Fed Fears Create Volatility and Value in Municipal Bonds

Attractive yields and high credit quality make munis compelling.

KEY INSIGHTS

- Absolute levels of municipal yields are attractive. In early 2022, municipal yields reached their highest levels since 2009 outside of a short spike in 2018.
- Record year-to-date outflows from municipal debt funds industrywide have exacerbated pressures triggered by rising interest rates.
- While an economic slowdown may hamper credit quality in municipal bonds to some degree, we believe the high-quality nature of the asset class remains in place.

The Federal Reserve’s (Fed) aggressive stance toward tightening monetary policy to stem high inflation triggered a 2022 sell-off in almost all fixed income segments, driving yields higher. Well-publicized supply chain disruptions exacerbated by the Russian invasion of Ukraine have kept inflation meaningfully higher than most investors anticipated, and the Fed has clearly telegraphed its intention to continue to raise the federal funds rate as well as reduce the size of its balance sheet. The municipal market

Fed Tightening Has Driven Up Muni Yields

Muni yields have become increasingly attractive

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<td>10-Year AAA Rated Muni Yield*</td>
<td>1.5</td>
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<td>10-Year A Rated Revenue Muni Yield*</td>
<td>1</td>
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Past performance is not a reliable indicator of future performance. As of June 30, 2022. Yield shown is yield to maturity. For illustrative purposes only. Data is subject to change. *The credit ratings are based on methodology of Bloomberg using S&P and Moody’s ratings. A rating of “AAA” represents the highest-rated investment-grade rating, and a rating of “A” represents the second-lowest investment-grade rating. Investors cannot invest directly in an index. Source: Bloomberg Finance L.P.
Taxes remain an issue for investors, and tax-exempt municipal bonds are one of the few ways investors are able to mitigate some of their tax burden.

has not been spared from the selling pressure amid the interest rate volatility, but, currently, yields on municipal bonds have reached levels that we believe represent compelling value.

While rate volatility remains high, we believe bond yields across the entire municipal curve are attractive and could represent a backdrop for compelling future returns. Using the 10-year maturity as an example, the yield for a 10-year AAA municipal bond (as of the end of June) was 2.75%, an increase of 1.70 percentage points since the beginning of the year. Meanwhile, 10-year A rated revenue-backed securities generated a yield of 3.47% for investors who were willing to take on the additional credit risk. We have not seen sustained yields at these levels since the global financial crisis of 2008–2009.

Municipals Provide a Way to Mitigate Some Tax Burden

Taxes remain an issue for investors, and tax-exempt municipal bonds are one of the few ways investors are able to mitigate some of their tax burden. For example, the 2.75% 10-year AAA municipal yield as of June 30 is equivalent to a taxable bond yielding about 4.58%.2

Municipals Remain High Quality

Municipal bond credit spreads3 have widened in sympathy with the rate sell-off even though credit quality remains strong. It is important to note that declining credit quality was not responsible for the recent selling pressure on municipal debt.

State and local governments have received a significant lift from federal aid related to the coronavirus pandemic. Examples include Illinois and New Jersey, which had both been in somewhat difficult fiscal positions headed into the pandemic. Illinois, which had a credit rating one notch above junk, has used the additional cash to bolster its financial circumstances, resulting in upgrades from the rating agencies. New Jersey made a full pension payment for the first time in 25 years. Other sectors, like hospitals and airports, also received substantial aid.

We are starting from a position of strength, and while we may see some credit quality softening if growth slows, we remain confident in the overall credit quality of municipal obligors broadly. Using our robust fundamental, bottom-up research, we believe we will be able to manage accordingly.

Industrywide Outflows Exacerbated Selling Pressure

For the year through June, we have seen record outflows from municipal bond funds industrywide. This follows 2021, when the industry saw record inflows. While the highest inflation readings in about 40 years and rising interest rates caused much of the selling pressure on municipal bonds, outflows from municipal debt funds exacerbated the increase in yields across the municipal yield curve. There are a number of reasons that investors are selling municipal bonds, but the result may be selling near lows.

The municipal market had seen fairly steady inflows for the past few years (outside of the COVID crisis). This steady state of demand was partially responsible for the relatively elevated valuations of municipal bonds over the past few years. We are watching this dynamic carefully for clues that the market is stabilizing in terms of flows.

1 Yield data source for yields provided: Bloomberg Finance L.P. Yields shown are yield to maturity. For illustrative purposes only. Data is subject to change.
2 To calculate a municipal bond’s taxable-equivalent yield, divide the yield by the quantity of 1.00 minus the federal tax rate expressed as a decimal.
3 Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
Unlike many other fixed income markets, such as corporate bonds, the size of the municipal debt market has remained roughly the same over the last 10 years. Additional changes as a result of the Tax Cuts and Jobs Act of 2018 have led to a reduction in tax-exempt municipal supply over the past few years. This lack of supply has created an imbalance of investment opportunities and cash looking to invest in the municipal market.

On the demand side, we anticipate that the industrywide outflows from municipal debt funds that exacerbated the early 2022 sell-off will slow or reverse as more investors realize that the asset class now offers attractive yields and compelling value. However, there is obviously a risk that this scenario will not materialize or take longer than we anticipate, which could extend the selling pressure and keep the market at relatively cheap levels.

In our view, the elevated level of uncertainty has created a rare opportunity to try to take advantage of some compelling value in the municipal market. The selling pressure on fixed income to date in 2022 has been punishing, but we are confident that bonds in general—and municipal bonds in particular—will rebound and should generally remain a core part of an investor’s diversified portfolio.

WHAT WE’RE WATCHING NEXT

Rate volatility continues to be high in fixed income markets. We are cautiously optimistic that the higher yields will attract investors to the municipal bond market. The technical backdrop for municipals remains supportive with below-average supply. Total municipal debt issuance in the second quarter was down 1.6% from the first quarter of 2022 and 18.6% lower than in the second quarter of last year, according to The Bond Buyer, providing near-term technical support.
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