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Plotting a Path for Second Half Muni Returns

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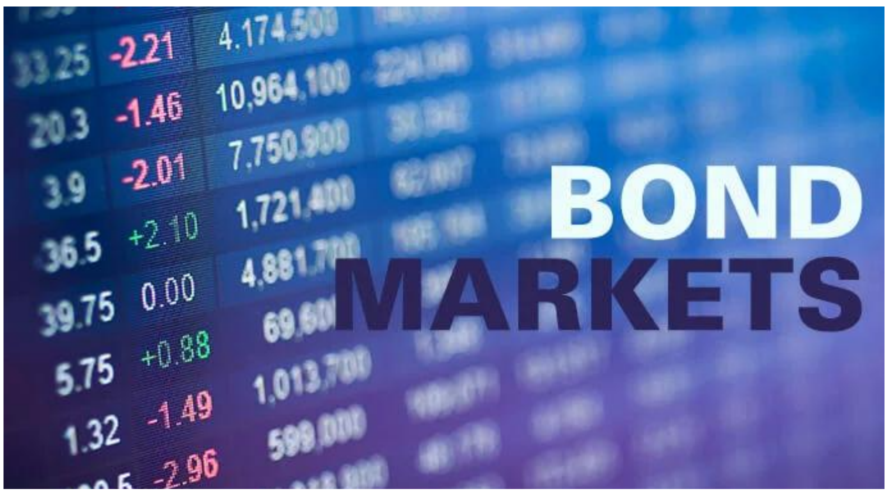
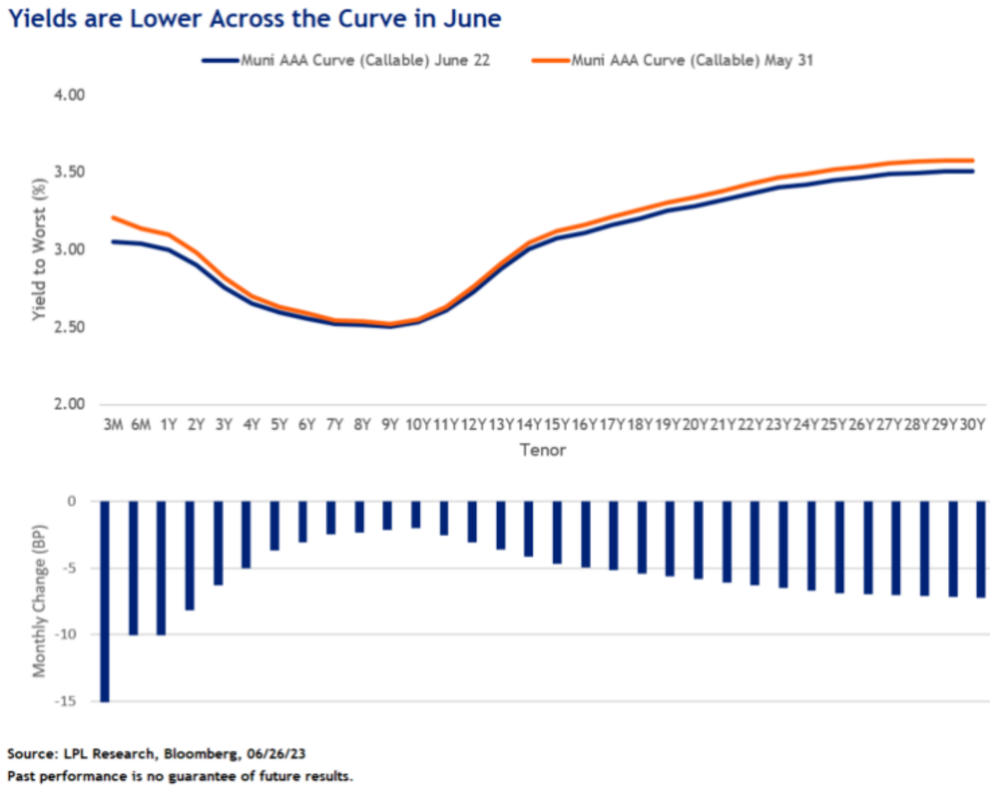


Tuesday, June 27, 2023

It's been a case of one step forward, two steps back for municipal (muni) bond investors this year. What started out as one of the best January's in recent memory for munis, quickly turned into one of the worst February's on record. And monthly returns have been uneven since. So, what can muni investors expect the rest of the year? Some thoughts:

- The muni curve is almost always steeper than the Treasury curve due to uncertainty about future tax rates, as well as strong demand from individuals for bonds maturing within 10 years, and because longer-dated issuance is normally tied to the expected life of an individual project. While this remains the case, for the first time in decades the municipal bond yield curve is inverted. That is, some shorter maturity muni securities are yielding more than some longer maturity securities. Core fixed income portfolios could use a barbell strategy to capture the cheapest parts of the curve—the very front end and the longer term tenors.



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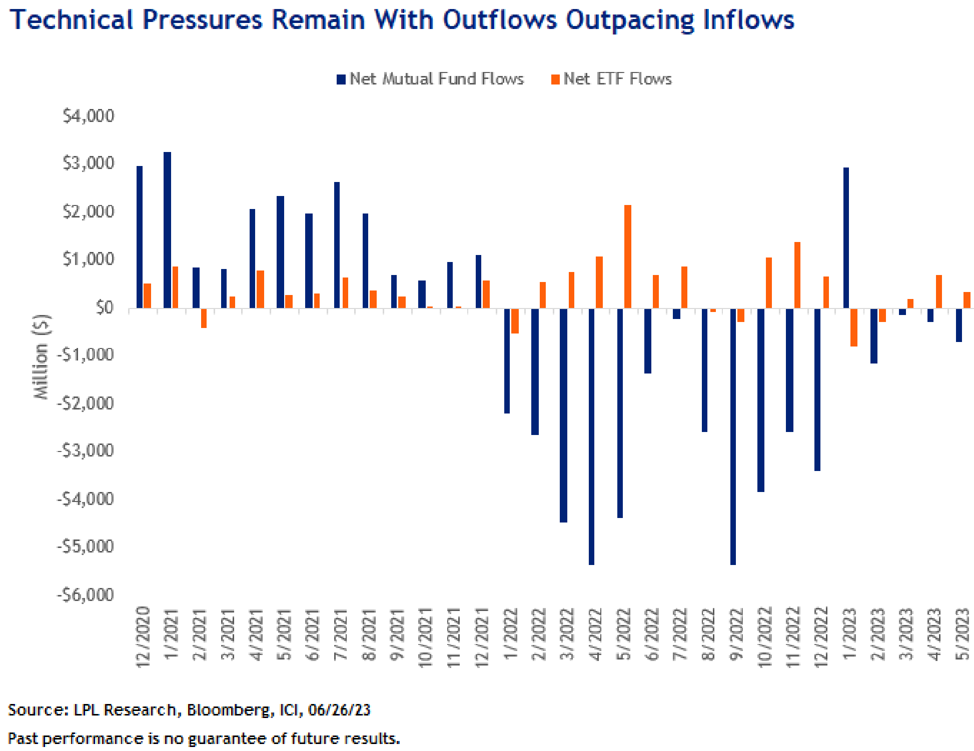
- According to recent Federal Reserve (Fed) data, the total market value of the municipal market increased by 1.9% in the first quarter to $4 trillion. Retail ownership (66%) remains the largest ownership block of holders, with banks (15%) and insurance companies (11%) also large holders. While total yields for muni securities have increased and may be attractive to retail investors, the relative value proposition of munis still isn't very compelling for banks and/or insurance companies, so the market is unlikely to get additional crossover support from those investors. So, performance for the second half of the year will likely be aided (or not) by the appetite of retail investors. As can be seen on the chart below, record outflows in 2022 have been followed by further outflows this year (aside from January). Despite still strong fundamentals (more below) and improved valuations, muni investors have, so far, been unwilling to stay the course.



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- While the Fed has stated additional rate hikes are possible, munis, which can provide additional tax-exempt income in higher-rate environments, have generated attractive after-tax returns at the end of Fed rate hiking campaigns. Over these last four hiking cycles, munis averaged a 9.0% after-tax return over the 12-month period after the Fed was done raising rates. Our base case is the Fed maybe raising rates one more time (perhaps two) but is close to the end of the rate hiking campaign. Once the Fed is done, we could see lower yields before the Fed even starts to cut rates. As such, investors may want to take advantage of longer maturity yields before they are gone.
- There is still a lot of uncertainty surrounding the impact on commercial real estate (CRE) in general, but the New York city comptroller recently provided some scenario analysis on that subject. According to their work, even in a doomsday scenario, where property values decline by 40% over the next few years, there would be a revenue short fall of only about 1.4% of city tax revenues. Obviously, this is just a scenario for New York City but given the importance of real estate taxes to its operating budgets, it does provide some relief that muni budget's broadly won't be severely impacted. And residential valuations are holding up, which helps offset some of the CRE issues.

Bottom Line: While munis have outperformed a number of taxable fixed income markets this year, after the historically bad year last year, it probably hasn't been the year (so far) that many muni investors had hoped for. But, with the Fed close to the end of its rate hiking campaign, we could see a smoother path for munis in the second half of the year. Despite a slowing economy, fundamentals are still strong compared to history. And while tax revenues may have peaked, high cash balances and reserves should allow most issuers to adapt to an economic slowdown. Total yields remain above longer-term averages and since starting yields are the best predictor of future returns (over longer horizons), we think the prospects of solid returns for munis have improved (no guarantees of course).

IMPORTANT DISCLOSURES

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes apply. If sold prior to maturity, capital gains tax could apply.

For a list of descriptions of the indexes and economic terms referenced in this publication, please visit our website at lplresearch.com/definitions.

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