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Municipal Bond Market Insight | January 2022

Munis Continue to Offer Diversification Value in 2022

Key takeaways

» A less accommodative Fed is likely to begin a tightening cycle. Munis have traditionally performed well over tightening cycles, and the muni curve is likely to flatten.

» Return expectations for 2022 are modest, but munis should remain a valuable building block of an investor's portfolio due to attractive tax-adjusted yields, diversification benefits, and improving credit characteristics.

» Our credit outlook remains positive due to strong tax receipts, federal stimulus, strong reserves, and increased pension contributions.

» A laddered bond portfolio allows investors to migrate into the prevailing rate environment as yields rise. Those who already have a laddered portfolio should consider tax-loss harvesting.

» Investors may choose a more dynamic total return approach, with active management designed to exploit market inefficiencies.

» We encourage investors not to shorten duration, particularly if it requires booking gains and giving up yield.

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Recap

The municipal market had a strong year on a relative value basis, with the Bloomberg Municipal Bond Index returning 1.52% for 2021. By comparison, the Bloomberg Treasury Index and the Bloomberg US Corporate Index were down -2.32% and -1.04%, respectively, over the year. Though total supply exceeded expectations, the key driver of performance was record mutual fund inflows of more than $100 billion. The American Rescue Plan signed into law by President Joe Biden in March 2021 provided the municipal market with roughly $650 billion of aid across sectors, an amount we considered overly generous when revenues were already faring better than expected. As the credit landscape improved and investors searched for yield, the lower-quality space significantly outperformed higher-quality bonds, as evidenced by the Bloomberg Municipal High Yield Bond Index returning 7.77% for the year.

Last year brought an impressive $475 billion of total bond issuance, although this was down 1.9% from the record-setting $484 billion in 2020. This issuance marked 2021 as the second-highest annual issuance year on record. Tax-exempt issuance grew 4%, and taxable issuance dropped 19% from 2020. This is a reversal from 2020, when taxable and refunding deals made up more than 30% of the market.

Congress failed to bring municipal bond provisions to fruition, neither reinstating tax-exempt advance refundings nor reauthorizing taxable infrastructure bonds. As a result, states and localities brought forward issuance in November and December, with rates still remarkably low. Unsurprisingly, California, Texas, New York, Pennsylvania, and Florida were the five states with the highest issuance. Notable jumps in issuance came from California, Washington, and Colorado, all increasing their issuances more than 20% from 2020. Notable decreases came from Florida, Ohio, and Hawaii, who cut their issuances by at least 15% from 2020.

Vaccinations changed the trajectory of the impact of COVID-19 in the spring of 2021, with a normalcy returning to everyday life and the economy recovering. Heightened consumer confidence and—more importantly—much healthier household spending led to a sharp increase in demand for services and goods. Supply chain issues resulted in product shortages, with basic input materials like steel and lumber skyrocketing in prices.

Inflation ran hot, but both markets and the Federal Reserve regarded it as transitory at the time. As a result, the Fed kept a very accommodative monetary policy, citing labor markets still looking to recover. However, that all changed when the consumer price index (CPI) hit 6.2% in October, the highest measured in over three decades. Along with consistently high inflation, labor markets began showing marked improvement, and the Fed finally outlined a plan to scale back its bond purchases.

Figure 1: Fixed income returns as of 12/31/2021

	MTD return	YTD return
Bloomberg Muni Index	0.16%	1.52%
Bloomberg US Treasury Index	-0.51%	-2.32%
Bloomberg US Aggregate Index	-0.26%	-1.54%
Bloomberg US Corporate Index	-0.08%	-1.04%

Source: Bloomberg, 12/31/2021. For illustrative purposes only. It is not possible to invest directly in an index.

Figure 2: AAA municipal yields as of 12/31/2021

Year	Current	MTD change	YTD change
2-year	0.25	0.00	0.11
5-year	0.65	0.01	0.43
10-year	1.21	0.00	0.50
30-year	1.69	0.00	0.30

Source: Thomson Reuters Municipal Market Data, 12/31/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: US Treasury yields as of 12/31/2021

Year	Current	MTD change	YTD change
2-year	0.38	0.15	0.26
5-year	1.26	0.10	0.90
10-year	1.51	0.07	0.59
30-year	1.90	0.11	0.25

Source: Bloomberg, 12/31/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

2022 outlook

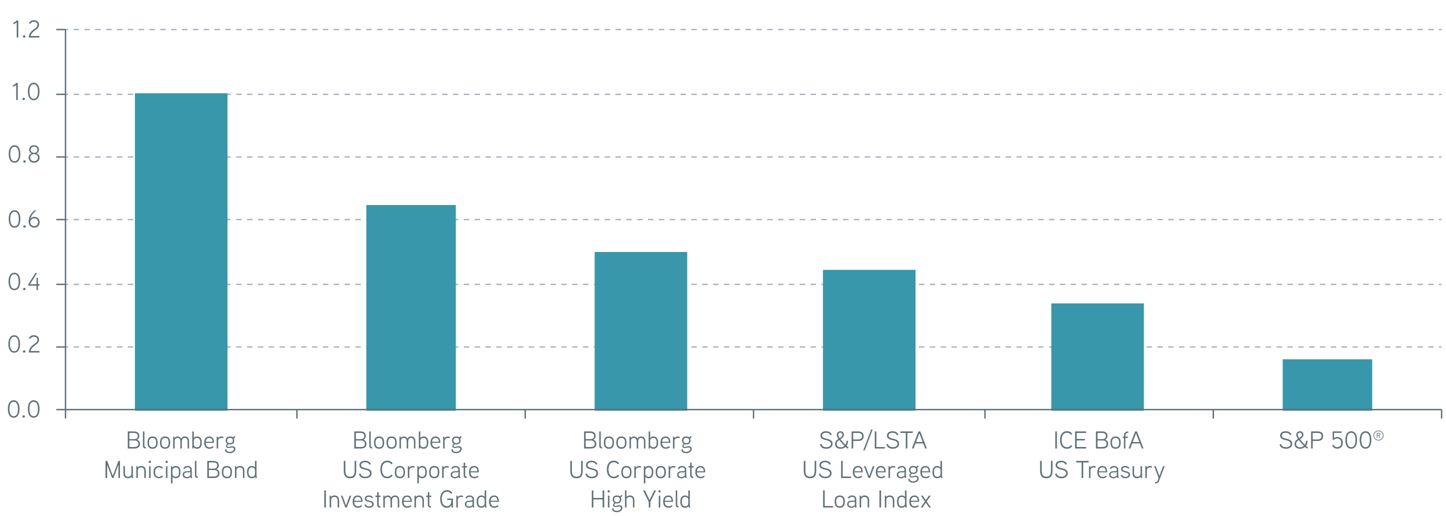
We remain optimistic about the muni asset class heading into 2022. Munis maintain their ability to deliver both positive absolute performance and continued solid relative performance. Strong demand was the primary factor driving outperformance for munis in 2021, with the market seeing its highest level of inflows for any year going back to 1992. We believe this will likely continue. Meanwhile, with the Bipartisan Infrastructure Deal no longer including any components directly impacting the supply side, we believe supply will remain manageable.

The obstacle for fixed income investors in 2022 is absolute rate levels, rich valuations, and the likelihood of rate volatility in Treasuries. The Fed has made a drastic pivot, acknowledging that the market will need a faster taper, along with the possibly of earlier-than-expected rate hikes. This primarily is a result of the economy experiencing the fastest pace of inflation since 1982, plus a quicker pace of recovery in the labor markets. Uncertainty remains around the new Omicron variant of COVID-19 and whether or not the Fed will help prolong this economic recovery or stall it too soon. The Treasury market will likely continue to adjust and price in different scenarios, resulting in a more volatile rate environment than what most investors have experienced. Municipals are primarily a retail market, and sharp increases in rates have typically resulted in significant outflows.

For most municipal issuers, credit fundamentals are very strong going into 2022, with states doing well and seeing revenues up on average about 17% from 2020 through September 21. This came as states and other municipal issuers saw a total of $1.2 trillion of federal aid over the past 18 months. States will likely see more aid in the form of funding or grants from the infrastructure bill. Defaults are down 25% this year from 2021, and the upgrade-to-downgrade ratio has been roughly two to one. A few sectors, such as higher education and transit, and individual issuers that may not have fared so well during this pandemic still present long-term concerns. As always, we urge professional credit oversight.

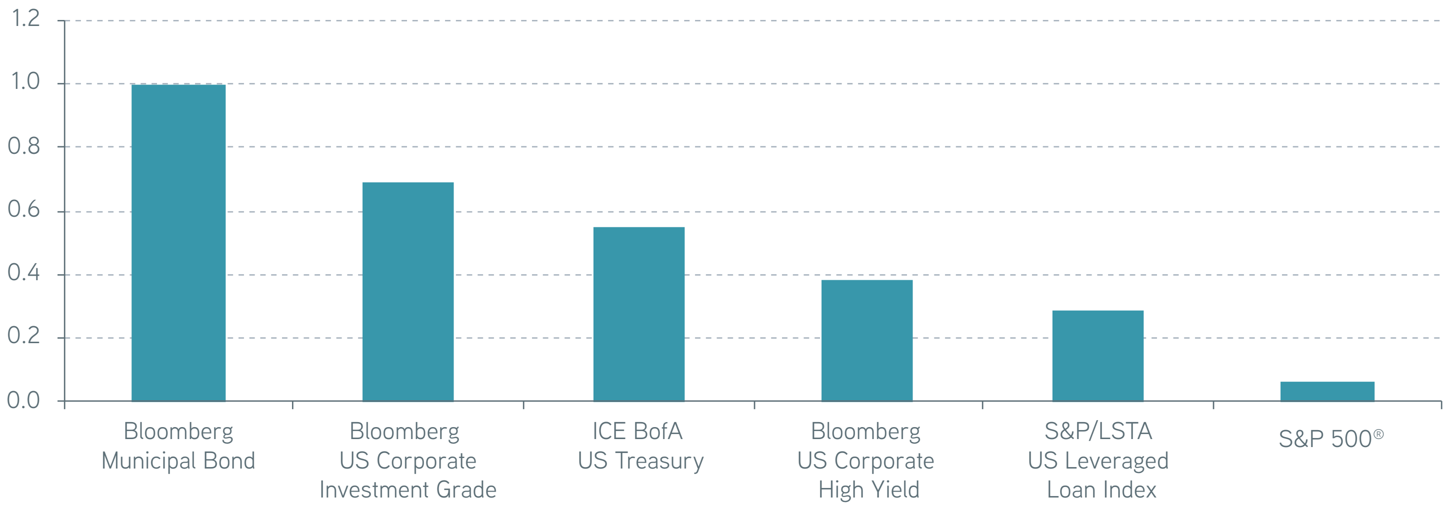
As equities continue to reach new records—the S&P 500® returning 26.9% in 2021—we continue to see the value of municipal bonds as a diversifier, especially for high-tax individuals. As an asset class, munis tend to exhibit less volatility than equities, and they have a low to negative correlation to equity and equity-like risks found in certain fixed income sectors. This makes the asset class particularly attractive today, with equities challenging traditional valuations and the market consensus possibly shifting toward a correction as the Fed looks to tighten. Although the level of anxiety is lower relative to last year, it's a worthwhile reminder to see the historical correlation of municipals to other fixed income categories over five- and 10-year periods.

Five-year muni correlation matrix, December 2016–November 2021



Source: Morningstar, 11/30/2021. For illustrative purposes only. Not a recommendation to buy or sell any security. It is not possible to invest directly in an index.

10-year muni correlation matrix, December 2011–November 2021



Source: Morningstar, 11/30/2021. For illustrative purposes only. Not a recommendation to buy or sell any security. It is not possible to invest directly in an index.

However, the recent Omicron surge and the potential for new economic weakness—shown by return-to-office delays, threats to consumer confidence, and service sectors like travel and restaurants taking a hit—could create a predicament. Although the Fed has done a good job of communicating policy changes to the market, there will no doubt be some discontent in 2022.

While many markets enter 2022 in a significantly healthier position, concerns around volatility remain for investors. For municipal bond investors specifically, the biggest concern is how to protect a municipal portfolio in a rising rate environment. A laddered bond portfolio is an excellent option for addressing this concern while reaping the benefits of investing in municipals. Investors can take out income at a market rate while migrating into the prevailing interest-rate environment as yields rise. Those who already have a laddered portfolio should consider using systematic tax-loss harvesting to create opportunities to reduce their tax payments.

Some investors may take a more opportunistic approach. A rising rate environment can exacerbate the inefficiencies of the fragmented and retail-dominated muni market. Active management may deliver additional return through relative value trading designed to exploit those inefficiencies. We encourage investors not to shorten duration, particularly if it requires booking gains and giving up yield. We firmly believe 2022 will be a year where investors will benefit the most if they keep calm and carry on.

Key economic data

Change in nonfarm payrolls (November)	+210k
Unemployment rate (November)	4.2%
Core CPI–YOY change (October)	4.6%
Core PCE–YOY change (October)	4.1%
Average hourly earnings–YOY change (October)	4.9%
Real GDP annualized QOQ (Q3 2021)	2.1%

Source: Bloomberg, 12/3/2021.

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