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Municipal Bond Market Insight | November 2022

Put the Income Back in Fixed Income

Key takeaways

» Economic data followed the same pattern as last month, mixed with some signs that higher interest rates were starting to have an impact. However, the all-important inflation data didn't moderate, with annualized Core CPI (+6.6%) and annualized Core PCE (+5.1%) both ticking up.

» The Bloomberg Municipal Bond Index yield finished the month at 4.21%, which is a level not seen since March 2009.

» Market volatility hasn't abated, and we see this as a constant through year end.

» Whatever uncertainties lie ahead, absolute yields on municipals have become quite compelling.

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General market update

October seemed to drift by like the leaves coming off the trees. There was no Fed meeting, the Russo-Ukrainian War slogged on, and many investors' attentions were focused on the upcoming midterm elections. Economic data followed the same pattern as in September, mixed with some signs that higher interest rates were starting to have an impact. However, the all-important inflation data didn't moderate, with annualized Core CPI (+6.6%) and annualized Core PCE (+5.1%) both ticking up.

Treasury yields rose yet again. The benchmark 10-year reached 4.24% on October 24 before closing the month at 4.05%, 22 basis points (bps) higher than the previous month. Stocks shrugged off the rise in yields and rallied 8.10% on the month. The Bloomberg Municipal Bond Index returned -0.83% for the month and 12.86% for the year. Municipal continued to outperform both US Treasuries and investment-grade (IG) corporate bonds. The Bloomberg US Treasury Index has returned -14.30% year to date, while the Bloomberg US Aggregate Index has returned -15.72%.

Market volatility hasn't abated, and we see this as a constant through year end. The midterm elections should offer some guidance on the path fiscal policy might take. Whatever uncertainties lie ahead, absolute yields on municipals have become quite compelling.

Supply

Total municipal issuance for the month of October brought $24.9 billion, down approximately 40% from the issuance seen in October 2021. Issuers once again delayed bringing deals to market amid significant rate volatility and the impending November Fed meeting. Total issuance through October was $337.5 billion, down approximately 16% from 2021's impressive issuance through October. Notable tax-exempt issuers that came to market in the month of October include New York City, the Commonwealth of Massachusetts, and the State of Connecticut.

Figure 1: Fixed income returns as of 10/31/2022

	MTD return	YTD return
Bloomberg Muni Index	-0.83%	-12.86%
Bloomberg US Treasury Index	-0.69%	-21.81%
Bloomberg US Aggregate Index	-1.30%	-15.72%
Bloomberg US Corporate Index	-1.03%	-19.56%

Source: Bloomberg, 10/31/2022. For illustrative purposes only. It is not possible to invest directly in an index.

Figure 2: AAA Municipals YTD as of 10/31/2022

Year	Current	MTD change	YTD change
2-year	3.18%	+0.09%	+2.94%
5-year	3.24%	+0.12%	+2.65%
10-year	3.39%	+0.09%	+2.36%
30-year	4.12%	+0.22%	+2.63%

Source: Thomson Reuters Municipal Market Data, 10/31/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: US Treasury yields as of 10/31/2022

Year	Current	MTD change	YTD change
2-year	4.49%	+0.26%	+3.75%
5-year	4.24%	+0.19%	+2.98%
10-year	4.07%	+0.27%	+2.57%
30-year	4.18%	+0.41%	+2.29%

Source: Bloomberg, 10/31/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Market opportunity

The Fed has shown a commitment to hiking overnight rates to slow the current economic cycle in the face of stubbornly high inflation. Chair Jerome Powell announced another 75 bps increase on November 2, bringing the range to 3.75%–4.00%. Powell signaled in his press conference that future rate increases may be smaller than the past four, but he reiterated that reducing the size of the increase does not mean the Fed is moving away from higher rates.

In the face of sticky inflation, rate volatility, and a committed Fed, why should investors consider fixed income strategies? At the end of the month, the Bloomberg Municipal Bond Index yield to worst was 4.21%. The last time we saw yields that high was March 18, 2009, when the world came out of one of the worst financial crises in history. Global economies are in a much stronger place today, especially US municipal issuers. We're seeing similar yield levels available to investors despite this sharp contrast.

The breakeven return on municipal bonds has increased significantly with the increase of interest rates this year. High-quality municipal bonds were offering between 1.00% to 1.50% in yields (per Thomson Reuters) at the end of last year, and the income return generated by these bonds wasn't sufficient to counteract the negative price return as rates increased. Today's starting yields are between 250 and 300 bps higher, which can help fixed income investments better offset future price movements if rates continue to be volatile.

Two paths for muni investors

Rates have reached levels not seen in more than a decade, and municipalities are broadly financially sound. How can investors take advantage? We see two different approaches:

- **The short-term approach.** Short-term municipal bond yields have increased dramatically this year and may offer attractive income for investors unwilling to take on longer-duration risks. For example, a five-year AAA-rated bond yields 3.24%, and an investor captures 79% of all yield available relative to going out 30 years. In addition, by using a laddered portfolio that weights maturity rungs equally up to five years, the portfolio maintains a shorter duration and as a result is likely to see less volatility if rates continue to move higher.
- **A longer-term focus.** Today's longer-term municipal bond yields may offer an attractive entry point for investors who understand that duration comes with volatility. Ten-year AAA municipal bonds are offering the highest yield levels in more than a decade, and longer-duration strategies allow investors to lock in bond yields that may not be available in the future. It's likely these longer-duration bonds would benefit if economic conditions worsened, and the Fed was forced to reverse course on rate increases. Today's higher level of income also provides some cushion if rates continue to increase. For example, a 15-year AAA-rated maturity bond is yielding 3.69%, which is a taxable-equivalent yield of 6.23%. Higher yields may provide investors with higher income levels than what we've seen in the past decade, along with an income cushion against higher yields.

Figure 4: AAA 10-year yield, 2008–2022

Source: Bloomberg, 10/31/2022. For illustrative purposes only.

Economic outlook

The Fed raised its policy rate by 75 bps on November 2 as expected, bringing the federal funds rate to 3.75% to 4.00%. Powell indicated that rates may rise further, but he softly suggested that the Fed would move to a slower pace if warranted. He continued to reiterate that rates will continue to go higher if inflation doesn't come down. The slight tweak in language buys the Fed time to see if the restrictive policy implemented this year is finally slowing down inflation. However, there was affirmation that the Fed was ready to plow ahead if needed. The market is now pricing in federal fund futures toward a 50-bps hike in December and continued hikes into 2023, capping out at 5%.

There continues to be wage pressure with a very solid labor market. The October jobs report provided an indication that there is little cooling in the extremely tight market. It's becoming increasingly difficult for the Fed to straddle that thin line of cooling inflation versus sinking economic growth. The Fed hikes have not had an impact on the pace of hiring yet, but changes to the speed of job growth can lag policy implementation. With just two more CPI prints and one jobs report before the December meeting, the Fed can only remain hopeful things begin to change.

Key economic data

Change in nonfarm payrolls (Oct)	+261k
Unemployment rate (Sep)	3.7%
Core CPI–YoY change (Sep)	6.6%
Core PCE–YoY change (Sep)	5.1%
Average hourly earnings–YoY change (Oct)	4.7%
Real GDP Annualized (Q3 2022)	2.6%

Source: Bloomberg, 11/4/2022.

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