Volatility Creates Opportunities in Municipals

Evaluating muni fundamentals at sometimes dislocated prices.

April 2020

Hugh McGuirk, CFA
Head of the Municipal Bond Team and Portfolio Manager

Dawn Mueller, CFA
Portfolio Specialist

KEY INSIGHTS

- Fears about the economic impact of the coronavirus pandemic in March led to nearly unprecedented volatility in the municipal bond market.
- Municipals are still experiencing bouts of volatility, generating periodic opportunities to buy municipals at historically attractive prices.
- We continue to closely monitor the market for opportunities to add fundamentally strong municipal bonds at dislocated prices.

Fears about the economic impact of the coronavirus pandemic in March led to nearly unprecedented volatility in the municipal bond market. This extreme market turbulence has generated periodic opportunities to buy municipals at historically attractive prices. Municipals experienced a strong rally later in the month but are still experiencing bouts of volatility. We continue to closely monitor the market for opportunities to add fundamentally strong municipal bonds at dislocated prices amid ongoing volatility.

Complete Yield Reversal

The municipal debt market started 2020 with yields at record lows only to have the market reverse completely in March as the scope of the pandemic suddenly became clear. This caused an abrupt increase in municipal yields relative to other fixed income segments, generating negative returns for the asset class.

Like many other fixed income markets, a lack of liquidity combined with concerns about the broad U.S. economy drove yields on municipal bonds higher in staggering increments. Municipal bid wanted activity—bonds put out to sell in the secondary market—reached record levels. A simultaneous lack of buyers brought trading in some market segments to a virtual standstill.

Municipal Ratios Extremely Volatile

The municipal ratio, which measures a municipal bond yield divided by the yield on a Treasury bond of the same maturity, is one metric to assess attractiveness in the municipal market. The ratio is typically below or near one (or 100%) to account for the tax advantages municipal bonds offer. In general, the higher the municipal ratio, the greater the value in municipal debt relative to Treasuries.

During the worst of the March sell-off in municipals, the 10-year municipal ratio reached a staggering 3.65 on

Losses Have Led to Strong Performance

Three-month losses and returns (%) for the next 12 months

Instances of Losses Below Given Threshold During Rolling Three-Month Periods
September 1993—February 2019

Loss Threshold	Broad Market	Intermediate Market	Short Market
<0%	72	62	49
<-1%	36	32	8
<-2%	21	14	2
<-3%	15	7	0
<-4%	10	3	0

Average Returns During Following 12 Months
September 1994—February 2020

Loss Threshold	Broad Market	Intermediate Market	Short Market
<0%	6.88	6.01	3.65
<-1%	8.47	7.03	3.98
<-2%	9.55	7.80	3.49
<-3%	9.94	7.26	–
<-4%	10.85	5.81	–

Past performance is not a reliable indicator of future performance.
As of February 29, 2020.
Source: T. Rowe Price analysis of Bloomberg Barclays Municipal Bond Index (broad market), Bloomberg Barclays Municipal 1–15 Year Index (intermediate market), Bloomberg Barclays 1–5 Year Blend Index (short market). Bloomberg Index Services Ltd. Copyright 2020, used with permission (see Additional Disclosure).

> During a downturn, it is almost impossible to predict the exact point when market sentiment will sustainably reverse...

March 23—10-year municipal yields were 365% or 3.65 times more than comparable maturity Treasuries. On the same day, the five-year municipal ratio was even higher at nearly 650%. Even taking into account that Treasury yields were at or near record lows, which skews the comparison to some degree, municipal ratios reached extremely dislocated levels. In another measure of the size of the dislocation, in some cases, municipal bonds were even yielding more than corporate bonds with similar credit ratings and maturities. Municipal bonds are generally a higher-quality asset class with tax advantages over corporates, so they typically yield less than comparable investment-grade corporate bonds.

Fed Program Supports Short-Term Municipals

The addition of municipals to the Federal Reserve's Money Market Mutual Fund Liquidity Facility (MMLF), which allows the central bank to lend money to securities dealers to purchase municipal obligations with maturities of 12 months or less, has helped liquidity in the short-maturity segment of the market. These holdings receive preferential treatment on dealer balance sheets regarding regulatory risk-based capital calculations. The MMLF has helped free up dealer capital and facilitate liquidity on longer-maturity municipals. In addition, as part of the CARES Act, the Fed may also lend money directly to municipal issuers or purchase certain municipal bonds in the secondary market through its open-ended quantitative easing program.

Strong Performance Historically Follows Downturns

During a downturn, it is almost impossible to predict the exact point when market sentiment will sustainably reverse, leading to gains. Rather than trying to forecast the bottom, we focus on finding municipal bonds that are trading at prices we think do not reflect their intrinsic value. We believe that these opportunities can produce solid longer-term returns. With that said, historical returns show that strong performance for the broad municipal debt market typically follows a period of negative returns for the asset class.

Evaluating Significant Risks

We are closely monitoring risks to a recovery in municipal bonds, many of which are common to other asset classes in this unprecedented environment. Outflows from municipal funds could continue as investors move to cash or reallocate to equities to try to take advantage of more attractive valuations following the stock sell-off. Although the Fed's aggressive actions to repair liquidity in short-maturity markets have resulted in better trading conditions, there is still meaningful risk that plumbing issues in the financial system could constrain investment in longer-term markets such as municipal bonds.

Perhaps the most meaningful risk facing municipal debt is the deterioration in the fundamentals of most issuers as the costs of the pandemic strain the finances of most municipalities. We believe that our municipal credit analysts are well prepared to evaluate this risk across issuers in their coverage areas, helping our portfolio managers select bonds with solid fundamentals that position them to withstand the financial pressures of the pandemic.

WHAT WE'RE WATCHING NEXT

Although the U.S. fiscal stimulus package enacted in late March should help support the economy during the pandemic, we are monitoring progress in actually getting the government funding to businesses, consumers, and municipalities. We also expect additional waves of fiscal measures as the impact of the pandemic becomes clearer.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

T.RowePrice®

Additional Disclosure

Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

Important Information

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action.

The views contained herein are those of the authors as of April 2020 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates. Debt securities could suffer an adverse change in financial condition due to a ratings downgrade or default, which may affect the value of an investment. Fixed income securities are subject to credit risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall.

This information is not intended to reflect a current or past recommendation, investment advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Investors will need to consider their own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

Past performance is not a reliable indicator of future performance. All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc.

ID0003159 (04/2020)
202004-1144581