Building a Case for High Yield Munis

Here are four reasons why we believe high yield municipal bonds may hold appeal for investors looking for attractive tax-free income.

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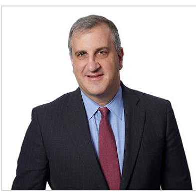
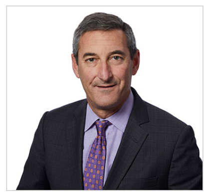


Daniel Solender, CFA
Partner & Director

Gregory Shuman, CFA
Managing Director, Portfolio Manager



Eric Friedland, CFA
Director of Municipal Bond Research

Figure 1. High Yield Munis' Yield Ratio versus Investment Grade Is Near Multi-Year Highs

Yield ratio (yield to worst basis) of the Bloomberg Barclays High Yield Municipal Bond Index versus the Bloomberg Barclays Municipal Bond Index, May 30, 2003–November 20, 2020

Source: Bloomberg. Data as of November 20, 2020. YTW=Yield to worst.

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Building a Case for

After a few years of outperformance for lower-quality investments in the municipal bond market, the COVID-driven selloff in March 2020 reversed that trend, as evidenced by comparative year-to-date returns. The high yield and BBB-rated segments of the municipal market have returned just 2.63% and 2.36% year to date through November 20, respectively; by comparison, AAA-rated bonds have returned 5.11%.[1] While the higher-quality part of the market has performed well this year, we believe the lagging recovery among lower-quality issues may present an opportunity for investors. Here are four reasons why we think high-yield munis offer attractive relative value:

1. The high yields are attractive relative to investment grade

While many high-quality fixed income markets have extremely low yields, high yield municipals still offer attractive yields on a relative basis. In a low-yield environment, investors could be drawn to the high yield municipal space, given the relatively low default rates, and attractive yields. In our view, the current yields offer reasonable compensation for the credit risk taken and if demand stays strong, credit spreads could potentially narrow from current levels, leading to better performance for lower-quality bonds.

2. A few defaults are likely to happen, but we think the volume will remain low.

While there have been media headlines suggesting that the fundamental credit quality in the municipal bond market has deteriorated and will continue to do so, we believe that this change has been small so far. Any such changes in credit quality would most likely be reflected more by minor credit downgrades than outright defaults, in our view.

Here, we think two comparisons may be useful. First, for the investment-grade area of the muni market, default rates have held at historical lows, as illustrated in Figure 2. (Note that the Lord Abbett High Yield Municipal portfolio has an approximate 35% weight in investment grade bonds as of September 30.)

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.

High-Yield Munis

On the high yield side, while some observers have suggested that there have been significant increases in muni-bond defaults, that is not really what is happening. While there have been a few more defaults among high yield muni bonds in 2020, the past few years have seen a very low number of defaults; a small increase from that low level would not have been out of the ordinary, in our view, even if the pandemic had not hit. The high yield municipal bond market has experienced roughly $1.8 billion in payment defaults year to date through November 12, based on Bloomberg data. That amounts to a default rate of just 0.5% based on the high yield muni market's total size of $300 billion.

3. Relative value likely will lead to a recovery in fund flows, in our view.

The municipal market is unique in that retail buyers have a far greater direct impact on the market versus other fixed income asset classes since, according to U.S. Federal Reserve data, they own two-thirds of the outstanding bonds through managed products or brokerage accounts. This means that the mutual fund flow pattern can have a significant impact on overall credit quality performance. While fund flows have been robust to many parts of the municipal market in 2020, particularly into shorter maturities, they've been negative for the high yield segment (see Figure 3).

Figure 3. High Yield Muni Fund Flows Are Negative for 2020, but Have Turned Positive in Recent Weeks

Week Ended 11/18/2020

	Fund Flows (Mil. $)		
Fund Type	Actual	YTD Total	4-week avg.
All Term Muni Funds	1,328	31,117	1,522
All Term Muni Funds ex-ETF	770	23,467	1,374
New York	1	-1,475	-28
California	39	172	35
National Funds	1,234	32,321	1,476
High Yield	369	-4,905	231
Intermediate	6	5,933	186
Long Term	960	4,328	413
Tax-Exempt Money Market	-604	-26,983	360
Taxable Money Market	4,503	688,131	-4,639
Taxable Fixed Income	5,631	234,818	7,315
U.S. & Global Equity	-15,241	-356,277	-5,645

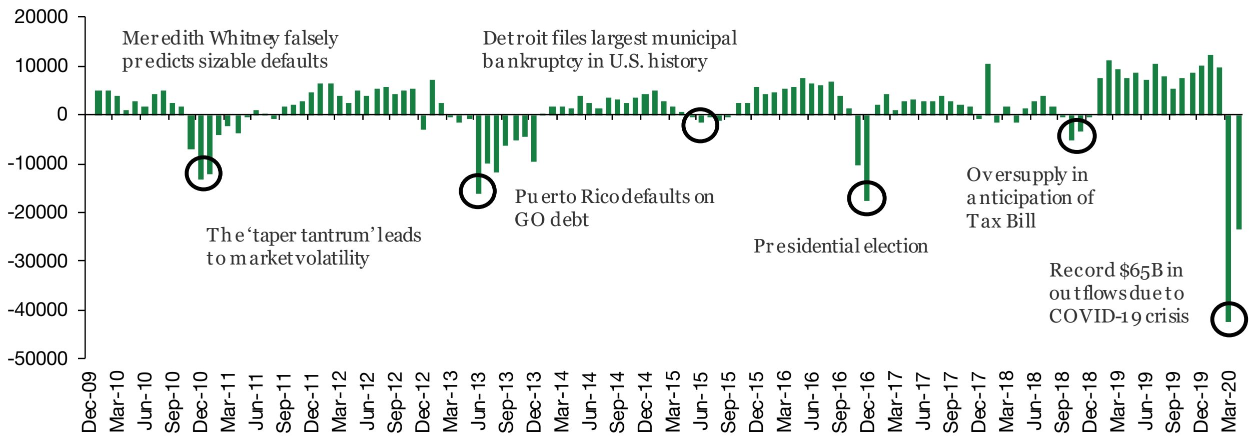
Source: Lipper. Data as of November 18, 2020. Figures shown represent funds that report on a weekly and monthly basis. ETF=Exchange-traded funds. **Past performance is not a reliable indicator or guarantee of future results**. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

As investors begin to realize that many of most dire predictions about the impact of COVID-19 on the U.S. economy—and the municipal bond market— have not panned out, flows may turn around and potentially drive better performance. This is a trend we've already seen in the last few weeks, as shown in Figure 3. If this continues, it would conform to a historical performance pattern stretching back more than a decade (see Figure 4).

Figure 4. Bond Fund Outflows Historically Have Signalled Opportunities in High Yield Munis

Municipal bond fund flows have seen strong recoveries following periods of large outflows…

Monthly municipal bond mutual fund flows (mil. $), January 2010 – March 2020



…while high yield has been among the muni market segments that have also proven resilient

One-Year Total Return

	12/31/2010-12/31/2011	06/30/2013-06/30/2014	06/30/2015-6/30/2016	12/31/2016-12/31/2017	10/31/2018-10/31/2019
Bloomberg Barclays Municipal Bond Index	10.7%	6.1%	7.7%	5.5%	9.4%
Bloomberg Barclays High Yield Municipal Bond Index	9.3%	3.9%	12.1%	9.7%	11.7%
Bloomberg Barclays (22+ Years) Municipal Bond Index	14.9%	8.0%	11.7%	8.2%	12.6%

Source: Bloomberg, Morningstar and Lord Abbett. Historical data as of November 20, 2020.

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4. Credit pressures likely will not be shared evenly.

While there are number of parts of the high yield municipal bond market that are under pressure, many sectors are performing well. As an example, bonds backed by tobacco consumption, sales taxes, and charter schools, have not seen declines anywhere near what was originally predicted in March during the heart of the market sell-off. Tobacco consumption has increased this year and that improves the credit quality of those bonds. Charter schools are supported by state funding tied to per-pupil enrollment; state funding is not expected to decrease materially in the intermediate term.

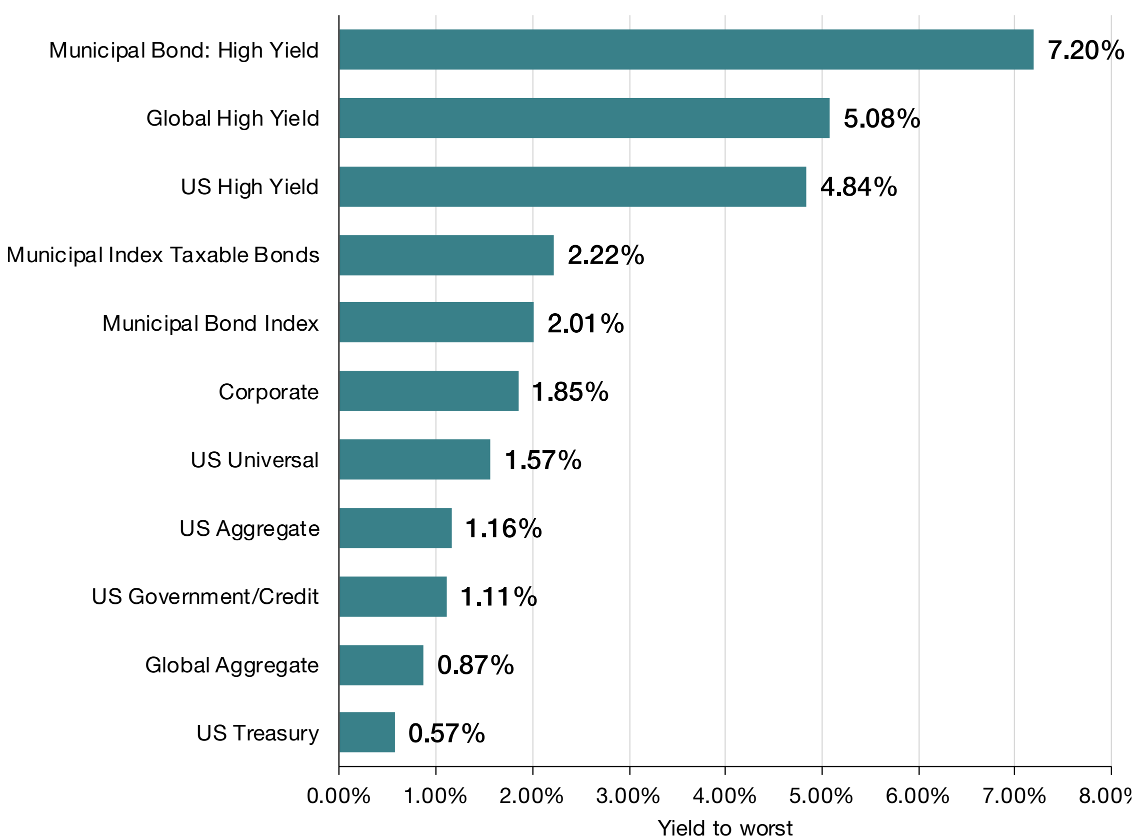
Meanwhile, sectors such as senior living and public-private partnership (P3) student housing deals have seen stress, but we believe many of the constituent issuers are still well positioned to weather the current situation due to having government support and/or strong enough balance sheets. As an example, many senior living facilities were helped by being eligible for loans under the Payroll Protection Program as part of the CARES Act. In the student housing sector, many universities have stepped in to provide financial support to struggling dormitory facilities, despite being under no obligation to do so; this assistance has been provided in order to help these issuers maintain their future access to the market. Of course, the financial stress from COVID-19 on these two sectors requires a cautious approach. However, an experienced research team with rigorous credit analysis capabilities gives an investment manager the potential to identify pockets of value amid the stress.

Summing Up

We believe that the high yield segment of the municipal bond market currently presents an attractive relative value proposition (see Figure 5). While COVID-19 has weighed on some high yield muni issuers, the impact has not been evenly shared, and many other issuers have maintained or even improved their credit quality. At the same time, a large swath of the sector has been penalized with wider spreads and underperformance even though only a small portion of high yield municipal bonds are likely to face major difficulties. With increasingly fewer options to find attractive yields in fixed income, we think the high yield municipal market deserves a closer look from investors.

Figure 5. High Yield Municipal Bonds Offer Compelling Yields in a Low-Rate Environment

Yields on various taxable and tax-exempt fixed income indexes, as of November 20, 2020



Source: Bloomberg Barclays Indices. Data as of November 20, 2020. Performance depicted here represents Bloomberg Barclays indexes (see definitions in the disclosure section at the end of this article). YTW=Yield to worst. Tax-equivalent yields on Municipal Bond Index and High Yield Municipal Bond Index; assumes 40.8% tax rate (tax-equivalent yields will differ based on underlying tax rates).

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[1]Performance figures are for ratings-specific subsets of the Bloomberg Barclays High Yield Municipal Bond Index (high yield) and Bloomberg Barclays Municipal Bond Index (BBB- and AAA-rated issues).

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A Note about Risk: The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. 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.

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

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.

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 Global Aggregate Bond Index** is a broad-based measure of the global investment-grade, fixed-income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate indexes. The index also includes euro dollar and euro/yen corporate bonds, Canadian government securities, and U.S. dollar investment-grade 144A securities.

The **Bloomberg Barclays Global High Yield Index** is a multi-currency flagship measure of the global high yield debt market. The index represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices. The high yield and emerging markets sub-components are mutually exclusive.

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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The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Total return comprises price appreciation/depreciation and income as a percentage of the original investment.

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The **Bloomberg Barclays U.S. Universal Index** represents the union of the U.S. Aggregate Index, the U.S. High-Yield Corporate Index, the 144A Index, the Eurodollar Index, the Emerging Markets Index, and the non-ERISA portion of the CMBS Index. Municipal debt, private placements, and non-dollar-denominated issues are excluded from the Universal Index. The only constituent of the index that includes floating-rate debt is the Emerging Markets Index.

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