown take into account these fees and expenses. The expense ratio of the Fund for the year ended November 30, 2014 was 1.73% (1.20% excluding interest expense).

(b) The unmanaged, unleveraged Barclays Municipal Bond Index covers the U.S. dollar-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds. Index returns do not reflect any fees or expenses and it is not possible to invest directly into an index.

(c) Morningstar's Closed-End High-Yield Municipal Funds category represents high-yield muni portfolios that typically invest at least 50% of assets in high-income municipal securities that are not rated or that are rated by a major agency such as Standard & Poor's or Moody's at the level of BBB and below (considered part of the high-yield universe within the municipal industry). Morningstar figures represent the average of the total returns based on net asset value reported by all of the closed-end funds designated by Morningstar, Inc. as falling into the Closed-End High-Yield Municipal Funds category. Category returns assume reinvestment of all distributions. It is not possible to invest directly in a Morningstar category.

Net Asset Value and Market Price

	As of 11/30/14	As of 11/30/13
Net Asset Value	\$ 13.27	\$ 12.52
Market Price	\$ 13.30	\$ 12.21

Prices and net asset value fluctuate and are not guaranteed.

Distribution Information

Twelve Months as of 11/30/14:

Income Dividends (common shareholders)	\$.92
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Capital Gain Distributions	\$.01	
November Income Dividend (common shareholders)	\$.0770	
Current Annualized Distribution Rate (Based on Net Asset Value) as of 11/30/14†	6.96	%
Current Annualized Distribution Rate (Based on Market Price) as of 11/30/14†	6.95	%
Tax Equivalent Distribution Rate (Based on Net Asset Value) as of 11/30/14†	12.30	%
Tax Equivalent Distribution Rate (Based on Market Price) as of 11/30/14†	12.28	%

† Current annualized distribution rate is the latest monthly dividend shown as an annualized percentage of net asset value/market price on November 30, 2014. Distribution rate simply measures the level of dividends and is not a complete measure of performance. Tax equivalent distribution rate is based on the Fund's distribution rate and a marginal income tax rate of 43.4%. Distribution rates are historical, not guaranteed and will fluctuate. Distributions do not include return of capital or other non-income sources.

Investment Portfolio as of November 30, 2014

	Principal Amount (\$)	Value (\$)
Municipal Bonds and Notes 141.0%		
Arizona 1.2%		
Maricopa County, AZ, Pollution Control Corp. Revenue, El Paso Electric Co. Project, Series B, 7.25%, 4/1/2040	1,570,000	1,848,424
California 14.7%		
California, Health Facilities Financing Authority Revenue, Catholic Healthcare West, Series A, 6.0%, 7/1/2034	1,000,000	1,173,430
California, M-S-R Energy Authority, Series B, 7.0%, 11/1/2034 , GTY: Citigroup, Inc.	1,310,000	1,837,157
California, Morongo Band of Mission Indians, Enterprise Casino Revenue, Series B, 144A, 6.5%, 3/1/2028	1,000,000	1,110,450
California, South Bayside Waste Management Authority, Solid Waste Enterprise, Shoreway Environmental, Series A, 6.25%, 9/1/2029	1,425,000	1,674,561
California, State General Obligation:		
5.0%, 11/1/2043	1,500,000	1,696,335
5.25%, 4/1/2035	1,230,000	1,433,565
5.5%, 3/1/2040	1,000,000	1,150,380
5.75%, 4/1/2031	1,000,000	1,178,660
6.0%, 4/1/2038	1,000,000	1,198,930
6.5%, 4/1/2033	1,950,000	2,382,666
California, State Public Works Board Lease Revenue, Capital Projects, Series I-1, 6.375%, 11/1/2034	1,000,000	1,230,310
California, State Public Works Board Lease Revenue, Riverside Campus Project, Series B, 6.125%, 4/1/2028	2,000,000	2,401,540
Riverside County, CA, Transportation Commission Toll Revenue Senior Lien, Series A, 5.75%, 6/1/2048	1,000,000	1,138,210
San Buenaventura, CA, Community Memorial Health Systems, 7.5%, 12/1/2041	500,000	600,955
San Francisco City & County, CA, Airports Commission, International Airport Revenue, Series A, AMT, 5.0%, 5/1/2044	1,000,000	1,106,400
San Joaquin Hills, CA, Transportation Corridor Agency, Toll Road Revenue, Series A, 5.0%, 1/15/2050	445,000	467,726
		21,781,275
Colorado 2.1%		
Colorado, Public Energy Authority, Natural Gas Purchased Revenue, 6.25%, 11/15/2028 , GTY: Merrill Lynch & Co., Inc.	635,000	815,975