MUNI REVIEW: REVISITING OPPORTUNITIES

No one would blame you for not closely following the municipal bond market—it's a relatively sleepy place, and it definitely doesn't get as much attention as high-growth tech stocks or equity markets in general.

But for many investors (and many of our clients) muni bonds are an important asset class. With the economic stress of the pandemic, a lot has happened in this corner of the market, and in this short paper we'd like to share some of the key issues and what you need to know as an investor.

I hope you find this paper interesting and informative. If you have any questions about what we've discussed here or how it applies to your portfolio, please don't hesitate to reach out. We'd love to hear your questions and thoughts as we work to provide as much education and information as possible.

Jeff Fishman

What's a Municipal Bond?

A municipal bond is a debt security issued by a state, municipality or county to finance its capital expenditures, including the construction of highways, bridges or schools. They can be thought of as loans that investors make to local governments.

Municipal bonds are exempt from federal taxes and most state and local taxes, making them especially attractive to people in high income tax brackets.

The Latest News

Municipal bonds delivered strong performance year-to-date relative to U.S. Treasuries and corporate bonds but took a bit of a pause beginning in September before bouncing back to post a strong November.[1]

After seeing prices rise earlier in the year, the volatility might create concerns for investors who rely on muni bonds as a steady part of their portfolios. The key benefits of munis haven't changed—they offer low default risk, predictable income, and tax-exempt status (most are free from federal and sometimes state tax)[2]—but a change in this part of the portfolio can feel a little intimidating.

Let's take a closer look at what's driven some of the news and what we expect going forward.

Credit Quality in the Coming Years

While there were some concerns about what might happen in the municipal market in light of COVID-19, the pace and strength of the economic recovery have benefited most municipalities. In fact, we've seen tax revenue growth across all major tax types (property, income, and sales).[3]

In the second quarter of 2021, the U.S. Census Bureau reported that total state and local government tax revenue exceeded $450 billion, a healthy 32.5% year-over-year increase from the same period in 2020.[4] While that is, of course, in comparison to an unusually weak 2020, second quarter 2021 revenues were still up 12.3% compared to the same period in 2019.[5]

In other words, tax revenue seems to be on solid footing.

This supports the fundamental credit quality of munis and underscores their already-low probability of default.

Beyond these figures, the average state now has a record of over 15% of its top-line budget in cash on hand for rainy day funds.[6] Reasonable budgets and strong economic tailwinds could make 2022 even stronger.

What is Credit Quality?

Credit quality is a description of how creditworthy a borrower is—it's an answer to the question, "Will they be able to repay their debt?" The higher the credit quality, the higher the likelihood that a debt will be paid. The municipal bonds with the highest credit quality have a AAA rating.

Support (and Risk) From Washington

Another component of credit quality is policy in Washington. Federal COVID-19 relief already boosted state and local government finances with $150 billion in direct aid from the CARES Act in 2020, plus an estimated $350 billion from the American Rescue Plan.[7,8]

This "shot in the arm" essentially provided a floor for municipal bond credit.

The recent passage of the $1 trillion infrastructure bill is another boon for municipal bond markets, as it will help shore up the balance sheets of local governments. The bill increases federal funding in road, bridges, airports, public transit systems, broadband internet service, water projects, and others.[9]

That being said, the bill left out proposals that could have increased muni issuance in a market that is still starved for supply.[10] This has led to a further rally of the highest-rated AAA municipal bonds, raising prices and reducing yields.[11] Longer term, the infrastructure bill could still lead to more issuance if infrastructure projects don't have all the federal support they need for completion.

The other impact of higher spending is a policy the Biden administration has already floated: raising tax rates on corporations and the wealthy.[12] While President Biden's infrastructure bill does not immediately raise taxes, the companion "Build Back Better" bill could increase tax rates at various levels, which could then further bolster investor demand for tax-exempt bonds.[13]

The Specter of Inflation

With an economy seemingly overheating like this, we would be remiss if we didn't confront the elephant in the room: inflation. Bonds generally don't perform well during periods of high inflation, and we've recently seen the worst headline inflation numbers in 30 years.[14]

However, the Federal Reserve's arsenal of over 400 Ph.D. economists predicts that inflation will fall under the Fed's 2% target in 2022.[15] In other words, the current spike in inflation is expected to subside as we work through short-term supply chain shocks and pent-up demand.

It's also worth noting that at the beginning of 2021 when bond yields spiked (which caused prices to fall), municipal bonds held their value better than other fixed-income securities.[16] Among bonds, munis are considered fairly defensive against inflation. Those that are worried about inflation can also consider municipal inflation-linked bonds, which adjust repayment amounts based on inflation.[17]

Finding Opportunities Requires Active Engagement

How do you navigate these changes in the municipal market? The reality is that there's a fair amount of uncertainty these days. If you cringe every time you get gas or experience sticker shock at the supermarket, you aren't the only one. While you may feel that very little is being done to curb inflation, we're here to help you find your way through these uncertainties—with prudence and a degree of caution.

We are big believers in big picture strategy guided by an appropriate time horizon, rather than short-term pressure. While some flexibility in investment strategy including inflation hedges may be appropriate in some cases, it should not be driven by emotion or stress.

The defensive nature of municipal bonds still makes the asset class an appealing choice for many types of investors. Moody's research shows minimal default rates in municipal bonds over the past 51 years,[18] and a supportive backdrop in credit quality, gradually rising rates, and a strengthening economy could help this asset class continue to provide both risk mitigation and tax-free income.

As always, please reach out to us with your questions. The situation will continue to evolve—maybe even in the weeks after you read this—and we're here to help you find the most prudent and appropriate path for your family.

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SOURCES

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