Are There Still Opportunities in High-Yield Munis?

Here are four reasons why we believe this diverse asset class continues to offer value to investors.

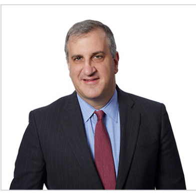

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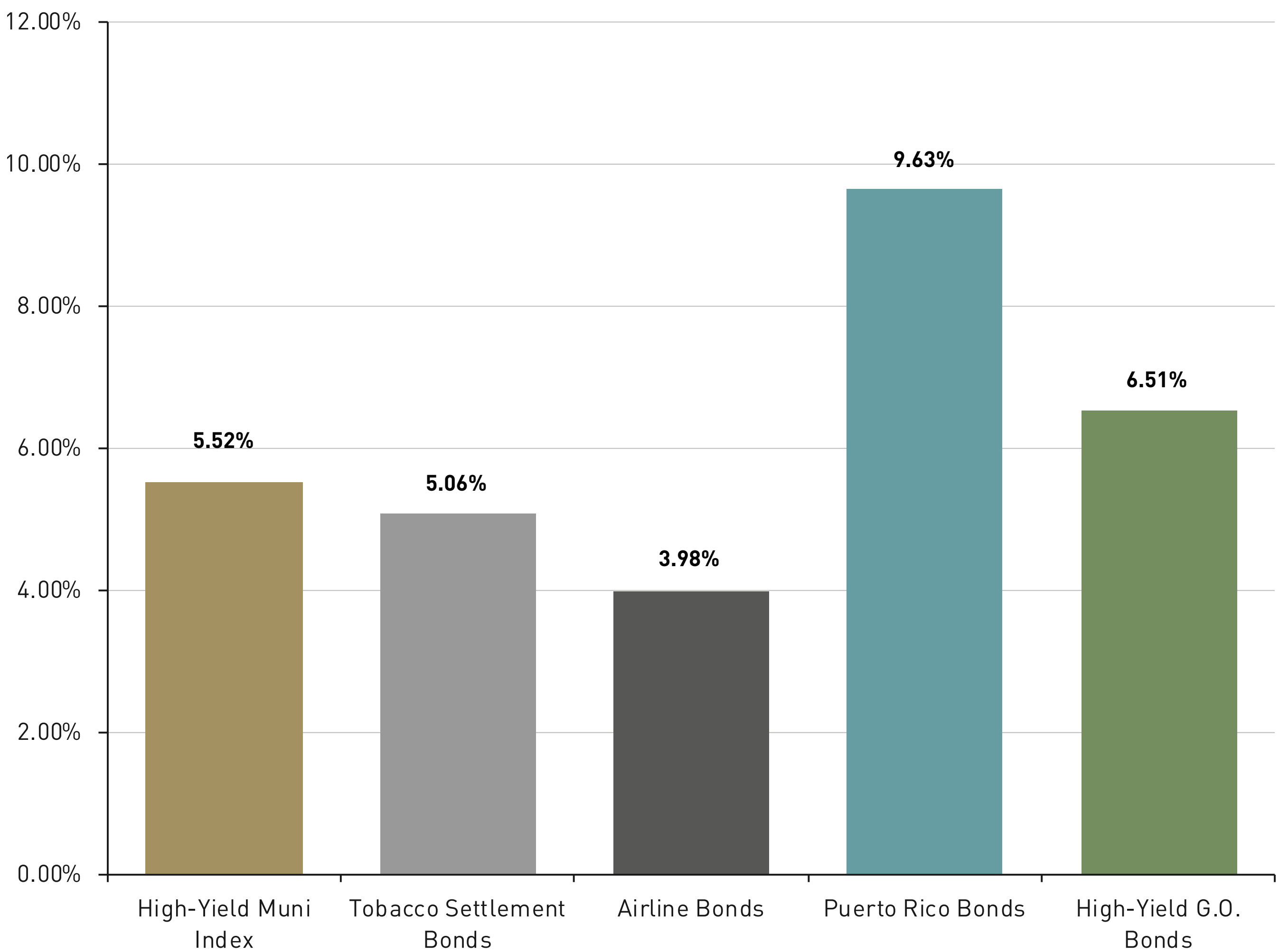
Chart 1. Returns of Key High-Yield Muni Sectors Have Varied Widely

Data for the Bloomberg Barclays High Yield Municipal Bond Index and component sectors, year to date through May 24, 2019



Source: Bloomberg. "G.O." refers to general obligation bonds. Data as of May 24, 2019.

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In Brief

- The strong recent performance of high-yield muni bonds has raised questions about whether value remains in the asset class. Here, we address that issue by examining four aspects of the current market.
- We think valuation concerns should be viewed in the context of the historically diverse performance of high-yield muni subsectors, along with substantial changes in the composition of the benchmark index.
- Further, we think it's useful for investors to understand how trading patterns affect spread comparisons, and the potential implications of current market fundamentals and technicals.
- High yield municipal bonds have outperformed investment grade munis in recent periods, and we believe the factors mentioned here illustrate why this trend may continue.

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Below-investment grade municipal bonds, as measured by the Bloomberg Barclays High Yield Municipal Bond Index (the high-yield muni index), have outperformed their higher-quality counterparts (as represented by the investment-grade Bloomberg Barclays Municipal Bond Index) during recent time periods—including year-to-date through May 24. (All muni index data in this article are from Bloomberg.) Much like the equity market, this extended period of strong performance has led to questions about the current valuation of the asset class, including recent articles in Bloomberg and the Wall Street Journal. We've also received some related questions from investors, so we thought we'd take this opportunity to address the topic.

We believe there is still value in high-yield municipals, an asset class that has the potential to provide attractive outcomes for those willing to take on additional credit risk. Here, we offer four key reasons that inform our opinion.

1. The high-yield muni market is diverse, with a broad range of potential performance.

It is typical for component sectors and credits of the high yield muni market to perform very differently and with wider dispersion than taxable high yield markets. So a blanket statement regarding valuations is not completely accurate. At all times, in our view, some parts of the high yield municipal bond market will represent value for new investments while some will not.

To illustrate, Chart 1 on the first page shows how the high-yield muni index and key component sectors have fared year to date (through May 24).

The performance range was wider last year, so based upon these outcomes, valuations are changing rapidly and not all parts of the high yield market are outperforming. It is therefore incorrect to say that "high yield municipals" as a broad category is under- or overvalued because it is really a case-by-case situation. By following the market each day, participants can react and adjust portfolios to sectors or credits that have strong relative value.

2. Substantial changes to the benchmark index have made comparisons trickier.

Historical analysis of the high yield municipal bond market, using spreads between high yield indexes and investment-grade indexes, is inexact. That's because large portions of the investment grade market have been downgraded over the past decade, leading them to enter the high yield index with large weightings. Some of those downgraded issues subsequently left the high yield index after a few years. These large composition changes represent a substantial shift in the universe of high-yield muni bonds, so the spreads used to broadly denote valuations represent very different bonds at varying times.

Here are two well-known examples of big compositional shifts in the high yield muni index:

- **Tobacco settlement sector ratings**. Ten years ago, most bonds in the tobacco settlement sector had investment-grade ratings. Then the sector was downgraded and it represented more than 20% of the market value of the high yield index. Today, it makes up about 15%.
- **Puerto Rico bond ratings**. Ten years ago, most Puerto Rico bonds had investment-grade ratings. After they were downgraded to below investment grade in 2014, these bonds represented more than 20% of the market value of the high yield index. Now, after the 2017 defaults and some subsequent restructurings, Puerto Rico municipal bonds represent approximately 11% of the index.

With all these bonds moving in and out of the index, historical spreads have changed dramatically at times, so a standard analysis of spreads between indexes does not really capture whether the high-yield sector is rich or cheap today. We believe valuation analysis needs to include a range of different time periods and adjustments for the composition changes in order for it to be useful for trading decisions. The index providers do not present this type of information, so it must be completed by proprietary analysis.

3. Trading patterns can affect spread comparisons.

The vast majority of bonds in the high yield municipal bond market indexes trade infrequently, so their valuations do not change as rapidly as the investment grade portion of the market, which can be marked to reflect live trading more often. This means that spread calculations for high-yield relative value can be volatile. This is not to say that the valuations for high-yield municipal bonds are not correct, but rather that they change more rapidly during times when they are trading more frequently. Muni trading values may be affected by factors such as the impact of shifts in the outlook for particular credit or market conditions changing the costs for liquidity.

4. Fundamental and technical conditions remain supportive, in our view.

Municipal bond credit quality has been strong, with more upgrades than downgrades by the rating agencies during 2018; we believe this trend has helped support improving the high-yield municipal bond market. For example, during 2018, the three primary rating agencies, Moody's, Standard & Poor's and Fitch, reported 2,075 upgrades and 1,164 downgrades of municipal issuers. Meanwhile, U.S. gross domestic product growth has been positive, and state and local tax revenues have been rising, according to data from the U.S. Census Bureau. All of this supports improving credit quality and tighter spreads, in our view.

Meanwhile, the 2017 U.S. tax legislation has had a dramatic impact upon supply and demand for municipal bonds. On the supply side the bill eliminated the ability for issuers to "advance refund" their outstanding bonds, that is, issue new bonds at lower rates to reduce borrowing costs by refinancing existing bonds prior to their call dates. These types of bond deals historically represented approximately 25% of new issuance. As a result, the supply of newly issued muni bonds is now much lower than it was a couple years ago.

On the demand side, the cap on state and local taxes has led to higher tax bills for people in higher-tax states such as California and New York, and this has contributed to record demand for municipal bonds. Indeed, Lipper data show that a record $34 billion has flowed into municipal bond mutual funds in the first four and a half months of 2019, based on data compiled since 1992.

Overall, in our view, these supply/demand trends have created a favorable backdrop for the high-yield muni market.

Summing Up: Taking the Measure of High-Yield Munis

High yield municipal bonds have been outperforming for a while, for what we consider a number of good reasons. We also think there is a lot of support for them to be good investments going forward. But finding the best opportunities will depend upon deep analysis of relative value within the market, in our view. Further, we believe monitoring investor sentiment will be important, as sentiment has always had an impact upon performance in the municipal bond market, which features a sizable contingent of individual investors.

One final thought: There will always be volatility when taking on additional credit risk, just as it seems there will always be people making broad generalizations about markets without fully understanding their inherent nuances and complexities. We think it is critical to consider the full range of information and viewpoints about the state of the high-yield municipal bond market before making an investment decision. ■

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