Municipal Bonds

May 2024

DWS

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The Duration Opportunity Through Taxable Municipal Bonds

Taxable municipal bonds have traditionally exhibited a number of consistent characteristics including high-credit quality, attractive yields relative to the investment-gtade spectrum, high coupon income for cash flow matching purposes, and low default rates and sector diversification compared to corporate bonds. In the current environment, these securities offer long duration availability, which can be appealing to insurance companies with liability matching considerations.

Taxable municipal universe

Recent new issuance has slowed due to the elevated rate environment since 2022, causing new issue supply to fall to USD$41 billion in 2023 from an average of USD$118 billion per year between 2019 and 2022. These figures include taxable municipals with corporate cusips.

Investment universe comparison

	Market value (USD bn)	Effective Duration (years)	Spread (bps)	Effective Yield (%)	Average Rating
Taxable municipals	360	7.72	64	5.01	AA2
IG corporates	8,325	6.74	94	5.36	A3

Source: ICE. Based on ICE BofA Broad US Taxable Municipal Securities Index (TXMB) and ICE BofA US Corporate Index (C0A0) as of 31 March 2024

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Based on current analytics, other than the longer duration, the immediate benefits of taxable municipals are not apparent with their lower spread and yield versus investment-grade (IG) corporates. However, by partitioning the two universes on a rating equivalent basis, taxable munis offer more duration, spread and yield especially with AA/A bonds. Hence for investors, such as insurers, who prefer high quality assets due to regulatory capital charges, taxable municipals become an interesting addition to their investment toolkit.[1]

Investment universe comparison (by rating)

	Taxable municipals			**IG corporates**		
Rating	Duration (years)	Yield (%)	Spread (bps)	Duration (years)	Yield (%)	Spread (bps)
AAA	7.07	4.80	40	9.31	4.80	38
AA	*7.85*	*4.97*	*60*	*7.19*	*4.95*	*51*
A	*7.68*	*5.19*	*84*	*6.72*	*5.23*	*80*
BBB	8.70	6.04	167	6.61	5.56	117
Overall	7.72	5.01	64	6.74	5.36	94

Source: ICE. Based on ICE BofA Broad US Taxable Municipal Securities Index (TXMB) and ICE BofA US Corporate Index (C0A0) as of 31 March 2024

Analysis
For Life insurers, especially with long-dated liabilities, the general interest will be on the 10+ year part of the yield curve. The taxable municipals universe has nearly 63% with maturities greater than 10 years compared to just 31% for IG corporates. Their average rating is roughly a full rating higher than IG corporates (AA2/AA3 versus A3).

Long duration investment universe comparison (by maturity)

	Taxable municipals				**IG corporates**			
Maturity (years)	Duration (years)	Yield (%)	Spread (bps)	Average Rating	Duration (years)	Yield (%)	Spread (bps)	Average Rating
10 – 15	7.15	4.97	76	AA2	8.76	5.44	120	A3
>= 15	10.97	5.13	78	AA3	13.62	5.52	110	A3

Source: ICE. Based on ICE BofA Broad US Taxable Municipal Securities Index (TXMB) and ICE BofA US Corporate Index (C0A0) as of 31 March 2024

Using monthly returns since January 2010, if we allocate some percentage of a long-dated IG corporate portfolio to taxable municipals, the historical results are:

Long duration historical asset allocation

	Allocation				
IG corporates 10+ years	100%	95%	90%	85%	80%
Taxable municipals 10+ years	0%	5%	10%	15%	20%
Annualized return	**4.97%**	5.00%	5.02%	5.05%	**5.07%**
Annualized volatility	**10.64%**	10.47%	10.31%	10.15%	**10.00%**

Source: ICE. Based on ICE 10+ Year Broad US Taxable Municipal Securities Index (TX9M) and ICE BofA 10+ Year US Corporate Index (C9A0) as of 31 December 2009 - 31 March 2024. Past performance is not a reliable indicator of future returns. Allocations are subject to change without notice.

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During this period, taxable municipals provided additional return pick-up and helped lower the portfolio volatility. Correlation between the two long duration indices was 0.86 for the time period.

For general insurers with shorter liabilities in the range of 3-5 years, a similar analysis shows:

Intermediate duration universe comparison (by maturity)

	Taxable municipals				IG corporates			
Maturity (years)	Duration (years)	Yield (%)	Spread (bps)	Average Rating	Duration (years)	Yield (%)	Spread (bps)	Average Rating
3 - 5	3.16	4.70	31	AA2	3.50	5.18	80	A3

Source: ICE. Based on ICE BofA Broad US Taxable Municipal Securities Index (TXMB) and ICE BofA US Corporate Index (C0A0) as of 31 March 2024

Intermediate duration historical asset allocation

	Allocation				
IG corporates 3 -5 years	100%	95%	90%	85%	80%
Taxable municipals 3-5 years	0%	5%	10%	15%	20%
Annualized return	**3.37%**	3.35%	3.33%	3.31%	**3.30%**
Annualized volatility	**3.70%**	3.63%	3.57%	3.51%	**3.45%**

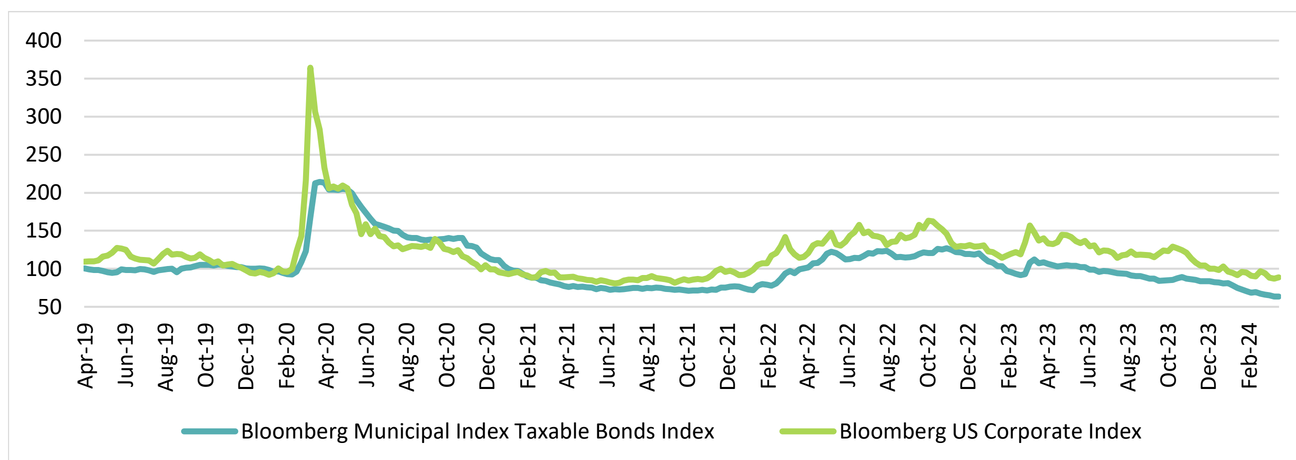
Source: ICE. Based on ICE BofA 3-5 Year US Taxable Municipal Securities Index (D2TM) and ICE BofA 3-5 Year US Corporate Index (C2A0) as of 31 December 2009 - 31 March 2024. Past performance is not a reliable indicator of future returns. Allocations are subject to change without notice.

The results suggests a diversification benefit with lower average volatility but no return pick-up. Correlation was 0.80 and therefore the taxable municipal investment story would appear to fit better with long duration portfolios.

Relative value

Currently, U.S. fixed income markets are showing elevated yields after two years of monetary policy tightening. But the spread difference between taxable municipals and investment-grade corporates also suggests taxable municipals are relatively more expensive at the moment.

Spread (in bps)



Source: As of 29 March 2024. Bloomberg. Past performance is not a reliable indicator of future returns.

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Taxable municipal spreads are near their lows given the tightening in corporate spreads as well as the light taxable muni new issue calendar in 2024 so far. If there is more equity volatility, then corporate spreads could widen and taxable muni spreads to follow too. Most of the taxable municipal supply over the past few years was driven by issuer refunding activity. Given the outlook for Treasury rates remaining uncertain, a large increase in supply is not to be expected. Therefore, taxable municipal spreads are less likely to move wider or tighter in the near term.[1]

Reviewing the last 5 years of market data, we find that taxable municipal spreads widened less than those of IG corporate under stressed conditions.

Spread widening experience March 2019 – March 2024

Date	S&P 500 total return	Bloomberg Taxable Municipal Index OAS (bps)	Bloomberg US Corporate Bond Index OAS (bps)	Spread Difference between taxable muni and IG Corp (bps)	Monthly taxable muni index OAS change (bps)	Monthly IG Corp index OAS change (bps)
March 2020	-12.35%	205	283	-78	109	160
September 2022	-9.21%	119	158	-38	5	18
April 2022	-8.72%	108	134	-26	12	20
June 2022	-8.26%	111	155	-44	-10	27
February 2020	-8.23%	96	123	-27	0	22

Source: As of 31 March 2024. Bloomberg Taxable Municipal Index and Bloomberg US Corporate Bond Index. Past performance is not a reliable indicator of future returns.

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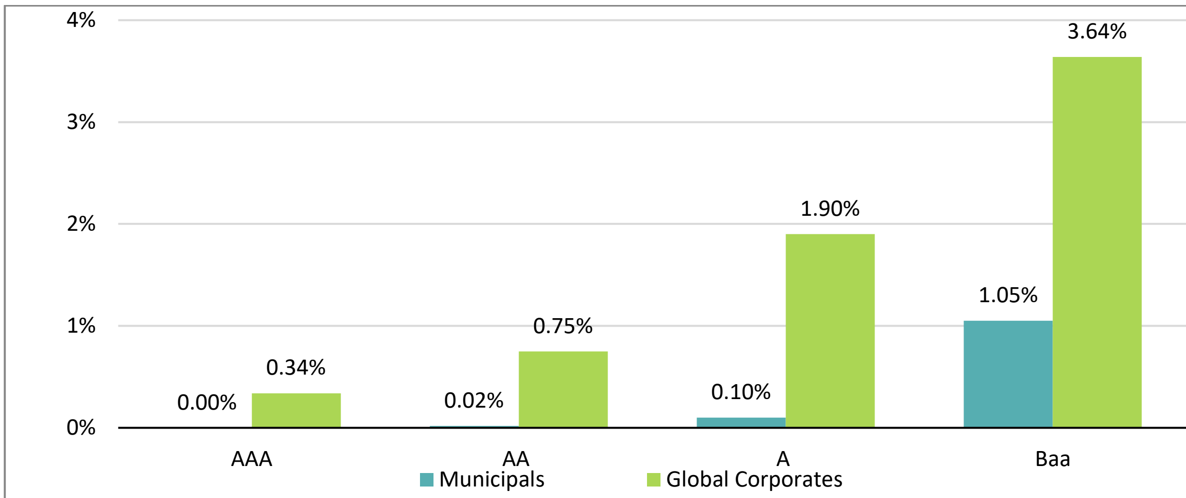
Default rate

Other than diversification, over time the cumulative default rate for municipals is much lower than investment grade corporates. For BBB-rated bonds, the default rate was 1.05% for municipals compared to 3.64% for IG corporates. Thus this helps with the investor's decision to include taxable municipals in an IG corporate portfolio.

Historical cumulative default rate (1970 – 2022)

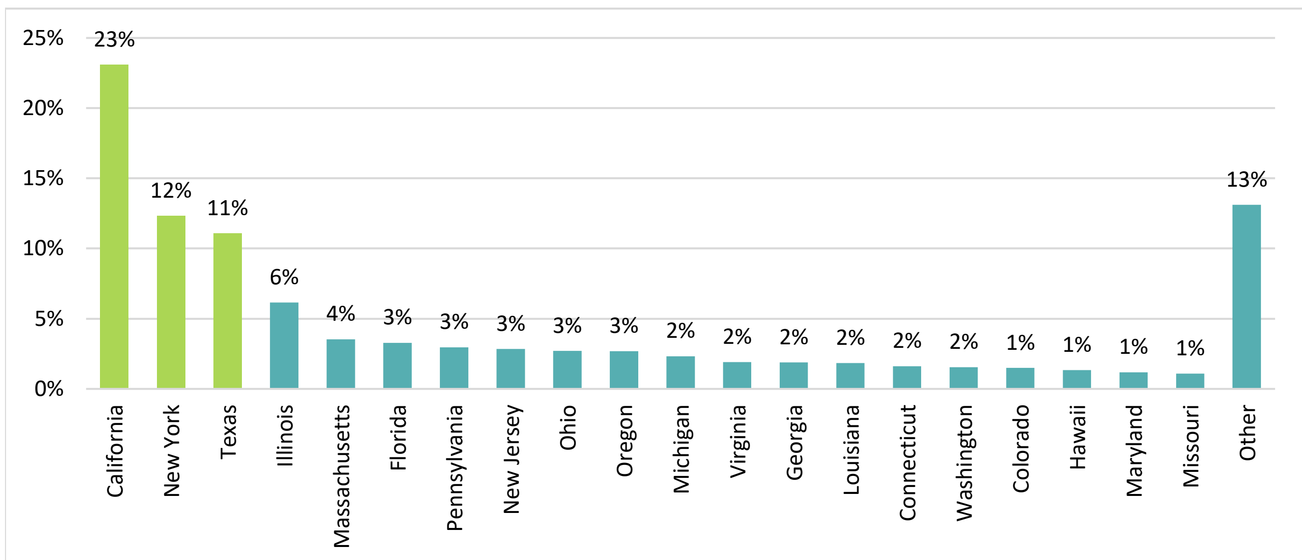


Source: Moody's U.S. Municipal Defaults and Recoveries 1970-2022.

More about the taxable municipals universe

Within the taxable municipal universe, the states with the most debt outstanding are California, New York and Texas.

Geographic split



Source: As of 31 March 2024. Bloomberg Taxable Municipal Index.

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California has a large and diverse economy that is the largest in the U.S. as measured by GDP for 2023 and ranks as the fifth-largest economy in the world. The state has a large exposure to high income taxpayers and as a result has a "boom or bust" revenue collection pattern. Due to lower-than-expected tax revenues, the state is facing a very large budget deficit of between USD$58 and USD$73 billion. Although DWS is more cautious about California's credit outlook, the state has a large amount of reserves that can be used to help cushion downturns in revenues.

For New York state, a majority of issuance is backed by dedicated taxes. As a result, 88% of the New York bonds in the taxable muni index are rated AA or higher. Within that exposure, New York City faces challenges with commercial property valuations and costs associated with the migrant situation. However, DWS expects the city's credit fundamentals to remain stable as they manage through these challenges by using their strong management, fiscal oversight, and experience dealing with past crisis.[1]

Lastly, issuers from the state of Texas are benefiting from a strong economy as it is one of the fastest growing states in the country. The state's general obligation rating is AAA by all three rating agencies due to its large and diverse economy. It is the second-largest state in the U.S by GDP as of 2023. With the state's affordable cost of living and business-friendly environment, DWS expects the state to grow at a faster pace than the nation.

Conclusion

Investing in taxable municipals is an interesting addition for IG-focused portfolios. For insurers with long-dated liabilities, including taxable municipals as part of the investment universe is worth the consideration. Taxable munis can help by increasing diversification and ratings quality, adding some return pick-up and lowering volatility. The case for adding taxable municipals to shorter-duration IG corporate portfolios is more mixed, however, as the long-term analysis did not show additional return, just reduced overall portfolio volatility.[2]

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