MAY 2022

MUNICIPAL BONDS
WINDOW OF OPPORTUNITY

A PERFECT STORM OF US MUNICIPAL BOND (MUNI) UNDERPERFORMANCE HAS CREATED A WINDOW OF OPPORTUNITY. WE BELIEVE INVESTORS SHOULD SERIOUSLY CONSIDER TAKING ADVANTAGE OF IT.

EXECUTIVE SUMMARY

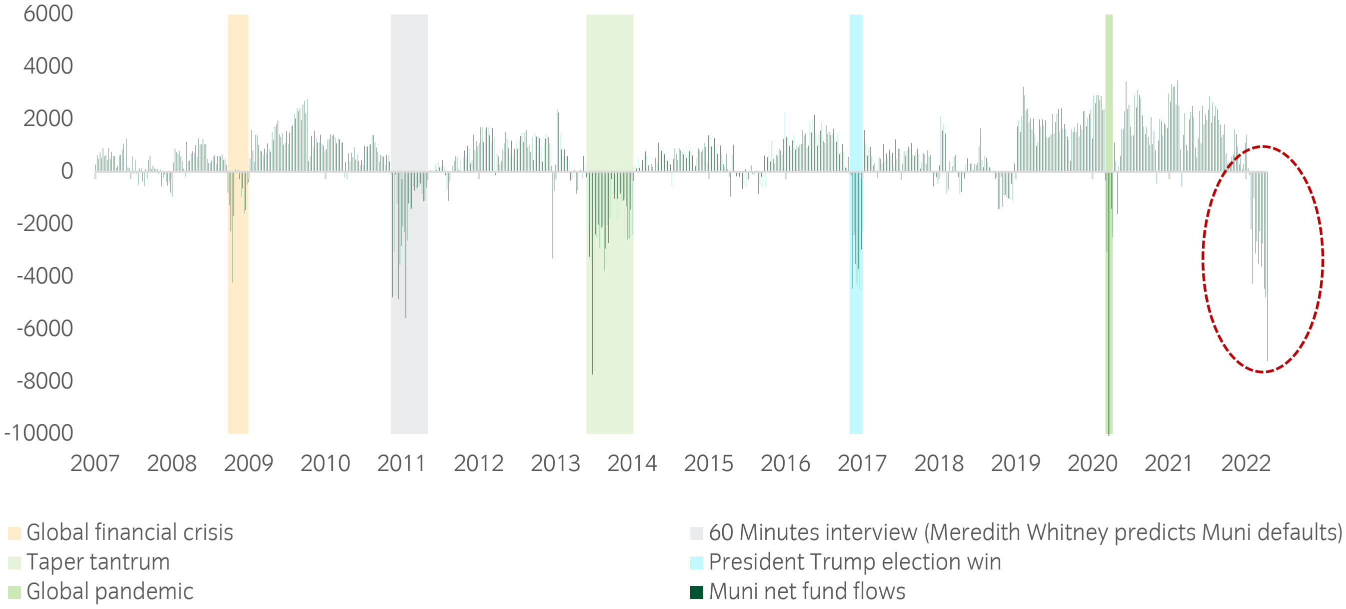
- Muni sell-offs have been rare, and have historically been followed by strong rebounds
- Technicals are reversing, creating a window of opportunity to access cheaper valuations
- Munis offer a measure of inflation protection and have historically performed well when rates have risen
- Muni fundamentals look particularly strong, with many states having spent only a fraction of their pandemic-era fiscal support

MUNIS HAVE SUFFERED A PERFECT STORM

The start of 2022 has been a “perfect storm” for the muni market. The Federal Reserve’s “hawkish pivot,” inflationary pressure and uncertainty driven by the Russian invasion of Ukraine contributed to uncertainty across all fixed income assets.

The result has been the heaviest net outflows since the onset of the pandemic in 2020 (Figure 1). The volume of munis out for bid in early April 2022 surpassed $2bn[1], a new high for the year. This was in stark contrast to a stream of almost continuous inflows over the previous year.

Figure 1: Muni fund outflows have been the heaviest since the start of the pandemic[2]



[1] Bloomberg, April 2022
[2] Bloomberg, April 2022

This has occurred during continued heavy issuance. Issuers have sold more than 10 deals of a billion dollars or more so far in 2022 and are on pace to beat the record of 26 set in 2020[3]. Even those huge budget surpluses have come to market, putting further downward pressure on prices.

THIS HAS CREATED A WINDOW OF OPPORTUNITY FOR INVESTORS

These types of sell-off have been rare in muni history. When they have happened, the market has consistently rebounded strongly, with inflows sharply increasing (Figure 2).

Figure 2: Similar drawdowns have preceded record rebounds[3]

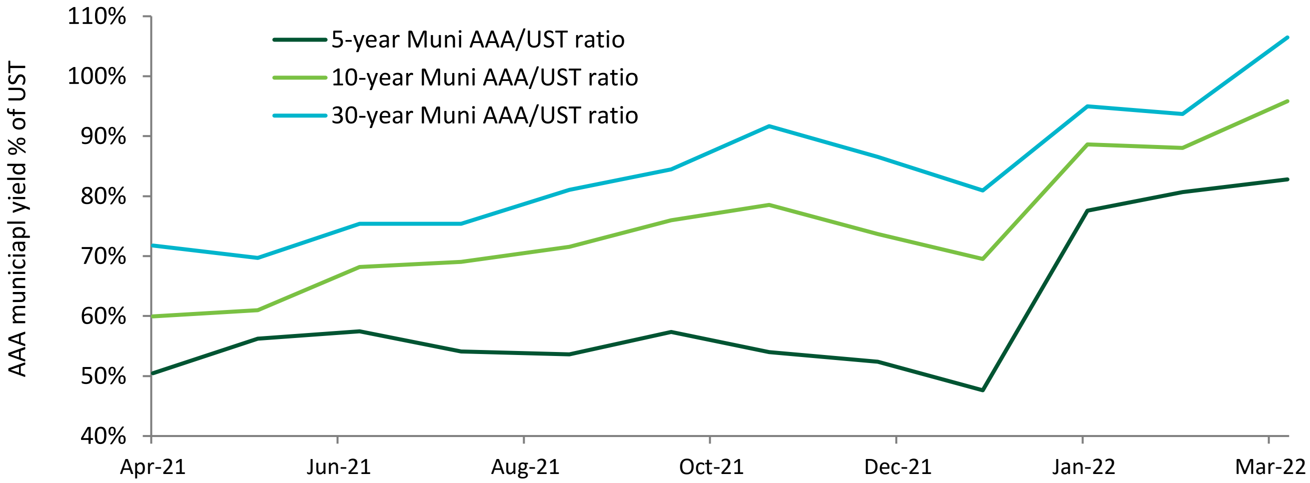
			Cumulative recovery post-drawdown	
Drawdown start date	Drawdown end date	Cumulative Drawdown	1-year return	2-year return
Mar-04	May-04	-5.29%	8.96%	10.89%
Jan-08	Oct-08	-11.12%	19.89%	29.28%
Oct-10	Jan-11	-6.46%	15.20%	21.84%
May-13	Sep-13	-6.77%	10.36%	13.40%
Jul-16	Dec-16	-5.71%	6.37%	7.20%
Mar-20	Mar-20	-10.94%	13.29%	9.17%
Aug-21	Present	-9.38%	?	?

We expect a potentially similar trajectory, particularly as technicals are set to reverse by the summer.

From a supply perspective, $39bn of munis are scheduled to mature in June, followed by $35bn in July and $36bn in August[3]. Further, we expect $5bn to $10bn of calls each month. Supply has potentially been front-loaded as many issuers sought to get ahead of rising interest rates this year. Still, the tax-exempt muni market is forecast to shrink by $40bn in 2022[4].

From a valuation perspective, ratios of muni yields to Treasury yields are increasingly attractive as they are now at their cheapest levels since the start of the pandemic, at close to neutral (Figure 3).

Figure 3: Muni ratios have cheapened[5]



[3] Bloomberg, May 2nd 2022. Index: Bloomberg Municipal Bond Index.

[4] JP Morgan forecast, Bloomberg Finance L.P., Refinitiv data, April 2022.

[5] Bloomberg, April 2022

Further, yields on taxable munis (i.e. not granted tax exemption for any US investors) are currently 35bp above AA rated US corporate bonds[6]. Meanwhile, European investors can benefit from a currency-hedged ~125bp pickup over AA euro sovereign debt and a ~80bp pickup over AA European corporate debt[7]

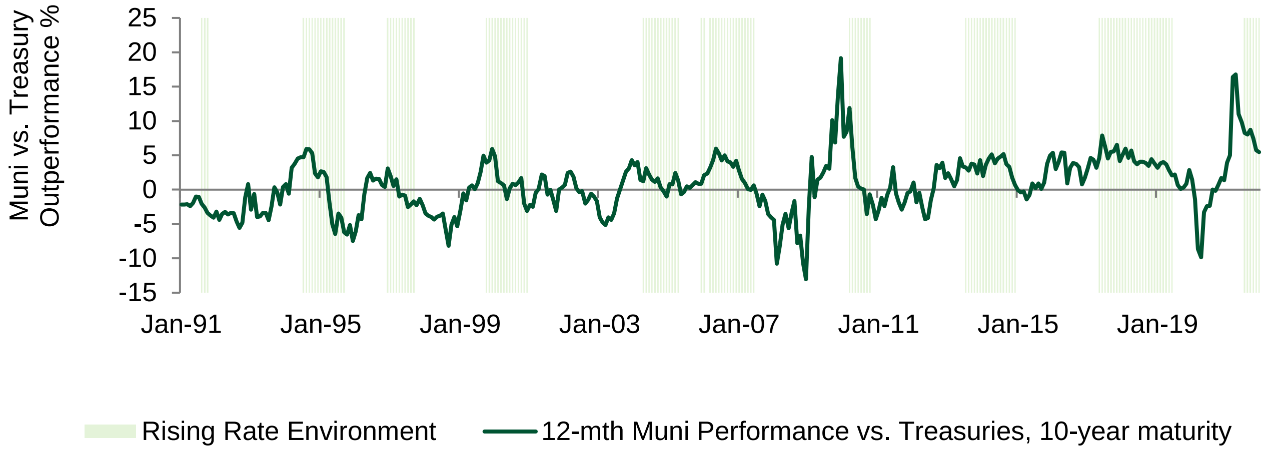
Investors have substantial cash on the sidelines, with balances in US money market funds still ~$1trn higher than pre-pandemic, waiting for entry points such as these (Figure 4).

Figure 4: Investor cash is waiting to be put to work where yields are compelling[8]

MUNIS MAY ALSO OFFER AN OPPORTUNITY TO DEFEND AGAINST RISING RATES AND INFLATION

Munis have tended to outperform Treasuries during rising rate environments (Figure 5).

Figure 5: Munis have tended to show positive excess returns when rates have risen[9]



Historically, during rising rate periods, retail investors have sought shelter in munis to benefit from higher tax-exempt interest rates. Further, supply tends to fall as municipalities prefer to avoid raising debt at higher rates.

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[6] Bloomberg, April 2022. Indices: Bloomberg Taxable Muni Index and Bloomberg AA Corporate Bond Index.

[7] JP Morgan, MRSB, April 2022. For 10-year maturities. Note: The 10Yr AA taxable muni yield is based on MSRB trade observations of $1mn or greater, non-call, 10-10.99yr taxable muni bonds. Buying or selling in size may require a premium/concession, depending on market conditions. JPM's MAGGIE 10yr AA Euro yield as of 04/25/2022. Cost of maturity-matched hedge defined as the maturity -matched FX cross-currency basis + domestic swap rate (3s curve) - foreign-currency swap rate (3s curve).

[8] Bloomberg, April 2022

[9] Barclays, Thomson Reuters, Insight as of December 31, 2021. Returns series shown is 12-month rolling total return difference between munis and treasuries. Treasury data based on Bloomberg 10-year treasury bellwether benchmark. Muni Data based on 10-year QA Direct by Refinitiv (formerly Thomson Reuters) MMD scale.Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations. The performance results shown are net of investment management fees and reflect the reinvestment of dividends and/or income and other earnings. Please refer to the important disclosures at the back of this presentation.

Munis can also offer a measure of inflation protection. Municipalities benefit from increased tax collections (such as sales tax) from higher prices during periods of strong economic growth. The strong performance of the housing market across the US also offers the potential for municipalities to see higher income from property taxes.

Further, many revenue bonds are tied to essential services projects such as power generation, where energy costs are being passed onto businesses and consumers. Additionally, structures such as tobacco master settlement agreement (MSA) bonds have their revenues directly tied to inflation.

MUNIS HAVE COMPELLING FUNDAMENTALS IN OUR VIEW

The recent volatility in munis has not been related to fundamentals. From a debt service perspective, we believe that munis are in excellent shape, particularly following several stimulus programmes from the Federal government including the American Rescue Plan (ARP).

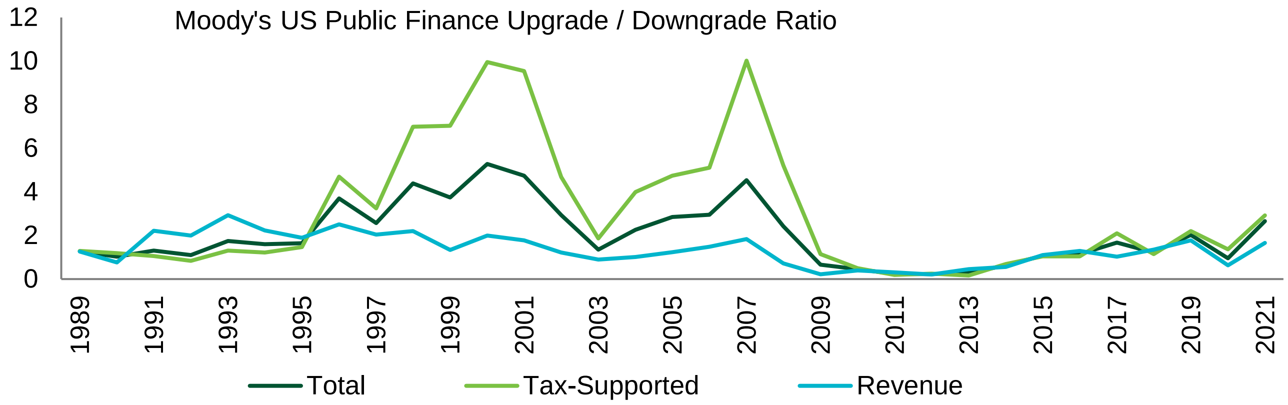
For example, New York state has only spent $10bn of the $26bn they received under the ARP, and only currently plan to spend a further $12.75bn, after which it will still have funds left over. Most states are in similar positions.

Further, given the Administration's sanctions on Russian energy, energy producing states (such as Texas, New Mexico and North Dakota) stand to benefit from direct taxes and second round effects of rising revenues to local economies. Alaska may also see $1bn in unexpected revenue from higher oil prices.

The airport sector has received a fundamental credit boost with air travel recovering close to pre-pandemic levels. We believe the rebound is set to continue as demand is expected to increase throughout the peak spring/summer travel season although higher energy prices may curtail future travel activity.

According to Moody's, municipal rating activity during 2021, was the most positive rating year since 2007 and the 10th strongest since 1989 with its upgrade to downgrade ratio at 2.7 to 1 (Figure 6).

Figure 6: Muni fundamentals are some of the healthiest in fixed income in our view[10]



CONCLUSION: TAKE ADVANTAGE OF THE WINDOW OF OPPORTUNITY

We believe that the perfect storm of muni bond underperformance has delivered an excellent opportunity for investors to consider entering the asset class, particularly before supply materially falls over the summer.

[10] Bloomberg, April 2022

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