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2022 Second quarter outlook and first quarter review

Taxable municipal bonds: Higher yields and wider spreads offer opportunity

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KEY TAKEAWAYS

- The first quarter was very challenging for fixed income, taxable municipals in particular.
- Technical pressures from rapidly rising U.S. Treasury rates pushed taxable municipal credit spreads wider.
- Credit conditions continue to improve. Revenues are exceeding pre-pandemic levels and upgrades have accelerated.

The first quarter was the most challenging quarter for taxable municipal bonds on record, as returns were negatively impacted by U.S. Treasury market volatility, persistent inflation concerns and geopolitical tensions. Credit fundamentals, however, remain very strong, with positive economic growth boosting tax revenues to all-time records. Once the U.S. Federal Reserve proves successful in reigning in inflationary pressures, interest rate volatility should begin stabilizing. We believe today's more attractive bond valuations and much higher yields bode well for longer-term performance.

OUTLOOK

Higher yields and attractive valuations offer opportunity

Historically, when yields rise by more than 100 basis points in a short time period, it created a favorable entry point. In prior markets and events, the long duration nature of taxable municipals led to further spread widening due to weaker market technical factors, notwithstanding strong their fundamentals.

Those conditions currently exist in the municipal market. The yield on the Bloomberg Taxable Municipal Bond Index increased by 113 basis points (bps) during the first quarter, ending at a 3.46%, which is the highest yield level since the second quarter of 2019. In early April, the same index average option adjusted credit spread reached +100 bps. This level of spreads has not been seen since prior to the vaccine rollout, the passage of the American Rescue Plan Act and the broader reopening of the U.S. economy, all of which have contributed to the more recent wave of upgrades across the market.

Based on the strength of credit fundamentals and valuations that do not currently align with these credit strengths, the current market environment offers what could be viewed in the future as an attractive entry point. The key question facing fixed income investors in the near term is when rates will begin to stabilize, thereby instilling greater confidence that it is a favorable time to invest.

While this timing is only known in retrospect, several positives are evident behind today's often grim headlines. Productivity and labor force participation are up, and technology is being used at an accelerating pace. These factors should help supply chains catch up to the robust demand unleashed as the pandemic receded. Simultaneously, the ultra-stimulative monetary and fiscal policies of the past two years are being normalized at a rapid pace.

THEMES

2022 taxable municipal market themes

- The path of inflation remains the wild card, with further uncertainty posed by geopolitical events. The U.S. Federal Reserve (Fed) is focused on combating inflation.
- Multiple Fed interest rate hikes are expected throughout the year.
- Peak economic expansion is behind us, but growth remains strong as the economy continues to normalize.
- Taxable municipal supply is expected to be flat to modestly down, especially as refunding activity has slowed.
- Technical factors are driving negative relative taxable municipal returns year-to-date; fundamentals remain sound.
- Credit fundamentals are strong; revenue collections and reserves are the highest in decades.
- COVID-19 outbreaks are more regionalized and broad shutdowns are unlikely.
- In an environment with volatile interest rates and strong credit conditions, we expect lower quality taxable municipal bonds to outperform relative to high grade.
- Even after taking into account the cost of foreign currency hedging, taxable municipals still remain attractive to non-US domiciled investors.

U.S. ECONOMY IS BETTER POSITIONED

Although U.S. economic growth is decelerating slightly from its torrid pace of 2021, the labor and housing markets remain strong and support a positive growth outlook for 2022 overall. Nevertheless, investors are concerned about a possible U.S. recession. Some surveys estimate the probability at more than 50% by 2023.

Numerous risks are driving these fears. The Fed's increasingly hawkish language leads to concerns of over-tightening policy to curb inflation. And the Russian invasion of Ukraine has exacerbated food and energy price increases. Lockdowns in many areas of China (most recently Shanghai) not only have the potential to slow the world's second largest economy, but also serve as a stark reminder of lingering pandemic risks.

In our view, the U.S. remains much better positioned than most of the world to withstand these difficult global events. Importantly, U.S. domestic food supplies and energy security are relatively strong compared with many areas of the globe. Both household and corporate balance sheets in the U.S. are in excellent shape, which should help the durability and resilience of the economic recovery.

THE FED BEGINS ITS TIGHTENING CYCLE

The Fed's increasingly hawkish rhetoric put fixed income markets on edge throughout the quarter. This shift in tone was driven by persistent inflation and exacerbated by political considerations such as confirmation hearings and upcoming mid-term elections.

The magnitude of the Fed's shift grew significantly during the first quarter. With one hike already behind us, futures markets now expect eight or nine more quarter-point hikes this year, bringing the fed funds rate to the 2.50% to 2.75% range. There has also been discussion of arriving at this "neutral" rate faster than the standard quarter-point increments.

In addition to short-term rate increases, Fed board members are discussing shrinking the balance sheet to drain excess liquidity and normalize bond holdings. Meeting minutes suggest a maximum reduction (including bond roll-off) of $95 billion per month of Treasuries and mortgage-backed securities, totaling $1 trillion per year over the next several years.

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All of this talk has investors worried about over-tightening. The Fed's rate hike cycle will eventually slow the economy and inflation rates, with likely an approximately 12-month lag. The goal is a soft landing, where interest rates rise to a neutral level, the economy grows slightly below its long-term trend and inflation declines without triggering a recession.

While the markets are skeptical, several positive developments are often overlooked. The pandemic has increased the pace of technology implementation, which enhances productivity. Interestingly, the U.S. economy recovered its pre-pandemic output level by the middle of 2021 with eight million fewer workers. GDP is significantly higher, using 1.5 million fewer workers than in 2019. New business applications increased 77% in the third quarter of 2021 from the second quarter, and more than double any quarterly report since 2004. Enhanced productivity should eventually be disinflationary.

Even while wages and housing prices are rising rapidly, some key prices have begun to fall, such as freight rates, used car prices and even gasoline futures. The hawkish language has boosted the U.S. dollar on global markets. All else being equal, a stronger U.S. dollar helps moderate import prices. Also, longer-term inflation expectations are up only slightly, indicating that people believe the Fed will successfully restrain inflation longer term.

An inverted yield curve is frequently highlighted as the harbinger of a recession 12 to 18 months in the future. We saw this inversion on some trading days during the first quarter, but the yield curve steepened and was positively sloped again by early April.

Even with the growing hype, the Fed has carefully noted that we are enduring a volatile and uncertain period with high geopolitical risks. Policies can change quickly with the conditions. Given this flexibility, and some favorable price declines, the rate hike cycle could end earlier than current market pricing suggests.

FISCAL POLICY NORMALIZATION IS PROGRESSING

Relatively little attention has been paid to the normalization of fiscal policy, which is progressing surprisingly well. Federal tax revenue collections are up 27% over the past year. April looks to be even stronger, given the amount of capital gains realized in 2021 amid strong financial markets and fears of higher tax rates going forward.

> *Federal revenues are at a record high on an absolute basis and as a percentage of GDP.*

Meanwhile, spending is down 6% over last year, as stimulus programs are expiring. Some smaller components of what was formerly called Build Back Better may be resuscitated and negotiated this summer. However, even if certain climate and energy support provisions are adopted, they are not likely to be paid for with tax increases. And the overall headline number would not change the current trajectory of the budget deficit reduction.

The federal deficit exploded during the pandemic, with a $6 trillion of stimulus over an 18-month period mostly deficit financed. On the positive side, the deficit has improved by $1.9 trillion over the last 12 months (from $4.1 trillion to $2.2 trillion) and this trajectory should continue throughout 2022. Deficit reduction as a percentage of GDP at -8.7% is the largest U.S. fiscal contraction since 1946. Federal revenues are at a record high on an absolute basis and approaching a new record high on a percentage of GDP basis.

Delays in fighting inflation have been frustrating. Some inflation drivers are global, and the timing of the Russian invasion exacerbated the commodity price surge. Nevertheless, the U.S. is seeing normalization in labor markets, fed policy and fiscal policy alongside enhancements to productivity. All of these factors argue for a disinflationary environment in the longer term.

VALUATIONS ARE A MAJOR SUPPORT FOR MUNICIPALS

Like most of fixed income, the first quarter posed a significant challenge for the municipal bond market. U.S. Treasury market volatility increased, inflation appeared less contained than originally expected and geopolitical events heightened uncertainty. The Bloomberg Taxable Municipal Bond Index returned -8.28%.

The 10-year U.S. Treasury yield increased by +83 bps, ending the quarter at 2.34%, the highest level since May 2019. Credit spreads were stable through January and February, however the persistent interest rate volatility caused technical pressure and widened taxable municipals during March. Credit spreads ended the quarter at +96 bps, wider by +19 bps compared to the beginning of the quarter.

Similar to other technically driven weaker markets, taxable municipal credit spreads were driven wider by the persistent selling pressure on higher beta names in the market. These higher beta names are included in the U.S. Aggregate Index and tend to be held across core bond strategies, credit strategies and crossover strategies. Outflows across the taxable fixed income mutual fund industry caused selling pressure in these higher beta taxable municipal securities and, over time, drove the rest of the taxable municipal universe spreads wider with them. The abrupt widening in credit spreads for taxable municipals has been noticed by investors, as demand for taxable municipals ended the quarter with a constructive tone.

Fundamentally, municipal credit quality is strong with favorable trends. Similar to the trajectory of the federal government, state government tax revenue collections are historically high and increased 22% in 2021 compared with 2020. This is 20% above pre-pandemic levels in 2019. Reserves reached a record collective high at $82.3 billion and state pension funds are expected to be more than 80% funded for the first time since 2009.

States reporting thus far show a 26% revenues growth rate year-to-date, led by a 35% increase in California. Similar to the federal government trajectory, we also anticipate a further increase in April driven by capital gains exercise.

Moody's issued 817 upgrades and 307 downgrades in 2021, compared to 296 upgrades and 209 downgrades in 2020. Given the strong revenue environment and record reserves, we believe municipal credit is well prepared for a recession in the event the Fed were to over-tighten policy.

Ironically, many factors remain today that drove the strong relative performance of taxable municipal bonds in 2021: strong fundamental credit trends and healthy demand from liability driven investors that has absorbed new issue and secondary market supply. But municipals have been more sensitive to the main factor that has changed: the interest rate environment.

Figure 1: Year-to-date returns

	1Q 2022 return (%)	Yield to worst (%)	Option adjusted spread (bps)	Option adjusted duration (yrs)
Taxable municipal bonds	-8.28	3.47	95.60	8.52
U.S. Treasury bonds	-5.58	2.41		6.70
U.S. aggregate	-5.93	2.91	39.96	6.48
U.S. corporate bonds	-7.69	3.58	113.97	8.04
Global aggregate (unhedged)	-6.16	2.13	41.67	7.18

Data source: Bloomberg, L.P., 31 Mar 2022. **Past performance is no guarantee of future results. Representative indexes: Taxable municipal:** Bloomberg U.S. Taxable Municipal Bond Total Return Index; **U.S. aggregate:** Bloomberg U.S. Aggregate Total Return; **U.S. Treasury:** Bloomberg U.S. Treasury Total Return; **U.S. government-related:** Bloomberg U.S. **Aggregate:** Government-Related Total Return; **U.S. corporate:** Bloomberg US Corporate Total Return; **U.S. corporate high yield:** Bloomberg U.S. Corporate High Yield Total Return Index; **Global aggregate:** Bloomberg Global-Aggregate Total Return Index. All returns unhedged and USD.

Supply

Total municipal bond supply declined by 14% from the same period last year to $94.8 billion, primarily because refunding deals declined by 42%. The market selloff appears to have stalled the incentive of many issuers to refund existing issues, at least temporarily.

Taxable municipal supply declined by 47% for the quarter compared with the first quarter of 2021. Taxable supply increased dramatically after the Tax Cuts and Jobs Act of 2017, and now regularly makes up approximately 20% to 25% of the new issue market under normal circumstances. If interest rates stabilize, we may see a catchup period of taxable new issuance after a sluggish first quarter, potentially offering more opportunity to long term investors to capitalize on new yield levels.

Demand

After consistently positive inflows in 2020 and 2021, the pace of new money entering the taxable municipal market decelerated during the quarter as investors wait for their entry point. Investor activity towards the end of the quarter, some of it driven by the beginning of the Japanese New Year, suggests that current yield levels are triggering new demand and interest.

Defaults

Through February 2022, first-time municipal bond defaults total just $360 billion, a very small percentage of the overall $4 trillion market and limited only to tax-exempt municipals. Defaults are mainly concentrated in below investment grade nursing homes and industrial development revenue bonds, as these categories include arguably the most idiosyncratic risks. Overall, we do not anticipate municipal payment defaults becoming widespread.

Credit spreads

Broadly speaking, taxable municipal credit spreads were relatively stable for the first two months of the quarter. However, the heightened volatility of March was a catalyst for taxable municipals spreads to widen relative to other asset classes. The steady widening of spreads for higher beta positions within the U.S. Aggregate Eligible Taxable Municipal Index pushed the rest of the taxable municipal asset class wider in an abrupt manner during March, bringing credit spreads for the Bloomberg Taxable Municipal Index to +96 bps, their widest point in over a year.

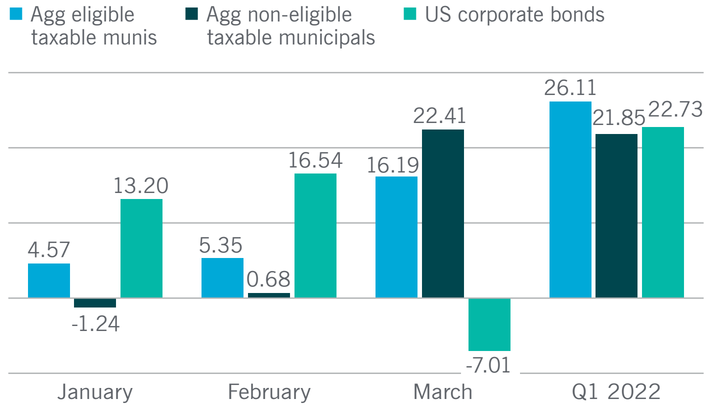
While the consistent outflows across taxable bond funds put pressure on U.S. Aggregate eligible taxable municipals during the quarter, taxable bond funds ended the quarter on a positive note, with $1.1 billion in inflows during the final week of the quarter. This positive momentum shifted the tone in corporate bond markets and high beta taxable municipal bonds, the spreads of which tightened by the end of the quarter.

Should this positive flow momentum continue across taxable bond funds, the technical pressures that widened taxable municipal bonds during the first quarter could potentially reverse, allowing fundamentals to once again be the dominant theme in performance.

The taxable municipal market ended the quarter with their credit spreads dislocated, especially relative to U.S. corporate bonds. Given how strong credit fundamentals are in the market with evidence suggesting that fundamentals will continue to strengthen as the U.S. economy is now without pandemic related restrictions, long-term investors are beginning to take notice of the attractive relative value in taxable municipal bonds.

Figure 2: Spread volatility for 1Q 2022

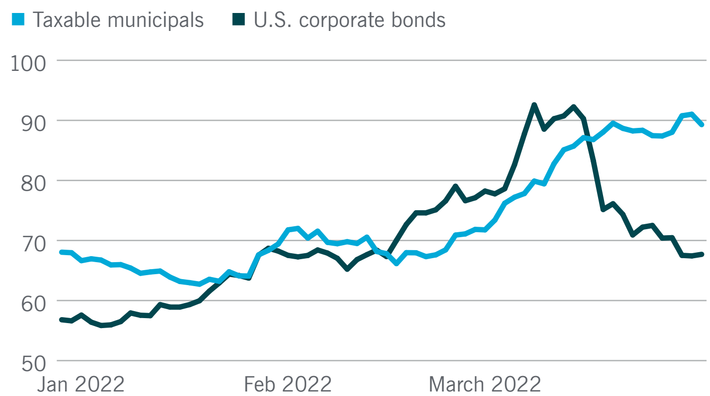
Change in option-adjusted spreads (bps)



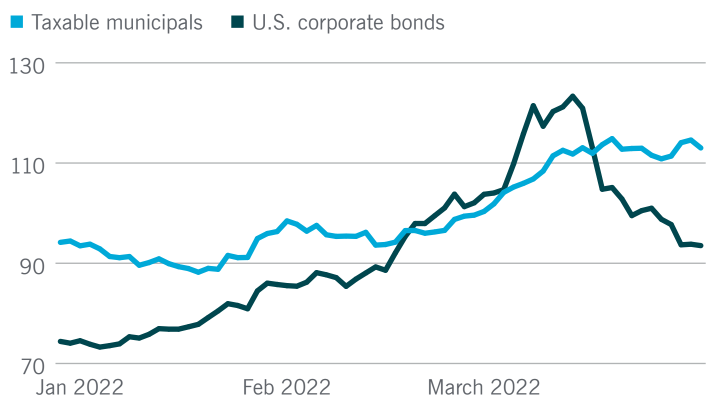
Source: Bloomberg Taxable Municipal Long Index, Bloomberg Taxable Municipal Agg Eligible Index and Bloomberg US Corporate Bond Index Option adjusted spreads.

Figure 3: Taxable municipal spreads attractive relative to U.S. corporate bonds

Daily AA-rated option adjusted spreads (bps)



Daily A-rated option adjusted spreads (bps)



Source: Bloomberg Taxable Municipal Index. A-rated and AA-rated option-adjusted spreads.

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Endnotes

Sources

Gross Domestic Product: U.S. Department of Commerce. Treasury Yields: Bloomberg (subscription required). Municipal Bond Yields: Bloomberg (subscription required). Fund flows: Morningstar. Municipal Issuance: Seibert Research. Defaults: Municipals Weekly, Bank of America/Merrill Lynch Research. State Revenues: The Nelson A. Rockefeller Institute of Government, State Revenue Report. State Budget Reserves: Pew Charitable Trust. Global Growth: International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD). Standard & Poor's and Investortools: http://www.invtools.com/. Flow of Funds, The Federal Reserve Board: http://www.federalreserve.gov/releases.pdf. Payroll Data: Bureau of Labor Statistics. Bond Ratings: Standard & Poor's, Moody's, Fitch. New Money Project Financing: The Bond Buyer. State revenues: U.S. Census Bureau.

New York City: New York City FY 2021 Comprehensive Annual Financial Report and the U.S. Bureau of Labor Statistics. MTA: MTA Continuing Disclosure. Tobacco: National Association of Attorneys General Annual Disclosure and the U.S. Bureau of Labor Statistics.

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