Municipal Bonds: A Window of Opportunity

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EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

The first four months of 2022 mark the worst start to a year in the history of the Bloomberg Municipal Bond Index. Municipal bonds are not alone as virtually every bond index is on pace for one of the worst years in history. The seemingly overnight shift in U.S. Federal Reserve (Fed) rate hike expectations in response to entrenched inflationary pressures has caused a massive recalibration in interest rates across the yield curve, resulting in a sharp drop in bond prices.

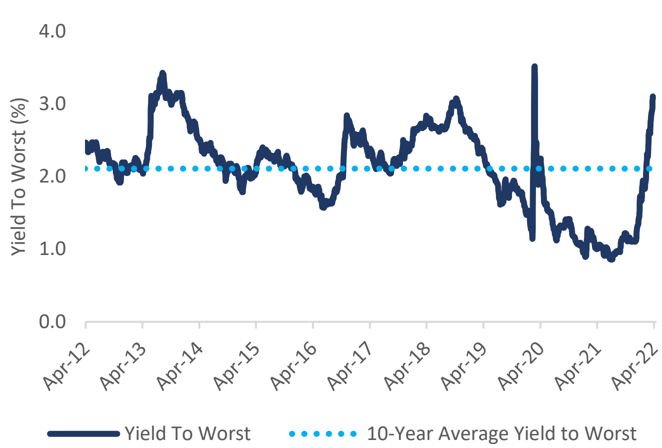
In the midst of arguably the most challenging period in history for bonds, many investors are understandably not focused on the opportunities present in the market. That said, it's worth noting that negative returns in the municipal bond market tend to lead to abnormally strong returns in subsequent quarters. In the history of the Bloomberg Municipal Bond Index, the index has posted 40 rolling 12-month periods with negative returns. In 39 of the 40 subsequent 12-month periods, returns for the index were positive. Past is not always prologue, but history suggests investors should use periods of weakness as entry points into the municipal market.

	Bloomberg Municipal Bond Index
Number of negative rolling 12-month returns since index inception	40
In the subsequent 12 months:	
Number of positive returns	39 out of 40
Maximum return	40.87%
Minimum return	-8.31%
Median return	11.91%
Average return	14.70%

Source: Bloomberg; data as of 12/31/2021

As a result of the current selloff, municipal bond yields are finally starting to get interesting, with the yield on the Bloomberg Municipal Bond Index just shy of its 10-year highs. Municipal yields at these levels have been fleeting and have historically preceeded multi-year rallies in municipal bonds. When compared to various taxable bond sectors, municipal bonds currently offer attractive yields, especially after tax considerations. Should interest rate volatility persist, investors now have a greater income cushion to offset mark-to-market volatility in bond prices.

Bloomberg Municipal Bond Index: Yield To Worst



Source: Bloomberg; data as of April 29, 2022.

	Yield To Worst
Global Government Bonds	2.65
US Treasuries	2.88
US Corporate Bonds	4.31
US Municipal Bonds	3.18
US Municipal Bonds (Tax-Equivalent)*	5.37

Source: Bloomberg; data as of April 29, 2022.

**Tax-Equivalent Yield: Computed using the Top Federal tax Bracket (37%) and the Medicare surtax (3.8%). State tax not included. Tax-Equivalent Yield = Yield-To-Worst / (1-40.8%)*

There are reasons to believe that the current selloff in municipal bonds may begin to moderate in the weeks ahead. There have been six sharp selloffs in municipal bond funds since the Investment Company Institute began tracking data on the flow of cash into and out of funds in 2006. The typical selloff has lasted 12 weeks on average, and the current episode has lasted 16 weeks. It's impossible to say with certainty when the selling pressure will end, but history would indicate that we're closer to the end than the beginning.

Furthermore, three major technicals are beginning to improve in the municipal market. The tax-exempt bond market is anchored by seasonality, which allows investors to position themselves opportunistically. First, summer months provide lower supply to the market. The $35.9 billion of municipal bond supply in April 2022 was down 17% month over month, and we expect May to continue its historical trend of 10% declines month over month. Second, the U.S. tax deadline consistently creates selling pressure in the market when investors sell bonds to fund their tax bills. Third, and most influential, summer redemption season begins in June. When including principal maturing, bonds called, and interest payments, $156 billion of cash will need to be reinvested over the course of June, July, and August. Over the last five years, summer redemptions have averaged 42% higher than the annual monthly average. This money will likely be reinvested into the market increasing demand for municipal bonds in conjunction with supply tapering off.

	Avg Summer Redemption	Avg Monthly Redemption
2022 Projected	40,200	27,967
2021	48,367	34,731
2020	47,220	33,985
2019	49,375	34,809
2018	50,872	35,206

Source: ICE Data Services, CreditSights Research; Data as of April 29, 2022.

Moreover, crossover buyers (e.g., institutions and foreign buyers) are beginning to enter the market now that nominal yields relative to other fixed income asset classes are starting to get interesting. Increasing demand and waning supply will keep a lid on how high interest rates move from here in the municipal market.

With supply and demand trends improving for municipal bonds, and with economic growth past peak and inflation likely in a topping process, intermediate- and long-term municipal rates may also be in a topping process. For investors with a long-term perspective, we think the current moment provides an attractive entry point given the availability of generous yields and the supportive macroeconomic and technical backdrop for municipal bonds.

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Diversification does not ensure a profit or guarantee against loss.

Investing in bonds involves risks that may adversely affect the value of your investment such as inflation risk, credit risk, call risk, interest rate risk, and liquidity risk, among others. The two most prominent factors are interest rate movements and the credit worthiness of the bond issuer. Investors should pay careful attention to the types of fixed income securities that comprise their portfolios and remember that, as with all investments, there is the risk of loss of capital.

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Definitions and indexes

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

Technicals refers to technical indicators of historic market data, including price and volume statistics, to which analysts apply a wide variety of mathematical formulas in their study of larger market patterns.

Fund flow is the net of all cash inflows and outflows into and out of a particular financial asset. It typically is measured on a quarterly or monthly basis. Investors and others look at the direction of fund flows for indications about the health of specific securities and sectors or the overall market.

Indices are unmanaged, and one cannot invest directly in an index.

The Bloomberg Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. The inception date of the index is January 31, 1980.

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