PUBLIC FIXED INCOME

Taxable Municipals

Market Review and Outlook

September 30, 2022

Chairman Powell delivered a harsh reality check to markets at the Jackson Hole Symposium in August: The Fed will keep hiking rates and will keep them there for longer until inflation moves firmly back towards the Fed's 2% target. This is not what the market was expecting. As late as August 15—*after* the red hot 8.5% CPI print in July and the large upside surprise to nonfarm payrolls—the 10-year Treasury was 2.79% and Fed Funds Futures were pricing in a terminal rate of 3.61% in the first quarter of 2023, followed by 50 basis points of cuts before the end of the year. Then Chairman Powell threw cold water on the idea of a Fed pivot time soon and the market got the message. The resulting surge in rates across the curve delivered a fresh dose of pain to fixed income investors. The 10-year Treasury climbed 82 basis points in the quarter and by September 30, Fed Fund Futures priced in a terminal rate of 4.53%.[1]

The surge in rates continues to hammer municipal returns. The longer duration Bloomberg Taxable Municipal Index returned -6.18% in the third quarter, bringing the year-to-date total return to -19.28%. As expected in light of the 2.32% surge in the 10-year Treasury year-to-date through September 30, rates were the primary culprit. Consider that the duration of the index was 8.21 as of September 30. Simple bond math indicates that 19.05% of the 19.28% in the negative year-to-date total return (8.21 years x 232 basis points = 19.05%) is explained by rates alone, ignoring curve and convexity effects. This may be cold comfort, but it does come with a silver lining: municipal fundamentals remain solid, and with higher rates come higher yields and lower dollar prices. As of September 30, the yield-to-worst of the Bloomberg Aggregate Eligible Taxable Municipal Index was 5.36%, compared to 2.60% on January 1. Similarly, the average dollar price of the index has plunged from $114.76 on December 31 to $89.71 as of September 30—a 25 point decline. We think the combination of higher yields and lower dollar prices will be supportive for Taxable Municipal spreads, particularly considering the limited supply of high-quality spread assets in a challenging economic environment.[2]

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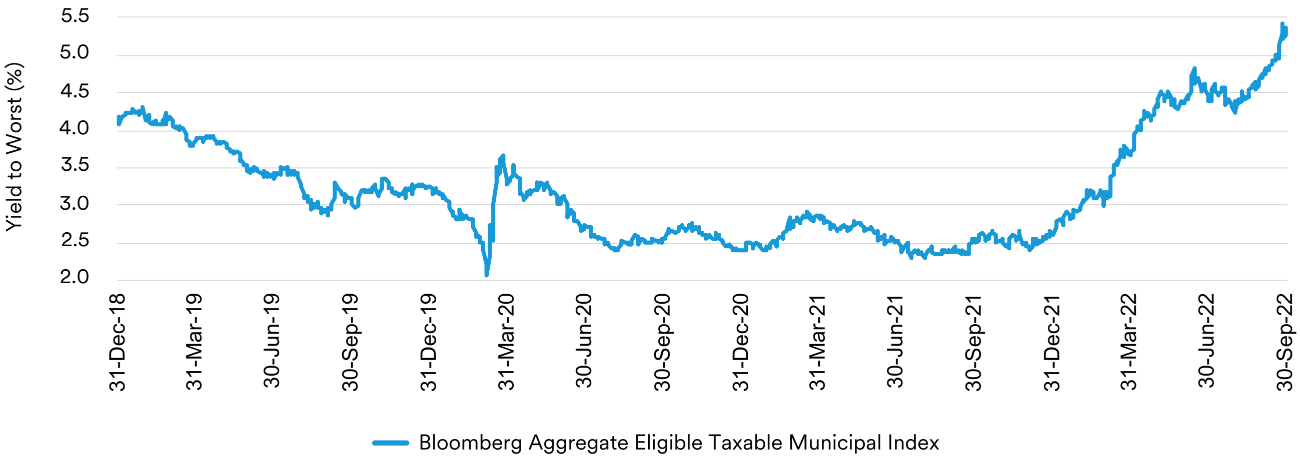
Figure 1 | Yield on Bloomberg Aggregate Eligible Taxable Municipal Index

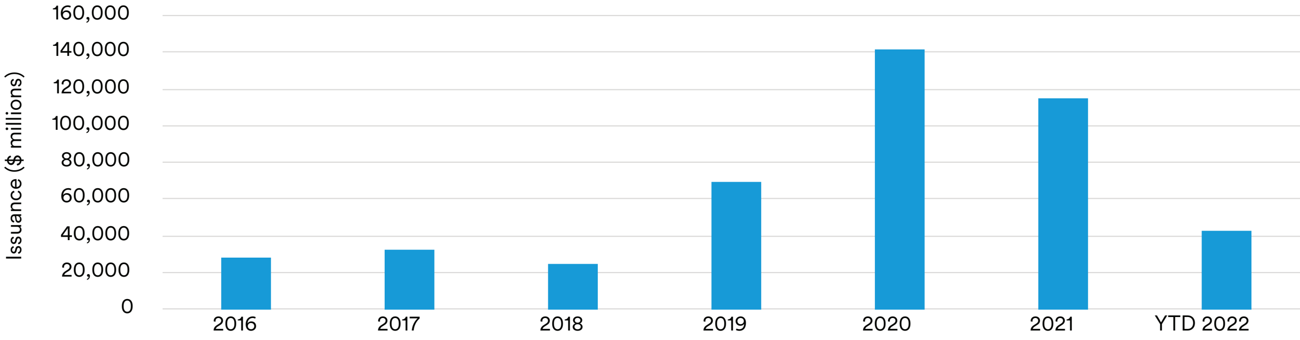


Source: Bloomberg

In the tax-exempt space, the Bloomberg Municipal Bond Index (7.9 year duration as of September 30) posted a quarterly return of -3.46%, bringing the year-to-date total return to -12.13%.[3] The narrative driving the tax-exempt market has been the relentless rate-driven fund outflows, which totaled a record $92 billion year-to-date through the third quarter.[4] In our view, outflows are likely to persist until rates peak or until the volatility in rates subsides. Until that happens, we believe yield-focused institutional investors should be looking at opportunities in long tax-exempts as the traditional retail investor base sells indiscriminately. In particular, we see value in lower coupon tax-exempt securities that trade at nominal yields that are higher than the nominal yields on fully taxable bonds from the same issuers. After including the benefit of the tax-exemption (tax-exempt yield / (1 – tax rate)), the taxable equivalent yields on highly rated long tax-exempt securities can significantly exceed the yields on similar maturity taxable municipals or the yields on long corporate securities rated multiple notches lower.

One interesting dynamic in the Taxable Municipal market this year has been the dearth of new issuance, driven by a surge in rates and a corresponding decline in taxable advanced refundings that previously fueled a surge in taxable issuance in 2019-2021. Through the third quarter and as shown in Figure 2, issuance of Taxable Municipals (municipal CUSIPs only) stands at $42.6 billion—a 49% decline year-over-year and a whopping 59% year-to-date decline relative to the record year in 2021. The most recent quarter is the first quarter we can recall in years with precisely *zero* issuance of Taxable Municipals with corporate CUSIPs (these are typically issued by nonprofit hospitals, universities, and not-for-profit institutions like foundations or museums). The decline in issuance has made price discovery for Taxable Municipals more challenging, which in turn has hampered liquidity. The pockets of liquidity that do exist have become more bifurcated, whereby large Taxable Municipal securities are relatively liquid but the trading volume for smaller securities and/or less well-known issuers is scarce. This is not in itself surprising given that CUSIP size is a logical proxy for potential liquidity. However, it does highlight an interesting predicament for the Taxable Municipal market, where only 309 (or 3.2%) of the almost 10,000 securities in the Bloomberg Taxable Municipal index are eligible for the broad US Credit Index by virtue of the $300 million minimum CUSIP size: liquidity is concentrated in a narrow segment of the market. This observation is supported by our examination of trading data for the three largest and the three smallest securities in the Bloomberg Taxable Municipal Index. We find that despite a 49% decline in Taxable Municipal issuance year-to-date through the third quarter, the trading volume for the three largest Taxable Municipal CUSIPs in the Bloomberg Aggregate Eligible Index *increased* by an average of 340% in third quarter of 2022 relative to the third quarter of 2021. Conversely, the trading volume for the three smallest Taxable Municipal CUSIPs in the index *decreased* by an average of 80% over the same time period (source: Bloomberg, MIM). We see this bifurcation as a potential risk to returns from the mispricing of less liquid securities in the short-term. However, we also see it as an opportunity for long-term investors to lock in significantly higher yields by providing liquidity on highly rated but smaller, less liquid securities at significantly wider spreads. In a market that prioritizes liquidity, we like taking some amount of liquidity risk over credit risk in portfolios heading into a likely recession in 2023.

Figure 2 | Taxable Municipal Issuance



Source: Bloomberg

In the fourth quarter we expect Taxable Municipal spreads to follow Investment Grade corporates wider as the Fed's stated tolerance of "below-trend real GDP growth" (read: recession) to drive inflation back toward the 2% target takes a toll on the labor market and corporate earnings. Taxable Municipals must also compete with the larger tax-exempt market, which remains pressured by a historic outflow cycle, and which continues to attract capital from institutional investors like banks and insurance companies. As long as long tax-exempts offer considerably higher taxable equivalent yields, the path for tighter Taxable Municipal spreads is a very narrow one. At the same time, the supply of Taxable Municipals has been scarce and the dynamic of low dollar prices, spreads near the year-to-date wides, and yields well over 5% for high quality assets will likely help keep institutional demand firm, and spreads contained. We have a year-end target of +150 OAS on the Bloomberg Index Eligible Taxable Municipal index.

In tax-exempts, we believe the market will recover when rates stabilize, and the cycle of fund outflows ends. We are reluctant to predict the exact moment when rates stabilize but we suspect it will coincide with evidence that inflationary pressures are receding, which would reduce the level of uncertainty related to Fed policy that is driving volatility. As of September 30, Fed Funds Futures estimate a terminal policy rate of 4.53% in the first quarter of 2023. When rates do stabilize, we envision a fast and aggressive rally in tax-exempts as the marginal buyer in the market switches from institutional buyers at a 21% corporate tax rate back to individual investors at much higher state and federal tax rates. Since retail investors get a much larger tax benefit from the tax-exemption, they are likely to drive valuations much tighter from current levels to lock in yields on quality assets that are difficult to match in any other market. Consider that to an individual in California in the 37% federal and 13.3% state tax brackets, the taxable equivalent yield of a AA-rated tax-exempt bond that yields 4.5% is over 9% (4.5%/(1-0.053)). We emphasize that we feel municipal fundamentals are strong and that the dislocation in tax-exempts has been entirely rate-driven. We have seen this dynamic before. Retail investors do not like to lose money in their municipal portfolios. When they do, they sell. But when rates stabilize, animal spirits typically return quickly to capitalize on compelling yields on high quality assets that are well-positioned to withstand a recession.

Endnotes

1. Bloomberg
2. Bloomberg
3. Bloomberg
4. Bloomberg

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