Invesco Fixed Income Investment Insights

US Municipal bond market recap and outlook

Third quarter 2020

Mark Paris
Chief Investment Officer,
Invesco Municipal Bond Team

Stephanie Larosiliere
Head of Municipal Business
Strategies and Development

Highlights

+ The municipal bond market advanced during the third quarter, recovering from its COVID-19 induced selloff in March, adding to its year to date gains.
+ Favorable market technicals–including strong demand, especially for taxable municipals–pushed up prices.
+ The rebound in municipal bond prices suggested that the investment climate might have shifted in favor of credit focused investors.
+ US federal stimulus continued to support the municipal market during the quarter but the delay of a rescue package for state and local credits dampened sentiment.

The global coronavirus (COVID-19) pandemic continued to weigh on the municipal bond market during the third quarter, as many states and localities awaited additional federal assistance and the timeline for reopening non-essential businesses remained unclear. Nevertheless, strong investor demand drove positive performance. Investment grade and high yield municipal bonds returned 1.23% and 3.09%, respectively, during the quarter, while taxable municipal bonds returned 1.71%.[1]

These gains wiped out the earlier municipal market 2020 calendar year losses. For the year-to-date through September 30, investment grade municipal bonds returned 3.80%. High yield municipal bonds lagged in comparison but still produced a year to date return of 0.37%. Taxable municipals bonds returned 9.79% for the 2020 year-to-date.

When the quarter began, the municipal market continued to benefit from federal support, including the Federal Reserve's purchasing plan of up to $500 billion in short-term municipal bonds and the availability of borrowing through the Municipal Liquidity Facility (MLF). The MLF enables two issuers per state, city or county to use proceeds from the sale of notes to service their debt payments. At quarter end, only two issuers had used the facility–the State of Illinois and the New York Metropolitan Transit Authority. This was in addition to the federal government funding for specific municipal sectors, such as airlines, transportation, and hospitals, through the Coronavirus Aid, Relief, and Economic Security (CARES) Act in March.

Another round of federal stimulus, with aid for states and localities, had been widely expected during the quarter but investors' hopes for a deal dimmed as Republicans and Democrats disagreed about the size of the rescue package. In late September, with Republicans determined to fill the vacant Supreme Court seat, market participants seemed to think that stimulus of any meaningful size was unlikely before the November US presidential election. Meanwhile, market volatility has increased ahead of the election.

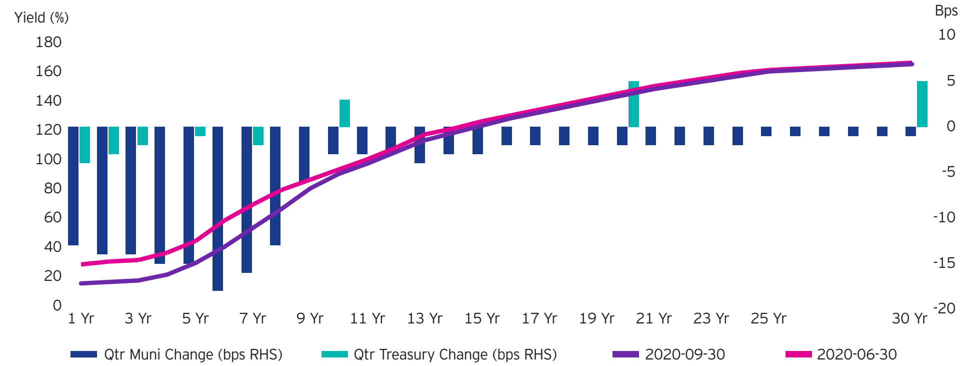
Both the municipal and US Treasury yield curves steepened during the third quarter, with the municipal yield curve experiencing relatively greater steepening (see Exhibit 1). The yield of a three-year AAA GO municipal bond declined 14 basis points (bps) to 0.14%, while the yield of a five-year AAA GO municipal bond dropped 15 bps to 0.26%. The yield of a 10-year AAA GO municipal bonds decreased 3 bps to 0.87%, and the yield of a 30-year AAA GO municipal bond dipped 1 bp to 1.62%.

In the Treasury market, shorter-term yields edged down, as the US Federal Reserve left the federal funds rate unchanged. The yield of a three-year Treasury bond fell 2 bps to 0.16%, while the yield of a five-year Treasury bond decreased 1 bp to 0.28%. Intermediate- and longer-term Treasury yields increased slightly. The yield of a 10-year Treasury bond rose 3 bps to 0.66%, and the yield of a 30-year Treasury bond rose 5 bps to 1.46%.

[1] Bloomberg Barclays. Investment grade municipal bonds are represented by Bloomberg Barclays Municipal Bond Index. High yield municipal bonds are represented by Bloomberg Barclays Municipal High Yield Bond Index. Taxable municipal bonds are represented by the Bloomberg Barclays Taxable Municipal Index.

Not a Deposit   Not FDIC Insured   Not Guaranteed by the Bank   May Lose Value
Not Insured by any Federal Government Agency

Exhibit 1: The municipal yield curve steepened more than the Treasury yield curve during the third quarter



Source: U.S. Department of the Treasury, Daily Treasury Yield Curve Rates.https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2015. Data as of September 30, 2020.

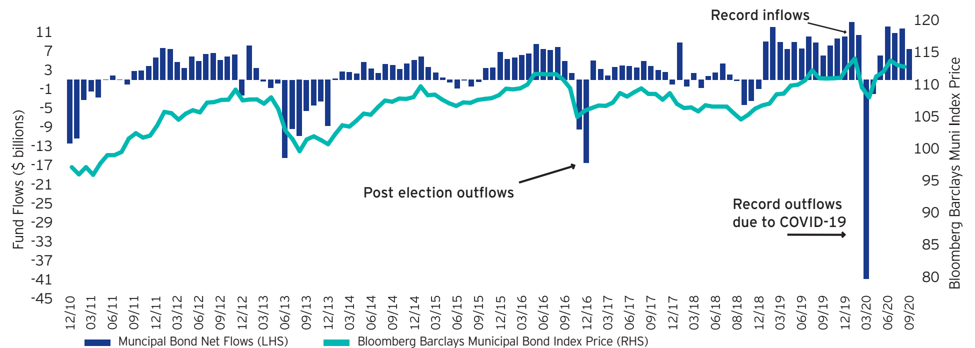
Strong demand and rising new issuance supported municipal prices

Supply and demand dynamics created a favorable environment for municipal bonds during the third quarter. New issuance totaled $135 billion, up 20% from the second quarter and up 26% from the third quarter of 2019. Year-to-date new issuance rose to $341 billion, 21% more than during the same period in 2019.

Taxable municipals played a significant role in the increase, accounting for more than 25% of the 2020 new issuance through August 31–the highest level since 2010.[2] Year to date issuance through September was three times the amount issued over the same period through September 2019.[3] Behind the surge was the 2017 Tax Cuts and Jobs Act (TCJA), which eliminated so called "tax-exempt advance refundings." Under TCJA, interest on advance refunding bonds–refunding bonds issued more than 90 days before the redemption or call date of the refunded bonds–is taxable. Interest on "current refunding bonds"–refunding bonds issued within 90 days or less of the redemption or call date of the refunded bonds–remains tax-exempt. Historically, the bulk of the refundings in the municipal market had been advance refundings. During the third quarter, low interest rates made it advantageous for issuers to advance refund their tax-exempt debt using taxable municipal bonds. Furthermore, taxable municipal bonds generally offer greater flexibility in the use of proceeds than tax-exempt issuance.

Demand was robust during the third quarter, as investors continued to return to the municipal market. Investment flows to municipal bond mutual funds were positive, with total inflows of approximately $27 billion. For the 2020 year to date, the $20 billion of total investment inflows reflected the impact of the significant outflows that had occurred in March and early April. (See Exhibit 2.)

Exhibit 2: Investment flows remained positive for the third quarter



Source: Strategic Insight (SI), Bloomberg Barclays, as of September 30, 2020. The Bloomberg Barclays Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market. An investment cannot be made directly in an index. **Past performance is not a guide to future returns.**

The demand was driven by a number of factors. First, there was seemingly insatiable appetite for taxable municipal bonds, which offered attractive yields compared to other segments of the fixed income market, such as corporate bonds. Moreover, because yields were extremely low or in negative territory in many parts of the world, the positive yields offered by taxable municipal debt made these bonds appealing to non-US buyers. Second, as investors wondered how the federal government was going to pay for its stimulus programs, many considered the impact tax-exempt municipal securities can have in an asset allocation. Tax-exempt income could look even more appealing if taxes remain the same or go up. Third, the TCJA's $10,000 cap on state and local tax deductions continued to create larger tax bills for people in states with high income taxes, increasing the potential value of tax-exempt income.

Credit downgrades were few during the quarter, as ratings remained largely intact. That is because rating agencies consider operating performance as well as an issuer's financial and budgetary ability to manage unexpected market shocks. The CARES Act also provided much needed funds for state and local governments, as well as the

[2] The Bond Buyer, Aug. 31, 2020.
[3] Refinitiv Thompson Reuters; BofA Global Research, June 30, 2020.

healthcare, education and transportation sectors. That said, New York City and New York State, which were at the epicenter of the COVID-19 outbreak in the spring, saw their ratings downgraded by one notch during the third quarter. Moody's Investors Service said the action was taken in response to the financial challenges faced by the city and state and because their recovery path might be longer than that of other US cities and states.

A new coronavirus relief bill, which was still in limbo at the end of the quarter, seemed likely to provide financial assistance to cash-strapped states and cities. Delays will not necessarily translate into a sharp deterioration in credit quality. The majority of credits entered the recession from a position of strength and were helped along the way by the federal government's first stimulus plan. And while a few defaults may make dramatic headlines, we believe the vast majority of municipal bonds will continue to pay coupons and principal as they come due. Municipal credits have a long history of low default rates as many provide essential services. Furthermore, municipal bonds are generally backed by physical collateral, such as facility or a building, which is one reason they have a lower historical default risk than corporate bonds (see Exhibit 3).

Exhibit 3: Municipal default rates have historically been lower than those of corporate bonds

Moody's and Standard & Poor's (S&P) Cumulative Historical Default Rates
Rated Issues Only

	Moody's* (1970-2019)		S&P* (1986-2019)	S&P* (1981-2019)
Rating Categories (Moody's/S&P)	**Munis (%)**	**Corps (%)**	**Munis (%)**	**Corps (%)**
Aaa/AAA	0.00	0.36	0.00	0.70
Aa/AA	0.02	0.79	0.04	0.72
A/A	0.10	2.11	0.09	1.08
Baa/BBB	1.10	3.58	0.78	3.00
Ba/BB	3.57	15.40	4.53	11.78
B/B	17.49	33.70	11.14	23.74
Caa-C/CCC-C	25.07	47.89	38.91	50.38
Investment Grade	0.10	2.25	0.18	1.91
Non-Invest Grade	7.29	28.68	8.70	20.22
All	0.16	10.17	0.28	8.80

Source: Moody's Investor Services ("Moody's") data through December 31, 2019, released July 15, 2020, latest data available. Standard and Poor's ("S&P") data through December 31, 2019, released July 11, 2020. 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. *2019 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 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.

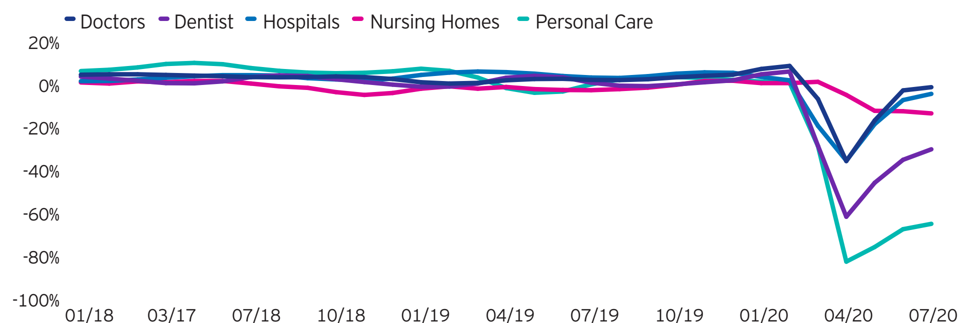
Healthcare: Evidence of recovery

One might have expected the spread of COVID-19 to drive more spending on medical services. However, hospital and doctor visits initially dropped about 40%. Healthcare municipal bond prices declined, as investors focused on pandemic-induced stress, rather than on underlying fundamentals. In the hospital sector, municipal credit spreads widened dramatically from March through June. Widening spreads indicate greater perceived risk.

And yet, while hospitals were under increased stress due to the COVID-19 crisis, larger multi-state hospital systems generally had the balance sheet strength needed to handle pandemic-related expense increases and a shift in patient mix. Many of them are supported by favorable demographics and geographies.

Indeed, investor sentiment began to improve during the spring as consumer spending rebounded. Spending on healthcare increased (see Exhibit 4), as consumers became more comfortable that COVID-19 cases were adequately isolated and as "tele-doc" technology became more widespread. Hospitals had benefited from federal stimulus and accelerated Medicare payments, which boosted their liquidity. Patient volumes increased, with some states and localities ending stay-at-home orders and as non-emergency healthcare services, such as elective surgeries, resumed. Hospital municipal spreads started narrowing in July and continued to tighten into the end of the quarter. Although valuations have risen, we believe attractive opportunities still remain for discerning investors.

Exhibit 4: Healthcare spending is improving and trending back toward pre-COVID-19 levels



Source: Bureau of Economic Analysis, data from Jan. 30, 2019, to July 31, 2020.

Outlook

The US economy has experienced an unusual recession–one triggered by public policy following a health crisis, rather than one that is economically driven. The recession took hold rapidly, as people were asked to stay home to limit the spread of COVID-19 and allow time for the healthcare sector to deal with a pandemic that caught the world unprepared. But as governments lifted many restrictions, economic conditions improved. Nevertheless, no one knows when the COVID-19 pandemic will abate and what challenges lie ahead.

In the municipal market, the lack of a consensus on federal aid to states and municipalities continued to weigh on investor sentiment at the end of the quarter. Still, many municipal issuers have strong balance sheets and cash on hand to help them bridge budget gaps. Some issuers are likely to raise funds through new municipal debt offerings, as evidenced by recent issuance by New York, New Jersey, and Illinois.

Federal stimulus packages, past and future, are likely to keep taxes elevated, if not push them higher. This should increase the appeal of municipal bonds, as they are one of the few income sources not subject to federal income taxes. Meanwhile, we expect taxable municipal issuance to remain at high levels as long as interest rates stay low and there is continued demand from corporate and non-US investors.

Now that municipal bonds have fully recovered from their first-quarter losses, we expect credit selection to drive the market going forward. We continue to rely on our seasoned credit research staff to sift through market noise and find attractive opportunities to add value during these times of ambiguity.

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.

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.

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.

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. If securities are rated differently by the rating agencies, the higher rating is applied. Not Rated indicates the debtor was not rated and should not be interpreted as indicating low quality. A negative in Cash indicates fund activity that has accrued or is pending settlement. Pre-Refunded / Escrowed to Maturity (Prerefunded / ETM) bonds are issues backed by an escrow account, invested in US Treasuries, which is used to pay bondholders. Other includes bonds rated below single B and bonds currently not paying a coupon. For more information on the rating methodology, please visit 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.

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.

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

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

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

Bloomberg Barclays Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market. An investment cannot be made into an index.