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Municipal Bond Market Insight | March 2023

# February's Sell-Off Offers Investors Another Bite at the Muni Apple

## Key takeaways

» Surprising consumer strength, extremely strong employment, and lingering inflation all helped propel rates higher in February.

» Muni issuance continues to surprise to the downside, with year-to-date (YTD) issuance down about 22% versus last year.

» We think the February sell-off represents a second chance for investors to lock in attractive yields out of the curve.

» All measures of inflation—including the Consumer Price Index (CPI), Producer Price Index (PPI), and Personal Consumption Expenditure (PCE)—surprised to the upside, supporting the notion that the path to lower inflation will be gradual.

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## General market update

February brought a chill to fixed income markets. Interest rates moved sharply higher, erasing much of 2023's strong year-to-date returns. Surprising consumer strength, extremely strong employment, and lingering inflation all helped propel rates higher. In the face of stickier inflation, the Federal Reserve reiterated its commitment to hiking the overnight rate. All this together created the worst February in 15 years for the municipal bond market.

Yields in both the Treasury and municipal markets increased over the month, resulting in a snapback in performance. The Bloomberg Municipal Bond Index returned -2.26% in February—slightly outperforming the US Treasury Index, which returned -2.34%—while the investment-grade corporate index declined -3.18%. Equity markets also reversed course, with the S&P 500® down -2.44%.

Volatility is likely here to stay. Markets across both equity and fixed income are reacting quickly and often abruptly to new economic data, with a particular focus on US unemployment. Yields today are reaching levels that historically have attracted strong investor demand. We view the higher income levels available today as an attractive opportunity to get invested in high-quality fixed income asset classes.

## Supply

February municipal issuance continues to surprise to the downside, coming in at $18 billion for the month—the first time February issuance came in below $20 billion since 2018. This marks a 42% drop in issuance year-over-year as issuers remain on the sidelines amid market volatility, the Federal Open Market Committee meeting at the start of the month, and strong economic data releases. March and April tend to be a test during tax season, potentially placing further pressure on municipals as we historically see issuance pick up and money flow out of funds due to tax-season selling. The largest issuers for the month of February include the University of California, the New York City Transitional Finance Authority, and Lamar Consolidated Independent School District in Texas.

### Figure 1: Fixed income returns as of 2/28/2023

| | MTD return | YTD return |
|---|---|---|
| Bloomberg Muni Index | -2.26% | 0.55% |
| Bloomberg US Treasury Index | -2.34% | 0.11% |
| Bloomberg US Aggregate Index | -2.59% | 0.41% |
| Bloomberg US Corporate Index | -3.18% | 0.70% |

Source: Bloomberg, 2/28/2023. For illustrative purposes only. It is not possible to invest directly in an index.

### Figure 2: AAA municipal yields as of 2/28/2023

| Year | Current | MTD change | YTD change |
|---|---|---|---|
| 2-year | 2.95% | 78 bps | 35 bps |
| 5-year | 2.64% | 59 bps | 12 bps |
| 10-year | 2.59% | 40 bps | -4 bps |
| 30-year | 3.56% | 36 bps | -2 bps |

Source: Thomson Reuters Municipal Market Data, 2/28/2023. For illustrative purposes only. Not a recommendation to buy or sell any security.

### Figure 3: US Treasury yields as of 2/28/2023

| Year | Current | MTD change | YTD change |
|---|---|---|---|
| 2-year | 4.79% | 61 bps | 36 bps |
| 5-year | 4.17% | 57 bps | 16 bps |
| 10-year | 3.90% | 41 bps | 3 bps |
| 30-year | 3.90% | 28 bps | -8 bps |

Source: Bloomberg, 2/28/2023. For illustrative purposes only. Not a recommendation to buy or sell any security.

## Market opportunity

At only two months into the year, the muni market gave new meaning to the phrase *deuces wild*. After testing 3.37% in January, the 10-year Treasury reversed course in February and looks set to make a second run at 4.00%. Strong investor interest inside of 10 years has buoyed the municipal market this year, but we've seen much less demand out the curve. This has resulted in two different relative value propositions, depending on where one looks on the curve. As we see it, after the relatively dramatic January rally made short municipals expensive, the February sell-off represents a second chance for investors to lock in attractive yields out the curve.

September 2022's yield to worst (YTW) on the Bloomberg Municipal Bond Index rose above 3.60%, the first time since the 2008 financial crisis that the yield had been that high. We noted this opportunity as an attractive entry point and suggested that long-term investors should consider locking in "the highest yields in a decade." We tempered our enthusiasm with concern that municipal market conditions were challenging given stubbornly high inflation, the Federal Reserve's commitment to hiking rates, and a record fund outflow cycle. But the February 2023 sell-off has taken index yield back above 3.60%, giving investors a second chance to lock in longer-term municipal yields. This opportunity is occurring against a more favorable backdrop: Inflation looks to be lower today; the Fed has tempered the size of its rate hikes; and fund flow picture in the municipal market is more mixed, with YTD flows turning negative only at the end of the month.

We think investors should consider taking advantage of this opportunity. For upper-bracket investors, national A-rated municipals 13 or more years out can have taxable-equivalent yields (TEYs) over 6%. For some taxpayers in specialty states where a manager might offer a state-specific portfolio, TEYs are approaching 8%. Historically, investors have responded to the risk/reward tradeoff of equity-like TEYs by taking on municipal market risk. We imagine they'll respond in a similar way as word gets out.

But let's remember that September 2022 doesn't represent a peak. The index YTW continued to rise, hitting 4.22% in mid-October. From there strong investor interest and large December and January reinvestment flows helped drive the index YTW down to a low of 3.07% in January. Typically the March-to-April tax season tends to be a test, and it's possible we see some pressure in those months as a result. However, current yields and notably constrained supply could mean that significant pressure may not come to fruition. Muni issuance continues to surprise to the downside, with YTD issuance down about 22% versus last year.

Given the improvement in underlying conditions and upcoming June and July reinvestment flows, we view the current environment as a welcome second opportunity to lock in yields out the curve. Investors who fail to act now may find a third opportunity a long time coming.

Bloomberg Municipal Bond Index yield to worst


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

 

### Key economic data

| | |
|---|---|
| Change in nonfarm payrolls (Jan) | +517k |
| Unemployment rate (Jan) | 3.4% |
| Core CPI–YOY change (Jan) | 5.6% |
| Core PCE–YOY change (Jan) | 4.7% |
| Average hourly earnings–YOY change (Jan) | 4.4% |
| Real GDP Annualized (Q4 2022) | 2.7% |

Source: Bloomberg, 3/2/2023.

## Economic outlook

January's stronger-than-expected inflation data, released in February, was a primary cause for interest rates rising in the month. All measures of inflation—including the Consumer Price Index (CPI), Producer Price Index (PPI), and Personal Consumption Expenditure (PCE)—surprised to the upside, supporting the notion that the path to lower inflation will be gradual. For example, Core PCE, which strips out food and energy prices, increased 0.6% month over month (MOM) in January, compared with the survey median of 0.4%. This tied for the second-highest MOM reading in the post-COVID-19 period. On a year-over-year basis, Core PCE increased 4.7%, lower than the 5.4% peak a year ago but seemingly a long way from the Fed's 2% target rate.

As a result, both short- and long-term interest rates rose meaningfully. Expectations for future Fed rate hikes climbed by 50 basis points (bps), with a terminal rate of 5.4% priced in as of this writing, up from 4.9% in late January. That would indicate market expectations of three more 25-bps hikes from a 4.6% effective rate in late February.

Interestingly, longer rates rose significantly as well. The 10-year US Treasury and the 10-year AAA Municipal yield both increased over 40 bps to finish the month at 3.9% and 2.6%, respectively. Higher rates of return that can be achieved further out the yield curve support our belief that now is a good time to add to fixed income allocations.

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