PARAMETRIC

Municipal Bond Market Insight | November 2021

Muni Returns Cool Off as Yields Rise

Key takeaways

» While the pace of inflows into the municipal market has slowed, it's yet to be seen if the three consecutive months of negative performance will be the catalyst for outflows out of the market and meaningful weaknesses in the coming month.

» President Biden's Build Back Better plan excludes the significant muni provisions that would have altered issuance into next year. Specifically, the return of advanced refundings and a program similar to Build America Bonds (taxable municipal bonds) were excluded.

» The spread difference between the Bloomberg High Yield Index yield and the 10-year AAA benchmark muni yield has hit a low going back to 2008, giving investors pause on weighing the risk versus reward on lower-credit-quality municipal bonds.

» As inflation is now the most common concern for investors today, this week's Fed meeting will hopefully offer insight into how the Fed is viewing inflation and if monetary policy should be shifted significantly to combat it.

Parametric
800 Fifth Avenue
Suite 2800
Seattle, WA 98104
T 206 694 5575
F 206 694 5581
www.parametricportfolio.com

©2021 Parametric Portfolio Associates® LLC

General market update

The momentum in high rates continued into October as the market priced in expectations that the Fed would start raising interest rates sooner than planned The Treasury yield curve flattened significantly, with two-year Treasury note yields increasing 22 basis points (bps) for the month, while 10-year Treasury note yields increased just 7 bps. While it may be no surprise that the Fed is expected to announce the start of tapering at the meeting this week, the market is looking out for a more hawkish tilt in its language that may possibly indicate a faster pace of tapering to combat higher inflation. As central banks around the world have already raised rates or are positioning to raise rates soon, the pressure seems to be on for the Fed.

Another month of rising interest rates resulted in most fixed income indices returning negative performance for the month of October. Risk assets held up well, with the Bloomberg Investment Grade Corporate Index returning 0.25% for the month and the S&P 500® returning a healthy 6.91%. The Bloomberg Municipal Bond Index returned -0.29% for the month—the third month of consecutive negative performance after August and September. While the pace of inflows into the municipal market has slowed, it has yet to be seen if the consecutive negative performance will be the catalyst for outflows out of the market and meaningful weakness in the coming months.

Supply

For the month of October the muni market saw total issuance of $36 billion of supply with a breakdown of $26 billion in tax-exempt and $10 billion in taxable issuance. Total issuance now stands at $394.6 billion year to date, and total tax-exempt issuance now standing at $286 billion year to date. Notable tax-exempt deals for the month of October included Central Puget Sound Regional Transit, California Community Choice Financing Authority Clean Energy Project, and Hudson Yards Infrastructure Corp. October is typically one of the heaviest months of municipal issuance. However, the overall lower issuance was likely a symptom of issuers maintaining a wait-and-see approach on the potential infrastructure package from Washington. The last week of October came in at only $8 billion of issuance, which was the lowest weekly issuance figure in seven weeks. Last, President Biden's most recent version of the Build Back Better plan excludes significant muni provisions that would have altered issuance into next year.

Figure 1: Fixed income returns as of 10/31/2021

	MTD return	YTD return
Bloomberg Barclays Muni Index	-0.29%	0.50%
Bloomberg Barclays US Treasury Index	-0.71%	-2.56%
Bloomberg Barclays US Aggregate Index	-0.03%	-1.58%
Bloomberg Barclays US Corporate Index	0.25%	-1.02%

Source: Bloomberg, 10/31/2021. For illustrative purposes only. It is not possible to invest directly in an index.

Figure 2: AAA municipal yields as of 10/31/2021

Year	Current	MTD change	YTD change
2-year	0.25	0.08	0.11
5-year	0.64	0.14	0.42
10-year	1.21	0.07	0.50
30-year	1.69	0.02	0.30

Source: Thomson Reuters Municipal Market Data, 10/31/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: US Treasury yields as of 10/31/2021

Year	Current	MTD change	YTD change
2-year	0.50	0.22	0.38
5-year	1.18	0.22	0.82
10-year	1.56	0.07	0.64
30-year	1.93	-0.11	0.28

Source: Bloomberg, 10/31/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

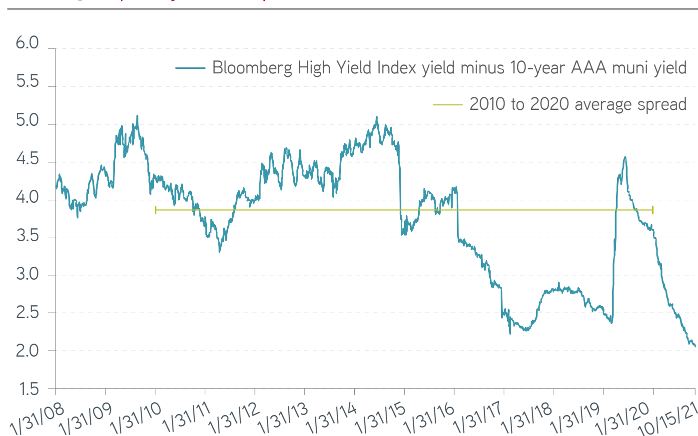
©2021 Parametric Portfolio Associates® LLC

Credit spreads in the municipal market

Municipal bond investors have had a lot to digest over the last couple of years. The stress and strain that the COVID-19 pandemic placed on state and local governments have been significant, matched only by the federal government's response. Nearly $5 trillion of stimulus and support has been deployed to support the economy, with aid flowing to unemployment benefits, health care, and mass transit. Investors have found comfort in the fiscal support for the muni sector and have flocked to the municipal bond market. According to Lipper, the pace of inflows into municipal bond mutual funds this year has broken records, with $88.5 billion flowing in through the first three quarters of the year.

The increased demand for municipal bonds has driven prices up and yields down. In the current low-interest-rate environment, it's hardly surprising the riskier parts of the muni market that tend to yield higher have experienced the greatest demand. Below is a chart of the spread between the Bloomberg High Yield Index yield and the 10-year AAA benchmark muni yield. Looking back to 2008, this difference in yield (or credit spread) has most recently been compressed to a historic low. Note the current spread level versus the average witnessed in the decade between 2010 and 2020.

Spread comparison between high-yield and high-quality municipal bonds



Sources: Bloomberg, Thomson Reuters, September 2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

Is sacrificing credit quality the only way to achieve extra yield?

The primary levers investors have used to achieve higher yield have been trending lower in credit quality or longer in duration—both translate to higher yields but also greater risks. Since risk and return are relatively correlated, achieving extra yield means taking on more risk. Importantly, however, there are other strategies that can be employed to achieve more yield.

Purchasing bonds with different structures, such as coupon rates or call dates, can result in a higher-yielding portfolio. Bonds with lower fixed coupons may see wider price swings in volatile markets compared to higher-coupon bonds and, as a result, compensate investors with more yield. Many muni bonds have embedded call options that enable issuers (not bondholders) to refinance debt at their discretion. Investors taking on this call risk may earn more yield than an investment in bonds with similar duration or interest-rate sensitivity. In both cases, investors may be subject to extension risk. At a time when investors could question whether credit spreads are adequately compensating for additional credit risk, these other strategies may prove increasingly useful.

What sectors still offer value?

Two sectors in particular—higher education and life care—have lagged others in performance and spread tightening. Higher-education entities are going through significant changes with the advent of virtual learning as well as a reimagining of the collegiate experience that predated COVID-19. Technological changes will keep the sector evolving, necessitating in-depth and experienced credit review and analysis. There will be winners and losers among providers of higher education as the space evolves. That evolution can likewise be witnessed among life-care providers, also known as continuing care and retirement communities, or CCRCs. As baby boomers retire, this sector will see growth and expansion. Like higher education, life care is a specialized, nuanced sector—especially when compared to the larger hospital and health care universe. Life-care facilities are experiencing changing business models and vibrant competition. Experience analyzing the sector is essential when seeking to identify the potential for investment success. Both higher education and life care are complex, changing sectors that are difficult to analyze. This may explain why spreads have remained wider than those of other sectors. With the right mix of skill and experience, investment opportunities in these sectors are compelling.

©2021 Parametric Portfolio Associates® LLC

Economic outlook

Key economic data

Change in nonfarm payrolls (September)	+194k
Unemployment rate (September)	4.8%
Core CPI–YOY change (September)	4.0%
Core PCE–YOY change (September)	3.6%
Average hourly earnings–YOY change (September)	4.6%
Real GDP annualized QOQ (Q3 2021)	2.0%

Source: Bloomberg, 11/2/2021.

Inflation is the most common concern for investors today. Prices of goods and services are noticeably higher than they were a year ago. This is evident in the year-over-year inflation data cited above—Core CPI, for example, is up 4% YOY. Some components of CPI, such as the cost for new and used vehicles, transportation, clothing, and housing, have increased by a large percentage since last fall.

Importantly, some of these prices are starting to increase at a much slower pace than earlier this year (rents or housing) or even decline (used autos and airline tickets). This trend is one we are following closely, as we believe many of the factors causing inflation today will reverse, especially as supply-chain issues subside and more labor comes on line.

If you observe the 12-month moving average of Core CPI, you can more easily assess a longer-term trend in prices each month (as opposed to a YOY snapshot). At 2.7%, the moving average is telling a more complete story—prices are climbing at a slightly higher pace than the Fed would like. The question then remains: Are these enduring changes or temporary ones? It might be that the economy witnesses a one-time bump that raises prices across the board. Assuming wages and household incomes receive a similar or greater bump, we would not expect this to impede economic growth.

©2021 Parametric Portfolio Associates® LLC

About

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, fixed income, alternative, and options strategies. Parametric also offers implementation services, including customized equity, traditional overlay, and centralized portfolio management. Parametric is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley, and offers these capabilities through offices located in Seattle, Boston, Minneapolis, New York City, and Westport, Connecticut.

Disclosures

This material may not be reproduced, in whole or in part, without the written consent of Parametric. Parametric and its affiliates are not responsible for its use by other parties.

This information is intended solely to report on investment strategies and opportunities identified by Parametric. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Past performance is not indicative of future results. The views and strategies described may not be suitable for all investors. Investing entails risks, and there can be no assurance that Parametric will achieve profits or avoid incurring losses. Parametric does not provide legal, tax, or accounting advice or services. Clients should consult with their own tax or legal advisor prior to entering into any transaction or strategy described herein.

Charts, graphs, and other visual presentations and text information were derived from internal, proprietary, or service vendor technology sources or may have been extracted from other firm databases. As a result, the tabulation of certain reports may not precisely match other published data. Data may have originated from various sources, including, but not limited to, Bloomberg, MSCI/Barra, FactSet, or other systems and programs. Parametric makes no representation or endorsement concerning the accuracy or propriety of information received from any third party.

An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads, and a lack of price transparency in the market. As interest rates rise, the value of certain income investments is likely to decline. Mortgage-backed securities are subject to prepayment risk. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. While certain US government–sponsored agencies may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the US Treasury. Mortgage- and asset-backed securities are subject to credit, interest rate, prepayment, and extension risk. Derivative instruments can be used to take both long and short positions, be highly volatile, result in economic leverage (which can magnify losses), and involve risks in addition to the risks of the underlying instrument on which the derivative is based, such as counterparty, correlation, and liquidity risk. Diversification does not guarantee profit or eliminate the risk of loss.

The views expressed in this report are those of the authors and are current only through the date stated at the top of this page. These views are subject to change at any time based on market or other conditions, and Parametric disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions are based on many factors, may not be relied on as an indication of trading intent on behalf of any Parametric strategy. This commentary may contain statements that are not historical facts, referred to as "forward-looking statements." The strategy's actual future results may differ significantly from those stated in any forward-looking statement, depending on factors such as changes in securities or financial markets or general economic conditions.

The hypothetical scenarios presented herein are provided for illustrative purposes only. They do not represent the experience of any investor, nor are they intended to estimate the performance of any investment strategy offered by Parametric. No representation is made that any client account will, or is likely to, achieve profits or losses similar to those shown. Actual performance results will differ and may differ substantially from the scenarios presented. Changes in assumptions may have a material impact on the hypothetical performance presented. The scenarios presented do not reflect the deduction of management fees and transaction costs, which will reduce a portfolio's returns.

S&P Dow Jones Indices are a product of S&P Dow Jones Indices LLC ("S&P DJI") and have been licensed for use. S&P® and S&P 500® are registered trademarks of S&P DJI; Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); S&P DJI, Dow Jones, and their respective affiliates do not sponsor, endorse, sell, or promote the strategy(s) described herein, will not have any liability with respect thereto, and do not have any liability for any errors, omissions, or interruptions of the S&P Dow Jones Indices.

Bloomberg® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Barclays® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indexes. Neither Bloomberg nor Barclays approves or endorses this material, guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom, and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

All contents ©2021 Parametric Portfolio Associates® LLC. All rights reserved. Parametric Portfolio Associates®, Parametric with the triangle logo, DeltaShift®, PIOS®, Custom Core®, Custom to the Core®, and Make passive investing personal® are trademarks registered in the US Patent and Trademark Office.

Parametric is headquartered at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.

27547 | 11.10.2021