Municipal bond market recap and outlook

During the third quarter of 2023, the municipal market recorded substantial declines. Investment grade municipal bonds returned -3.95%, high yield municipal bonds returned -4.25%, and taxable municipal bonds returned -3.70%.1 The selloff was driven by events in the Treasury market, rather than supply and demand dynamics in the muni market. A drop in buying by investors, along with persistent inflation, federal budget deficits, and political infighting added to the murkiness of the quarter. Year to date, investment grade, high yield, and taxable municipal bonds returned -1.38%, 0.00%, and 0.88% respectively.1

When the quarter began in July, the municipal market was rather quiet, posting a slight gain overall for the month. On July 27, the Federal Reserve (Fed) raised the federal funds target rate by 25 basis points (bps) to 5.50%, the highest level since 2007,2 and said further action would be data dependent. Inflation continued to decline, while the US economy remained resilient, helped by strong labor markets. In early August, the performance of municipal bonds was rather flat, then turned negative in the latter part of the month amid a downturn in the US Treasury markets. The selloff continued into September, accelerating during the last week of the month after the Fed suggested interest rates would remain “higher for longer.” Although Fed officials held rates steady at their September 20 policy meeting, they signaled one more rate hike before year-end. They also reduced the number of rate cuts they had previously forecast for 2024 from four to two.

US Treasury yields rose along the curve during the third quarter, with yields on longer maturities increasing more significantly than yields on shorter maturities. In late September, five- and ten-year Treasury yields rose to their highest levels since 2007, and the 30-year US Treasury yield reached its highest point since 2011. For the quarter overall, the yields of two-, five-, ten-, and thirty-year Treasury bonds rose 16 bps, 47 bps, 78 bps, and 88 bps, respectively. The Treasury yield curve remained inverted between two- and ten-year maturities at the end of the quarter. Historically, an inverted Treasury yield curve has often preceded a recession.

Municipal yields, especially in the shorter maturities, increased more overall than Treasury yields (see Exhibit 1). Furthermore, yields on short-term AAA-rated municipals hit their highest levels since 2007, while yields on longer-term municipals surpassed their 2022 highs, climbing to near 2013 levels.3 During the third quarter, the yields of two-, five-, ten-, and thirty-year AAA general obligation (GO) bonds rose 73 bps, 79 bps, 89 bps, and 85 bps, respectively. The municipal yield curve stayed inverted between one- and seven-year maturities as investors remained uncertain as to when the Fed would end its current rate hiking cycle. That inversion had occurred for the first time in municipal market history in December 2022.
Exhibit 1: Municipal yields rose more overall than Treasury yields during the third quarter

Source: US Department of the Treasury, Daily Treasury Yield Curve Rates. Data as of September 30, 2023. A yield curve is a curve showing several yields to maturity or interest rates across different contract lengths for a similar debt contract. Past performance does not predict future returns.

Demand was weak amid continued low supply

Credit fundamentals remained strong during the third quarter, largely due to fiscal stimulus and strong revenue collections. Municipal credit upgrades have outpaced downgrades over the past nine quarters by a ratio as high as 6:1.4 Even as pandemic aid has started to wane, default risk in the municipal market appears extremely low, in our opinion. Furthermore, municipal default rates have historically been lower than those of rated corporate bonds (see Exhibit 2) even during periods of recession (see Exhibit 3).

Exhibit 2: Municipal bonds enjoy historically low long-term default rates

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<tr>
<td></td>
<td>Munis (%)</td>
<td>Corps (%)</td>
<td>Munis (%)</td>
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<tr>
<td>Aaa/AAA</td>
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<td>0.34</td>
<td>0.00</td>
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<td>Aa/AA</td>
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<td>0.75</td>
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<td>0.71</td>
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<tr>
<td>Ba/BB</td>
<td>3.31</td>
<td>15.82</td>
<td>3.63</td>
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<tr>
<td>B/B</td>
<td>16.65</td>
<td>34.66</td>
<td>10.29</td>
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<tr>
<td>Caa-C/CCC-C</td>
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<tr>
<td>Investment Grade</td>
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<td>2.23</td>
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<tr>
<td>Non-Invest Grade</td>
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<td>29.81</td>
<td>7.30</td>
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<tr>
<td>All</td>
<td>0.15</td>
<td>10.72</td>
<td>0.24</td>
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Sources: Moody’s Investor Services (“Moody’s”) data through December 31, 2022, released July 19, 2023, latest data available. Standard and Poor’s (“S&P”) data through December 31, 2022, released March 30, 2023. Past default rates are no assurance of future default rates. The data presented is the most recent data available from the various bond rating agencies. *2022/2023 data may increase cumulative default rates from both municipal and corporate bonds. 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 Standard and Poor’s rating methodology, please visit www.standardandpoors.com and select ‘Understanding Credit Ratings’ under ‘About Ratings’ on the homepage. For more information on Moody’s rating methodology, please visit www.ratings.moodys.com and select ‘Rating Methodologies’ on the homepage.
Exhibit 3: Municipal defaults in recessionary times

Source: Moody’s Investors Service, SIFMA, J.P. Morgan as of 12/31/2022. Municipal defaults in absolute dollar amounts and defaulted debt as a percentage of outstanding market size have been a fraction of those in the corporate bond market, with differences particularly high in low-growth periods such as 2001-2002, 2008-2009, and 2020.

Meanwhile, we believed the impact of a further US sovereign debt downgrade—this time by Fitch Ratings—was likely to be limited. (In 2011, Standard & Poor’s Ratings had downgraded US sovereign debt following a prolonged dispute in Congress over the federal government’s borrowing limit.\(^5\) The 2011 downgrade was closely followed by actions on municipal credits that were directly linked to the US government.\(^6\)) On August 1, 2023, Fitch Ratings downgraded the rating of US sovereign debt from AAA to AA+,\(^7\) citing rising debt at the federal, state, and local levels and a “steady deterioration in standards of governance” over the past two decades\(^8\) but did not take action on municipal credits.

New issuance remained low, while investment outflows continued

Market technicals remained relatively unchanged during the third quarter. Although the municipal market benefited from the summer reinvestment period, a time historically characterized by negative net supply, outflows remained. Demand overall was muted, with investment outflows from municipal bond mutual funds continuing.

New municipal issuance was approximately $95 billion in the third quarter, slightly less than the $100 billion of new supply during the second quarter and in line with the $94 billion issued during the third quarter of 2022.\(^6\) On a year-to-date basis, new municipal issuance dropped 10% year over year to approximately $270 billion.\(^6\) Tax-exempt supply accounted for approximately $245 billion of the total, lower than historical norms, as issuers with ample cash on their balance sheets had little incentive to bring debt to market at higher interest rates. Because of their strong fiscal positioning, many state and local governments have been able to delay issuing new bonds until interest rates come down. As for taxable supply, it remained low during the third quarter at just $7 billion, for a total of only $25 billion in the 2023 year to date.\(^9\) Taxable municipal supply dropped as interest rates rose, with a substantial increase unlikely in the near term given that few deals are in the pipeline. Municipal supply overall has steadily declined since 2021 peaking in 2020 (see Exhibit 4).
Exhibit 4: Municipal supply has declined significantly since 2021

As for demand, investment flows from municipal bond mutual funds were negative, though the market was bolstered by the summer reinvestment season. The months of June, July and August are typically favorable for supply and demand as investors reinvest proceeds from bond coupon payments, calls, and maturities. Investment outflows totaled $3.9 billion during the third quarter, lower than the $6.3 billion in outflows during the second quarter. At the end of the quarter outflows for 2023 totaled $12 billion, driven predominately by interest rate volatility continuing to push some investors to the sidelines.10 (See Exhibit 5.) At the same time, foreign investors have reduced their purchases of municipal bonds, especially taxable munis, as hedging costs have risen, driven by the Fed’s hawkish stance and the appreciation of the US dollar.

Exhibit 5: Municipal demand continued to drop amid persistent interest rate volatility

The shape of the more than $4 trillion municipal market shifted in recent quarters. Banks and life insurers have decreased their municipal holdings, while the direct ownership stake of individual investors has grown. Many households accumulated large cash reserves starting in late 2019 and continued to do so through the pandemic. We believe that as the Fed gets closer to ending the current rate hiking cycle many of those households will be looking for places to invest and with munis at their highest yields in over a decade, the attractive tax-equivalent yields may be appealing enough to shift net outflows into net inflows.
Rising short-term interest rates offer opportunities and challenges

Short-term municipal bond funds have taken advantage of higher interest rates to invest in variable rate demand notes and other short-duration instruments. These investments offer attractive yields and return potential, especially if the federal funds target rate remains elevated and the Fed implements expected rate cuts slowly during 2024 and 2025. On the other hand, municipal closed end funds (CEFs) have been squeezed by the rise in short-term rates, given that their leverage costs are often pegged to Securities Industry and Financial Markets Association’s (SIFMA) 7-day high-grade market index. Many municipal CEFs use borrowed money to invest in longer-term municipal securities as a way to boost returns; however, higher interest rates have pushed down the value of longer-term maturities and increased the cost of leverage. SIFMA, which resets weekly, peaked at a rate of 4.47% on August 23 and reset on September 27 at a rate of 3.98%, versus a low of 0.04% during January 2022. As a result, many municipal CEFs in the industry announced distribution cuts.

Pennsylvania joins the credit ratings upgrade list

In early September, Moody’s Investors Service revised its outlook for Pennsylvania to positive from stable.11 The upgrade included the Commonwealth’s general obligation bonds and appropriation backed debt, as well as some transportation, school district, and pension related credits. According to the ratings agency, Pennsylvania’s increased budget reserves had brought its fiscal position in line with higher rated states. The Commonwealth has also bolstered its rainy-day fund, making it more equipped to handle potential economic downturns. This positive development, a dynamic we expect to continue across the US, likely stems from the benefits of the various federal stimulus measures, including the American Rescue Plan Act, the Infrastructure Investment and Jobs Act, the Inflation Reduction Act, and others.

Outlook

We expect a “bumpy landing”—a relatively brief and shallow economic slowdown driven by Fed’s aggressive monetary policy tightening. We believe the US is likely to avoid a substantial broad-based recession because of its tight labor market. Based on current disinflationary trends, we expect the Fed to end its current rate hiking cycle by the end of 2023. Once Fed rate hikes are in the rearview mirror, we think that high absolute yields, low issuance, strong fundamentals, and investors’ migration out of cash may create a positive environment for the municipal bond market.

From a supply and demand perspective, the fall season is likely to bring heavier new issuance and less cash for reinvestment through coupon payments, bond maturities and calls. We also believe that higher municipal yields mean there is potential for attractive tax-exempt income for investors. That can be a big benefit, especially for Americans living in high tax states. Dollar-cost averaging, or investing the same amount of money at regular intervals regardless of market levels, is one way to put money to work immediately and can also reduce the temptation to engage in market timing.

Going forward, we will continue to rely on our experienced portfolio managers and credit research staff to navigate the marketplace as they look for opportunities that can provide long-term value for investors.

1. Source: Bloomberg, as of September 30, 2023. Investment grade municipal bonds are represented by Bloomberg Municipal Bond Index. High yield municipal bonds are represented by Bloomberg Municipal High Yield Bond Index. Taxable municipal bonds are represented by the Bloomberg Taxable Municipal Index.
2. Source: Federal Reserve.
4. Source: Standard & Poor’s, S&P Global Ratings announced 465 upgrades versus 76 downgrades, includes rating actions during the second quarter of 2023 and the eight prior quarters.
5. Source: Associated Press, as of August 1, 2023.
6. Source: Standard & Poor’s, as of August 5, 2011.
7. Source: Fitch Ratings, as of August 1, 2023.
8. Source: Bloomberg, as of September 30, 2022.
10. Source: Lipper, as of September 30, 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 pay interest that is typically tax-free 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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A Yield Curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.

An Inverted Yield Curve slopes downward, indicating short-term interest rates exceeding long-term rates.

Market technicals is the price movement and patterns of a security.

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

An investment cannot be made into an index.

Bloomberg Municipal High Yield Bond Index is generally representative of bonds that are non-investment grade, unrated or rated below Ba1.

Bloomberg Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market.

Bloomberg Taxable Municipal Index measures the US municipal taxable investment grade bond market.

Federal Funds Rate is the interest rate that banks charge each other to borrow or lend excess reserves overnight.

Bloomberg Treasury Index is an unmanaged index of public obligations of the US Treasury.