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Municipal Bond Market Insight | June 2022

Muni Investors See Some Relief at the End of May

Key takeaways

- At midpoint it appeared May would offer a continuation of the uptrend in rates. However, a relatively strong, if partial, recovery nudged the Bloomberg Municipal Bond Index toward positive returns.
- Yield movements are historically hard to predict, and the last two weeks of May may have been a head fake before the market continues its path higher.
- However, it highlights the sharp volatility municipal investors have been subject to this year and serves as a reminder that changing a long-term investment approach in the face of short-term market movement can be costly.
- The yield levels available in the municipal market today are attractive, considering what has been available to fixed income investors over the past 10 years.
- The Fed will keep raising rates, with another 50-bps move in June. However, it will be tough for policymakers to shrug off concerns around slower growth, especially with hints that inflation is cooling down.

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General market update

At midpoint it appeared May would offer a continuation of the uptrend in rates. However, a relatively strong recovery began for some parts of the bond markets—those that may have gotten somewhat oversold—allowing them to close the month out with positive returns. This rally didn't extend to the long end of the Treasury market, however. Through May, the US Long Treasury Index was down -20.08% after declining -1.89% for the month.

Other indexes outperformed. The US Corporate Bond Index gained 0.93% on the month and is now down -11.92% YTD. The Bloomberg Municipal Bond Index rose 1.49% on the month and is down just -7.47% YTD. This is in sharp contrast to the lows of May, when that index was showing a -1.94% MTD return.

Several factors contributed to the recovery. Economic data released in May indicated inflation was moderating and perhaps the economy was beginning to slow. The annualized rates for Core CPI and the PCE deflator fell to 6.2% and 6.3%, respectively. Some leading indicators, such as mortgage applications (-1.2%) and building permits (-3.2%) suggest that higher rates were already impacting economic activity.

Concerns about growth weighed on the stock market. The Dow Jones Industrial Average and the S&P 500® closed out the month up only slightly—0.326% and 0.184%, respectively—after being battered in April. Equity volatility likely created some flight-to-quality buying in May. The five-year Treasury yield fell 13 bps, and the 10-year Treasury yield fell nine bps for the month, but the trough-to-peak rally was even more impressive, at 36 bps and 38 bps, respectively. This buying buoyed both the corporate and municipal markets as their relative value became compelling.

Municipals benefited from the attractive relative valuations, which brought not only banks and insurance companies into the market but other crossover buyers as well. Market participants may also have been looking forward to the large reinvestment flows that hit the market June 1 and July 1. Those inflows, combined with a seasonal decline in issuance that's to be expected in the summer months, should support the municipal market going forward. While the market no longer feels oversold, it remains quite attractive.

Supply

Muni issuance in May totaled approximately $30 billion, which was down roughly 19% from April. Year-to-date issuance now stands at approximately $166 billion. With the muni market finding some footing, issuers may look to take advantage of the firmer demand while it lasts. Though supply is expected to pick up in the coming months, strong reinvestment flows into the market will likely be able to easily absorb new-issue deals. Top deals for the month included New York City, Illinois GO, and San Francisco BART.

Figure 1: Fixed income returns as of 5/31/2022

	MTD return	YTD return
Bloomberg Muni Index	1.49%	-7.47%
Bloomberg US Treasury Index	0.18%	-8.33%
Bloomberg US Aggregate Index	0.65%	-8.92%
Bloomberg US Corporate Index	0.93%	-11.92%

Source: Bloomberg, 5/31/2022. For illustrative purposes only. It is not possible to invest directly in an index.

Figure 2: AAA municipals YTD as of 5/31/2022

Year	Current	MTD change	YTD change
2-year	1.83%	-39	+159
5-year	2.09%	-36	+150
10-year	2.47%	-25	+144
30-year	2.81%	-24	+132

Source: Thomson Reuters Municipal Market Data, 5/31/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: US Treasury yields as of 5/31/2022

Year	Current	MTD change	YTD change
2-year	2.56	-14	+183
5-year	2.82	-9	+156
10-year	2.85	-4	+134
30-year	3.05	+10	+116

Source: Bloomberg, 5/31/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

What does the rebound in yields mean?

Still an opportunity in municipal bonds

Year to date, municipal investors have weathered a storm. Yield volatility is elevated, and performance has been sharply negative as interest rates trudged higher each month. Municipal yields have increased between 130 and 160 bps through the end of May across the maturity curve. As we stare down the barrel of future Fed interest rate hikes and continued high levels of inflation, it's not surprising that municipal investors have been exiting the asset class. Through May 25, investors have pulled approximately $65 billion from municipal mutual funds in 2022, according to the Investment Company Institute.

The silver lining through the turbulence is that investors can now buy municipal bonds at yields not seen since 2011, excluding a two-day period at the start of the COVID-19 pandemic in March 2020. The yield to worst of the Bloomberg Municipal Bond Index touched 3.50% on May 18 and today is 2.92%. Assuming the highest federal tax bracket, that's a 4.93% tax-equivalent yield. Compared with taxable alternatives, municipals appear attractive. But will that opportunity be around for long? The market may be changing its tune.

Strong seasonal reinvestment period

Historically, the summer months are slower issuance periods for municipalities. This comes at a time when many securities are maturating, paying coupon payments, or both. In years past, this has created a favorable technical backdrop and can set the stage for positive municipal bond returns. This year, expected net issuance across June, July, and August is estimated to be -$15.9 billion after accounting for bonds maturing, and this is before the approximately $46 billion in coupon payments.

Over the past five years, municipal performance from June 1 through August 31 has averaged +1.48%. This strong seasonal period may be lining up to occur just as retail mutual fund outflows reverse. According to Lipper US Fund Flows data, municipal bond funds broke their 15-week outflow streak and saw $1.2 billion of inflows for the week ending June 1. Heading into the summer months, strong seasonal reinvestment and the potential end of this outflow cycle may combine to help cool down municipal bond yields.

Growth struggles ahead?

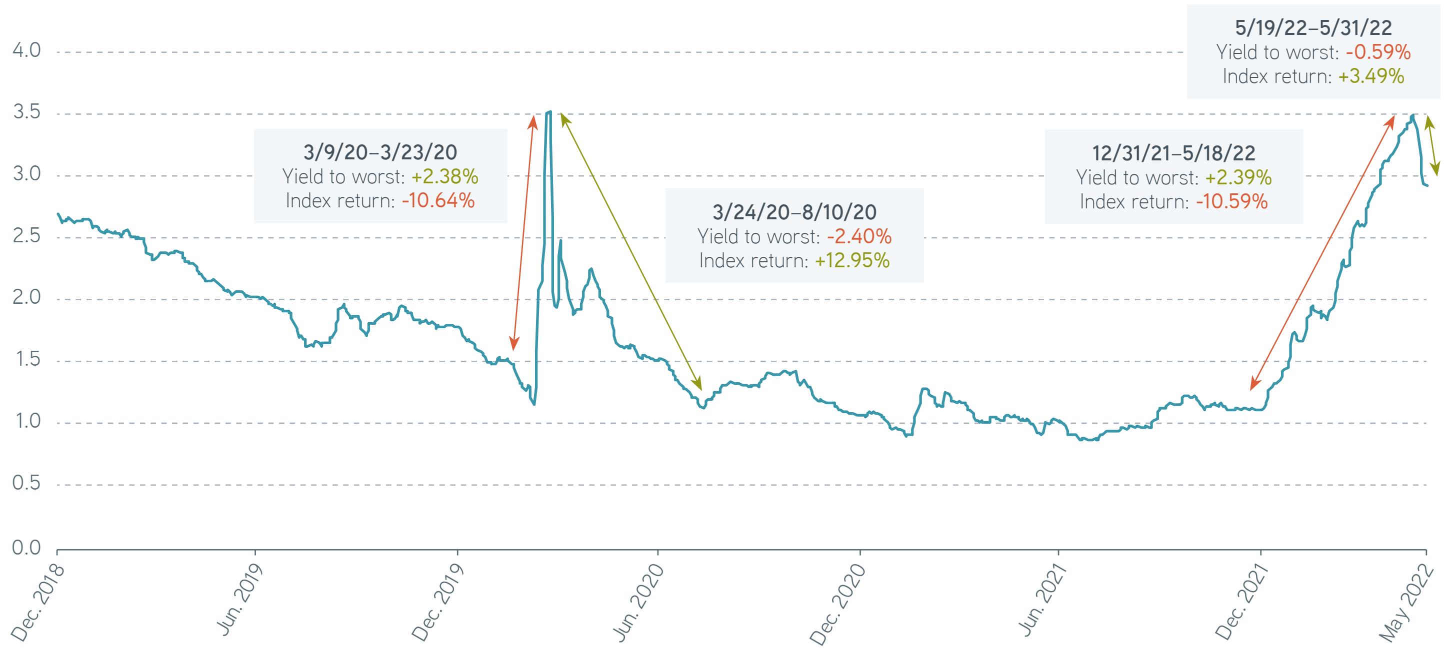
The US economy surprised economists with a first-quarter contraction of -1.5%. Many continue to predict a strong full calendar year of growth, but with inflation still an issue on the minds of all consumers and supply-chain relief nowhere in sight, there may be more growth hiccups on the horizon. Fed chairman Jerome Powell indicated that future 50-bps rate increases are "on the table," and some notable economists see the risks of a recession increasing. If growth expectations slow, longer-term yields may be dragged lower as well.

Capitulation or a temporary halt in the march higher?

With equity markets reeling in May, halfway through the month yields paused their march higher and experienced a sharp move lower. After moving 2.39% higher YTD and dragging performance down more than -10.50%, the Bloomberg Municipal Bond index saw some welcomed relief from May 19 through May 31.

From May 19 through the end of the month, the index returned just shy of +3.50%, with the yield to worst down -0.59%. The market still has a long way to go to catch up on the negative performance generated YTD, but the short-term movement lower has been strong. For perspective, the last two weeks of May generated higher returns (+3.49%) than the 10-year annualized average of the index (+2.54%).

Figure 4: Bloomberg Municipal Bond Index yield to worst, December 2018–May 2022



Source: Bloomberg, 5/31/2022. For illustrative purposes only. It is not possible to invest directly in an index. Not a recommendation to buy or sell any security.

Two weeks don't make a trend

Yield movements are historically hard to predict, and the last two weeks of May may have been a head fake before the market continues its path higher. However, it highlights the sharp volatility municipal investors have been subject to this year and serves as a reminder that changing a long-term investment approach in the face of short-term market movement can be costly. While we're unsure of the path rates will take, we believe the nominal yields available in the municipal market today are attractive, especially compared with what's been available to investors over the past 10 years. Any additional volatility may be a great entry point for those tax-minded investors with cash on the sidelines. For current investors, we continue to believe that the inefficiencies in the market as a result of rate volatility will provide opportunities for relative value trading and tax-loss harvesting.

Economic outlook

A flurry of recent economic data has caused a bit more confusion around the growth trajectory of the economy, and for economists a bit of concern. Recent corporate earnings are showing signs of weakness, with higher costs eating into company profits as consumers can no longer absorb the impact. Though retail sales remain strong, consumer confidence has taken a hit as higher inflation erodes household incomes. While there seems to be no shortage of demand for many services, and even goods, we've yet to see whether consumers will keep calm and carry on to keep the economy going.

On the labor front, ADP reports showed a significant slowdown in private payroll employment. In fact, this was the weakest monthly gain since the pandemic began. Wage growth also has slowed, which may cause the Fed to reconsider its approach to interest rate hikes. Tight labor markets have no doubt been a source of higher inflation.

We still believe the Fed will continue to raise rates, with another 50-bps move in June. However, it will be tough for policymakers to shrug off concerns around slower growth, especially with hints that inflation is cooling down. This may take until the fall to fully play out, but it would give the Fed time to slow its rate hikes if needed.

Key economic data

Change in nonfarm payrolls (April)	+428k
Unemployment rate (April)	3.6%
Core CPI–YoY change (April)	6.2%
Core PCE–YoY change (April)	4.9%
Average hourly earnings–YoY change (April)	5.5%
Real GDP annualized QoQ (Q1 2022)	-1.4%

Source: Bloomberg, 5/31/2022

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