Five Factors Favoring Short-Dated High Yield Munis

Here's why we think short-duration high yield municipal bonds offer attractive relative value in the current market.

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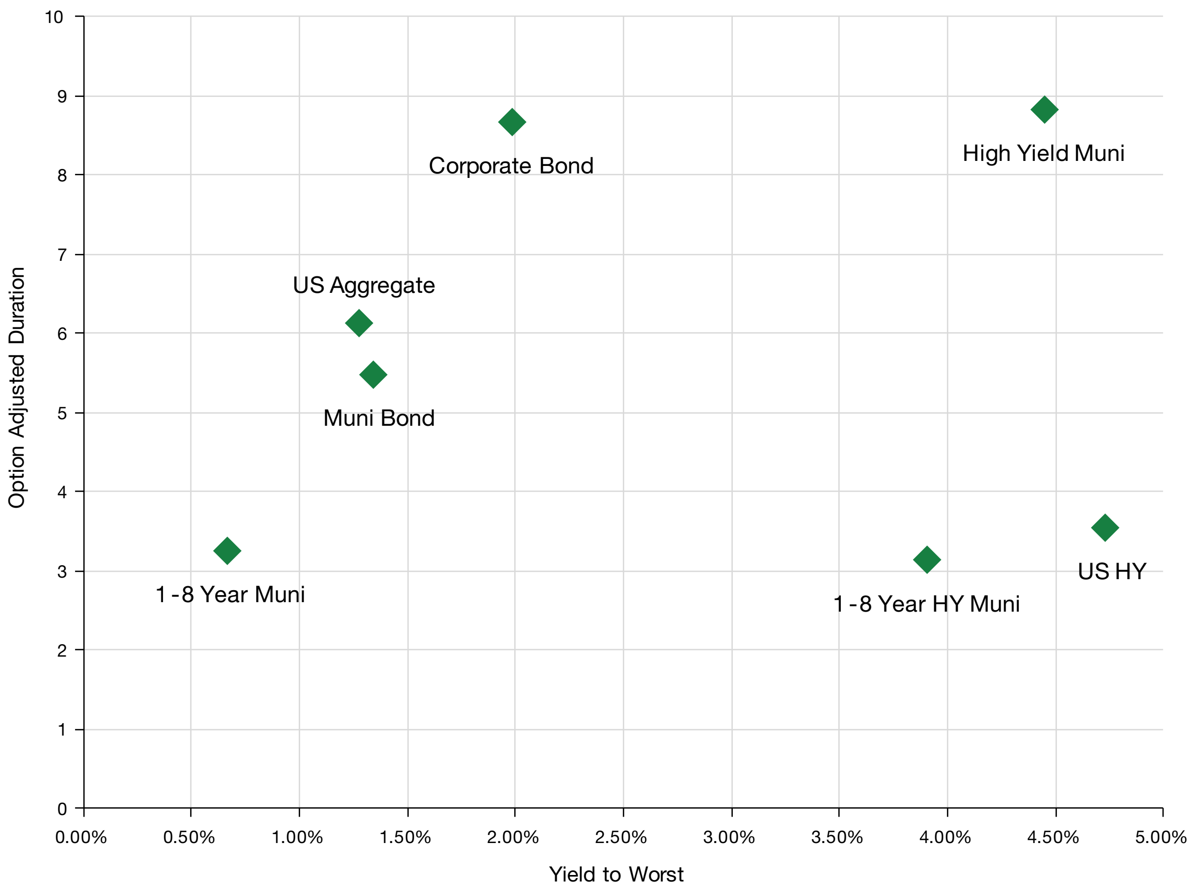
Figure 1. Short High Yield Munis Recently Offered Attractive Yields with Lower Interest-Rate Risk

Yield and duration data for indicated indexes as of November 12, 2020



Source: Bloomberg. Data as of November 12, 2020. 1-8 Year Muni=Bloomberg Barclays 1-8 Year Municipal Bond Index. 1-8 Year HY Muni=Bloomberg Barclays 1-8 Year High Yield Municipal Bond Index. Muni Bond=Bloomberg Barclays Municipal Bond Index. US Aggregate=Bloomberg Barclays U.S. Aggregate Bond Index. Corporate Bond=Bloomberg Barclays U.S. Corporate Bond Index. High Yield Muni= Bloomberg Barclays High Yield Municipal Bond Index. US HY= Bloomberg Barclays U.S. High Yield Bond Index.

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short-dated

One part of the municipal bond market that has not recovered as quickly as other sectors from the COVID-driven market selloff of March 2020 is *short duration high yield*. During the worst of the March-April volatility, yield ratios on the high-grade segment of the market reached historically high levels, with AAA-rated municipals yielding 889% of U.S. Treasuries at the two-year maturity. With the ensuing market recovery, that ratio has since narrowed to 112% and the Bloomberg Barclays 1-8 Year Municipal Bond Index has returned 2.77% year to date (as of November 1). By comparison, the year-to-date return of its non-investment grade counterpart, the Bloomberg Barclays 1-8 Year Municipal Bond Index, has been a modest 0.74%.

Considering that underperformance, we believe the short duration high yield segment of the muni market offers a fair amount of relative value for investors. Here are five reasons why:

1. Historical and current default rates for muni bonds remain low.

While there have been media headlines around the deterioration of fundamental credit quality in the municipal bond market, we believe that this change will be reflected more by credit downgrades than outright defaults. Here, we think two comparisons may be useful.

First, for the investment-grade area of the muni market, default rates have held near historical lows, as illustrated in Figure 2. (Note that the Lord Abbett Short Duration High Yield portfolio has an approximate 40% weight in investment grade bonds as of November 12.)

Figure 2. Municipal Bonds Have Featured Historically Low Default Rates

Average 10-year cumulative default rates, 1970–2018

Credit Quality	10-Year Cumulative Default Rates	
Moody's Rating	Municipals	Corporates
Aaa	0.00%	0.37%
Aa	0.02%	0.78%
A	0.11%	2.10%
Baa	1.13%	3.70%
Investment Grade	0.10%	2.28%
Non-Investment Grade	7.47%	28.79%
All Rated*	0.16%	10.13%

Source: Moody's, "Moody's US Municipal Bond Defaults and Recoveries, 1970–2018," August 2019. Data show the average 10-year cumulative default rates of Moody's rated corporate and municipal bonds for a study covering the period 1970-2016. *Rating outlooks are not assigned to all rated entities. Data are the most recent available.

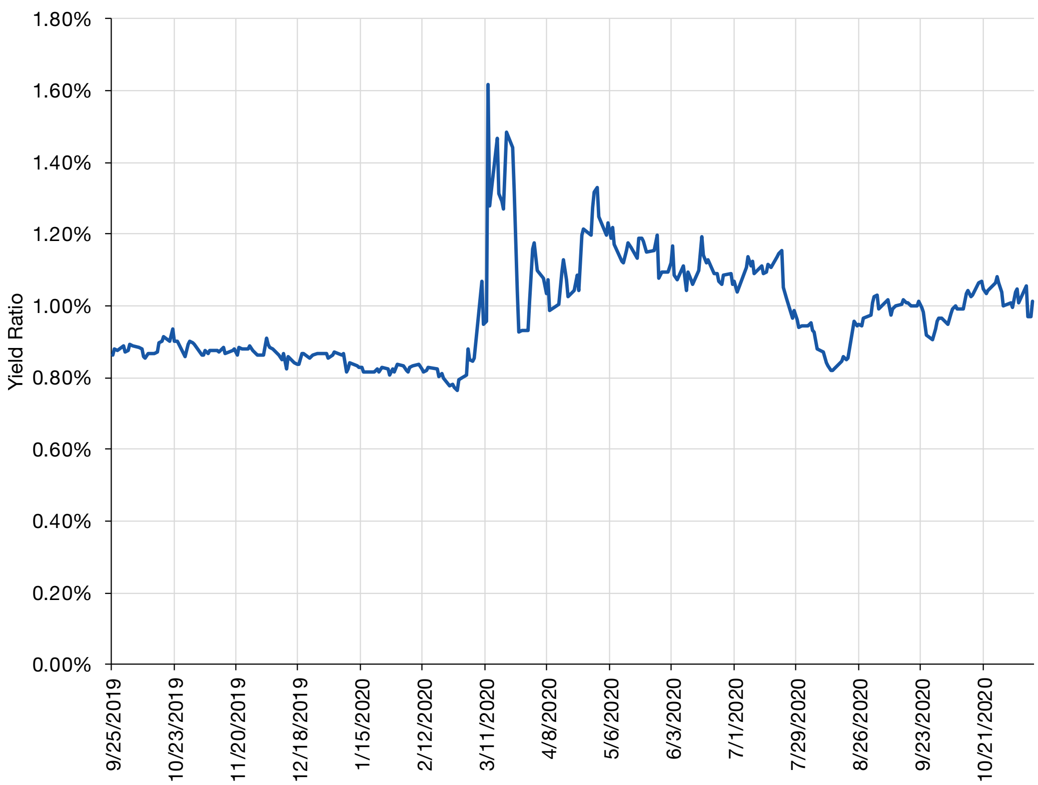
On the high yield municipal side, the market has experienced roughly $1.75 billion in payment defaults year to date through November 12, based on Bloomberg data. That amounts to a default rate of just 0.6% based on the high yield muni market's total size of $300 billion.

2. The absolute relative value of short high yield munis is attractive versus other asset classes, in our view.

A significant component of the short high yield municipal market is industrial revenue bonds, which typically are backed by corporations that have taxable bonds outstanding. Many of the investments in the industrial revenue sector are rated investment grade, such as the bonds featured in Figure 3 (Baa2/BBB+). Earlier in 2020, the U.S. Federal Reserve intervened to shore up the corporate bond market but did not provide the same level of support for municipals. In our view, this has resulted in a situation where many municipal bonds in the industrial revenue segment are trading at historically inexpensive valuations relative to their corporate-bond counterparts. We think this should bode well for this important segment of short high yield muni portfolios.

Figure 3. AEP's Industrial Revenue Bond Has a Higher Yield than Its Similarly Rated Corporate Issue

Yield ratio of American Electric Power (AEP) 2.5% industrial revenue bond due 2040 versus 4.3% corporate senior notes due 2028, both rated Baa2/BBB+



Source: Bloomberg. Data as of November 12, 2020.

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3. Short high yield munis' yield is compelling versus the interest-rate risk.

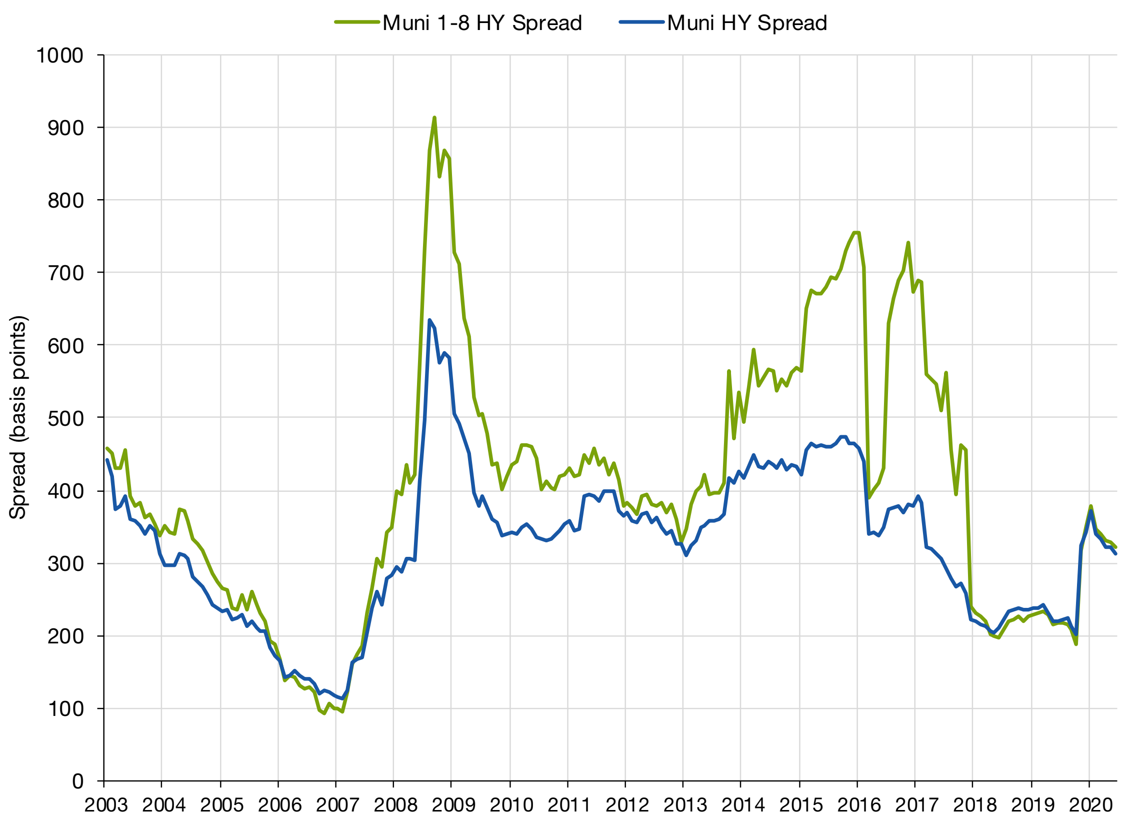
While much has been made of the increasing interest-rate risk in major bond market indexes, the short duration high yield municipal benchmark has an effective duration of about 3.1 years. (See Figure 1, front page.) This means that it would likely take an interest rate increase of over 1.00% in a year to produce negative returns.

4. The credit curve in municipals is flat and short maturity credit spreads remain attractive.

In our view, buyers should typically be paid a higher risk premium for lending to an issuer for an extended period. However, because there are comparatively few short maturity high yield buyers in the municipal bond market, investors are typically paid a similar amount, and often more, for taking credit risk in shorter maturities. In the Morningstar high yield municipal category there are 196 funds; however, by our count only six of them focus on the short end of the market. Also, interest-rate risk and maturity profiles vary among short duration high yield municipal funds. The relatively flat credit curve in municipals is inconsistent with most other types of fixed income (note the recent steepening in the U.S. Treasury curve) and is a good way to capture attractive returns without excess interest rate risk, in our view. An example of this can be seen in the recent competitive sale of State of Illinois general obligation bonds on October 20, 2020. According to Bloomberg, the 2031 maturity bonds with a 5% coupon priced at 3.93%, a spread of 2.94% over AAA-rated municipals of comparable maturity, while bonds due in 2042 priced at 4.35%, a 2.80% spread over AAA municipals.

Figure 4. Little Difference in Spreads for Short-Dated and Broader High Yield Muni Indexes

Data for the period May 30, 2003–October 30, 2020



Source: Bloomberg. Data as of October 30, 2020. Muni 1-8 Year HY=Bloomberg Barclays 1-8 Year High Yield Municipal Bond Index. Muni 1-8 Year=Bloomberg Barclays 1-8 Year Municipal Bond Index.

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5. A high yield municipal fund does not mean only below-investment grade rated bonds.

The broad high yield municipal Morningstar category has a variety of funds with differing credit qualities. While the short duration high yield market offers very attractive risk-adjusted returns, we believe a strategic blend of short-dated high yield and investment-grade munis offers the best opportunity to capture relative value across the short duration rating spectrum and add balance to the portfolio. That approach is illustrated in Figure 5, which depicts the historical performance of a 50-50 blend of high yield and investment-grade munis in the 1-8 year maturity range. The investment grade portion of the portfolio has historically lowered volatility while maintaining a compelling total return profile. Since index data became available in 2001, this blended short high yield and investment grade portfolio has seen positive returns in any 36-month holding period over a time frame which includes the fallout from the 1999-2000 dot-com bubble, the September 11, 2001, terrorist attacks on the United States, the global financial crisis of 2008–09, and the current global pandemic.

Figure 5. How a Blend of High Yield and Investment-Grade Short Munis Has Performed Over Time

	Return data for the period 1/31/2001-10/31/20			
	1 Month	12 Months	24 Months	36 Months
Maximum	3.01%	10.70%	7.92%	7.23%
Minimum	-4.59%	-4.53%	-1.20%	0.11%
Average	0.31%	3.80%	3.74%	3.73%
% of Negative Periods	24.89%	9.73%	5.14%	0.00%

Source: Bloomberg and Lord Abbett. Data as of October 31, 2020. Data for various return periods for a blend of 50% Bloomberg Barclays 1-8 Year High Yield Municipal Bond Index and 50% Bloomberg Barclays 1-8 Year Municipal Bond Index.

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Summing Up

We believe that short duration high yield muni bonds represent an attractive segment of the municipal market that is often overlooked by investors. This lack of awareness may reflect the fact that there is no formal Morningstar category for short high yield munis (they are grouped with longer-term high yield municipals). Since retail investors drive much of the activity in the muni market, this less-noticed part of the market can potentially offer unique pockets of value and opportunity. In sum, we believe the short-dated high yield segment of the municipal bond market offers good relative value for investors and may be poised to outperform after lagging in the post-March 2020 recovery.

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A **basis point** is one one-hundredth of a percentage point.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Option-adjusted duration is a duration calculation for bonds that have embedded options.

A **general obligation (GO) bond** is a municipal bond backed by the credit and taxing power of the issuing jurisdiction rather than the revenue from a given project.

Industrial revenue bonds are municipal debt securities issued by a government agency on behalf of a private sector company and intended to build or acquire factories or other heavy equipment and tools.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. One such comparison involves the two-year and 10-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

A **yield spread** is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

The **yield to worst (YTW)** is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

The **Bloomberg Barclays 1-8 Year Municipal Bond Index** is the 1-8 year maturity component of the Bloomberg Barclays Municipal Bond Index, which is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. The index is a broad measure of the municipal bond market with maturities of at least one year. Bonds must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million.

The **Bloomberg Barclays 1-8 Year High Yield Municipal Bond Index** is the 1-8 year maturity component of the Bloomberg Barclays High Yield Municipal Bond Index, which is an unmanaged index consisting of noninvestment-grade, unrated or below Ba1 bonds.

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The **Bloomberg Barclays U.S. Corporate Bond Index** includes all publicly held issued, fixed-rate, nonconvertible investment-grade corporate debt. The index is composed of both U.S. and Brady bonds.

The **Bloomberg Barclays U.S. High Yield Index** covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included.

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