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Municipal Bond Market Insight | May 2022

Turning Lemons into Lemonade for Municipal Bond Investors

Key takeaways

» The 8.82% year-to-date decline in the Bloomberg Municipal Bond Index has left yields at significantly higher levels. Recently, munis have seen renewed support from banks, insurance companies, and more importantly retail investors, as municipal bonds offer attractive relative value in today's environment.

» Year-to-date issuance now stands at approximately $137 billion, down approximately 9% from the same period last year. Continued market volatility has deterred new issuance, which may reverse later in the year if interest rates stabilize.

» Given this year's significant move in yields, the opportunity is ripe for investors to enjoy the benefits of tax-loss harvesting in their municipal bond portfolios.

» The Fed maintained a hawkish stance that was confirmed with a 50 bps increase this week, along with further monetary tightening to rein in inflation. While that will help cool demand, global supply chain stresses are still in place, largely resulting from the war in Ukraine and rising COVID-19 infections in China.

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General market update

Through April, rates have now risen every month of 2022. The trend accelerated in April, which may be a sign of an approaching selling climax; that's not to say getting here hasn't been painful. Through April, the US Long Treasury Index was down -18.53%, the US Corporate Bond Index was lower by 12.73%. The 8.82% decline in the Bloomberg Municipal Bond Index looks mild by comparison. Munis have been supported by attractive relative value, resulting in buying interest from banks and insurance companies.

Economic releases in April continued to point to strong employment growth and persistent inflation. The annualized rates for Core CPI and the PCE Deflator based on March data were 6.5% and 6.6%, respectively. The Fed maintained a hawkish stance that was confirmed with a 50-bps increase this week, along with further monetary tightening to rein in inflation. While that will help cool demand, global supply chain stresses are still in place, largely resulting from the war in Ukraine and rising COVID-19 infections in China.

The municipal curve, similar to the US Treasury curve, reversed some of the recent flattening. For the month, the two-year AAA muni yields were 46 bps higher, 10-year AAA muni yields were 54 bps higher, the two-year Treasury note was 42 bps higher, and the 10-year Treasury note was 56 bps higher. This year's rising interest rates have also offered a very attractive entry point we haven't seen in quite some time. We expect investors to take advantage of today's yields in the municipal bond market to help produce higher tax-free incomes.

Supply

Muni issuance in April totaled approximately $36 billion, down roughly 17% from last month but only 2% lower than April 2021. Year-to-date issuance now stands at approximately $137 billion, down approximately 9% from the same period last year. Continued market volatility has deterred new issuance, which may reverse later in the year if interest rates stabilize. Notably, California has seen an approximate 40% decline in issuance this year from the same period last year. Despite the slowdown, California still ranks first in overall issuance this year.

Figure 1: Fixed income returns as of 4/30/2022

	MTD return	YTD return
Bloomberg Muni Index	-2.77%	-8.82%
Bloomberg US Treasury Index	-3.10%	-8.50%
Bloomberg US Aggregate Index	-3.79%	-9.50%
Bloomberg US Corporate Index	-5.47%	-12.73%

Source: Bloomberg, 4/30/2022. For illustrative purposes only. It isn't possible to invest directly in an index.

Figure 2: AAA municipals YTD as of 4/30/2022

Year	Current	MTD change	YTD change
2-year	2.22%	+46	+198
5-year	2.45%	+48	+186
10-year	2.72%	+54	+169
30-year	3.05%	+52	+156

Source: Thomson Reuters Municipal Market Data, 4/30/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: US Treasury yields as of 4/30/2022

Year	Current	MTD change	YTD change
2-year	2.29%	+42	+197
5-year	2.91%	+49	+165
10-year	2.89%	+56	+139
30-year	2.95%	+50	+106

Source: Bloomberg, 4/30/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Use losses to your advantage with tax-loss harvesting

This year's significant rise in yields has left many municipal bond investors with significant losses in their portfolios. Though not the ideal outcome in terms of returns for clients, this presents an incredible opportunity for tax-loss harvesting. Investors can use tax-loss harvesting opportunities to reduce the impact of capital gains taxes on portfolio returns. All too often, investors harvest losses only toward year-end. With limited replacement options and typically wider bid-ask spreads, however, the tax alpha that may be generated at the end of the year is likely below potential. We often see that the economic loss of selling out of positions at an inopportune time eliminates any tax benefit. We believe more optimal results can be achieved by partnering with a professional manager with the capability to harvest losses throughout the year for the following key reasons.

More favorable liquidity

The last few weeks of the year historically experience lower trading volume. Market participants operating on a calendar year generally reduce activity during this time, and overall liquidity suffers as a result. High liquidity costs can sometimes erode or outweigh the tax benefit of harvesting the loss. Minimizing transaction costs can help maximize tax alpha.

Access to attractive replacements

Issuance typically slows at year-end as well. By trading throughout the year, investors are likely to find more opportunities to access the new-issue market when replacing sales. Active new-issue supply helps reinvestment and increases the likelihood of finding compelling replacement bonds. Access to a wider variety of bonds may also prevent wash-sale violations and ensure portfolio characteristics are maintained.

Optimal timing

We believe the best tax-loss harvesting strategy is one in which positions are monitored daily and no opportunities are wasted. If tax-loss selling takes place only at year-end, yield fluctuations throughout the entire year will create lost opportunities. Only twice over the past 25 years has the annual peak in municipal yields occurred in December, in 2016 and 2020.

Efficiency and scale

Not only can year-round loss harvesting elevate after-tax total return potential, it can also increase scale and efficiency for the advisor and client. By opting in to professional and continuous monitoring of individual securities, the advisor no longer needs to make year-end manual requests, which can be time-consuming and labor-intensive. Clients benefit from a manager who focuses their time and attention on identifying opportunities and providing superior execution.

To illustrate the value of tax-loss harvesting, the table below shows a scenario for an equally weighted one-to-10-year laddered portfolio under various interest rate increases over one year.

Figure 4: One-year total return of 1-to-10-year BBB laddered portfolio (hypothetical)

Interest rate rise	Pretax return	With tax-loss harvesting	Value add
0.50%	1.26%	1.92%	0.66%
0.75%	0.28%	1.34%	1.06%
1.00%	-0.69%	0.77%	1.46%
1.50%	-2.57%	-0.35%	2.22%
2.00%	-4.40%	-1.43%	2.97%

Sources: Bloomberg and the Parametric Laddered Muni Interest Rate Scenario Tool, 5/5/2022. The information presented in the tool is for hypothetical and illustrative purposes only. Results may not represent the experience of individual investors and should not be construed as tax or legal advice. An investor should consult a financial or tax professional concerning their specific situation before making any financial decisions. The use of tools cannot guarantee performance. Any references to future returns should not be construed as an estimate of the results a client portfolio may achieve. The following inputs were used for the interest-rate scenario analysis above: national portfolio, maturity range: five- to 15-year; minimum credit rating: BBB; taxable income: maximum. Cumulative total returns are shown before the deduction of investment advisory fees and other expenses, which would reduce returns. Investing involves risk, including the loss of principal. For additional information about the tool, please visit https://platform.parametricportfolio.com/FixedIncomeLadder.

For example, if yields increase by 1% (*parallel shift*) over the next 12 months on a one-to-10-year ladder, pretax performance will be approximately -0.69%. Optimizing loss-harvesting opportunities, however, can generate approximately 0.77% of tax alpha, resulting in higher after-tax performance by 1.46%.

Year-round tax-loss harvesting can benefit not only existing clients with losses but also new clients looking to employ defensive tools in a rising rate environment. For high-tax-bracket individuals, the tax alpha generated in municipal portfolios can enhance portfolio returns over the life of the portfolio.

Economic outlook

Key economic data

Change in nonfarm payrolls (March)	+431k
Unemployment rate (March)	3.6%
Core CPI–YoY change (March)	6.5%
Core PCE–YoY change (March)	5.2%
Average hourly earnings–YoY change (March)	5.6%
Real GDP annualized QoQ (Q1 2022)	-1.4%

Source: Bloomberg, 5/5/2022

The Federal Open Market Committee (FOMC) raised the overnight interest rates by 50 bps at the May meeting to between 0.75% and 1%. Chairman Powell confirmed the committee's intention to fight inflation with a series of 50-bps hikes over the next few meetings. He also clarified the magnitude of quantitative tightening (QT), where the FOMC will allow government securities to roll off its balance sheet. This will start on June 1 with roughly $48 billion a month and ramp up to $95 billion a month in August. With more than $8 trillion in assets at the Federal Reserve, this measured pace should very slowly remove liquidity in the market.

Although the Fed is in the early innings on the path to higher overnight rates, we feel the bond market is in the later innings. Longer-dated interest rates are up more than 150 bps YTD, as the 10-year US Treasury sits at 2.95% at the time of this writing. Some economic indicators are cooling, including spending on goods, especially big-ticket items like housing and automobiles. Meanwhile, other indicators continue to show strength, including the overall labor market and consumer spending on services.

Last, the most recent reading of first-quarter GDP was -1.4%, below the survey of +1%. This contraction in overall economic activity is misleading, as it rightsizes much of the strength in the 4Q21 GDP reading (+6.9%). A large shift in net exports from the previous period contributed to the negative growth figure as we imported more than we exported. There was also lower inventory building and lower government spending in the quarter. We've discussed growing inventories in the past as a reflection of businesses trying to insulate themselves from supply chain disruptions by shifting away from just-in-time inventory management. It seems logical those same companies may have built up their inventories to comfortable levels today and no longer need to do so at the same pace. Of course, this could also be a sign of larger issues ahead, but we're taking a wait-and-see approach.

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