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Municipal Bond Market Insight | July 2021

Inflation Cools as the Summer Heats Up

Key takeaways

- The bond market warmed to the Fed's view of temporary inflation in June by flattening the yield curve and sending long-term interest rates lower.
- Total municipal issuance through the first half of the year now stands at $223 billion, up from $210 billion in the first half of 2020.
- Substantially richer muni valuations today are a result of a tremendous amount of federal support via liquidity facilities and direct aid, as well as high individual tax burdens and an overall lackluster tax-exempt new issue supply pipeline.
- The increase in nonfarm payrolls for June was 850,000, the highest gain this year and slightly higher than economists' surveyed median of 720,000. This job growth confirms expectations for increased hiring as the economy continues to improve.

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General market update

Summer is here and the temperature outside is rising, but we're witnessing some cooling down in market segments related to a reopening economy in June. Prices fell from recent highs in real estate, copper, and lumber. The economy is indeed picking up, but the retreat in these previously red-hot segments, closely watched as inflation indicators, appears to bolster the Federal Reserve's view that supply-demand imbalances may well be temporary. Prices fell as supply chains restarted, production picked up, and pent-up demand was finally met with increased supply. Looking ahead, we view the fall as a pivotal time in determining the state of the recovery as enhanced unemployment benefits expire and children are due back in school.

The bond market took comfort in the Fed's view of temporary inflation playing out as expected, flattening the yield curve and sending long-term interest rates lower. The Bloomberg Barclays Corporate Bond Index had a solid month with a return of 1.70%, as did the Bloomberg Barclays US Treasury Index, which returned 0.64%. The municipal market, still handily outperforming all other fixed income asset classes year to date, finally trailed corporates and Treasuries in the month of June, with the Bloomberg Barclays Municipal Index returning 0.27%. Equities remained optimistic on reopening prospects, and the S&P 500® returned 2.22% for the month.

Supply

The muni market easily absorbed $43 billion of new issue supply, roughly a 30% increase from May 2021. June's tax-exempt and taxable supply came in at $31 billion and $10 billion respectively. Total municipal issuance through the first half of the year now stands at $223 billion, up from $210 billion in the first half of 2020. As a reminder, issuance for the first half of 2020 was largely disrupted by the market sell-off in March and April, causing issuers to hold off on issuing new debt in the volatile market. We expect issuance going forward to remain at a steady and relatively high pace, especially while yields remain low and demand remains robust as a result of the summer reinvestment flows. Notable deals for the month of June include the New York State Dormitory Authority, the State of Tennessee, and the Los Angeles Department of Water.

Figure 1: Fixed income returns as of 6/30/2021

	MTD return	YTD return
Bloomberg Barclays Muni Index	0.27%	1.06%
Bloomberg Barclays US Treasury Index	0.64%	-2.58%
Bloomberg Barclays US Aggregate Index	0.70%	-1.60%
Bloomberg Barclays US Corporate Index	1.63%	-1.27%

Source: Bloomberg, 6/30/2021. For illustrative purposes only. It is not possible to invest directly in an index.

Figure 2: AAA municipal yields as of 6/30/2021

Year	Current	MTD change	YTD change
2-year	0.16	0.06	0.02
5-year	0.49	0.01	0.27
10-year	0.99	0.00	0.28
30-year	1.50	-0.01	0.11

Source: Thomson Reuters Municipal Market Data, 6/30/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: US Treasury yields as of 6/30/2021

Year	Current	MTD change	YTD change
2-year	0.25	0.14	0.12
5-year	0.89	0.09	0.53
10-year	1.47	-0.13	0.55
30-year	2.09	-0.20	0.44

Source: Bloomberg, 6/30/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

Midyear recap

Municipal bond investors have spent the past year watching the market closely for signs of an attractive entry point. Since the credit-driven liquidity scare of March 2020, absolute yields across fixed income markets have substantially decreased, with municipals outperforming all investment-grade fixed income asset classes. Substantially richer muni valuations today are a result of a tremendous amount of federal support via liquidity facilities and direct aid, as well as high individual tax burdens and an overall lackluster tax-exempt new issue supply pipeline.

Supply versus demand

The muni market has seen incredible demand since last spring's market disruption. Although the new issue calendar has steadily increased over the past few months, it's been no match for the strong pace of demand. Net inflows for 57 of the last 58 weeks into the municipal fund space have amounted to $120 billion, while tax-exempt new issue supply only modestly increased over that time frame. We see little relief ahead on this front now that the traditionally tight summer season in full swing. In fact, we estimate that reinvestment demand will far outstrip new issue supply to the tune of $35 to $55 billion, perhaps keeping a lid on valuations relative to other taxable alternatives.

Investor comfort with municipal credits has come a long way from extreme concern in March and April 2020, when states shut down and extreme revenue shortfalls were predicted. Over the past year, municipalities were granted $500 billion of direct aid from the 2020 Coronavirus Aid, Relief, and Economic Security (CARES) Act and the 2021 American Rescue Plan. Additional legislation enacted in the period has provided indirect aid to several sectors that enjoy access to tax-exempt financing, such as hospitals, airlines, and transportation agencies. For context, the amount of direct aid to states was roughly four times the state budget shortfalls projected by Moody's and over 20 times those for local governments. This type of aid has placed many municipalities in a substantially better financial position, alleviating investor fears of further downgrades or defaults. For a heavily retail-dominated market, eliminating these concerns has played a huge role in keeping the pace of demand strong.

Two components of the 2017 Tax Cuts and Jobs Act (TCJA) had been major contributors to the tight valuations for tax-exempt munis coming into the pandemic. The elimination of advanced refunding and the repeal of the state and local tax (SALT) deduction cap simultaneously decreased new issue volume and increased demand for municipals. In our view, at a minimum, it's likely that the return of advanced refunding may be a part of a forthcoming infrastructure bill, which could be a catalyst for higher supply in the future.

Interest rates

Since the Democratic Party took control of both chambers of Congress and the White House, $2.8 trillion in fiscal stimulus has been signed into law. After a slow start, efforts to inoculate US citizens with one of the three FDA-approved COVID-19 vaccines have largely succeeded. According to the Centers for Disease Control and Prevention (CDC), 46% of the country has received the full vaccine dose. This has helped many states reopen their economies and lift various pandemic-related restrictions. The market received these actions positively, as evidenced by interest rates meaningfully rising from their 12-month lows.

The Fed has committed to keeping short-term borrowing costs low to fuel recovery, a policy whose success is reflected in recent economic data. Increased economic activity and the prospects for its acceleration have brought about discussions of increased inflation expectations, Fed tapering, and an accelerated timetable for rate hikes. However, recent guidance from the Fed has the market convinced that price pressures will prove to be transitory, resulting in a meaningful retrenchment of Treasury rates seven years and out.

As some market participants point out, there's still a risk that inflation may not be transitory. In that event, an upside move in the Treasury market is possible. A recent study published by JPMorgan on the municipal market flows "suggested that outflow cycles follow monthly index results of -2% or lower." While we haven't seen a negative monthly return of that magnitude yet, it's not a far stretch to think that sustained Treasury volatility with compressed valuations relative to taxable alternatives could lead to profit taking, underperformance, and perhaps outflows. For investors who are subject to high taxes and looking for duration, we suggest capitalizing on any softness when possible during those time periods.

Key economic data

Change in nonfarm payrolls (June)	+850k
Unemployment rate (June)	5.9%
Core CPI—YoY change (May)	3.8%
Core PCE—YoY change (May)	3.4%
Average hourly earnings—YoY change (June)	3.6%
Real GDP annualized QoQ (Q1 2021)	6.4%

Source: Bloomberg, 7/2/2021.

The increase in nonfarm payrolls for June was 850,000, the highest gain this year and slightly higher than economists' survey median of 720,000. This job growth confirms expectations for increased hiring as the economy continues to improve. The labor market is making steady progress as more people find work, recovering some of the roughly eight million jobs lost last year. The average monthly gain in payrolls for 2021 stands at 543,000. One other important note on the labor front is the increase in the unemployment rate from 5.8% in May to 5.9% in June. This is generally viewed as a positive: It shows people reentering the labor force who are actively seeking work but haven't been hired yet.

At the conclusion of the Federal Open Market Committee's June meeting, we learned that six more Fed members expect short-term rate hikes sooner than they projected back in March. The latest median dot plot, which signals the Fed's interest rate outlook, indicates a liftoff in rates to 0.625% by the end of 2023. The Fed funds futures market indicates a slightly higher rate of 0.84% by 2023 with an initial liftoff by the end of 2022. The Fed remains steadfast in its commitment to help the labor market recover, since it expects higher inflation readings will be temporary.

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