Invesco

Investment Insights | Invesco Fixed Income

Municipal bond market recap and outlook

Mark Paris
Chief Investment Officer,
Invesco Municipal Bond team

Stephanie Larosiliere
Head of Municipal Business
Strategies and Development

Overview

- Propelled by strong gains in November and December, the municipal market posted positive returns for the fourth quarter and 2023 calendar year.
- Municipal bonds ranked among the best-performing asset classes of 2023.
- Limited new issuance helped to stem the tide as persistent investment outflows continued through the fourth quarter.
- Credit quality remained strong overall, with credit rating upgrades outpacing downgrades.

Fixed income markets rallied during the final two months of 2023, delivering positive returns for the fourth quarter and the calendar year as a whole. The gains were driven by a significant drop in interest rates, as investors anticipated the Federal Reserve (Fed) could be at or near the end of its interest rate hiking regime. Investment grade municipal bonds returned 7.89% in the fourth quarter and 6.40% in 2023, while high yield municipal bonds returned 9.21% and 9.21%, respectively. Taxable municipal bonds returned 7.89% for the fourth quarter and 8.84% for the year.[1] Tax-exempt and taxable munis were among the strongest performing asset classes of 2023.[2]

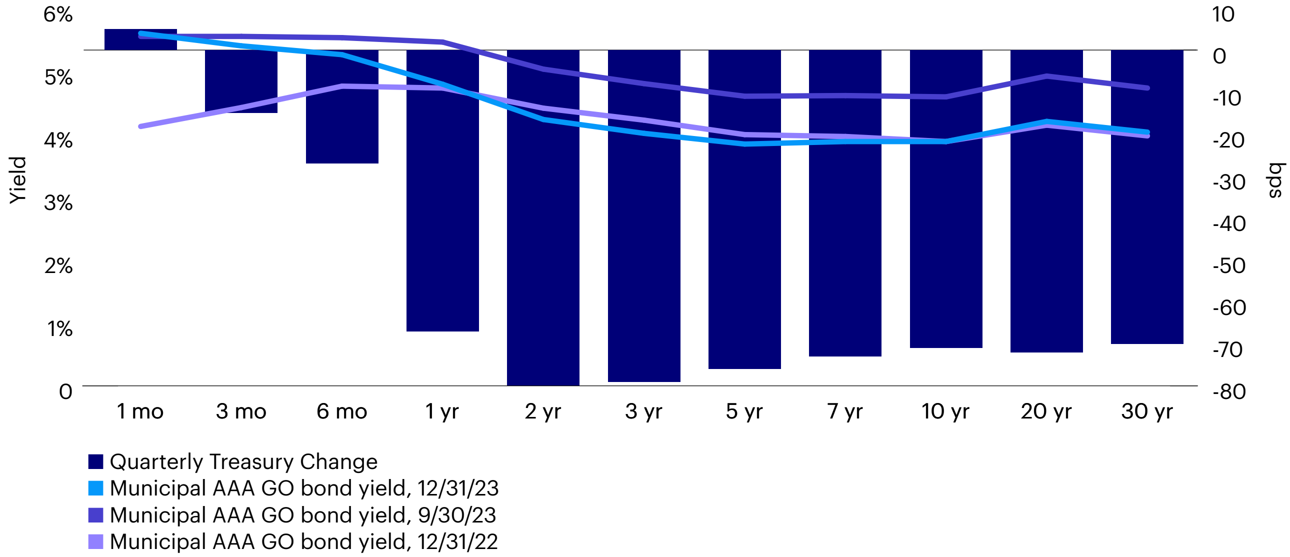
Municipal bonds began October in the midst of a selloff, which had been sparked by a downturn in the US Treasury markets. After the Fed suggested interest rates would remain higher for longer, bond yields soared. Underlying inflation had cooled faster than the Fed had expected, suggesting its efforts to restrain inflation had largely been successful, but policymakers expressed concern that stronger-than-expected economic growth could boost inflationary trends. Geopolitical turmoil added fuel to the fire, causing yields to spike mid-month. On October 19, the monthly moving average of AAA-rated municipal yields hit its highest level since June 2022. The average daily move of the 10-year municipal yield was 6 basis points (bps), significantly higher than the historical average of 2 bps. The story was similar in the Treasury market where the average daily move of the 10-year Treasury yield was 7 bps compared to the historical average of 4 bps.[3]

Investor sentiment shifted in early November, as the Fed held interest rates steady at 5.50% and publicly backed away from the rate hike it had signaled for December. Bond yields fell, igniting a rally across the fixed income market, including both tax-exempt and taxable municipal bonds. The rally continued through November and into December, as inflation continued to ease and US economic growth remained contained. In December, the Fed again left interest rates unchanged and adopted a transitory tone, suggesting to market participants that rate cuts might be coming in 2024.

US Treasury yields, which are strongly affected by expectations about Fed policy, were volatile during 2023. After rising in the first two months of the year, they plunged during March, only to start an erratic climb upward in the second and third quarters. They then fell during the fourth quarter, with shorter-term yields falling more than longer-term yields. The yields of two-, five-, ten-, and thirty-year Treasury bonds declined 80 bps, 76 bps, 71 bps, and 70 bps, respectively. For 2023 as a whole, the yields of two- and five-year Treasury bonds fell 18 bps and 15 bps, respectively. The yield of ten-year Treasury bonds ended the year unchanged, while the yield of thirty-year Treasury bonds was up 6 bps. At the end of 2023, the Treasury yield curve remained inverted between one- and ten-year maturities. Historically, an inverted Treasury yield curve has often preceded a recession.[4]

Municipal yields fell more than Treasury yields during the fourth quarter, with the yields of two-, five-, ten-, and thirty-year AAA general obligation (GO) bonds dropping 114 bps, 113 bps, 117 bps and 92 bps, respectively (see Exhibit 1). Municipal yields also fell for 2023 overall, ending the year lower than they began. The yields of two-, five-, ten-, and thirty-year AAA GO bonds were down 8 bps, 24 bps, 35 bps, and 16 bps, respectively, during 2023. The municipal yield curve remained inverted between one- and seven-year maturities at the end of the year, largely because of uncertainty about when the Fed might begin raising interest rates. The inversion had occurred for the first time in municipal market history during December 2022.

Exhibit 1: Municipal yields fell more than Treasury yields during the fourth quarter



Source: TM3 and US Department of the Treasury, Daily Treasury Yield Curve Rates. Data as of December 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. The Municipal AAA GO bond yield is represented by the Municipal Market Data proprietary yield curve of AAA-rated state general obligation bonds, based on the institutional block size of $2million-plus market activity in both the primary and secondary bond market. **Past performance does not predict future returns.**

Municipal credit conditions remained positive during 2023

Many states and municipalities have built solid credit foundations, having taken advantage of federal fiscal stimulus and healthy tax receipts to boost their reserves and rainy-day funds. As a result, municipal credit quality continued to strengthen during 2023, reflected by consecutive quarters in which rating upgrades exceeded rating downgrades. For instance, in third quarter of 2023, Moody's Investors Service and S&P Global Ratings upgraded more than 1,400 ratings and downgraded less than 350 ratings — a combined upgrade/downgrade ratio of 4 to 1[5] (see Exhibit 2).

Exhibit 2: Credit upgrades continued to outpace credit downgrades

S&P upgrades exceeded downgrades for the 10th consecutive quarter in 3Q23

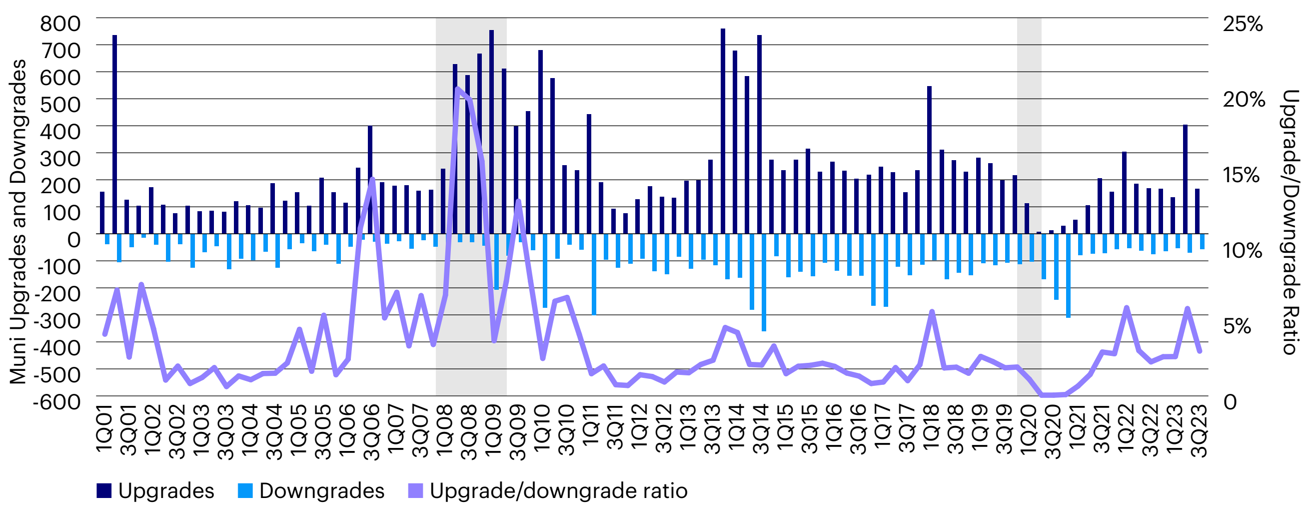
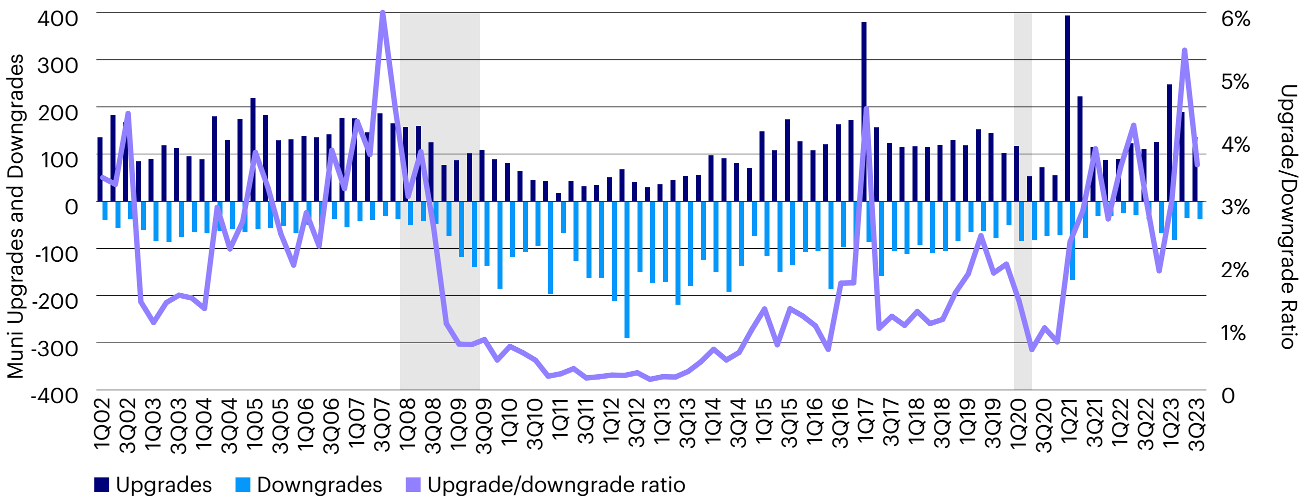


Exhibit 2, continued: Moody's upgrades exceeded downgrades for the 11th consecutive quarter in 3Q23



Source: S&P Global Ratings Research, J.P. Morgan. Gray shaded area indicates recessionary period. Moody's Investors Service, J.P Morgan. Gray shaded area indicates recessionary period (data not available prior to 1Q02). 1Q17 saw a revision of local govt GO methodology, leading to one-time spike in upgrades.

Limited new issuance and negative investment flows persisted

Market technicals were mixed during the fourth quarter and 2023 overall, as issuers and investors alike struggled with uncertainty about the Fed's intentions regarding interest rates. Although 2023 was the fifth consecutive year of positive net supply, new issuance declined. Meanwhile, investment flows were negative for the calendar year, though by much less than in 2022.

New municipal issuance was approximately $99 billion in the fourth quarter, slightly more than the $95 billion in the third quarter and 39% higher than the $71 billion of new issuance during the fourth quarter of 2022.[4] Total new issuance for 2023 was approximately $369 billion, roughly in line with the $370 billion of new issuance in 2022.[4] Tax-exempt supply accounted for approximately $334 billion of the total, more than the $313 billion issued in 2022, but still lower than historical norms. Municipal borrowers, many of which had ample cash on their balance sheets, had little incentive to issue new bonds or advance refund existing bonds given that higher interest rates increased the cost of borrowing and made the economics of new issuance and refundings less attractive. As for taxable supply, it increased slightly during the fourth quarter to about $10 billion. On a year over year basis, taxable new issuance declined from approximately $58 billion in 2022 to approximately $35 billion in 2023.[6]

Regarding demand, investment outflows from municipal bond mutual funds increased during the fourth quarter but slowed considerably during the calendar year. Fourth-quarter outflows totaled $11 billion, higher than the $7 billion in outflows during the third quarter. For 2023, negative mutual fund flows were partially offset by the over $12 billion in inflows into municipal exchange traded funds – resulting in a calendar year outflow of $17 billion, much lower than the record outflows of $126 billion in 2022.[7]

Individuals—either through direct ownership or through fund vehicles—remained the largest group of investors in the municipal market during 2023. Banks and insurance companies had comparatively smaller footprints, given that their holdings of tax-exempt municipals had decreased after the enactment of the 2017 Tax Cuts and Jobs Act (TCJA). TCJA cut the corporate tax rate from 35% to 21%, giving banks and insurance companies less reason to invest in tax-exempt securities; however, banks and insurers, as well as non-US investors, continued to favor taxable municipal bonds. These investors may like taxable munis because of their high credit quality, especially as similarly rated investment grade corporate bonds can be scarce. Taxable municipal bonds can also be useful to investors who want to increase the diversification of their overall portfolio.

Outlook

At the end of 2023, we believed the US economy would continue to demonstrate remarkable resilience to the effects of the Fed's monetary policy tightening. Once the Fed's rate hikes are in the rear-view mirror, we believe high absolute yields, low issuance, strong fundamentals, and investor migration out of cash will present positive opportunities for municipal bonds.

Historically, municipal bonds have performed well following periods of stress, with drawdowns helping to set the stage for positive total returns and higher income (see Exhibit 3).

Exhibit 3: Drawdown history of municipal bonds and subsequent performance

Investment Grade Municipals

Period	Peak Date	Bottom Date	Drawdown	18-month return following bottom
Fed Raising Rates ('04 - '06)	3/17/2004	5/13/2004	-5.29	+9.39
Global Financial Crisis	1/23/2008	10/16/2008	-11.22	+23.04
Fear of Default Crisis*	10/12/2010	1/17/2011	-6.46	+18.53
Taper Tantrum	5/2/2013	9/5/2013	-6.77	+12.75
Trump Election Victory	7/6/2016	12/1/2016	-5.71	+6.00
Covid-19 Pandemic	3/9/2020	3/23/2020	-10.94	+15.49
Inflation Crisis	12/31/2021	10/25/2023	-13.02	—

High Yield Municipals

Period	Peak Date	Bottom Date	Drawdown	18-month return following bottom
Fed Raising Rates ('04 - '06)	3/15/2004	6/14/2004	-3.05	+17.81
Global Financial Crisis	1/23/2008	12/17/2008	-28.53	+41.77
Fear of Default Crisis*	10/25/2010	1/14/2011	-6.86	+28.17
Taper Tantrum	5/22/2013	9/10/2013	-11.85	+18.77
Trump Election Victory	9/29/2016	12/1/2016	-7.69	+15.15
Covid-19 Pandemic	02/28/2020	3/23/2020	-19.09	+32.67
Inflation Crisis	12/31/2021	10/25/2023	-18.11	—

* This period refers to the 2010 crisis of confidence sparked by an unfounded fear that hundreds of billions of dollars' worth of municipal defaults were on the horizon.

Source: Bloomberg, as of 12/31/23. Investment Grade Municipals represented by the Bloomberg Municipal Bond Index, is an unmanaged index considered representative of the tax-exempt bond market. High Yield Municipals represented by the Bloomberg Municipal High Yield Bond Index, is an unmanaged index considered representative of the tax-exempt bond market. An investment cannot be made directly into an index. **Past performance does not guarantee future results.**

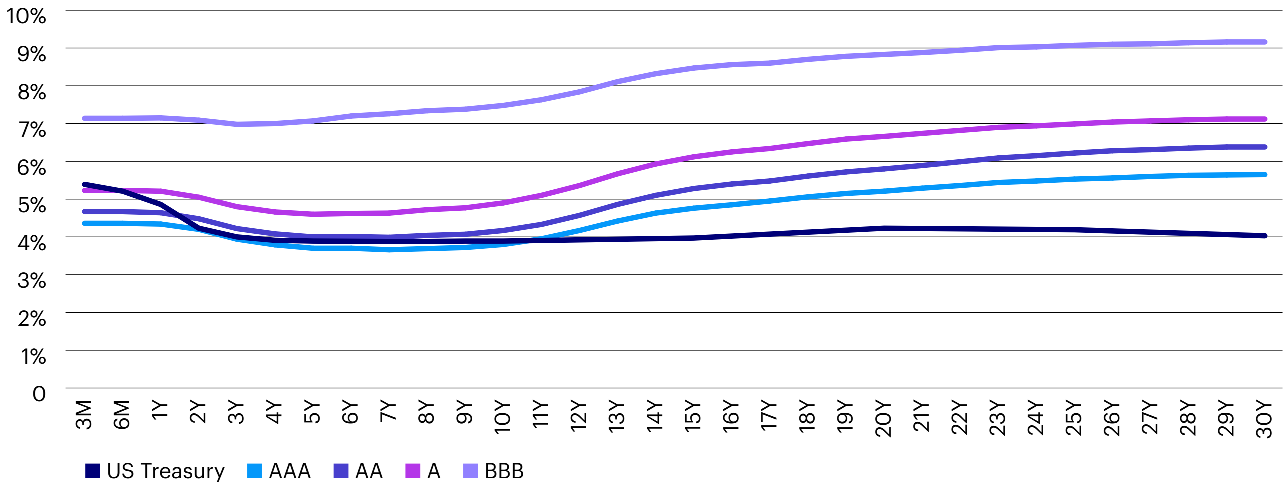
We expect municipal bonds to continue their advance at the beginning of 2024, though at a more measured pace. After January and February, the municipal market could get back to its normal seasonal pattern, in our view, with a slight pull-back in March and April due to tax season, strength during the late spring and summer months, another pull-back in the fall, and ending the year with positive momentum.[8]

Overall, municipals continued to look attractive based on the tax-exempt income they can provide—a potentially welcome benefit, especially for Americans in higher tax brackets and those living in high tax states. This may be of particular interest to investors who want to prepare for the "sunsetting" of a number of the TCJA's tax provisions. Without additional policy change, many Americans may be facing much larger tax liabilities than they have been accustomed to more recently. Notably, when these provisions sunset on December 31, 2025, the top individual tax bracket will go from 37% back to 39.6%, and for those in tax brackets where rates were lowered because of the TCJA, tax rates are expected to increase on average by 4.2%.[9] TCJA had also nearly doubled the standard deduction, the child tax credit, and the estate tax exemption.

On a tax-equivalent basis, municipal bonds looked compelling at the end of 2023. While the yield advantage was greater in longer maturities, it could also be found elsewhere on the municipal yield curve (see Exhibit 4). Looking at the long end, the tax-equivalent yield of a 30-year AAA-rated municipal bond and a 30-year BBB-rated municipal bond was 5.65% and 9.16%, respectively. By comparison, a 30-year US Treasury was yielding 4.03%.[5] Tax-exempt municipals were also attractive relative to corporate bonds on a tax-equivalent basis. For example, an individual in the 40.8% tax bracket would need to earn a 8.45% yield on a corporate bond to match the return on a comparable tax-exempt bond yielding 5.00%.[5]

Exhibit 4: Tax-equivalent yields on municipal bonds were compelling at year-end

Tax Equivalent Yields at 40.8%*



Source: Bloomberg, as of December 31, 2023. BBB-rated municipal is represented by the Bloomberg Municipal Bond BBB Index, AAA-rated municipal is represented by the Bloomberg Municipal Bond AAA Index, AA-rated municipal is represented by the Bloomberg Municipal Bond AA Index, A-rated municipal is represented by the Bloomberg Municipal Bond A Index, and US Treasury is represented by the public obligations of the US Treasury. 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. An investment cannot be made directly into an index.

* (37% Federal Tax Rate + 3.8% NIIT) effective as of January 1, 2024. Irs.gov, as of November 9, 2023. Top marginal tax rate for single taxpayers with more than $578,125 in taxable income or couples with $693,750 or more. NIIT is the Net Investment Income Tax of 3.8% on investment income for single taxpayers with more than $200,000 in taxable income or couples with $250,000 or more.

Regarding credit fundamentals, we expect stability overall during 2024, with a more neutral but still positive upgrade/downgrade ratio; however, we do not anticipate an increase in defaults. In our opinion, muni credits will stay in good shape overall, as federal pandemic aid and strong tax collections continue to bolster balance sheets. Fiscal restraint should also help keep most credits in a resilient position. That said, a number of factors suggest the peak of the credit cycle may have passed. These factors include the ongoing effects of inflation and higher interest rates on the operating and capital budgets of states and municipalities, the impact of wage increases and cost-of-living adjustments in labor contracts, return to office trends, and the impact of commercial real estate on large cities' property taxes, among others.[10]

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 December 31, 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: Barclays, as of January 3, 2024.
3. Source: JPMorgan, as of November 1, 2023.
4. Source: Bloomberg, as of December 31, 2023.
5. Source: BofA Global Research, as of December 1, 2023.
6. Source: The Bond Buyer, as of December 31, 2023.
7. Source: Lipper, as of December 31, 2023.
8. Source: JPMorgan, as of December 31, 2022, based on a 5-year average of net supply from 2017-2022: January: -$9bn; February: -$10bn; March: $0; April: $1bn; May: -$2bn; June: -$5bn; July: - $17bn; August: -$14bn; September: $4bn; October: $5bn; November -$5bn: December: -$10bn. Market technicals include supply and demand for a security and how it can affect changes in price, volume, and volatility. Net negative supply allows for favorable technicals in the municipal market.
9. Congressional Research Service, November 21, 2023.
10. Source: BofA Global Research, as of November 10, 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.

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.

Invesco does not provide tax advice. The tax information contained herein is general and is not exhaustive by nature. It is not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding tax penalties that may be imposed on the taxpayer under US federal tax laws. Federal and state tax laws are complex and constantly changing. Investors should always consult their own legal or tax advisor for information concerning their individual situation.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

Past performance does not guarantee future results.

Diversification does not guarantee a profit or eliminate the risk of loss.

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice.

Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations.

There is no guarantee the outlooks mentioned will come to pass. These opinions may differ from those of other Invesco investment professionals.

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. NR indicates the debtor was not rated and should not be interpreted as indicating low quality. 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; www.fitchratings.com and select 'Ratings Definitions' on the homepage.

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 techincals 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.