Municipal Bonds: Where We See Value Now

A closer look at the muni yield curve offers clues as to where investors might find the potential for attractive returns.

Featured Contributor

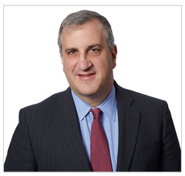

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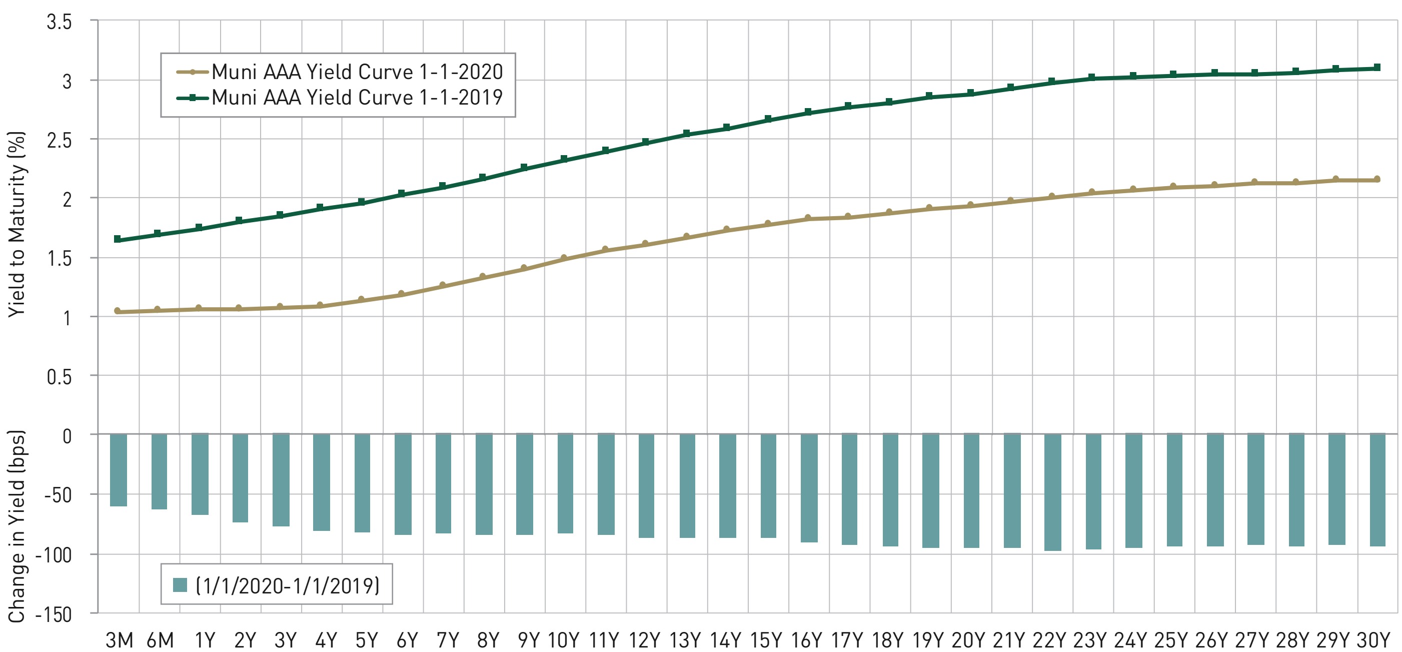
Chart 1. After a Strong 2019, the Muni-Bond Yield Curve Remains Upward Sloping

Yield by maturity for the indicated dates (upper); difference in yield (lower)



Source: Bloomberg. Data as of January 1, 2020.

Past performance is not a reliable indicator or guarantee of future results.

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In Brief

- After broad strength in municipal bonds in 2019, investors may be wondering about potential opportunities in the muni market in 2020.
- Based on a recent examination of a widely used municipal bond yield curve, the best opportunities for expected returns in 2020 lie in longer-dated issues, in our view.
- Next, by factoring in duration, we determined that investors looking to potentially optimize the risk-return tradeoff in munis should consider intermediate maturities.
- Based upon tax-equivalent yields, we believe municipal bonds look attractive compared to most other markets for non-retirement accounts.

Municipal bonds had a banner year in 2019. Municipal-bond mutual funds had record inflows of more than $90 billion, according to Lipper, with longer maturities outperforming. The main drivers of last year's gains, in our view, were falling interest rates, strong performance of lower- rated bonds, and increasingly favorable supply/demand dynamics.

But what about 2020? Given the market's strong showing last year, we think it may be useful to evaluate the relative value among maturities to help determine what investments to make now.

We've written before about how investors may have been surprised that the muni yield curve stayed upward sloping in 2018 even as the U.S. Treasury curve was flattening. The muni curve had actually *steepened*, creating a lot of value in longer maturities, in our view. Investors began to recognize that value in 2019 as longer maturities outperformed, meaning that long-bond rates fell more than short rates. Still, as of early 2020, the municipal-bond yield curve remains steeper than the Treasury yield curve.

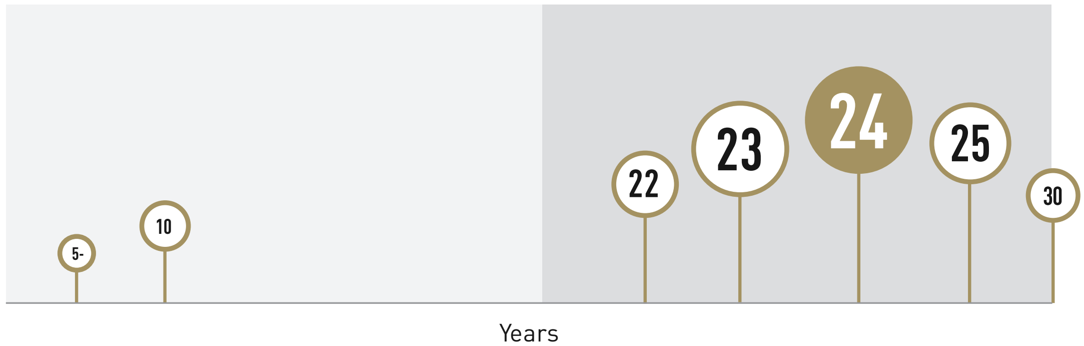
Watching the Municipal Bond Curve

Might the curve stay that way? Given the current economic backdrop (low inflation, modest growth), the consensus base case appears to be that rates will not rise significantly this year. With this assumption, the next step would be to analyze the municipal-bond yield curve along with the market dynamics that could impact its shape.

A starting point for this analysis would be to assume that the shape of the yield curve stays the same over the next year and then to determine what expected returns would be for each maturity. This can be done by calculating bond prices for each maturity today and then assuming each maturity becomes a year shorter a year from now; each maturity is assumed to have the year-shorter yield a year from now. For example, if the 10-year yield today is 1.23% and the nine-year yield is 1.15%, using today's data, the price can be calculated as a 10-year bond today and a nine-year bond a year from now. By doing this we can calculate the change in bond prices to determine what the total return would be for the year. In this example, instead of just earning the yield of 1.23%, the investor would get a total return of 1.82%.

Employing the widely used municipal-yield curve published by Municipal Market Data, we ran these calculations across muni-bond maturities on January 21. This graphic summarizes our findings:

Which Muni-Bond Maturities Do We Think Have the Greatest Return Potential in 2020?



Source: Municipal Market Data and Lord Abbett. Based on projection of expected return based on an analysis of current and projected one-year later yields on January 21, 2020, for various maturities on the Municipal Market Data AAA yield curve as of that date; assumes slope of the yield curve remains unchanged.

The above described analysis is a hypothetical illustration of a mathematical concept using the noted assumptions. There is no guarantee that the noted maturities will perform according to our analysis. If the yield curve or interest rates change our analysis may differ.

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We found that the maturities with the best expected returns over the next year were solidly on the long end. For 10-year maturities and shorter, the longest point at 10 years was best, with very little difference between maturities five years and below, all of which had low expected returns. Based upon this analysis, in our view, *municipal bond investors whose goal is to maximize returns should consider longer maturities.*

Duration Considerations

If the investment goal is to maximize the risk-return tradeoff rather than only focusing upon the optimal total return, we believe the *duration* of each maturity must be part of the calculation. When incorporating this metric into risk-return calculations, the best risk-return trade-off, in our view, comes from seven- and eight-year maturities. Next best would be 24-, 23-, and 19-year maturities. These results are based upon our internal models which have differing results as market yields fluctuate, but suggest that *investors looking to optimize the risk-return tradeoff should consider intermediate maturities.*

It is important to remember that this is the base case, assuming that the yield curve and interest rates do not change over the next year. If interest rates do rise, that would change the results most for longer maturities.

Other Factors Affecting Muni Valuations

Market dynamics may also have an impact upon which maturities will perform best. Tax-exempt new issue supply is likely to be somewhat higher than last year, in our view, given the stable U.S. economy and improving credit trends, but it is not expected to increase significantly. So, we expect that supply levels should not pressure the municipal-bond market.

What of demand? Municipal-bond fund flows continue to be strong, with 55 consecutive weeks of positive flows as of late January 2020, according to Lipper. Interestingly, while still early in the new year, approximately two-thirds of the money continues to go into long-duration funds or high-yield funds similar to the pattern during 2019. This trend supports the positive performance of the longer portion of the yield curve, which adds to the positive relative value of longer bonds. Of course, a large increase in interest rates or volatility could negatively affect flows, but such a development appears unlikely in the near term, according to the consensus. Thus, the supply/demand characteristics of the municipal-bond market support all maturities, in our opinion, but benefit longer bonds most.

We think another good starting point for relative value analysis is to look at the ratio of "AAA"-rated municipal-bond yields to Treasuries. As of January 30, the ratio was 59% at a maturity of two years, 60% at five years, 73% at 10 years, and 88% at 30 years. All of these ratios are on the richer side compared to average levels, but the shorter maturities are the richest. Given the cap on state and local taxes from the tax bill, there is support for these ratios being lower than previous years because it is harder to find ways to get tax-exempt income from other sources.

Summing Up

Based upon tax-equivalent yields, we believe municipal bonds look attractive compared to most other markets for non-retirement accounts. Our analysis suggests that the best expected returns potentially are in longer maturities because the municipal bond yield curve is steeper than its taxable counterpart, but the best risk-return relationships are in intermediate maturities. We think municipal bond market-specific supply and demand dynamics are very supportive and don't show signs of changing. Yield ratios of municipals to Treasuries are more attractive for longer maturities even though they are a little richer than normal for all maturities, in our view.

Overall, for municipal bond investors, we think the market environment has very positive characteristics and that there are a range of attractive, differing expected returns based upon maturities. Which to choose depends upon an individual's overall investment goals.

IMPORTANT INFORMATION

This *Market View* may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

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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.

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.

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.

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.

Tax-equivalent yield is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of a tax-free municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond in order 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.

Yield ratio is a measure of the yield on AAA-rated municipal bonds relative to the yield on a U.S. Treasury bond of similar maturity.

Yield to maturity is the rate of return anticipated on a bond if held until it matures.

The **Thomson Reuters Municipal Market Data (MMD) AAA Curve** is a proprietary yield curve that provides the offer-side of "AAA" rated state general obligation bonds, as determined by the MMD analyst team. The "AAA" scale (MMD Scale), is published by Municipal Market Data every day at 3:00 p.m. Eastern standard time, with earlier indications of market movement provided throughout the trading day. The MMD AAA curve represents the MMD analyst team's opinion of AAA valuation, based on institutional block size ($2 million+) market activity in both the primary and secondary municipal bond market. In the interest of transparency, MMD publishes extensive yield curve assumptions relating to various structural criteria which are used in filtering market information for the purpose of benchmark yield curve creation.

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