Surveying Potential Opportunities in Municipal Bonds

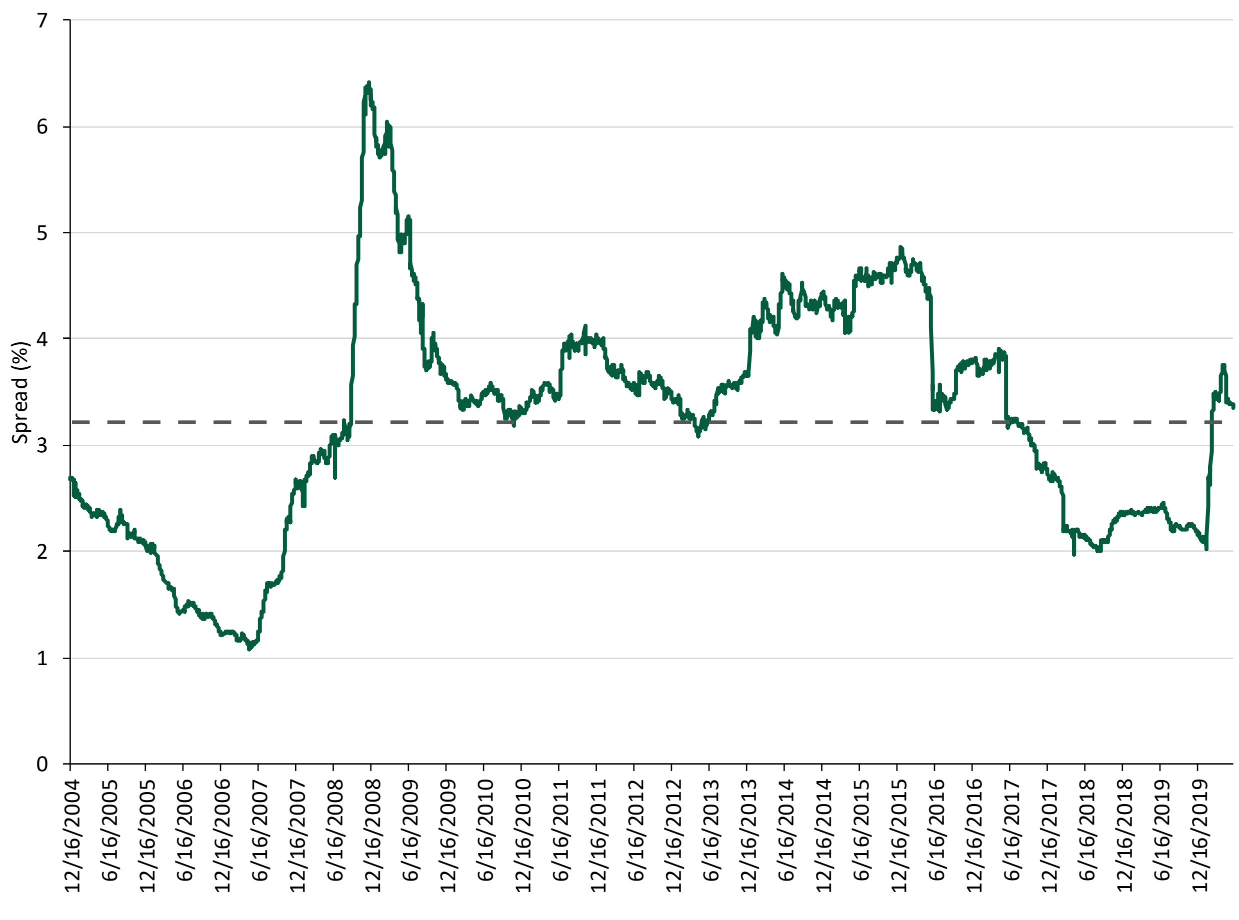
Here, we summarize recent insights on key segments of the municipal bond market.

John George
Product Consultant

Matthew Schaller, CFA
Product Consultant

Figure 1. High Yield Municipal Bond Spreads Remain Wide

Spread of Bloomberg Barclays High Yield Municipal Bond Index versus Bloomberg Barclays Municipal Bond Index, January 1. 2005–July 10, 2020



Source: Bloomberg. Data as of July 10, 2020.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (one one-hundredth of a percentage point).

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.

MUNICIPAL BONDS

In the June 8, 2020, *Market View*, we discussed opportunities across the risk spectrum among U.S. equities and taxable fixed income investments. That piece got a strong response from readers and prompted requests for a similar survey of potential investment choices within the municipal bond space.

Requests granted. Here, we examine four potentially appealing muni segments, drawing on the insights of Lord Abbett Partner and Director of Municipal Bonds, Dan Solender.

Higher Quality Municipal Bonds

After a difficult March, municipal bond prices started recovering in April in the high-quality segment of the market, with the rebound subsequently extending to bonds in lower rating categories as we entered June. One of the turning points for the market was when the U.S. Federal Reserve (Fed) decided to find ways to extend support to municipal bonds, culminating in the creation of the Municipal Liquidity Facility (MLF), announced on April 9.

Higher quality municipal bonds have rallied since their year-to-date lows in the middle of March. Despite being down by as much as 7.5% in mid-March, the primarily investment grade Bloomberg Barclays Municipal Bond Index has recovered, returning 2.43% year-to-date (through July 9), paced by strong performance in AAA and AA rated bonds.

Based on data from JP Morgan, the ratio of municipal bond yields to Treasury yields remains elevated, though well below the extreme levels seen in March. As of July 6, the yield ratio on AAA-rated municipal bonds was 176% for maturities of two years, 138% for five years, 134% for 10 years, and 114% for 30 years. The fact that ratios remain well above historical averages suggests that tax-equivalent yields among higher-rated municipal bonds present attractive relative value.

Intermediate-Term Municipal Bonds

As Solender noted in a detailed summary of the potential appeal of intermediate-term municipal bonds published on June 3, intermediate-term muni bonds represent the largest weighting of assets in municipal bond mutual funds. The reasons for their popularity are understandable, he notes, as they:

- Have had lower volatility than longer muni bonds,
- feature more attractive yield ratios versus Treasury bonds than shorter muni maturities,
- have attractive risk/return characteristics, and
- typically have had high expected total returns due to steepness of the yield curve.

High Yield Municipal Bonds

Investors looking to take advantage of relatively "cheap" municipal bonds, attractive tax-equivalent yields, and the potential benefits created by the MLF, may wish to consider high yield municipal bonds. There is a notable incremental yield advantage as you move lower on the credit spectrum.

To be sure, the high yield segment of the muni market came under significant pressure during the March market turmoil. Even more striking, after all the elevated volatility in March, the Bloomberg Barclays High Yield Municipal Bond Index was down only 2.07% year to date through July 9, and still had a positive 12-month return of 1.36%. Factor in munis' tax-exempt status, and the tax-equivalent return would be roughly comparable to some other fixed income investments. We believe forced liquidations of bonds in many funds created a "fire-sale" price environment for the high yield market and these credits are still relatively attractive. Indeed, spreads remain near multi-year highs, as seen in Figure 1 on the first page. Should the market continue to stabilize, these spreads may represent an attractive entry point for municipal bond investors.

In terms of credit fundamentals, high yield municipal bonds have had much lower historical default rates than comparably rated corporates. We believe this dynamic will not change, despite concern from market participants in response to the coronavirus outbreak. In our view, investors have largely factored minor ratings downgrades and select negative outlooks from ratings agencies into the prices of securities.

Revenue Bonds

Revenue bonds have underperformed the broader municipal market thus far in 2020 (through July 9), as investors have favored bonds in the upper credit quality tiers. In a recent commentary, Solender noted that revenue bonds' credit quality "is still very strong" and fits into the range of the investment grade market, which has historical default rates close to 0%, based on a 2019 Moody's study. Further, the subset of the Bloomberg Barclays Municipal Bond Index that tracks revenue bonds has outperformed the general obligation (GO) bond subindex in five of the past six years.

In our view, the entities supporting sectors within the revenue bond universe that supply essential services (for example, utilities, water systems, transportation, ports) are poised to remain in solid financial condition as the U.S. economy stabilizes. We believe these sectors are well positioned to support their obligations through this environment.

A Final Word

As always, investors must make decisions regarding whether to target yield or total return and how much risk they want to take. As Solender put it in his June 24 commentary, "while municipal bonds have been recovering well from the March downturn, we think there are still intriguing opportunities to consider as the market continues to rebound."