Invesco Fixed Income Investment Insights

U.S. Municipal bond market recap and outlook

Second quarter 2019

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Highlights

- Municipal bonds added to their 2019 gains during the second quarter, benefiting from falling interest rates and supportive market technicals.
- Municipal yields fell along the curve but fell less than US Treasury yields, increasing municipals' attractiveness to individual investors, especially those in high tax states.
- New issuance, which remained low by historical standards, was insufficient to meet voracious demand.

Municipal bonds rallied during the second quarter of 2019, building on strong first-quarter performance. The investment grade municipal bond market generated a return of 2.14%, driven primarily by strength in the hospital and industrial development revenue/pollution control revenue sectors. Lower-rated investment grade credits generally outperformed their higher-quality counterparts. As for the high yield municipal bond market, it produced a return of 2.73% in the second quarter. During the first half of 2019, investment grade bonds and high yield municipal bonds recorded total returns of 5.09% and 6.66%, respectively.[1]

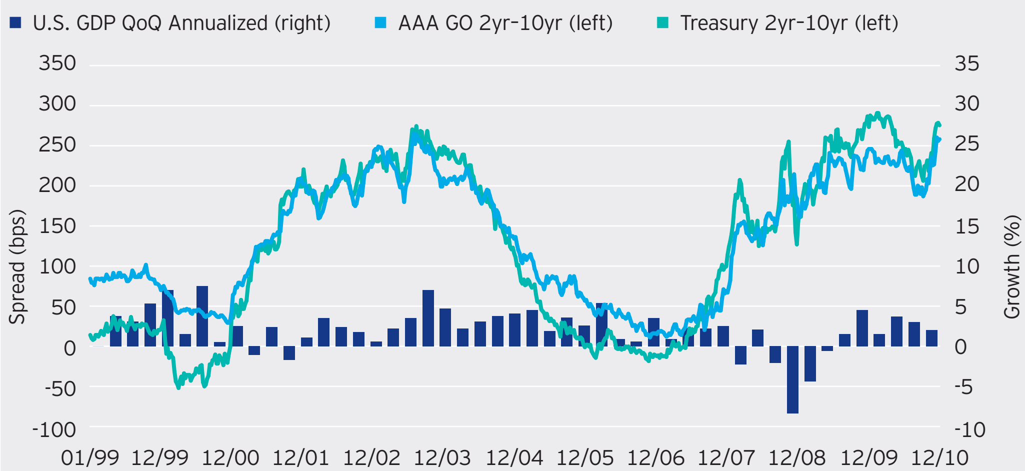
The rally in municipal bonds was driven by a dramatic decline in interest rates, which dropped in response to market expectations of a US Federal Reserve (Fed) rate cut. As the US-China trade dispute escalated, Fed policymakers signaled they were prepared to cut short-term rates in support of the US economy. By the end of the second quarter, the market was pricing in a 100% chance that the Fed would cut the target federal funds rate by 20 to 25 basis points (bps) at its July meeting. (Indeed, on July 31st, the Fed announced a 25 bps rate cut.)

In this environment, municipal yields fell, ending the quarter lower than they started. The yield of a three-year AAA GO fell 24 basis points (bps) to 1.24%, while the yield of a five-year AAA GO dropped 26 bps to 1.31%. The yield of a 10-year AAA GO municipal bonds declined 23 bps to 1.63%, and the yield on a 30-year AAA GO municipal bond decreased 29 bps to 2.31%.[2]

US Treasury yields generally fell further, with yields of three-year, five-year, 10-year and 30-year Treasury bonds decreasing 50, 47, 41 and 29 bps, respectively. The Treasury yield curve, which began the quarter with a partial inversion at the very short end, inverted further amid expectations of a Fed rate cut. By the end of the second quarter, the yield of a one-month Treasury bond was higher than the yield of a 10-year Treasury bond.

However, we were not overly concerned, given that two-year Treasury yields remained lower than 10-year Treasury yields. In a full inversion, two-year Treasury yields rise above 10-year Treasury yields; full inversions have been harbingers of recession for the last 40 years. That said, even if the Treasury yield curve experiences a full inversion, we do not expect the municipal yield curve to invert as well. We think it is more likely to flatten (see Figure 1). The light blue line, representing municipal securities, does not fall below zero, which indicates that the municipal yield curve does not follow the Treasury yield curve into inversion.

Figure 1: The two-year to 10-year portion of the municipal yield curve does not invert before a recession, unlike the Treasury yield curve, though it does flatten



Source: Citigroup, Citi_2019 Mid Year Outlook_6.20.2019.pdf, page 18.

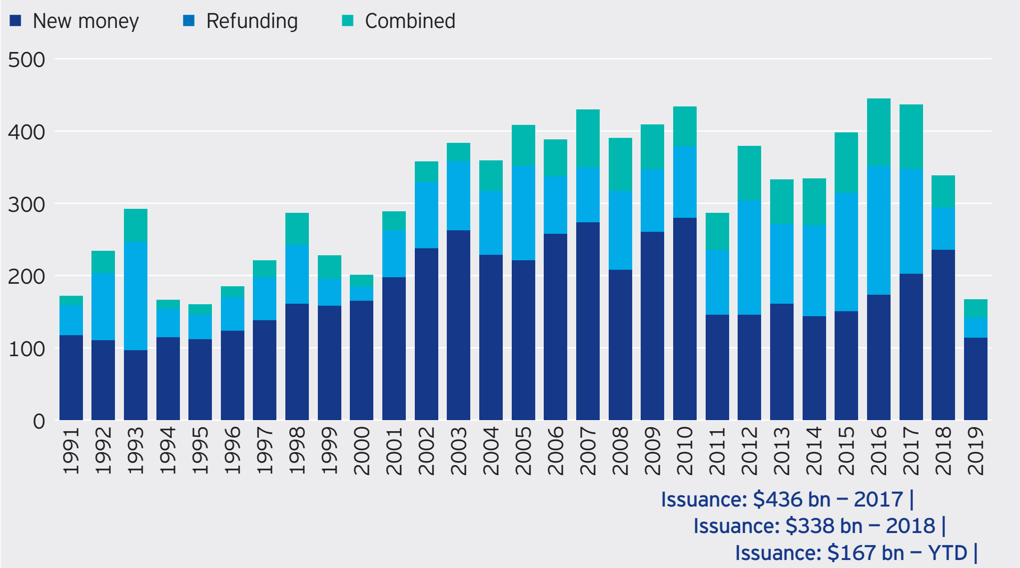
Municipal-Treasury (M/T) ratios increased, as US Treasury yields fell more than municipal yields. (M/T ratios compare the yields of municipal bonds to the yields of duration-equivalent US Treasuries. If M/T ratios are below 100%, municipal bonds appear rich compared to Treasuries.) During the second quarter, five-year and 10-year M/T ratios rose approximately four bps to 74.43% and 81.50%, respectively. As for 30-year M/T ratios, they rose approximately seven basis points to 91.66%.[3]

Municipal bonds generated positive total returns across the yield curve, with longer duration municipals outperforming their Treasury counterparts in the second quarter. Shorter- and intermediate-term municipals underperformed comparable duration Treasuries, after reaching rich levels during the first quarter on strong demand for maturities of 10 years and shorter by US separately managed accounts and short-term municipal bond mutual funds.

Market technicals supported municipal performance

Municipal bonds benefited from tight supply-and-demand conditions. Although new issuance increased slightly, it remained low by historical measures (see Figure 2). Approximately $92 billion of new bonds came to market in the second quarter versus $75 billion in the first quarter. For the year to date through June 30th, new issuance was $167 billion versus $161 billion during the same period in 2018. Many observers predicted total net supply in 2019 would be similar to that of 2018.[5]

Figure 2: New issuance remained low in the wake of the Tax Cuts and Jobs Act
Municipal bond issuance ($ billion) – 1991-June 2019



Source: SIMFA updated June 30, 2019, Municipal Bond Issuance; The Bond Buyer, Investment Company Institute, through June 30, 2019.

The low supply was due in part to the absence of advance refunding deals. The Tax Cuts and Jobs Act (TCJA) eliminated the tax exemption for advance refundings, which had previously represented a significant portion of municipal issuance. In addition, states and municipalities held off on infrastructure-related issuance in the hopes of federal action.

Demand overwhelmed the available supply during the quarter, with individual investors leading the buying. Investment inflows to municipal bond mutual funds were $20.9 billion, attaining their highest second-quarter levels since 1992.[4] For the year to date, inflows totaled $47.8 billion – putting 2019 on pace to qualify as a record year. The positive flows began in January and continued through June, averaging almost $8 billion per month. By the end of June, individuals accounted for 46% of the $3.8 trillion municipal market, up 4% from the end of 2018.[5]

The cap on the federal deduction for state and local income taxes (SALT), mandated by TCJA, contributed to the increased demand. According to Bank of America Merrill Lynch, the municipal debt in states most affected by SALT posted some of the highest total returns in April, driven by particularly strong investment inflows. In addition, as interest rates fell during the quarter, some investors may have decided to enter the municipal market in search of higher incremental yields.

At the same time, banks and property and casualty insurers trimmed their municipal holdings. After the passage of TCJA, which cut the corporate tax rate from 35% to 21%, these companies have had less incentive to hold tax-exempt securities.

Seasonal pressures were also at play during the second quarter, as the amount of new issuance typically dips during June and remains low through the summer. At the same time, there are a large number of maturity and call dates, driving strong demand for reinvestment.

State income tax collections increased despite the cap on SALT deductions

When TCJA was passed, the states that would be most affected by the $10,000 cap on SALT deductions predicted dire consequences. However, tax revenues came in better than expected during the spring of 2019. Some observers believe this may be due to TCJA's higher adjusted gross income, the result of lower federal tax rates, and stability in state income tax rates amid continued economic growth. In addition, high tax states did not see a mass exodus of the wealthy. The increased tax revenue helped states offset budget shortfalls and/or add to their existing surpluses. Some state governments announced they would use the unexpected revenue to help manage pension debt or reduce property taxes.

Internet sales tax adopted by more states

A majority of US states have implemented ecommerce sales tax thresholds, with others likely to follow suit. Most are using the $100,000 or 200 transactions threshold, a standard upheld by the US Supreme Court in Wayfair v. South Dakota. Before that ruling, the payment of sales taxes could only be required if a business had a physical presence in a state. This resulted in significant tax revenue losses. With more online transactions now subject to sales tax, the increased revenue is likely, in our view, to be a net positive at both the state and local levels in the coming years.

Outlook

At the end of the second quarter, we continue to believe that municipal fundamentals are strong. Overall, we expect positive market technicals to persist through the summer months. However, we do not expect to see the same level of investment inflows during the second half of 2019 as seen in the first half of the year. We believe strong demand from individual investors should continue. As for supply, new issuance could increase if states and municipalities decide to fund long-deferred infrastructure projects. Going forward, the team plans to focus on attractive opportunities created by the momentum in the municipal bond market during the first six months of 2019.

Invesco Municipal Bond Team

The Invesco Fixed Income Municipal Bond Team's investment philosophy is based on the belief that creating long-term value through comprehensive, forward looking research is the key to providing clients with diversified portfolios that aim to maximize risk-adjusted returns. Proprietary credit research and risk management are the foundations of our investment process, supported by a deep and experienced team of investment professionals with expertise that spans the entire municipal investment universe. We maintain an integrated, team-based investment process that combines the strength of our fundamental credit research analysts with the market knowledge and investment experience of our portfolio managers.

Our position among the top-10 municipal investment managers by assets in the US enables us to access preferred market opportunities and gain valuable market insight. Our team has established relationships with more than 120 national and regional municipal debt dealers in the US. We believe these established relationships, as well as our size, allow us to achieve fluid execution in daily transactions. Our ability to aggregate trades across multiple portfolios also enables us to obtain lower institutional pricing, which can contribute to portfolio performance.

About risk

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

Junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

All fixed income securities are subject to two types of risk: credit risk and interest rate risk. Credit risk refers to the possibility that the issuer of a security will be unable to make interest payments and/or repay the principal on its debt. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Municipal bonds are issued by state and local government agencies to finance public projects and services. They typically pay interest that is a tax in their state of issuance.

Because of their tax benefits, municipal bonds usually offer lower pre-tax yields than similar taxable bonds.

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

1 Source: FactSet Research Systems Inc. as of June 30, 2019. Investment grade municipal bonds represented by Bloomberg Barclays Municipal Bond Index. High yield municipal bonds represented by Bloomberg Barclays Municipal High Yield Bond Index.
2 Source: The Municipal Market Monitor as of June 30, 2019.
3 Source: The Municipal Market Monitor as of June 30, 2019.
4 Source: Strategic Insight as of June 30, 2019.
5 Source: Bond Buyer as of 6/30/2019.

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A basis point is a unit that is equal to one one-hundredth of a percent.

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