Municipal Bonds Stay on Track in an Unpredictable Year

A look at the key trends that have contributed to the solid performance of the municipal bond market since Fall 2020.

Featured Contributor

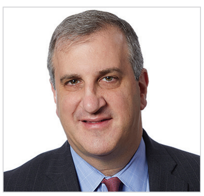

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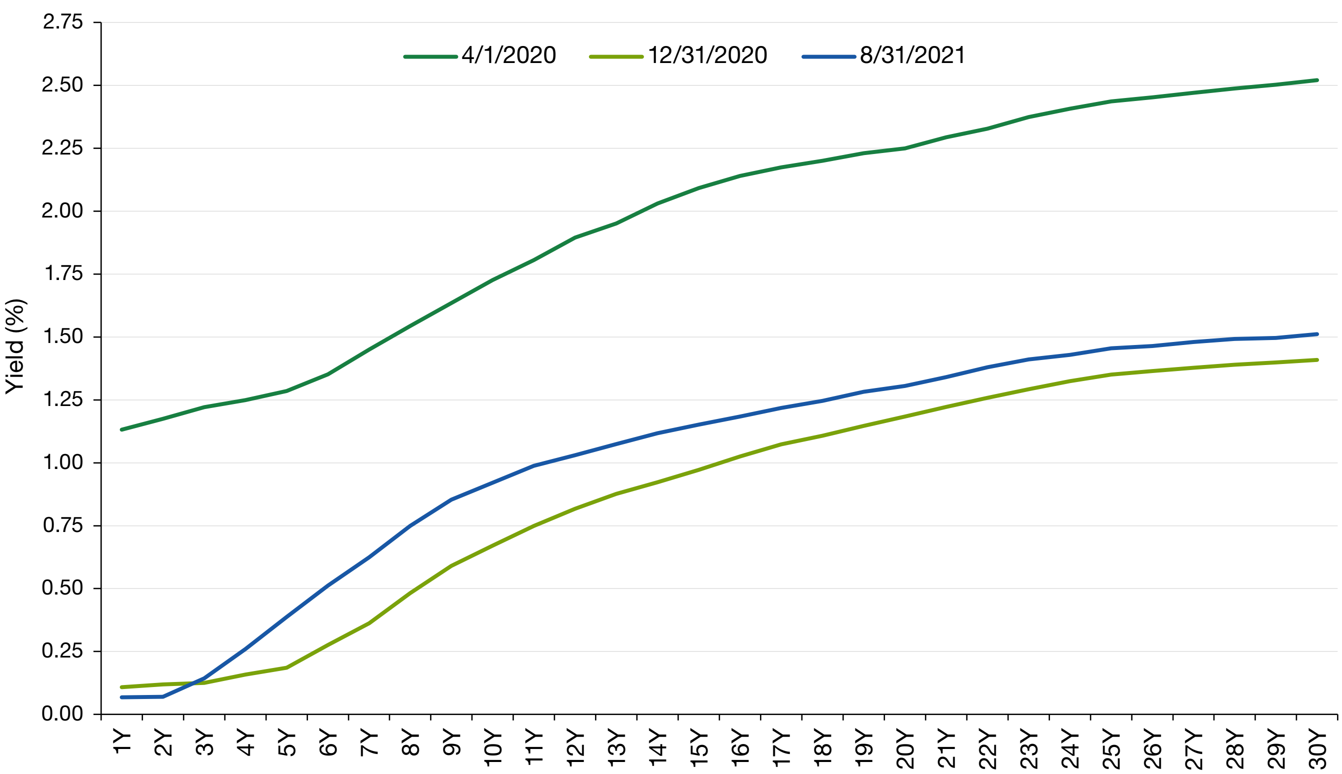
Figure 1. Long-Term Muni Bond Yields Continue to Offer Higher Yields



Source: Bloomberg. Data as of August 31, 2021. 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. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

After a challenging 2020, municipal bond investors wondered what 2021 would bring. Now that the current year is nearing the three-quarter mark, we think a review of what has happened in the muni market is in order.

Think about how the market landscape looked one year ago. September 2020 was an uncertain time. We didn't have a vaccine. Students were in hybrid or stay-at-home school environments. State and local government budgets were expected to have low tax receipts as the pandemic weighed on the economy. The list of concerns was long.

So, what portfolio strategy has led to the strongest performance in the municipal bond market this year? Overweighting credit risk (see Figure 2), which almost seems counterintuitive given market expectations 12 months ago, for economic growth and issuer credit quality. What happened since then?

Figure 2. A Muni-Bond Category Scorecard for 2021

Morningstar Category Performance	
Category	**YTD Performance (through August 31)**
Short	0.58%
Intermediate	1.75%
National	2.57%
High Yield	5.19%

Source: Morningstar. Data as of August 31, 2021. **National** municipal bond portfolios invest in bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. To lower risk, these portfolios spread their assets across many states and sectors. **Short** municipal bond portfolios have durations of less than 4.5 years (or, if duration is unavailable, average maturities of less than five years). **Intermediate** municipal bond portfolios have durations of 4.5 to seven years (or, if duration is unavailable, average maturities of five to 12 years). **High yield** muni portfolios invest at least 50% of assets in high-income municipal securities that are not rated or that are rated by a major agency such as Standard & Poor's or Moody's at the level of BBB (considered speculative in the municipal industry) and below. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

Fall 2020: Preparing for the Turn

Until the efficacy of COVID-19 vaccines was reported on November 9, 2020, AAA- and AA-rated issuers had significantly outperformed for the year—up about 5% based on ratings-specific components of the Bloomberg Barclays Municipal Bond Index. The BBB-rated and high yield parts of the market were close to unchanged. With market sentiment being negative due to the COVID-19-led uncertainty, and the rating agencies having negative outlooks on just about every sector, meticulous analysis was necessary to correctly position portfolios for the market turn that was about to start.

On the research side, a range of analysis was necessary.

1) Analysts needed to study issuer balance sheets. For example, most airports carried high cash balances which would help them through periods of lower passenger volumes.
2) Fiscal stimulus from the Federal government reached beyond state and local governments to provide funding for municipal bond sectors such as airports, transit systems, and hospitals.
3) The Federal Reserve had created the Municipal Liquidity Facility for large issuers who might have trouble with funding. Perhaps surprisingly, only two issuers tapped the facility—the State of Illinois and the New York Metropolitan Transportation Authority—but other issuers did better by going directly to the market.
4) State and local governments had predicted huge deficits, but revenues were coming in much better than expected. Unemployment was a problem, but high-income workers were working at home and doing well in the stock market, so revenues were going to run well above projections.

After doing this analysis, investors need to conclude that lower-quality muni-bond issuers were underperforming due to negative sentiment rather than long-term credit problems. This suggested that the market was going to turn fast, and demand was going to be strong, so portfolios needed to be adjusted well in advance.

2021: Steady Improvement

As 2021 started, people were getting vaccinated, and the Biden administration was planning more fiscal stimulus. Even though the high yield municipal bond fund category had seen net outflows for 2020, high yield flows had been positive over the final months as investors became more comfortable with the outlook. It was an uncertain time, but there were reasons for optimism.

After moving higher when the pandemic started (see Figure 1), rates had come down but were rising again in February when inflation indicators were increasing. Once again, investors had to study the situation carefully, because the inflation scare was short-lived as interest rates fell again, leading to a second important performance driver for 2021: the outperformance of longer-maturity municipal bonds.

After eight months, municipal bond fund flows have reached a record pace. With flows of approximately $80 billion, 2021 is already the second highest year since the tabulations started in 1992. New bond issuance has been average and when combined with record demand, there has been an imbalance with more demand than supply. Municipal bond dealers have been holding very low inventories, and secondary trading volumes have been low. On the credit side, ratings agencies have moved almost all sectors to stable or positive outlooks from the negative outlooks they assigned last year (see Figure 3).

Figure 3. Ratings Outlooks Have Improved for Several Municipal Bond Sectors

Moody's Sector Outlooks			
Sector	**Negative Date**	**Stable/Positive Date**	**Current Outlook**
State GO	12/1/2020	3/11/2021	Stable
Local GO	5/4/20	3/11/2021	Stable
Transportation	11/17/2020	4/27/2021	Stable
Healthcare	3/18/2020	N/A	Negative
Higher Ed	3/18/2020	3/22/2021	Stable

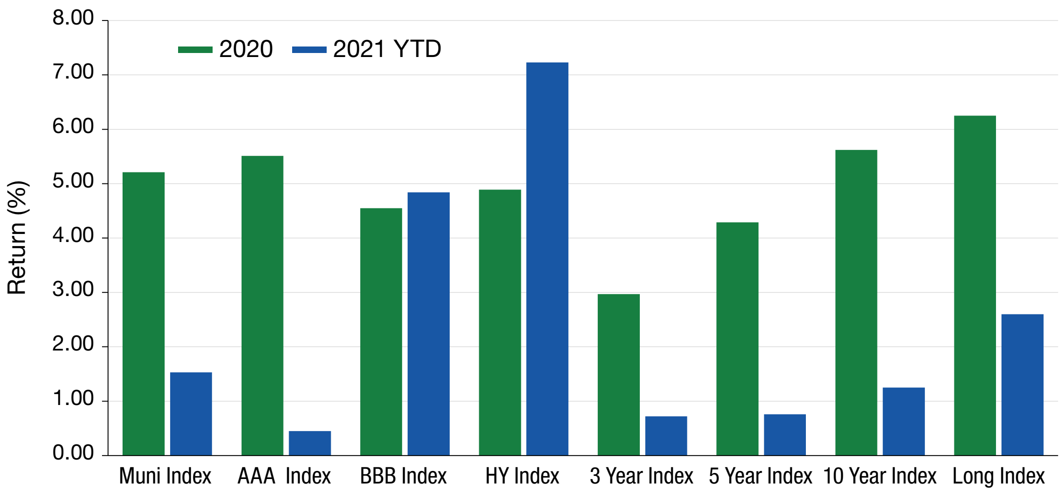
S&P Sector Outlooks			
Sector	**Negative Date**	**Stable/Positive Date**	**Current Outlook**
State GO	4/1/2020	3/24/2021	Stable
Local GO	4/1/2020	3/24/2021	Stable
Transportation	3/16/2020	3/24/2021	Stable
Healthcare	1/1/2021	6/23/2021	Stable
Higher Ed	1/16/2020	N/A	Negative

Source: Moody's Investors Service and S&P Global. Data as of August 31, 2021. Negative and stable/positive dates reflect when those sector outlooks were assigned by the respective rating agencies. GO=General obligation bonds. N/A=Not Applicable. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

So far, there has been a wide range of performance depending upon whether portfolios are of long, intermediate, or short maturity; investment grade or high yield; and which of several portfolio strategies were applied. The long end of the muni yield curve has outperformed with interest rates rising less on long maturities than intermediate ones. Short maturities have provided very low returns. High yield has dramatically outperformed investment grade with the Bloomberg Barclays High Yield Municipal Bond Index up more than 7% year to date through September 2, and the Bloomberg Barclays Municipal Bond Index (Muni Index), representing the investment-grade muni universe, up 1.5%. During 2020, the AAA-rated segment of the Muni Index outperformed the high yield and BBB-rated indexes, but positive performance among lower-quality munis in the fourth quarter allowed them to almost catch up before year-end, after the efficacy of COVID-19 vaccines was announced in November 2020.

Figure 4. Muni-Bond Performance Shifts Since 2020

Returns by index for 2020 and 2021 (through August 31)



Source: Bloomberg. Data as of August 31, 2021. Muni Index= Bloomberg Barclays Municipal Bond Index. AAA and BBB indexes are ratings-specific subsets of the Muni Index, while 3-year, 5-year, 10-year, and Long (22+ years) indexes are maturity-specific subsets. HY Index=Bloomberg Barclays High Yield Municipal Bond Index. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

Against this backdrop, the best-performing portfolio management strategies this year have been primarily to take credit risk, and secondarily, to not reduce interest-rate risk. The discrepancy between high yield and investment-grade performance has been extremely wide. New bonds being brought to the market for issuers rated BBB and lower continue to be well oversubscribed as fund flows remain strong, and the credit outlook remains positive.

Looking Ahead

Of course, much could change with four months still to go in 2021, but the municipal bond market has had very low volatility this summer despite large fluctuations in other markets. We think these will be key indicators to follow going forward:

1) Fund flows, which would be at the top of the list reflecting individual investor sentiment.
2) Ratios of AAA-rated municipal bond yields to Treasury yields, which reflect relative value.
3) Economic statistics such as inflation.
4) Federal Reserve actions.
5) The impact of the delta variant on state and local tax revenues.

For the municipal bond market, we think the following conditions may prevail:

1) With economic growth remaining solid and fiscal stimulus still in effect, credit quality should perform well.
2) Tax rates are either going to stay the same or rise; either outcome should favor municipal bonds.
3) The pending infrastructure bill is unlikely to have a material impact on municipal bond supply.

Despite this very positive backdrop, the outlook for future market performance depends upon the sentiment of the individual investors who make up approximately 70% of the municipal bond market. Their biggest concerns with municipals are typically credit quality and interest-rate risk. On the credit side, conditions are stable, which should limit market concerns in this area. With low interest rates around the world, most economies still being negatively impacted by COVID-19, and the Fed remaining cautious, interest rates do not seem poised to move significantly higher, but this is clearly the most unpredictable part.

While there is always uncertainty, which needs to be monitored, the municipal bond market appears to be in a good position. We don't think returns are likely to be as high as the first two-thirds of the year, but with a fundamentally positive outlook, the municipal bond market is likely to continue to have more stability and good relative performance compared to most other parts of the financial world.

Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

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

The value of investments and any income from them is not guaranteed and may fall as well as rise, and an investor may not get back the amount originally invested. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance.

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

Fixed Income Investing Risks

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. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

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.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

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Glossary & Index Definitions

General obligation (GO) bonds are backed by the "full faith and credit" of a government and are issued by entities such as states, cities, counties, and school districts. **Revenue bonds** are backed by revenues from a specific projects or facilities (such as toll roads, water/sewer systems, or airports).

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 Bloomberg Barclays Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term, tax-exempt bond market. Bonds must be rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies.

The Bloomberg Barclays High Yield Municipal Bond Index is an unmanaged index consisting of noninvestment-grade, unrated or below Ba1 bonds.

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