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Fixed-Income Insights

2021 Investment Outlook: Municipal Bonds

Lord Abbett's Director of Municipal Bonds talks about the challenges that muni issuers faced during the pandemic, and the prospects for the municipal market as we move forward to a recovery in 2021.

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Two Sides to the Municipal Market

Municipal credits have held up well and maintained their historically strong quality during the COVID-19 crisis. On a credit-impact basis, two primary contributors supported fundamentals during this period. First, reported tax revenues did not fall as much as the market anticipated. State and local government issuers responded quickly to the crisis with cost-cutting initiatives in order to maintain budgets. Similar reactions were seen across multiple municipal sectors, largely sustaining credit fundamentals in the wake of declining revenue. Second, the CARES Act provided support across a broad range of municipal issuers, including hospitals, senior living facilities, and airports, for example. The combination of CARES Act support and crisis-induced reactions to address costs helped to alleviate credit impacts, evidenced in the much lower-than-expected number of credit-rating downgrades reported during the past year (see Figure 1).

The municipal market is also driven by sentiment, a substantial portion coming from retail investors who own approximately 70% of municipal issues. Sentiment has consistently improved since the early stages of the pandemic and strengthened further with the announced COVID-19 vaccines, allowing for a broadening in ownership, to a degree, across issuers and credit quality. Although the lower-quality segment of the market lagged investment-grade sectors for most of the year, the combination of fundamental credit support and constructive sentiment brought together both sides of the municipal market toward the end of the year. We saw the seventh straight year of positive performance with the Bloomberg Barclays Municipal Bond Index posting a return of 5.2% for 2020. The high-yield segment, represented by the Bloomberg Barclays High Yield Municipal Bond Index, returned 4.9%.

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Figure 1. 2020 S&P Municipal Credit Rating and Outlook Changes

S&P ratings actions across approximately $2.7 trillion in municipal credit securities

	S&P Rated Issuers	
Rating Downgraded	$137B	5%
Outlook Lowered	$391B	14%
Placed on Negative Watch	$68B	3%
Total Negative Actions		22%
Rating Upgraded	$14B	0.5%
Outlook Raised	$18B	1%
Removed from Watch	$14B	0.5%
Total Positive Actions		2%
Total Unchanged Ratings		76%

Source: S&P Global Ratings. Data as of 9/30/20. S&P Global Ratings is a U.S.-based credit rating agency and a division of S&P Global that publishes financial research and analysis on stocks, bonds, and commodities.

Pre-Recovery Phase

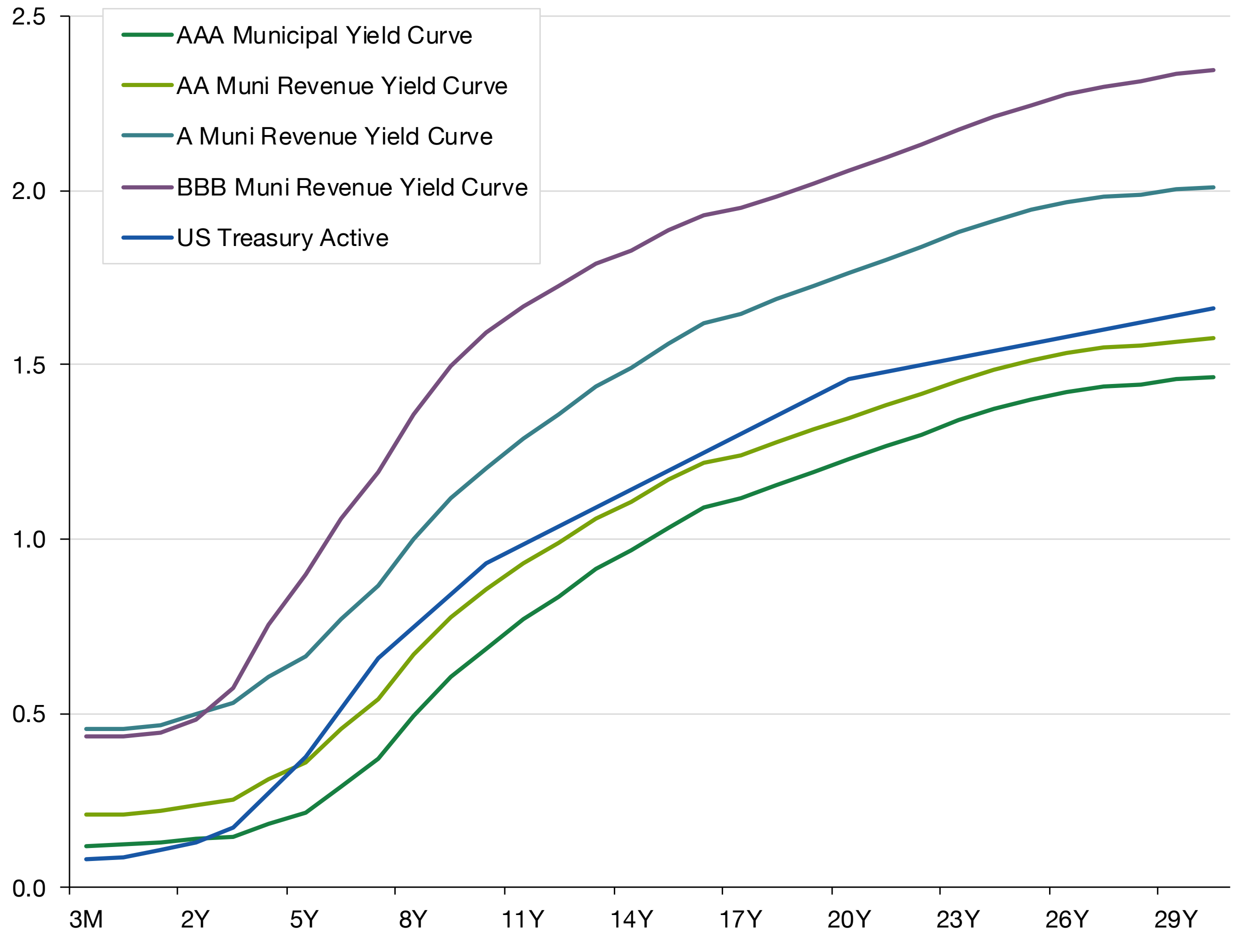
Moving forward into 2021, municipal issuers will need to continue to respond to current challenges, pending a full recovery provided by the vaccines. State and local governments have already taken steps to address budget constraints while revenues come under pressure, although less than expected, and we have seen similar responses from a broad range of sectors in the municipal market. After a rough spring, hospitals were able to add back high-margin procedures, such as elective surgeries. Airports and universities continue to realign processes to maintain operations and have also taken steps to adjust budgets. Overall, the municipal market has shown resilience, which we believe bodes well for the sector, as we progress toward the recovery phase of the pandemic.

Post-Pandemic Period

Looking further into 2021, potential areas of opportunity, in our view, could come out of the lower-quality segment of the market where spreads have widened, and performance is still lagging the higher-quality portions of the market. Relatively attractive tax-equivalent yields, based on the steeper yield curve of lower-quality municipal bonds, could also provide return opportunity to a broader base of investors (see Figure 2).

Figure 2. Yields on Lower-Quality Muni Bonds Could Provide Attractive Opportunity in 2021

U.S. Treasury yield curve versus municipal bond yield curves by quality segment, December 30, 2020.



Source: Bloomberg. Data as of 12/30/20. 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. The municipal bond curves displayed in this chart represent ratings-specific segments of the Bloomberg Barclays Municipal Bond Index.

A continuation of current U.S. Federal Reserve policy of low short-term interest rates potentially provides relative support to all maturities but especially intermediate-term municipals on a risk-return basis. During 2020, with uncertainty still weighing on the municipal market, demand had been primarily strongest within the five-year maturity range. As the outlook has turned more positive with the vaccines, risk taking has increased, which is already benefiting intermediate- and long-term maturity segments of the market, and is likely to continue to do so going forward, as short rates have moved very low.

The Move to Blue

Additional positive implications for the municipal bond market recently surfaced with the election results that unfolded in early January. A Democratic majority in Congress raises the prospect of additional aid to state and local governments, providing further support for those credits. In our view, the election outcome also increases the probability of higher corporate tax rates down the road, following the recovery period in 2021. Higher corporate taxes could entice previous market participants that were buyers of tax-exempt municipals historically, such as banks and insurance companies, back into the market.

Importantly, issuance in the tax-exempt space has been just average. However, taxable municipal bond issuance grew dramatically during 2020. Supply-and-demand dynamics could prove beneficial with income tax rates still providing attractive tax-equivalent yields and tax-exempt supply not picking up much, as the lower rates continue to make taxable municipal bond rates attractive to issuers. After the economic recovery is firmly in place, the move to blue in Washington creates a more feasible environment in which the new administration could implement changes to personal income tax rates, making tax-exempt municipal bonds more attractive to certain individuals. Overall, our outlook for the municipal bond sector is positive given these factors.

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Bloomberg Barclays Municipal Bond Index: 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. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million.

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

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