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AAM
Insurance Investment Management

Valuations for Taxable Municipals Remain at Attractive Levels

Second Quarter Municipal Bonds Update

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Market Recap

Market rate performance during the 2nd quarter continued to be influenced by the aggressive pace of tightening in monetary policy by the Federal Reserve. In its efforts to combat persistent inflation, the federal funds rate was pushed higher by 125 basis points (bps) during the quarter, with another 75bps hike expected in July. That resulted in Treasury rates during the quarter in 2 and 10yrs to rise by 62 and 68bps, respectively[1].

The higher rate environment continued to provide struggles for the municipal market. Returns for the Bloomberg IG Tax-Exempt Index and the Bloomberg Taxable Muni Index produced negative results for the quarter of -2.94% and -6.20%, respectively[2].

1 Bloomberg
2 Bloomberg, Barclays

Tax-Exempt Relative Valuations Remain Elevated

Relative valuation levels for the tax-exempt market have been under pressure all year from the heavy outflow cycle from mutual funds. For the quarter, outflows totaled -$56.7 billion, and for the year, outflows have produced a new record of -$74.7 billion[3]. Bid list activity to raise the needed liquidity to cover the outflows averaged $1.5 billion per day, which was an increase of 52% relative to the selling activity that was observed during the first quarter[4].

The net result of these weak demand technicals was for relative valuation levels to remain at elevated levels. Muni-to-Treasury yield ratios in 10yrs started the quarter at 93%, would climb to as high as 105% during mid-May, before ending the quarter at 91%[5].

Although there remains pressure for the tax-exempt market to absorb additional outflows as the market continues to expect the Federal Reserve to push rates higher, there have been recent signs that this cycle may be slowing. During the first 3 weeks of July, funds that report on a weekly basis have reported average outflows of -$268 million per week. That's a sharp decline of 90% relative to the reported weekly average of -$2.6 billion during June and a similar decline of 89% relative to the weekly average during the 2nd quarter of $2.4 billion[6].

Taxable Munis Continue to Look Attractive

For taxable munis, relative valuation levels have also remained at elevated levels during the quarter. In looking at option adjusted spreads (OAS) for the Bloomberg Taxable Muni Aggregate Index, spreads which started the quarter at 120bps, widened by 16bps to end the month of May at 136bps. However, with taxable munis tracking the stronger performance in corporates during May, the OAS for munis would tighten by 9bps to end the quarter at 127bps. That tightening was evident in performance during June, with the Taxable Muni index producing a positive return of 1.42%[7].

Even with the improved performance for the sector during June, we still find that the current spread levels for munis remain attractive. We view the 7 to 30yr range as the most attractive for the sector, with the 10yr area providing the most compelling area relative to historical valuations. In looking back at historical spreads for 'AAA' 10yr spreads from 2012 to the end of 2019, we found that the widest spread occurred on 1/3/12 at 95bps. During 2020, after the market disruptions from COVID, we also observed that the average spread in 10yrs from 3/1/20 to 12/31/20 was 97bps. Today, we are observing trading levels for 'AAA' taxable munis at ~90bps and that appears to be in line with levels that are more associated with market dislocations over the last 10yrs. Consequently, we view current spread levels in this area of the curve as a very compelling entry point to continue to add to the basis for the sector[8].

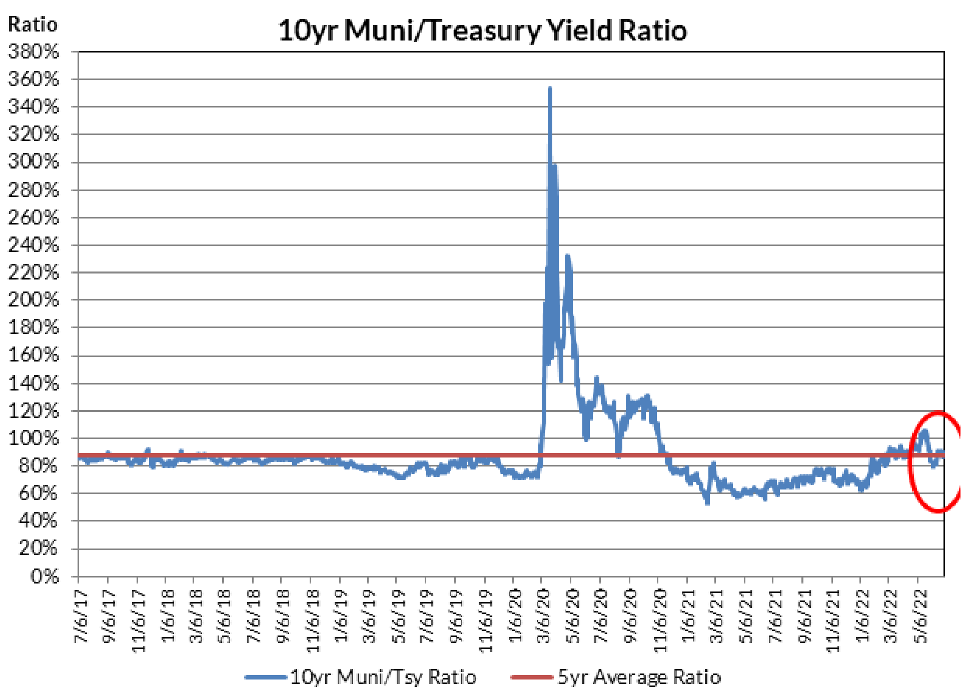
3 Lipper
4 Bloomberg
5 Bloomberg, Refinitiv
6 Lipper
7 Bloomberg, Barclays
8 Bloomberg, AAM

Outlook: Favorable Technicals and Fundamentals Should Support Spread Performance

Looking forward, we are maintaining our expectation for spread levels to stabilize and eventually tighten over the balance of 2022. We continue to expect supply technicals to provide a favorable backdrop. Refinancing activity tied to advance refundings have largely been absent in 2022 as soaring Treasury rates and taxable muni spread widening have removed the favorable present value savings that were available over the last two years. That's been reflected in taxable new issuance that has averaged only $4.4 billion per month on a year-to-date basis. That's down 52% relative to average monthly issuance levels throughout 2021[9].

Additionally, in our opinion, underlying fundamentals should remain solid for the sector, buoyed by already applied federal stimulus dollars, and strong revenue performance as the economy continues to grow. Revenues for state and local governments through the first quarter of 2022 came in at a very strong 21.3% relative to the 1st quarter of 2021. That follows the strong 22.7% growth in revenues for 4th quarter 2021 versus 4th quarter 2020 levels[10]. The strength in revenues, combined with COVID -related fiscal stimulus, have left state and local governments in a very stable fiscal position, with state budget stabilization funds at record levels. That should provide these issuers with plenty of budget flexibility in the event that aggressive monetary policy results in a recessionary environment[11].

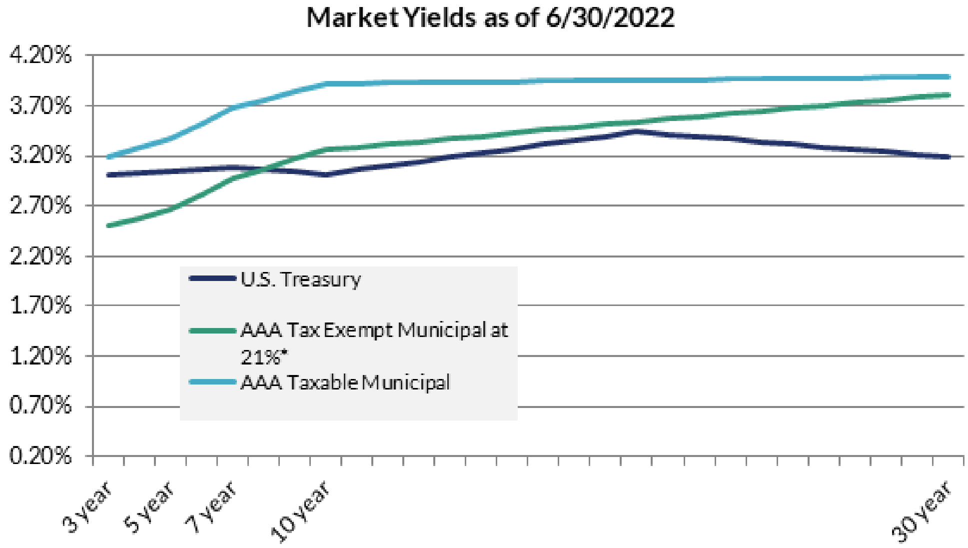
Exhibit 1: Tax-Exempt Relative Valuation Levels



Source: Refinitiv Municipal Market Data, Bloomberg

9 Bond Buyer
10 US Census Bureau
11 NASBO, Bloomberg, Bond Buyer

Exhibit 2: Taxable Munis: Compelling Alternative to Tax-Exempts



Source: Refinitiv Municipal Market Data, Bloomberg, AAM

**21% Corp Rate Tax-Adjusted at a Factor of 1.1994*

Gregory Bell, CFA, CPA *is a Principal and Director of Municipal Bonds at AAM with 29 years of investment experience. He oversees all municipal bond trading and research. Prior to joining AAM, Gregory worked at the Northern Trust Company in several positions, including Vice President and Senior Municipal Bond Portfolio Manager. Gregory is a CFA Charterholder as well as a licensed CPA. He earned a BA in Accounting from Chicago State University and an MBA in Finance and Accounting from the University of Chicago.*