PUBLIC FIXED INCOME

Taxable Municipals

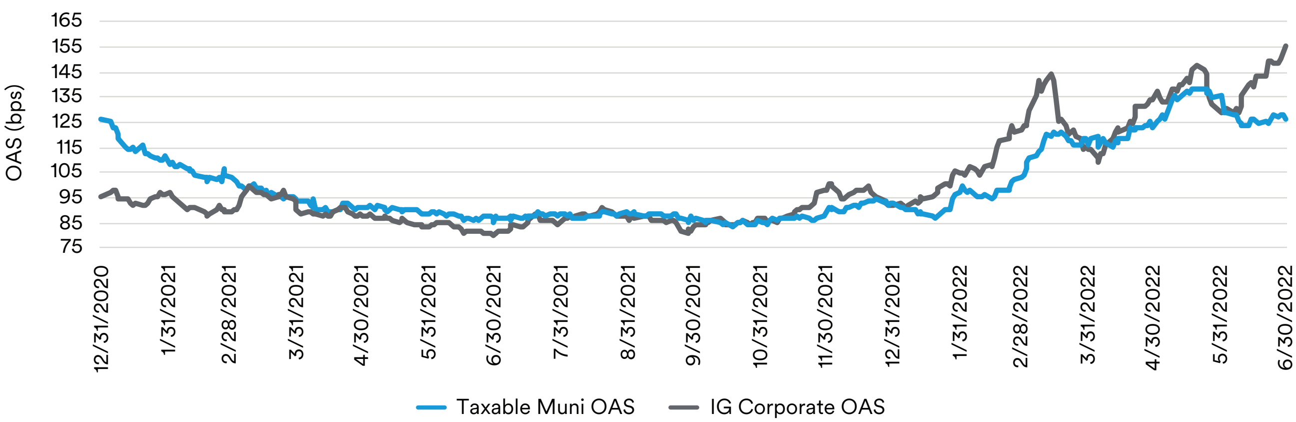
Market Review and Outlook

June 30, 2022

"The beatings will continue until morale improves." — unknown

The beatings did continue in the second quarter as the market wrestled with the impacts of an aggressive Fed, persistently high inflation, and signs of weaker growth. The path for rates was unmistakably higher but was riddled with fits and starts in reaction to the latest readings on inflation and any other economic data indicating whether the ultimate destination is a recession. The Bloomberg Taxable Municipal Index posted a negative total return -6.20%, as "morale" (i.e. interest rates) indeed failed to improve. The 30-year Treasury closed the quarter 73 basis points higher, while the OAS on the Bloomberg Aggregate-Eligible Taxable Municipal Index increased by 15 basis points. By comparison, as shown in Figure 1, the OAS on the Bloomberg Investment Grade Corporate Index increased by 39 basis points.[1]

Figure 1 | Taxable Municipal Spread versus Investment Grade Corporate Spread



Source: Bloomberg

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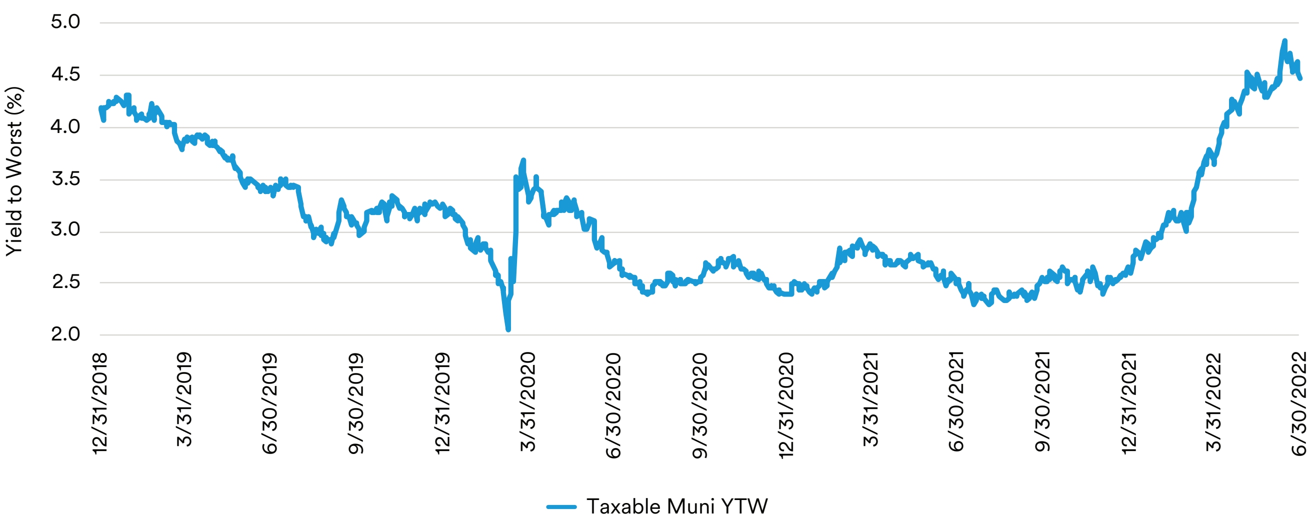
This leads us to two observations from the second quarter:

1. Most of the damage to Taxable Municipal returns was inflicted by higher rates. To the extent that rates have recalibrated to the aggressive trajectory of rate hikes, most of the damage may already be done and return prospects for the second half of the year should be much more favorable in our view.
2. Consistent with historical observations, Taxable Municipal spreads outperformed Investment Grade Corporates in a volatile "risk off" period. As the market narrative shifted toward the increasing probability of a recession engineered by aggressive policy tightening, the OAS on the Investment Grade Corporate Index surged from a low of 109 basis points on April 5th to 149 basis points on May 20th – a 40 basis point move in just a few weeks. Over the same time period, the spread widening in Taxable Municipals was notably less severe, at 28 basis points.[2]

The 128 basis point move higher in the 30-year Treasury was by far the largest contributing factor to the -13.97% year-to-date total return for the Bloomberg Taxable Municipal Index. While the adjustment has been painful, the silver lining in the large negative returns is the significant repricing of Taxable Municipals yields. The yield-to-worst of the Bloomberg Aggregate-Eligible Taxable Municipal Index bottomed at a paltry 2.29% in August 2021.[3] By June 30, 2022, the index yield had almost doubled to 4.46% with no material change in the credit composition of the index. In our view, this partially explains why Taxable Municipal spreads have been relatively resilient: higher yields have supported demand for high quality longer duration assets as expectations of weaker growth favor up-in-quality positioning, and as the curve continues to flatten or invert. We expect this dynamic to continue playing out through the rest of the year, particularly as corporate profits start to roll over and jobless claims trend higher.

Figure 2 | Yield on Bloomberg Aggregate Eligible Taxable Municipal Index

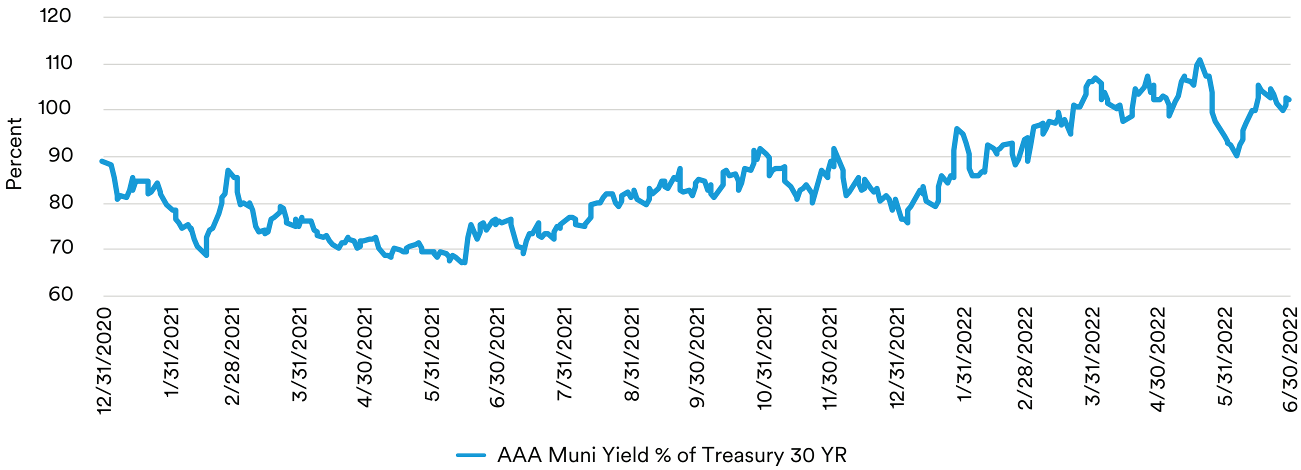


Source: Bloomberg

One challenge for investors looking to participate in the Taxable Municipal market has been the sharp decline in new issuance compared to 2021. Year-to-date issuance of Taxable Municipals through June 30th totals $40.8 billion (including bonds issued by municipal issuers with corporate CUSIPs) – a 36% decline year-over-year.[4] The primary culprit for the decline in issuance is higher rates, which undermine the economics of refunding transactions that had been a significant source of taxable new issue supply since tax-exempt advanced refundings were eliminated in 2018.

With more limited Taxable Municipal supply, a U.S. investor would be well served to keep an eye on the tax-exempt market. This overwhelmingly retail market offered little value for institutional investors in 2021, with abysmal yields and valuations at historical tights. However, the sharp rise in rates has led to record outflows from tax-exempt funds, which in turn has forced a severe adjustment in valuations. At times in the second quarter, tax-exempt yields became so dislocated that they appeared very compelling even to corporate taxpayers subject to much lower tax rates. A measure of relative value that we follow closely, the ratio of the 30-year AAA tax-exempt curve to 30-year U.S. Treasuries, surged from 81% at the beginning of the year to 111% in May. This ratio hit a low of 67% in 2021.[5] At these times of dislocation when ratios spike to well over 100%, certain tax-exempt securities can offer (and have offered) a substantial yield pickup of 100 basis points or more on a taxable-equivalent basis relative to taxable municipal bonds from the same issuer. In these circumstances, we believe that allocations to tax-exempts can be highly advantageous in institutional portfolios subject to corporate tax rates.

Figure 3 | 30-Year AAA Tax Exempt BVAL Curve Relative to the 30-Year Treasuries



Source: Bloomberg

From a credit perspective, we see that municipals are holding in very well and do not expect the trend to change materially. In the second quarter, Fitch Ratings upgraded 33 US public finance ratings and downgraded 12; a 2.75X ratio of upgrades to downgrades. We reiterate our call from last quarter that the municipal market is likely at peak credit quality for the cycle: it's probably not getting much better, but we also do not expect it to get significantly worse. If a recession is indeed around the corner, we believe municipal issuers would be heading into it from a position of strength. The decline in the equity market will pressure tax revenues for state governments going forward, which means that the large budget surpluses of the last fiscal year are unlikely to be repeated. However, by and large, municipal issuers including states and essential service providers have the inherent pricing power (or the taxing authority) to navigate turbulent waters.

Looking forward, we are cautious on Taxable Municipal spreads heading into the third quarter. As of June 30th, the OAS on the Agg-Eligible Taxable Municipal Index was 13 basis points lower than the year-to-date peak of 140 basis points set on May 18th. Conversely, the OAS on the IG Corporate Index was 155 basis points, or 6 basis points wider than the YTD peak.[6] The direction of traffic for the Taxable Municipal Index seems at odds with the path of spreads in other markets. The magnitude of the divergence in spreads between Taxable Municipals and Investment Grade Corporates adds to our cautious near-term outlook. On June 30th, the OAS on the Taxable Municipal Index was 28 basis points tighter than the OAS on the Investment Grade Corporate Index. By comparison, over the last three years the Taxable Municipal Index has traded 8 basis points wider on average than the Investment Grade Corporate Index, which difference we attribute primarily to differences in size, liquidity, and structure (i.e. optionality) between the two markets. Whatever the cause, the current spread relationship is 36 basis points out of line with the long-term average, which is the largest spread deviation between the two indexes since April 2020.[7] We believe that some amount of mean reversion is likely in the third quarter, although not necessarily all the way back to the long-term average of 8 basis points. We identify a few factors that should be supportive of Taxable Municipal spreads through year end:

1. The AA average rating of the Taxable Municipal Index is considerably higher than the A-/BBB+ average rating of the IG Corporate Index.[8] The preference for high quality is a rational response in an environment where the probability of recession over the next 12 months has been steadily rising.
2. Historically the Taxable Municipal Index widens less than the IG Corporate Index in times of acute market stress. For example, at the height of the COVID crisis in 2020, the IG Corporate Index widened by 251 basis points from the end of February to the peak in March, while the Taxable Municipal Index widened by 151 basis points over the same period.[9]
3. From a credit perspective, historical rating transition data from S&P shows that the downgrade frequency for Municipals in periods of recession is far lower than for IG Corporates. Following the 2008-09 recession, S&P's ratio of upgrades to downgrades for US Municipals dropped to a low of 0.69x in the fourth quarter of 2011 (compared to the 5-year average of 3.86x). In the corporate market, this ratio dropped to a low of just 0.08x (compared to the 5-year average of 0.57x).[10]
4. New issue supply of Taxable Municipals is down 36% through June 30, 2022, compared to the same period in 2021. This is largely due to the evaporation of refunding transactions that accounted for a substantial share of new issuance in 2020 and 2021. Absent a material increase in Taxable Municipal issuance, there are few forces at play to drive spreads wider.

These factors would lead us to add more Taxable Municipal risk on weakness in the second half, as the OAS differential between the Taxable Municipal Index and the Investment Grade Corporate Index gets closer to the historical average. Our view is that a recession is likely mid-to-late 2023. For investors with longer duration needs, we like the higher credit quality and lower volatility of Taxable Municipals in an environment with increasing macroeconomic risks.

Endnotes

1 Source: Bloomberg
2 Source: Bloomberg
3 For reference, the index has a duration of 10.4 years and an average rating of AA as of June 30/2022.
4 Source: Bloomberg
5 Source: Bloomberg
6 Source: Bloomberg
7 Source: Bloomberg
8 Source: Blackrock Aladdin
9 Source: Bloomberg
10 Source: Standard & Poor's

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