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Municipal bond market: Finding the optimal spot on the curve

While the sell-off in 2022 resulted in the market being more attractive, opportunities in the taxable and tax-exempt sectors differ. Credit fundamentals appear mostly strong, supported by federal support and robust revenues.

Executive summary

- Record outflows resulted in a difficult year for the municipal bond market in 2022, creating attractive opportunities and increased yield. Fundamentals remain strong, assisted by federal support programs and rebounding tax revenues.
- Some portions of the market are currently more attractive than others. The short end of the municipal bond yield curve is offering more appealing opportunities in the taxable sector than in the tax-exempt sector, even on a tax-equivalent basis.
- Taxable munis also offer greater diversification benefits when compared to corporate bonds.
- In the tax-exempt sector, the long end of the curve is steep, presenting potential for total return if fund flows normalize.
- While high yield munis may seem an obvious play on a market rebound, BBB- and A-rated munis may present a better opportunity, given the possibility of an economic slowdown. Stresses in certain segments of the high yield muni market, especially healthcare, merit some caution.

Current environment: Healthy technicals, yields and fundamentals

While 2022 saw record outflows from municipal bond mutual funds, it resulted in more attractive opportunities. Negative flows totaled $121 billion, or about 11% of total municipal bond mutual fund assets, causing spreads to widen, especially on bonds of lower quality and those subject to the Alternative Minimum Tax (AMT). Despite this widening, these yields are especially appealing, given the strength of the market's credit fundamentals. Ongoing support from the American Rescue Plan and a strong rebound in post-pandemic revenues have left municipal bond issuers in relative health.

Additionally, not all market participants saw outflows in 2022. Retail separately managed accounts (SMA) saw their assets grow, increasing to about $900 billion, or roughly 25% of the outstanding municipal bond issuance, based on dealer information and data. These SMAs, which focus primarily on maturities up to 12 years, have helped create opportunities in other parts of the market.

Because of the lack of demand for longer maturities due to mutual fund outflows and by the lack of participation of retail SMAs, the municipal bond/Treasury ratio curve has steepened. The three-year average difference between the 30-year ratio and the five-year ratio is 13 percentage points, and as of mid-March, the 30-year ratio was 92% and the five-year ratio was 61%, making the current difference 31 percentage points. So, while demand at the short end of the curve is holding steady, it has been weaker further out.

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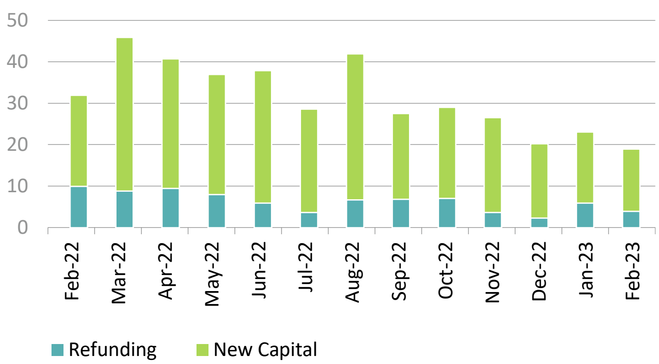
While demand has been strong at the short end in the tax-exempt market, supply side factors are more supportive in the taxable market. New issuance declined 21% last year, according to The Bond Buyer, driven largely by a steep decline in taxable issuance, and that was due largely to a lack of refundings. Taxable issuance amounted to $53 billion last year, after averaging $166 billion in 2020-21, when issuers were advance-refunding tax-exempt issues with taxables. Tax-exempt supply was also down, but only by 11%. In 2023, we expect new supply to be moderate. Much of this will fund infrastructure projects, and some will qualify as "green bonds," which continue to make up 10-11% of new issuance, based on DWS and Bank of America estimates.

Overall issuance has moderated

U.S. Municipal bonds issuance ($B)

Hover values listed in order of legend labels.



Source: SIFMA 2023

As for fundamentals, though revenues are expected to decline, most muni issuers are starting from a solid position, based on DWS's analysis. State and local governments appear to still be benefiting from the federal stimulus and the robust tax revenues that occurred in the wake of the pandemic. As a result, state "rainy day" funds at the end of fiscal 2022 hit a historic $136.5 billion, or about 11.6% of annual expenditures, according to the Pew Charitable Trust.

State pension funding has improved as well. Although last year's poor market performance dropped the average funded ratio by 7.9%, states are generally in good shape. At the end of 2021, this ratio stood at 84.8%, largely due to strong market performances in 2020 and 2021. This is a notable change from the low 70s that were common between 2011 and 2020. States diverge significantly, however; six states have ratios of less than 60%

Another caveat on fundamentals concerns the healthcare sector. Issuers in this sector continue to struggle with profit margins, due largely to rising labor costs resulting from a nursing shortage. So, this sector merits some caution.

Taxable market: Focusing on the short end

In the taxable market, DWS sees the most opportunities at the short end of the curve. As noted above, the narrow municipal/Treasury ratios at the shorter end are due largely to demand from retail SMA investors, who focus on tax-exempt bonds; in that portion of the curve, taxable munis make more sense.

Taxables also make sense for their diversification benefits. These are greatest when the stock market is volatile and are greater than those offered by corporate bonds. Over the past five years, the option-adjusted spreads (OAS) on taxable versus corporate bonds differ by about nine basis points (bps), on average. Because taxable munis are less risky, their OAS is lower. But during the stock market's most volatile five-month periods, that difference in spreads averages 43 bps because spreads on corporate bonds widen dramatically.

Correlation coefficients with the stock market confirm this benefit. Over the past five years, the correlation of the Bloomberg U.S. IG Corporate Index with the S&P 500 Index is 0.61. But the correlation of the taxable muni index with that index is only 0.34.

Investors should note that the taxable market today is not only much larger than in the recent past, but its investor base is broader, with international participants playing a larger role. Prior to 2019, the taxable market amounted to $450 billion; currently it totals approximately $850 billion, based on estimates from Citigroup and DWS. Some of this growth has come as issuers have recognized the greater flexibility allowed with the use of proceeds. Two examples of this in 2022 were a California General Obligation (GO) bond and a Texas Rate-Reduction bond.

In addition, convexity among taxables is better currently now that dollar prices are lower. Since 2019, approximately $182 billion in index-eligible taxable bonds have been issued; about one-quarter of those bonds are longer than 20 years, and about half of those are callable. The average dollar price of those holdings is around $77, as opposed to at issue, where they are priced at par. Convexity, therefore, is much better, and callable bonds priced at a steep discount will not shorten duration as rate fall as opposed to callable par bonds that price to the shorter call date.

Tax-exempt munis: Opportunities at the long end

In this segment, DWS is seeing attractive opportunities in the 15- to 20-year part of the curve. As noted above, these opportunities are due in part to the weak demand from retail SMAs, which tend to focus on the shorter end. The spread on the 10- to 15-year portion of the curve is about 60 basis points (as of mid-March), or about 1.6 standard deviations above the norm. Furthermore, this part of the curve looks attractive even versus the taxable market.

Moreover, additional spread is available to investors who focus on A-rated names or bonds subject to the AMT. We believe these issues may not only match the corporate spread but also offer a better total return possibility. To the extent fund flows return, the steep long end of the curve should normalize, leading to some price appreciation.

High Yield: A Replay of 2013?

Our view is that the performance of high yield munis in 2022 was largely due to outflows, not weak fundamentals. Record outflows forced portfolio managers to sell, which led to price deterioration.

The role of forced selling is evident from the performance of some investment-grade munis. In addition to lower-rated credits, high yield municipal bond funds typically own BBB- and A-rated bonds. And when selling pressures arise, managers sell the higher-rated bonds, which tend to be more liquid.

DWS's viewpoint is that is what occurred in much of the year. On a relative basis, although high yield munis were also affected, they held up better than the more liquid investment-grade munis. For the year as measured by the yield to worst of the various rated components of the Bloomberg Municipal indices, munis rated A widened almost 75 bps, while BBBs widened almost 100 basis points. High yield widened by only about 70 basis points. Interestingly, BBB-rated bonds, which do not carry the same level of credit risk, underperformed high yield munis. This is what led us to conclude it was record outflows, not credit risk, behind the weak performance of both.

Against this backdrop, where should investors consider positioning themselves? Over the last 20 years or so, the muni market has posted back-to-back negative years only once — in 2007-08. Therefore, if investors want to "bet" on mean reversion, high yield munis might seem to be an obvious choice. However, since high yield munis underperformed due to their longer duration and spreads did not widen as much as lower investment grade, there is more potential for spread widening as we enter an economic slowdown.

But 2007-08 might not be the best parallel. The years 2013-15 might be more appropriate. In 2013, the Fed's attempt to taper its bond purchases produced large outflows from muni bond mutual funds, and high yield and BBB munis both performed poorly. However, in the following two years — both 2014 and 2015 — BBBs and As, not high yield, outperformed.

That said, the circumstances of 2013 may not be a perfect parallel with today. In 2013, the high-yield market was hindered by some credit headlines, including Puerto Rico bonds and Detroit's bankruptcy, which may have weighed on high-yield performance. Though today's market is not facing major credit concerns currently, that could change quickly if a significant economic slowdown occurs.

Given this possibility and that high yield munis have not widened as much as BBBs and As, there is potential for a repeat of 2013. So, these higher-quality munis could once again perform better than high yield. In fact, at 220 bps, high-yield spreads are tighter than their long-term average of 245 bps, so macroeconomic or credit events could cause them to widen further. Therefore, we think BBBs and perhaps As have potential to outperform, especially if the economy experiences a "harder landing" than is currently expected.

Nevertheless, some distinctions are possible. Various studies from credit rating agencies have shown that defaults among municipal issues are rare, and we believe that will continue to be the case even if the economy tips into recession at some point this year. Among high yield munis, however, it is likely to be a different story. While they do not default at the same rate as high yield corporates, in today's market, pressures are weighing on the healthcare sector, especially in the senior living segment. Staffing shortages and occupancy challenges resulting from the pandemic, as well as more recent cost inflation, are putting significant stresses on this segment. The market is already seeing defaults in senior living, and we expect that to tick up as the year progresses. Other segments, such as project finance, may also come under pressure.

Another area that may see weakness is any project that is facing inflation in construction costs. Pricing pressures have hurt financial results and have also caused delays, as skilled workers are in short supply.

While investors have less to worry about in investment-grade munis, pockets of the high yield muni market are seeing some stress. This provides additional support to our thesis that high yield, though attractive, may not outperform in the coming months.

Munis can be a nice option in the toolkit

Despite some conventional perceptions, munis could offer value to institutional investors. When looking at bonds in the tax-exempt sector and equate them to taxable equivalents, a metric to be employed is looking at the tax adjustment factor, which focuses on the after-tax yield. In situations where the tax-exempt curve becomes particularly steep, going out 10- to 15-years, an active manager with discretion can find opportunities in the tax-exempt space; this is where the ratios become particularly important when determining where to allocate because those relative value opportunities can move around.

In the case of taxable munis, which is a smaller sub-sector, those can serve as more of a diversifier and relative value play versus corporate credit. Additionally, the relative value is there compared with corporates. It is also a reason that overseas investors in Europe and Asia are having more interest in taxable munis. If they are finding themselves overexposed to U.S. corporate credit, these bonds offer them added high-quality, good-yielding diversification along with relative value opportunities.

In Summary

The record outflows in the municipal bond market produced by stubborn inflation and the Federal Reserve's tightening policy have created pockets of opportunity. Investors should consider short-term munis in the taxable market and longer-term maturities in the tax-exempt market. While credit fundamentals remain strong overall, some areas of the high yield muni market merit some caution.

Important risk information

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