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Municipal Bond Market Insight | July 2022

June Sets the Stage for a Better Second Half of 2022

Key takeaways

» June price action in the bond markets was remarkably similar to May's price action, in that rates peaked midmonth before rebounding in the second half—but while May provided a respite from the uptrend in rates, June didn't.

» This month saw particularly anemic supply, with issuance roughly $13 billion lower than the average June of the past five years. Heading into July, bond redemptions—which likely return to the market as reinvestment—are expected to exceed issuance by $20 billion to $30 billion based on supply forecasts.

» While rate volatility will likely persist over the second half of the year, we believe a majority of the move to higher rates is behind us. Decade-high yields and cheaper valuations should keep muni buyers engaged in the coming months.

» Evidence of tightening financial conditions includes increased layoffs in mortgage- and tech-related industries, a slowing housing market, weaker supply chains, falling auto sales, and lower confidence surveys.

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General market update

June price action in the bond markets was remarkably similar to May's price action, in that rates peaked midmonth before rebounding in the second half. However, there were two notable differences. While May provided a respite from the uptrend in rates, June didn't. Total returns were uniformly negative across all sectors. The US Long Treasury Index was down -1.47% on the month and is now down -21.25% YTD. The Bloomberg Municipal Bond Index underperformed, falling 1.64% in June and -8.98% YTD. The US Corporate Bond Index also underperformed, dropping -2.80% for the month and -14.38% YTD.

The second notable difference between May and June was an uptick in volatility. The 10-year Treasury began the month with a 2.91% and finished it at a 3.02% yield, but not before almost testing a 3.50% yield. June's peak-to-trough range for the 10-year Treasury was 66.5 basis points (bps), more than double the 30.7 bps trading range in May.

Inflation data would seem to be the impetus for moving rates. The June 10 consumer price index (CPI) report delivered an unwelcome surprise, coming in at 1.0% versus an expected 0.7%, which helped fuel the midmonth spike in yields. The Federal Reserve hiked rates 75 bps on June 15, helping to reassure market participants of their commitment to curbing inflation. A slightly better-than-expected May PCE deflator report, up 0.6% instead of an expected 0.7%, helped bond markets to firm up at the end of the month.

Concerns about the Fed's ability to contain inflation without sending the economy into a recession weighed on the equity markets. The Dow fell -6.56%, and the S&P 500® fell -8.26%, flirting with bear-market territory. Once again in June, equity volatility likely created some flight-to-quality buying in bonds. Though we've seen brief instances of inversion between two- and 10-year Treasuries, end-of-day spreads have remained slightly positive. The spread opened the month at 26 bps but tightened after the June 10 CPI report, falling to less than 10 bps, and closed out the month at six bps. Municipals outperformed, but ratios remain attractive.

Figure 1: Fixed income returns as of 6/30/2022

	MTD return	YTD return
Bloomberg Muni Index	-1.64%	-8.98%
Bloomberg US Treasury Index	-0.88%	-9.14%
Bloomberg US Aggregate Index	-1.57%	-10.35%
Bloomberg US Corporate Index	-2.80%	-14.39%

Source: Bloomberg, 6/30/2022. For illustrative purposes only. It is not possible to invest directly in an index.

Figure 2: AAA municipals YTD as of 6/30/2022

Year	Current	MTD change	YTD change
2-year	1.95	0.12	1.71
5-year	2.22	0.13	1.63
10-year	2.72	0.25	1.69
30-year	3.18	0.37	1.69

Source: Thomson Reuters Municipal Market Data, 6/30/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: US Treasury yields as of 6/30/2022

Year	Current	MTD change	YTD change
2-year	2.96	0.40	2.23
5-year	3.04	0.32	1.78
10-year	3.02	0.17	1.51
30-year	3.18	0.13	1.28

Source: Bloomberg, 6/30/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Supply

Muni issuance in June totaled approximately $30 billion, down roughly 12% from last month. June of saw particularly anemic supply, with issuance roughly $13 billion lower than the average June of the past five years. Year-to-date issuance now stands at approximately $196 billion. Supply is expected to remain manageable, especially as strong reinvestment flows work their way into the market. Heading into July, bond redemptions—which likely return to the market as reinvestment—are expected to exceed issuance by $20 billion to $30 billion based on supply forecasts. Top deals for the month of June included New York City Transitional Finance Authority, short-term City of Los Angeles notes, and the State of Maryland.

Recapping the first half of 2022

The Bloomberg Municipal Index fell -8.98% over the first half of the year—the worst start to a year on record. Yields across fixed income markets surged as the Fed pivoted toward tighter policy in hopes of taming inflation, which had reached a 40-year high. AAA-rated muni yields increased 150 to 180 bps across the curve, which was two to eight times higher in certain tenors than where we started the year. The move has brought benchmark muni yields to the highest levels in over a decade, above the peaks witnessed during other historic market routs, including Meredith Whitney's 2010 muni default prediction, 2013's taper tantrum, 2016's post-election sell-off, and 2020's COVID-19 liquidity crisis.

Similar to those periods, negative performance drove record muni mutual fund outflows. Investors pulled $76 billion from muni funds over the first half of 2022, exceeding 2013's -$69 billion outflow-cycle record. In addition to higher yields, munis have cheapened relative to taxable alternatives such as Treasuries and corporates. For example, the 10-year AAA muni/Treasury ratio ended the quarter at 90%, considered cheap by historic standards and well above the richer valuations that persisted over 2021. Likewise, for investors in higher tax brackets, munis offer value compared to corporates. For example, a 10-year A-rated muni ended the quarter yielding 3.30%. Assuming a tax rate of 40.8%, comprising a 37% top federal tax bracket plus a 3.8% Affordable Care Act surcharge, that's a taxable equivalent yield of 5.56%—approximately 1% above a similarly rated corporate.

In our view, investors should remain comfortable with A and BBB credit exposure, given strong muni fundamentals. Despite a record sell-off and outflow cycle, the municipal bond market is strong from a credit standpoint, with state liquidity and tax revenue reaching an all-time high last year. According to JPMorgan, state and local tax revenue was 16% higher in Q1 2022 relative to Q1 2021 and 35% above Q1 2019. All major tax collection categories saw strong growth. There continues to be meaningful amounts of money available from four different stimulus packages enacted since March 2020, and rainy-day fund balances across the country are back to or near all-time highs.

While rate volatility will likely persist over the second half of the year, we believe a majority of the move to higher rates is behind us. Decade-high yields and cheaper valuations should keep muni buyers engaged in the coming months. Over July and August, the near-term muni market should remain supported by elevated reinvestment flows, with net tax-exempt supply expected to be -$30 billion. The drivers behind a more sustained muni rally will be the broader rates market and muni fund flows. If the market begins to worry about slow growth and a possible recession, falling Treasury yields may result in a sharp muni rebound and a return to positive fund flows. That's what happened at the end of May, when the 10-year Treasury rallied from 3.13% to 2.75%, and the Bloomberg Muni Index was up 3.50%. Looking back on the previous historic routs we mentioned earlier, average performance for broad market indexes in the six and 12 months that followed was 8.5% and 14%, respectively. Compared with these periods, we believe current conditions offer an attractive entry point for long-term investors.

Economic outlook

Uncertainty around future economic growth and inflation is causing extreme market volatility. The Fed is committed to battling 40-year highs in inflation with an aggressive tightening cycle. This was evident in its most recent June 15 meeting, where the Federal Open Market Committee increased rates by 75 bps to a target range of 1.50% to 1.75%—the highest rate hike following a single Fed meeting since November 1994. In addition, the median dot plot forecasts the overnight rate to reach 3.375%—another 1.75% higher—by the year's end.

Evidence of tightening financial conditions includes increased layoffs in mortgage- and tech-related industries, a slowing housing market, weaker ISMs, falling auto sales, and lower confidence surveys. The Fed's actions and rhetoric to date are certainly affecting some level of demand. Investors are trying to assess how substantial this is and how much higher interest rates can go before overall economic activity is reduced enough to cause a recession. A true balancing act is underway.

Key economic data

Change in nonfarm payrolls (May)	+318k
Unemployment rate (May)	3.6%
Core CPI–YoY change (May)	6.0%
Core PCE–YoY change (May)	4.7%
Average hourly earnings–YoY change (May)	5.2%
Real GDP annualized QoQ (Q1 2022)	-1.6%

Source: Bloomberg, 6/30/2022.

About

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Disclosures

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