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Municipal Bond Market Insight | January 2023

Fixed Income Finally Delivers the Second Half of Its Name

Key takeaways

» We expect demand from high-tax-bracket individuals to be favorable for most of the year. After record outflows in 2022, we expect flows to turn modestly positive as investors look to lock in attractive yields.

» Municipal credit spreads should remain stable, since issuers' revenues have been growing, liquidity has increased, and rainy-day funds for most states and cities are at all-time highs.

» Though short-end yields remain attractive, we favor adding duration in client portfolios and locking in more attractive yields out in the intermediate to long part of the curve.

» We believe clients should take advantage of ongoing credit oversight, market inefficiencies, and year-round tax-loss harvesting this year.

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Recap

The year 2022 was undoubtedly a tumultuous one for fixed income markets—as in, the worst year for bonds in more than a century. Investors faced inflation at 40-year highs, unprecedented quantitative tightening with simultaneous rate increases, and correlated equity and bond price action. All this occurred against the backdrop of the ongoing Russo-Ukrainian War and an ebbing COVID-19 pandemic. *Tumultuous* may be an understatement.

Municipal bonds specifically returned -8.53%, outperforming most taxable asset classes. High-yield municipals returned -13.10%, while investment-grade corporate bonds returned -15.76% and US Treasuries returned -12.46%, as proxied by bond market indexes. Despite an all-time-record month of fixed income returns in November, we still ended the year sharply in the red. Issuance in the municipal market declined roughly 20% to $384 billion. Municipal mutual fund flows broke the record for largest calendar-year outflows, clocking in at -$121 billion.

Importantly, credit didn't drive the sell-off. Municipal issuers are in strong financial standing, especially after receiving $1.9 trillion of financial aid from the federal government over the past two years. This aid helped stabilize municipal credit during the pandemic and set most issuers up for solid growth in 2021 and into 2022. Tax revenues also came in significantly stronger than expected in 2020 and 2021 as the economy recovered. Tax receipts in 2022 went up by an average 16.2% versus 2021.

2023 market outlook

As rate hikes impact the economy, data indicates growth has slowed. While it's possible the Fed may still achieve a soft landing, bringing down inflation while maintaining economic growth, there's a growing expectation among market participants that the US could slip into a recession in 2023. Several factors make us inclined to believe this will be the case.

The inversion in the Treasury curve between the two- and 10-year yields that began on July 5, 2022, widened from 50 basis points (bps) at the beginning of November to a peak of 84 bps on December 8. This spread ended the year at 56 bps. This type of inversion has historically been a good predictor of a contraction in economic activity. We interpret that widening inversion as a sign that investors expect a recession.

Figure 1: Fixed income returns as of 12/31/2022

	MTD return	YTD return
Bloomberg Muni Index	0.29%	-8.53%
Bloomberg US Treasury Index	-0.52%	-12.46%
Bloomberg US Aggregate Index	-0.45%	-13.01%
Bloomberg US Corporate Index	-0.44%	-15.76%

Source: Bloomberg, 12/31/2022. For illustrative purposes only. It is not possible to invest directly in an index.

Figure 2: AAA municipal yields as of 12/31/2022

Year	Current	MTD change	YTD change
2-year	2.60%	+0.07%	+2.36%
5-year	2.52%	-0.11%	+1.93%
10-year	2.63%	-0.08%	+1.60%
30-year	3.58%	+0.06%	+2.09%

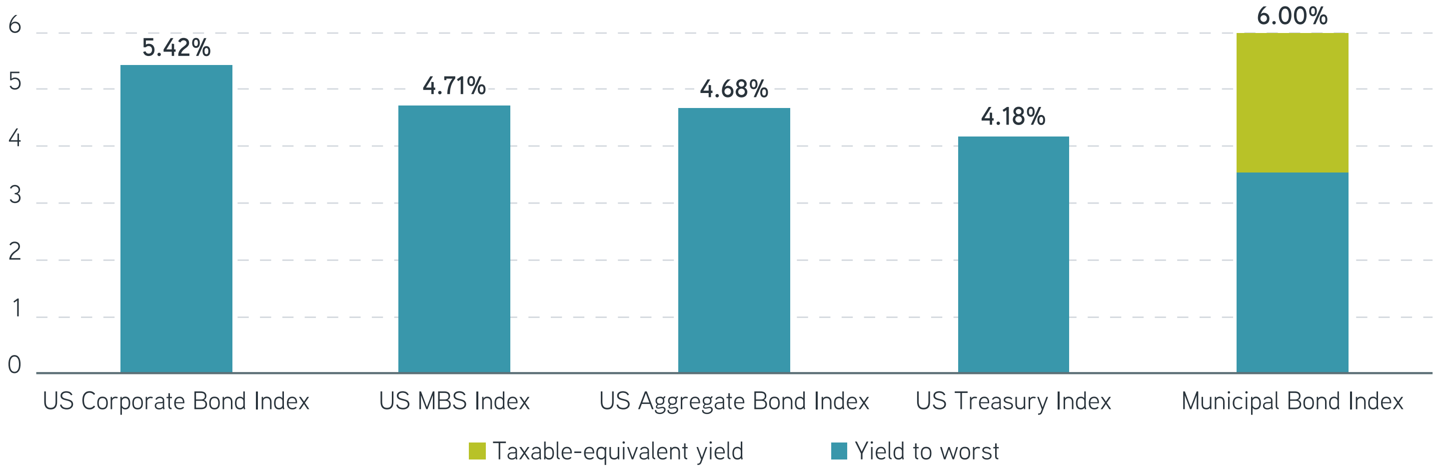
Source: Thomson Reuters Municipal Market Data, 12/31/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: US Treasury yields as of 12/31/2022

Year	Current	MTD change	YTD change
2-year	4.43%	+0.12%	+3.70%
5-year	4.00%	+0.26%	+2.74%
10-year	3.88%	+0.27%	+2.37%
30-year	3.97%	+0.23%	+2.08%

Source: Bloomberg, 12/31/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 4: Index yield to worst



Source: Bloomberg, 12/31/2022. For illustrative purposes only. Not a recommendation to buy or sell any security. It is not possible to invest directly in an index. Yield of the municipal bond index shown as taxable-equivalent yield assuming the highest federal tax bracket (40.8%).

We believe municipal bonds are poised for strong performance, given higher yields and a macro environment set up for slower growth. We believe high quality will perform well and broad muni indexes will post positive performance in excess of their yield. We also expect strong technicals to help drive short-term performance. The first quarter of 2022 could see low issuance and positive flows, especially as a result of seasonal demand from reinvestment flows.

The performance challenges of 2022 were difficult to navigate. Most areas of fixed income were sharply negative, resulting in few asset classes where investors could ride out the storm. However, today's fixed income assets are providing attractive yield levels compared with where rates lingered over the last decade. At the end of 2022, 10-year AAA municipal yields were 2.63%, more than double the yield available at the end of 2021. On a taxable-equivalent basis, assuming the highest federal tax bracket, the highest-quality municipal bonds offer 4.44%. For long-term investors, higher yields are a good thing.

Short-end yields remain attractive, and the overall yield curve is flat, which means investors aren't picking up significantly higher levels of income by purchasing longer-maturity bonds. However, longer-term yields typically fall during the later stage of Fed tightening cycles. Adding duration may be an attractive option for longer-term investors.

Looking ahead, credit selection will be important, even though financials are stable. As a reminder, all US states except Vermont are required by state law to balance their operating budgets. State governments engage in a practice known as fund accounting, in which revenues are deposited and expenditures come from particular funds. The general fund in almost every state receives almost all tax and fee revenue, and the legislature then makes most of its appropriations from this fund. When talking about a balanced budget, we're most often discussing the general fund budget specifically.

State revenue and expenses are procyclical: When a recession hits, receipts drop and expenses may increase as laid-off workers stop being taxpayers and start looking to draw down benefits. Since states can't initiate stimulus, investors often worry that stressed states may elect to fail to meet their obligations to bondholders, preferring instead to aid their voting populace. We believe municipal issuers will be able to weather economic stress successfully through the various structural aspects of budgeting, the flexibility to manage expenses, and higher levels of liquidity. However, professional credit management will be critical in client portfolios should an economic downturn occur. Muni investors will likely take one of two paths:

- **Short term:** 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 maturity bond yields 2.52%, and an investor captures 71% of all yield available relative to going out 30 years. In addition, by using a ladder structure that weights maturity rungs equally up to five years, the portfolio maintains a shorter duration, which makes it likely to see less volatility if rates continue to move higher.

- **Long term:** For investors who understand that duration comes with volatility, today's longer-term municipal bond yields may offer an attractive entry point. As discussed above, 10-year AAA municipal bonds are offering yield levels not seen for most of the last decade, and longer-duration strategies allow investors to lock in bond yields that may not be available in the future. If economic conditions worsen and the Fed is forced to cut short-term rates, it's likely these longer-duration bonds would benefit. For example, a 15-year AAA-rated maturity bond is yielding 3.15%, which is a taxable-equivalent yield of 5.32%. While rates could rise further, today's yields may provide investors with a higher income stream than what we've seen in the past decade, so locking in for longer is definitely worth considering.

This year's significant rise in yields has left many municipal bond investors with substantial losses in their portfolios. Though not the ideal outcome in terms of returns for clients, it presents an incredible opportunity for tax-loss harvesting. Investors can use tax-loss harvesting to reduce the impact of capital gains taxes on portfolio returns. Too many investors harvest losses only toward the year's end, when replacement options are limited and bid-ask spreads are often wider. This means tax alpha that investors may generate at the end of the year is likely below potential. We also typically 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.

Key economic data

Change in nonfarm payrolls (Dec)	+223k
Unemployment rate (Dec)	3.5%
Core CPI–YOY change (Nov)	6.0%
Core PCE–YOY change (Nov)	4.68%
Average hourly earnings–YOY change (Dec)	4.6%
Real GDP Annualized (Q3 2022)	2.9%

Source: Bloomberg, 1/6/2023.

Economic outlook

As we assess the economy on a forward-looking basis, we anticipate that restrictive monetary policy will help lower inflation by slowing GDP growth. Recent data supports the notion that inflation has likely peaked. Core PCE continued its decline to 4.68% in November, down from readings of 5.2% year over year (YOY) in September and as high as 5.4% YOY in February. Core CPI readings surprised to the downside in November, creating a sharp rally across fixed income assets.

For the economy to slow and inflation to decline, the labor market must soften. We see some weakening in employment, such as increased layoffs in areas of the economy—most notably housing—and rising continuous jobless claims. However, this month's 223,000 increase in nonfarm payrolls and 3.5% unemployment rate serve as a reminder that the road to 2% inflation will be long.

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