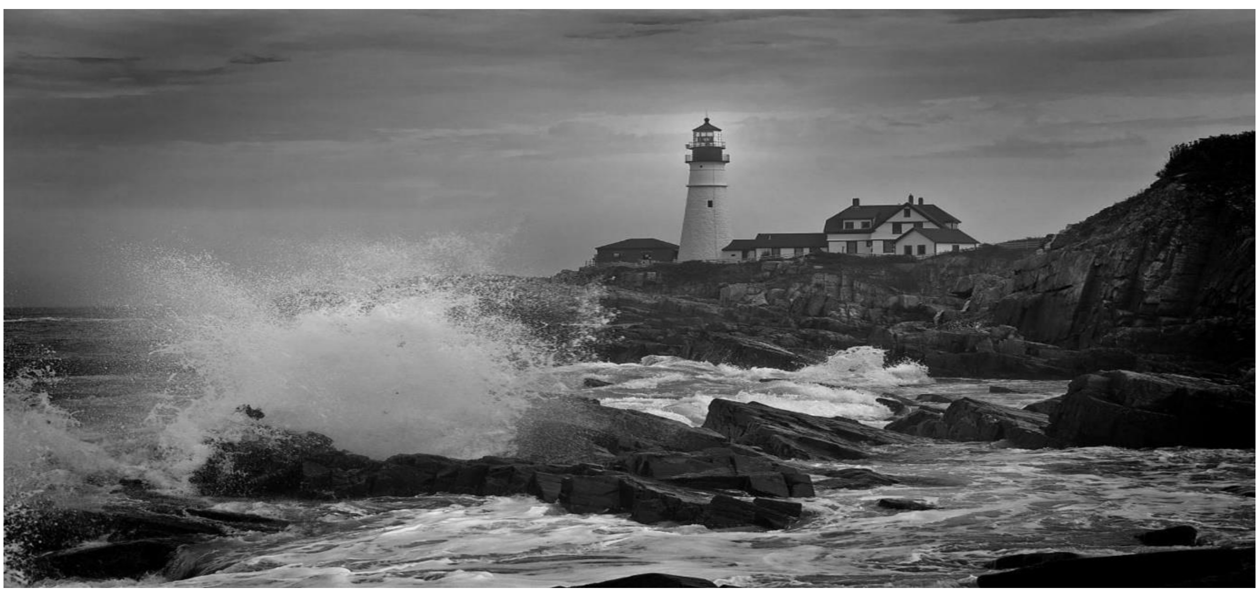
Municipal Comment April 2022

Rough Start

While we may continue to experience municipal bond market volatility in the coming weeks and months driven by inflation concerns, new issue supply, and seasonal factors, the current price dislocation in new issue and secondary markets, coupled with the opportunity to buy high-grade munis at ~100% of US Treasury yields presents an opportunity not seen since 2020. Now may be a good time for investors to consider and revisit muni allocations.



Thankfully 1Q22 is behind us, as the municipal bond market concluded its worst quarterly performance in forty years, finishing down 6.23%. Munis have undergone a perfect storm of challenges resulting in turbulence across the yield curve. As concerns about high and potentially stubborn inflation grip fixed income markets, several rounds of Fed rate hikes have also been priced in over a short time span. In addition, the international response to the Russian invasion of Ukraine and the corresponding spikes in commodity prices have also contributed to overall market volatility.

Persistent redemptions from municipal bond mutual funds have weighed on the market since January. Muni funds have recorded net year-to-date outflows of about $25 billion, causing a significant negative impact on market performance. The selloff picked up steam in March with portfolio managers nearly doubling the amount of bonds ‘out for bid’ compared to levels from March 2021.

New issue supply has also been a factor. While not as robust as recent years, it has nevertheless presented challenges to a market experiencing such volatility. Price dislocation occurs when new issues stall and must be sold at levels to clear the market. Those levels have been a moving target in an environment where price discovery is occurring on an almost daily basis.

Munis in Fed Tightening Cycles

Given that Fed rate hikes are underway, it is worth reviewing the past performance of tax-exempts during previous periods of tightening. There have been four rate hike cycles over the last 30 years, and during these cycles munis have historically outperformed both Treasuries and corporates on a tax-adjusted basis. In fact, during the last two Fed rate hike cycles, Munis outperformed Treasuries by an average of 344bps and corporates by 253bps respectively.

Credit

Generally, state and local tax receipts remain quite strong as credit conditions improve and businesses recover from the challenges of the pandemic. Many state and local governments also continue to hold unspent funds from past rounds of federal relief funding that can still be appropriated in 2022. These federal funds will help stabilize a wide range of municipal sectors, including higher education, airports, and health care.

Better Yields and Ratios

Current AAA municipal to US Treasury ratios are somewhat 'cheap to fair value' and taxable equivalent yields are the highest they've been in nearly two years. Last summer 10-year munis were quite expensive at 67% of 10-year UST. The historical average has been ~80%, but we are now seeing AAA munis at 95% of UST, and many credits in the AA and A-rated range above 100%. Traditionally ratios in this range have presented a buying opportunity.

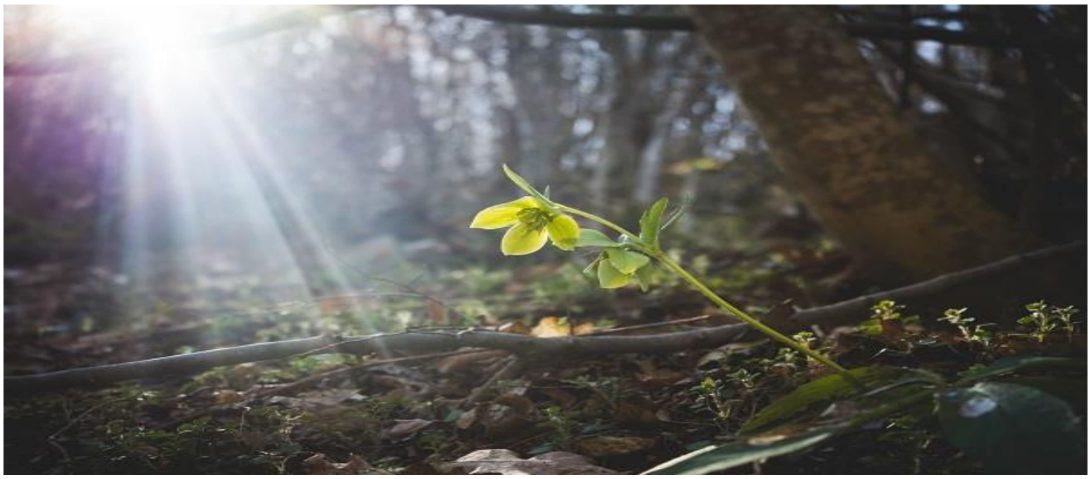
Current Ratios & Taxable Equivalents

	Year	US Treasury	Muni AA	Muni/UST Ratio	Taxable Equivalent
2	2024	2.45	2.06	84%	3.49%
5	2027	2.56	2.35	92%	3.98%
10	2032	2.38	2.57	108%	4.36%
30	2052	2.43	2.99	123%	5.06%

Low duration muni yields have also risen substantially in recent weeks, making them a worthwhile alternative to other short-term investments that continue to yield only a fraction of a percent. For instance, two-year AA rated tax-free munis are yielding in the 2.20% range, which is approximately 3.70% taxable equivalent for an investor in the top tax bracket. This short-duration option offers an attractive tax-free yield and a place to potentially ride out the storm over the near-term.

What Next?

The tax-exempt muni market could continue to experience volatility this spring, but the disorderly environment may offer the most attractive opportunity in years to consider high quality munis at more than 100% of UST's.



We favor the short/intermediate range, particularly premium callable bonds given the incremental additional yield and defensive characteristics. At Riverbend we adhere to a disciplined strategy involving high quality credits and moderate duration as we seek to help our clients balance investment risk with their bond allocations.

Please feel free to contact us anytime if you'd like to discuss the topics cited in this update, or any others related to the municipal bond market.

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