Investment Insights

Thoughts From The Municipal Bond Desk

Mark Paris
Chief Investment Officer,
Invesco Municipal Bond team

Stephanie Larosiliere
Head of Municipal Business
Strategies and Development

Overview

- Municipal bond prices rose and municipal yields fell amid a broad flight to quality driven by investors' concerns about the health of global banks.
- Municipal credit fundamentals, which are unrelated to the crisis in the banking sector, continued to support the market as states and localities broadly maintained fiscal balance.
- Banks are not expected to engage in substantial selling due to the turmoil in the banking sector.
- The Federal Reserve continues to monitor inflationary pressures and is taking measures to protect the US banking system.

Stephanie: In just a few weeks it seems that we've gone from worrying about inflation and interest rates to the health of the global banking system. How has the municipal market been affected by the recent regional bank failures?

Mark: As you'd expect, given the sense of uncertainty that currently exists following the collapse of Silicon Valley Bank, markets have been experiencing a flight to quality with municipal bonds following the US Treasury market. Investors historically shift their asset allocation away from riskier investments amid market turmoil. In this environment, Treasury and municipal yields both fell, though the declines were comparatively modest in the municipal market.

Stephanie: The turmoil in the banking sector – does it have an impact on the overall health of the municipal market?

Mark: No, the municipal market remains healthy overall based on the strength of credit fundamentals. Investors are focused on liquidity and solvency issues at banks, but they don't generally have those concerns about states and municipalities. In fact, municipal governments have plenty of cash on hand and are well insulated from banking system volatility. States often run investment pools for the benefit of both the state general fund and local municipalities. Generally, these pools are not heavily invested in bank deposits. For example, California's Pooled Money Investment Account had $200 billion as of February 28, of which over 85% was invested in Treasurys and Agencies.[1]

Stephanie: Banks own about 13% of the outstanding bonds in the muni market, should investors be worried that there might be widespread municipal bond selling by banks?

Mark: I don't think it's likely especially when you consider that more than half of their investments are in direct loans to municipalities. Banks have also been buying much fewer munis in the last 6 years due to the 2017 Tax Cuts & Jobs Act.[2] The law lowered the top statutory corporate tax rate from 35% to 21%, making tax-exempt munis much less attractive to banks. As for the failed banks, Silvergate liquidated its municipal portfolio in 2022, Signature Bank has very little exposure, and Silicon Valley Bank sold a portion of its holdings early this year.[3]

Stephanie: How do you think the events in the banking sector affected the Federal Reserve's (The Fed) decision to hike rates by 25 basis points (bps)?[4]

Mark: Before the bank failures the market expected the Fed to move 50bps, but after the turmoil of the last few weeks sentiment seemed split between the idea that the Fed would either pause in March or tread lighter and move by 25bps. That said, this is not completely unexpected, inflation remains a top priority for the Fed, but policymakers also have a responsibility to protect the US banking system, so this feels like a compromise. Inflation is still running hot, but higher interest rates have caused liquidity problems for some banks. I think we are now dealing with a Fed that will tread carefully as events continue to unfold.

Munis by the numbers

A quick look at some commonly used municipal market datapoints.

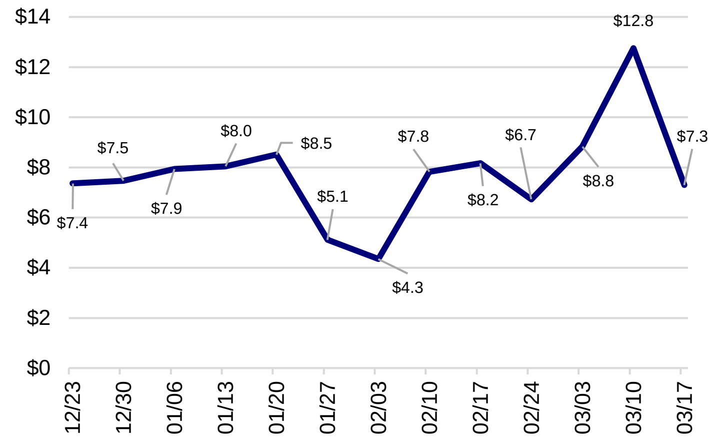
Fund Flows - Weekly and Monthly Reporters ($millions)

Week ending March 15, 2023

	Actual	YTD Total	4-wk avg
All term muni funds	(461)	(1,111)	(417)
All term muni funds ex ETF	(378)	(822)	(362)
New York	(7)	(408)	(12)
California	49	(174)	(17)
National	(441)	259	(354)
High Yield	301	1,296	(189)
Intermediate	(172)	1,463	251
Long Term	162	4,025	(114)
Tax-exempt money market	(5,086)	1,392	1,671

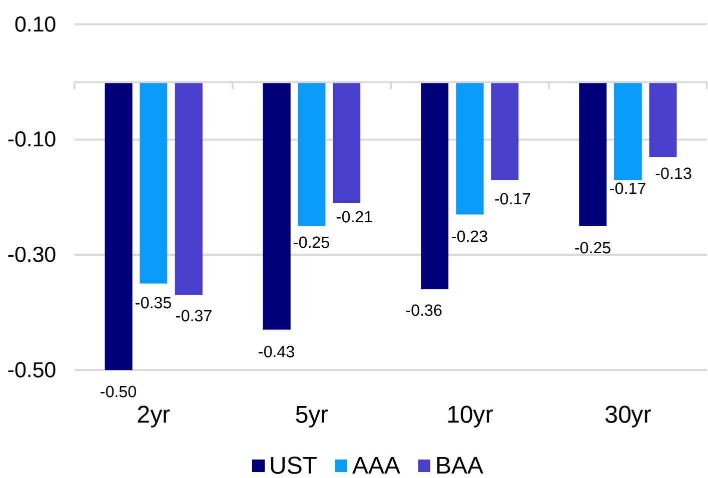
Source: Lipper US Fund Flows, JP Morgan, as of March 16, 2023. YTD = year to date.

30-day Visible Supply ($billions)



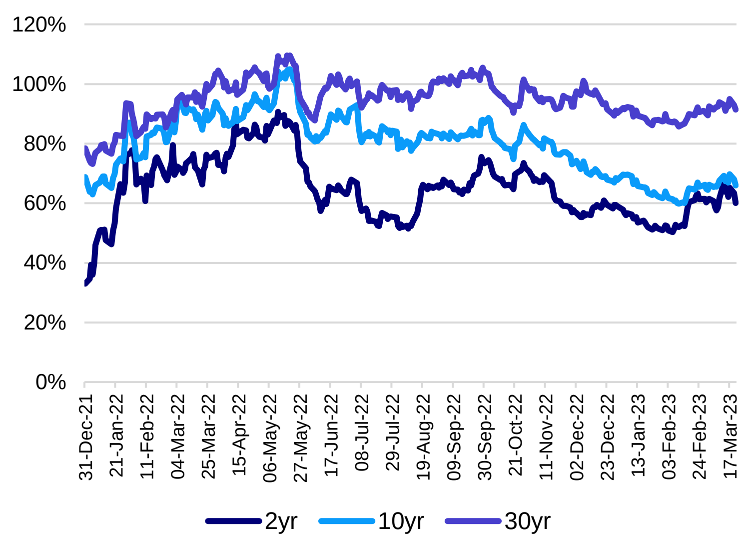
Source: The Bond Buyer. The 30-day visible supply is compiled daily from The Bond Buyer's Competitive and Negotiated Bond and Note Offerings calendars. It reflects the dollar volume of bonds expected to reach the market in the next 30 days. Issues maturing in 13 months or more are included. From December 23, 2022 – March 17,2023.

1-Month Yield Change 2/21/23 – 3/21/23 (% Change)



Source: Refinitiv MMD Curve, US Department of Treasury, from February 21, 2023 – March 21, 2023. UST = United States Treasury. A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other debts. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. For more information on rating methodologies, please visit the following NRSRO websites: www.standardandpoors.com and select 'Understanding Ratings' under Rating Resources on the homepage; www.moodys.com and select 'Rating Methodologies' under Research and Ratings on the homepage.

Municipal/Treasury Ratio



Source: Thomson Reuters TM3, as of March 21, 2023. Treasuries are backed by the full faith and credit of the US government as to the timely payment of principal and interest, while legislative or economic conditions could affect a municipal securities issuer's ability to make payments of principal or interest.

Sources:

1. PIMA, February 28, 2023.
2. Barclays, March 14, 2023.
3. Barclays Credit Research, March 2023
4. Federal Reserve, March 22, 2023

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 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. 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.

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All data as of March 23, 2023, unless otherwise stated.

All data provided by Invesco unless otherwise noted.

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

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