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Municipal bond market recap and outlook

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Overview

- Municipal bonds generated positive returns during the first quarter, supported by robust credit fundamentals and favorable technicals.
- Ratings upgrades continued, as state and local governments benefited from strong tax revenues and federal aid.
- Investment outflows persisted during the quarter, as many investors remained on the sidelines.
- Supply was exceptionally low, as rising interest rates driven by Federal Reserve policy and worries about the stability of the banking sector disincentivized issuers.
- Banks, which are being challenged by high interest rates, are unlikely to sell a significant portion of their municipal bond holdings.

The broad fixed income market experienced significant volatility during the first quarter of 2023 amid uncertainty about the scope of Federal Reserve (Fed) interest rate hikes, the outlook for inflation and US economic growth, and a series of bank failures. Overall, this volatility reflected investor concerns that the Fed could increase interest rates too much, leading to an economic slowdown or even a recession.

Municipal securities weathered the turmoil relatively well. Investment grade municipal bonds returned 2.78% during the first quarter, while high yield municipal bonds returned 2.73%. Taxable municipal bonds, which tend to be more sensitive to trends in the US Treasury market, returned 5.21%.[1]

The first quarter started off on a strong note, supported by the January reinvestment season. Investment grade, high yield, and taxable municipal bonds all posted gains as municipal yields dropped, following the falling yields in the US Treasury market. Investors may have thought that the Fed was nearing the end of its rate hiking cycle, given that policymakers had raised short-term interest rates 50 basis points (bps) in December 2022 after four consecutive 75 bps rate hikes. There was also good news about inflation, as the Personal Consumption Expenditures price index continued to ease in December, the sixth consecutive month with a lower print, which raised hopes that June 2022 might have been this cycle's peak inflation print.

Investors grew more cautious after the Fed's February 1 policy meeting. Although Fed officials raised short-term rates 25 bps, in line with market expectations, they made it clear in their post-meeting commentary that inflation remained a top concern and said that ongoing rate hikes would be "appropriate." The Fed's stance had a larger impact on the US Treasury market than on the municipal market, but municipal bonds still gave back most of their January gains.

In March, the focus unexpectedly shifted to the US banking sector. On March 10, Silicon Valley Bank collapsed after a bank run, marking the second-largest bank failure in US history. Higher interest rates have caused liquidity problems for certain banks, as longer-dated Treasury and agency mortgage holdings decreased in value over the past year. Fears about the health of the global banking system ensued, and demand for perceived safe-haven asset classes increased, driving down Treasury and municipal yields. In this environment, the market—which had previously expected the Fed to hike rates by 50 bps at its March meeting—seemed split between the idea that policymakers would pause or tread more lightly. Ultimately, policymakers implemented a 25 basis-point rate hike—taking the federal funds target rate to a range between 4.75% and 5.00%, its highest level since 2007—as they sought to strike a balance between their continued fight against inflation and their responsibility to protect the US banking system.

During the first quarter, US Treasury yields fell, except in maturities of six months and less, which tend to be most affected by Fed policy action. The yields of two-, five-, ten-, and thirty-year Treasury bonds dropped 35 bps, 39 bps, 40 bps, and 30 bps, respectively. At the end of the quarter, the US Treasury yield curve remained inverted between two- and ten-year maturities. Historically, an inverted Treasury yield curve has often preceded a recession.

Municipal yields fell during the first quarter, though to a lesser degree than Treasurys. The yields of two-, five-, ten-, and thirty-year AAA general obligation (GO) bonds fell 22 bps, 30 bps, 36 bps and 28 bps, respectively. The municipal yield curve also remained inverted between one- and ten-year maturities (see Exhibit 1). The inversion, which had occurred for the first time ever during December 2022, seemed to be driven by market uncertainty about when the current rate hiking cycle might end.

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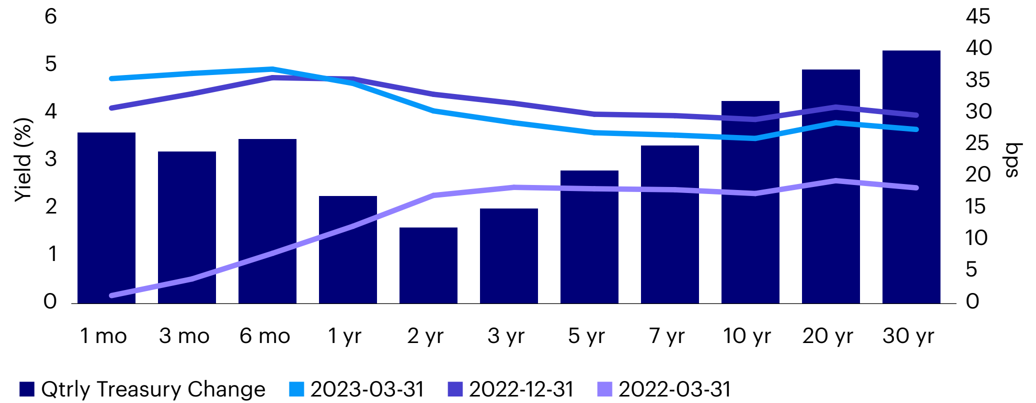
Not Insured by any Federal Government Agency

Figure 1: At the end of the first quarter, the municipal yield curve remained inverted between one- and ten-year maturities

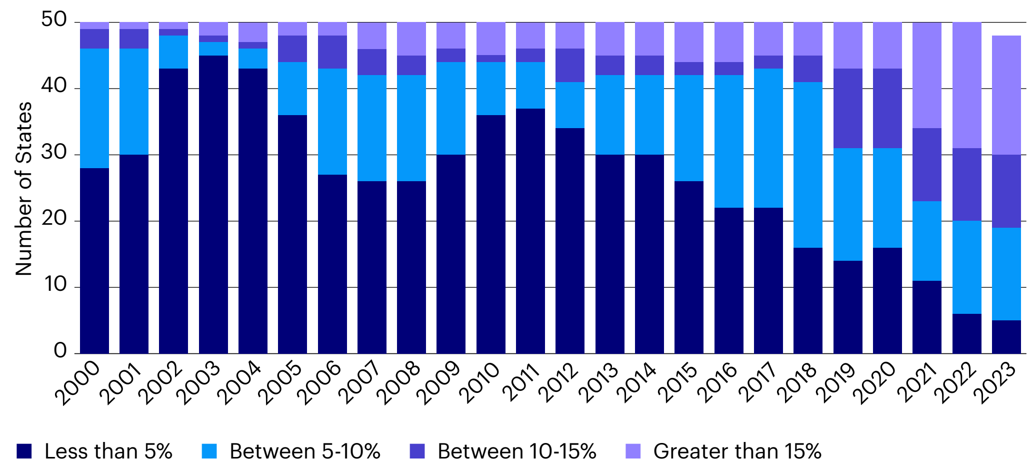


Source: US Department of the Treasury, Daily Treasury Yield Curve Rates. Data as of March 31, 2023. A yield curve is a curve showing several yields to maturity or interest rates across different contract lengths for a similar debt contract. Past performance does not predict future returns.

Municipal credit quality remains strong as rating upgrades continue

Higher tax revenues and the effect of federal stimulus measures, including the American Rescue Plan Act, the Infrastructure Investment and Jobs Act, and the Inflation Reduction Act, continued to bolster the fiscal health of municipal credits, allowing them to shore up rainy day funds and strengthen their balance sheets. At the end of 2022, rainy day funds in 37 states had hit all-time highs, reaching at their highest levels in more than 20 years.[2]

Exhibit 2: At the end of 2022, rainy day funds hit all-time highs



Source: NASBO, as of January 25, 2023. Fiscal 2023 figures are based on enacted budgets and exclude balance data for two states that do not estimate future balance levels.

At the same time, municipal governments had significant cash on hand to support new and existing projects and services. Additionally, because of federal aid, many of them were able to invest in infrastructure improvement without having to raise taxes, borrow at high interest rates, or take other unpopular measures to raise funds. In 2022 there was a 25% increase in infrastructure contract awards, the largest growth rate since 1997. Across 40 states there are 4,000 additional projects for highways and bridges in the works.[3] Additionally, the federal government recently allocated $585 million to repair aging water systems - a total of 83 projects in 11 western states.[4]

Furthermore, given their ample cash on hand, municipal governments 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 more than 85% was invested in US Treasury and agency securities.[5]

Reflecting these solid fundamentals, credit rating upgrades exceeded downgrades for the second year in a row during 2022.[6] The trend continued into 2023, with rating upgrades of municipal issuers exceeding downgrades by nearly three times during the month of January.[7] Early February marked the 90-day point since the last Chapter 9 bankruptcy petition was filed, well above the long-term average since 1982 of 52 days.[8] Among notable recent upgrades were the State of Illinois, the City of New York and the City of Las Vegas.[9]

Finally, as the debate continues on whether Fed actions will lead the economy to a soft or hard landing, we continue to believe that defaults in the municipal market will remain stable, especially when compared to corporate debt (see Exhibit 3). Municipal credits have a long history of low defaults as many provide essential services to all Americans.

Exhibit 3: Municipal defaults are few compared to corporate bond defaults during periods of slow economic growth, including recessions

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

Source: Moody's Investors Service, SIFMA, J.P. Morgan as of 12/31/2022

Supply remained exceptionally low amid stable demand

The trend of low municipal bond supply continued through the first quarter. New municipal issuance was approximately $74 billion, which was about $4 billion more than in the fourth quarter of 2022, but 29% lower than the first quarter of 2022. Tax-exempt supply accounted for $63 billion of the total, also lower than historical norms, as issuers with cash on their balance sheets have been reluctant to take on debt at higher interest rates.[10] Because of their strong fiscal positioning, municipal issuers can generally afford to hold off issuing new bonds or refunding existing bonds until interest rates come down. As for taxable supply, it accounted for $11 billion in new issuance, 50% less than the $22 billion brought to market in the first quarter of 2022.[11] Nevertheless, taxable municipal bonds maintained their sizeable footprint in the municipal market.

Demand improved during the first quarter, although investment flows remained negative, as some investors put available cash to work, while others are choosing to wait until the end of the hiking cycle. Investment outflows from municipal bond funds totaled approximately $1.7 billion in the first quarter, representing considerable slowing compared to the record annual outflows of $122 billion in 2022.[11] Mutual fund flows had briefly turned positive in January, as investors flooded into the market, reaching $5.7 billion—the best monthly total since August 2021.[12] The following month they turned negative after the Fed's February 1 policy meeting and stayed negative through the end of March.

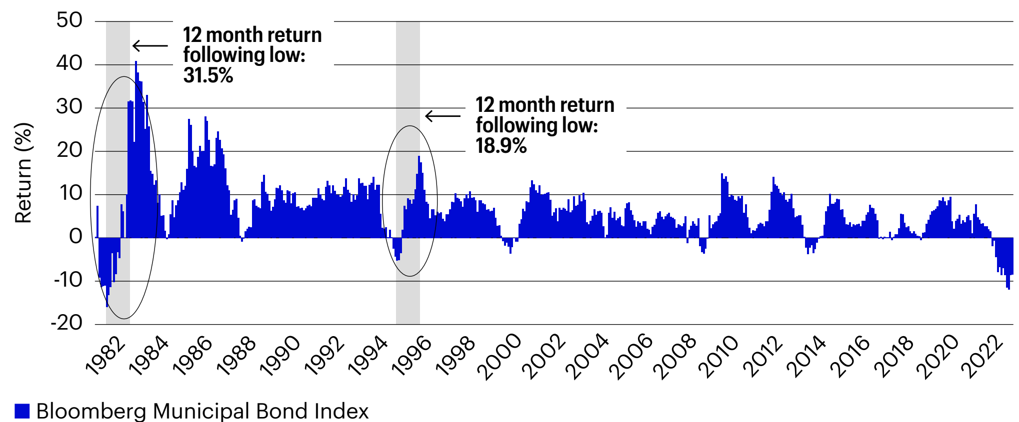
Bank ownership of municipals

The bank failures in March raised concerns that banks would sell a significant portion of their municipal holdings. Banks own about $592 billion of municipal bonds[13] or about 13% of the outstanding bonds in the municipal market. However, sizeable liquidations did not occur. Overall, banks have about $130 billion in available for sale (AFS) bonds and slightly more in held to maturity (HTM) bonds that are carried at amortized cost and are much harder to sell. HTM holdings also contain unrealized losses that would be realized only if the bonds are moved to AFS and sold. Furthermore, banks have been buying much fewer municipals since the passage of the 2017 Tax Cuts & Jobs Act.[14] The law lowered the top statutory corporate tax rate from 35% to 21%, making tax-exempt municipal bonds much less attractive to banks. As for the failed banks, Silvergate liquidated its municipal portfolio in 2022, Signature Bank had very little exposure, and Silicon Valley Bank sold a portion of its holdings earlier in 2023.[15]

Outlook

We continue to believe that 2023 will be a better year for municipal bonds than 2022. This view is supported by the performance of the municipal market during the first quarter. Although we expect continued volatility, we think investors should look at these periods as entry points back into the market. Waiting on the sidelines, in the past, has proven to be costly. Exhibit 4 shows that returns are strong in the 12 months following a 12-month rolling return of -5% or worse. This underscores the idea that timing the bottom is very difficult and recoveries can happen quickly. Being late by even a few months can be costly.

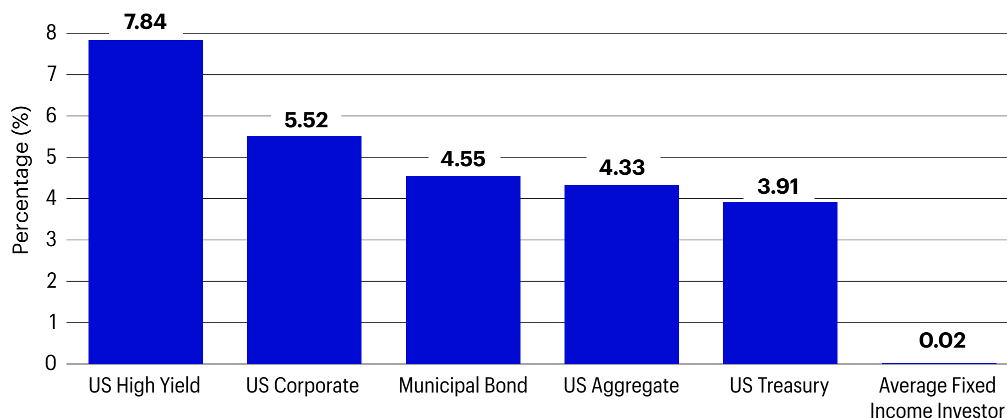
Exhibit 4: Municipal bond returns have been strong 12 months after a cycle low



Source: Macrobond. Historical analysis reviews Bloomberg Municipal Bond Index (1) annualized rolling 12-month total return data dating back to index inception (1/31/1980). Grey highlights signify the 12 months following the 12-month annualized low greater than -5%. An investment cannot be made in an index. Past performance is not a guarantee of future results.

In our observation, being a little early has historically been better than being late when the cycle turns. Investors might consider dollar-cost averaging, which allows them to invest the same amount of money at regular intervals, regardless of market levels. This strategy can decrease the temptation to engage in market timing. Consider a recent DALBAR study, which showed that the average fixed income investor has earned only 0.2% annualized over the past 20 years (see Exhibit 5). In our view, the disparity of returns is most likely due to investors moving money between asset classes at times when it is not beneficial to overall results, highlighting the high cost of market timing.

Exhibit 5: Twenty-year fixed income annualized returns (2001-2021)



Source: Macrobond. Indices shown are the Bloomberg Municipal Bond Index, the Bloomberg US High Yield Index, the Bloomberg US Treasury Index, the Bloomberg US Aggregate Bond Index, and the Bloomberg US Corporate Index. Average asset allocation investor return is based on an analysis by DALBAR, Inc., March 2022 QAIB report which utilizes the net of aggregate mutual fund sales, redemptions, and exchanges each month as a measure of investor behavior. Past performance is not a guarantee of future results. An investment cannot be made in an index.

On the fundamental side of the equation, we maintain a positive outlook for municipal credits given that municipalities are flush with cash, rainy day funds are near record highs, and revenues are still strong. Furthermore, we believe fiscal support from the American Rescue Plan Act, the Infrastructure Investment and Jobs Act, and the Inflation Reduction Act will be beneficial to municipals over the coming years.

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

1. Source: Bloomberg, as of 3/31/23. 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: National Association of State Budget Officers.
3. Source: The Bond Buyer, February 14, 2023.
4. Source: US Department of the Interior.
5. Source: PIMA, February 28, 2023.
6. Source: Standard & Poor's, December 31, 2022.
7. Source: Bank of America Global Research.
8. Source: Bank of America Securities, February 10, 2023.
9. Source: Bank of America Global Research.
10. Source: Bloomberg Financial L.P., JPMorgan.
11. Source: JPMorgan.
12. Source: The Bond Buyer, February 7, 2023.
13. Source: JPMorgan, Federal Reserve.
14. Source: Barclays Credit Research, March 2023.
15. Source: Federal Reserve, March 22, 2023.

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

Personal Consumption Expenditures Price Index (PCE) is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

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

Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Bloomberg U.S. Corporate High Yield Bond Index measures the US dollar-denominated, high yield, fixed-rate corporate bond market.

Bloomberg U.S. Corporate Bond Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate bond market.

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. An investment cannot be made into an index.

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

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

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