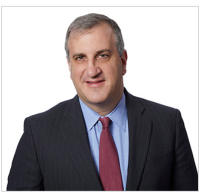
Municipal Bonds:
A Potential Roadmap for 2021

Lord Abbett's director of tax-free investments identifies the trends—and opportunities—that may define the municipal bond market in 2021.

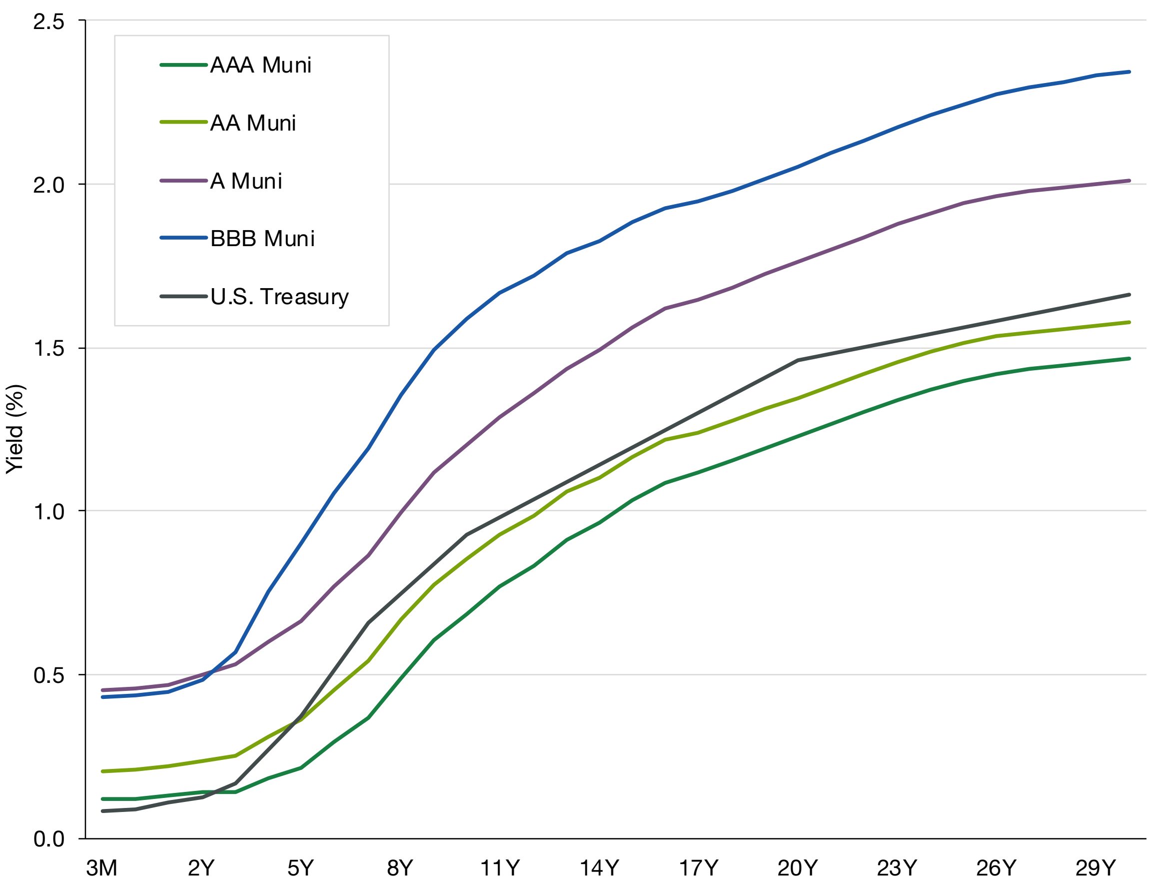
Featured Expert



Daniel S. Solender, CFA Partner & Director

Figure 1. Yields on Lower Quality Muni Bonds Could Provide Attractive Opportunity in 2021

U.S. Treasury yield curve versus municipal bond yield curves by quality segment, December 30, 2020



Source: Bloomberg. Data as of 12/30/20. A 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. The municipal bond curves displayed in this chart represent ratings-specific segments of the Bloomberg Barclays Municipal Bond Index. The U.S. Treasury curve is based on the U.S. Treasury Actives Curve compiled by Bloomberg.
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MUNICIPAL BONDS

Editor's note: This Market View *is excerpted in part from a forthcoming white paper offering a detailed examination of factors that could influence the municipal bond market in 2021.*

In previous weeks, *Market View* has presented viewpoints from Lord Abbett investment leaders on the macroeconomic picture and prospects for U.S. fixed income in 2021 as well as key themes for U.S. equity markets in the New Year. In this, the third of our series on the investment outlook for 2021, we will focus on the municipal bond market, drawing on the insights of Daniel Solender, Partner and Director of Tax-Free Fixed Income.

A Remarkable Rebound

A Bloomberg report published December 30 noted that the $3.9 trillion U.S. municipal bond market, as represented by the Bloomberg Barclays Municipal Bond Index, was poised to finish 2020 with returns of about 5.2%, the seventh straight year of positive performance.[1] The 2020 gains were paced for most of the year by strength among higher-rated issuers, with lower quality bonds finally making more positive moves during the fourth quarter. The market rebounded from a pandemic-fueled selloff in March as government stimulus programs such as the CARES Act, and late-year developments on the COVID vaccine front, helped lift investor sentiment.

Also lending support, in our view, was the strong underlying credit quality of the overall muni market, and the ability of issuers in different sectors to respond to the challenges posed by the economic damage caused by the virus. After very negative outlooks in the spring, credit quality has remained relatively stable, giving investors comfort, in our view. Moving forward into 2021, we think municipal issuers will need to continue to deal with the current challenges pending a full recovery enabled by the vaccines. State and local governments have already taken steps to address budget constraints while revenues come under pressure, although holding up much better than predicted, and we have seen similar responses from other sectors in the municipal market. Hospitals, after a tough spring, were able to add back higher margin procedures such as elective surgeries. Airports and universities continue to realign processes to maintain operations and have also taken steps to adjust budgets.

Overall, the municipal market has shown some resilience, which we believe bodes well for the sector as we progress toward the recovery phase of the pandemic.

Potential Opportunities in 2021

Looking further into 2021, potential areas of opportunity, in our view, could come out of the lower quality segment of the market where spreads have widened and performance is still lagging higher quality muni bonds during the recovery. Relatively attractive tax equivalent yields based on the steeper yield curve of lower quality municipal bonds could also provide return opportunity to a broader base of investors (see Figure 1, page 1).

A continuation of current U.S. Federal Reserve policy of low short-term interest rates potentially provides relative support to all maturities but especially intermediate term municipals on a risk-return basis. During 2020, with uncertainty still weighing on the municipal market, demand had been strongest within the five-year maturity range. As the outlook has turned more positive with the vaccines, risk taking has increased, which is already benefiting intermediate and long-term maturity segments of the market and is likely to continue to do so going forward as short rates have moved very low.

Importantly, issuance in the tax-exempt space has been just average as taxable municipal bond issuance has grown dramatically during 2020. (Issuers sold about $140 billion of taxable long-term municipals in 2020, more than double the amount of the prior year, according to the Bloomberg article cited earlier.) Supply and demand dynamics could prove beneficial with income tax rates still providing attractive tax equivalent yields and tax-exempt supply not picking up much as the lower rates continue to make taxable municipal bond rates attractive to issuers. Overall, our outlook for the municipal bond sector is positive given these factors.

[1] *Danielle Moran, "Munis Set for Seventh Straight Year of Gains Amid Record Supply," Bloomberg, December 30, 2020.*

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Fixed-income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Lower-rated securities are subject to greater credit risk, default risk, and liquidity risk. Credit risk is the risk that debt issuers will become unable to make timely interest payments, and at worst will fail to repay the principal amount. Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements. The municipal bond market may be impacted by unfavorable legislative or political developments and adverse changes in the financial conditions of state and municipal issuers or the federal government in case it provides financial support to the municipality. Income from the municipal bonds held could be declared taxable because of changes in tax laws. Certain sectors of the municipal bond market have special risks that can affect them more significantly than the market as a whole. Because many municipal instruments are issued to finance similar projects, conditions in these industries can significantly affect an investment. Income from municipal bonds may be subject to the alternative minimum tax. Federal, state and local taxes may apply. Investments in Puerto Rico and other U.S. territories, commonwealths, and possessions may be affected by local, state, and regional factors. These may include, for example, economic or political developments, erosion of the tax base, and the possibility of credit problems. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market.

No investing strategy can overcome all market volatility or guarantee future results.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

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Glossary and Index Definitions

The **Coronavirus Aid, Relief, and Economic Security Act**, also known as the CARES Act, is a $2.2 trillion economic stimulus bill enacted in March 2020 in response to the impact on the U.S. economy of the COVID-19 pandemic.

The **tax-equivalent yield** is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of the tax-exempt yield on a municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond to see which bond has a higher applicable yield.

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.

The **Bloomberg Barclays Municipal Bond Index** 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.

Bloomberg Barclays Index Information:
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