JUL 2022

Investment Highlights

US Municipal Bond

WESTERN ASSET

Key Takeaways

- *The municipal market posted positive returns in July, as yields sharply declined across the curve.*
- *Market technicals improved somewhat, considering slowing outflows and negative net supply trends.*
- *Strong labor trends and record revenue collections bode well for muni fundamentals as many municipalities entered into a new fiscal year.*
- *Western Asset municipal funds experienced mixed performance relative to benchmarks.*

Market Review

In July, municipals posted positive returns, and tax-exempts outperformed most other high-grade fixed-income sectors. The tax-exempt Bloomberg Municipal Index and Bloomberg High Yield Municipal Index returned 2.64% and 3.73%, respectively. The Bloomberg Taxable Muni Index returned 1.92%, underperforming the 2.44% return for the US Aggregate Index and the 3.04% return for the US Credit Index.

The US labor market showed continued strength. The unemployment rate remained at 3.6% in June, with nonfarm payrolls rising by 372,000, slightly down from last month's increase of 384,000, and the labor force participation rate maintained at 62.3%.

US inflation in June printed higher than expectations year-over-year (YoY), with core CPI at 5.9% and headline CPI at 9.1%. In month-over-month (MoM) terms, headline CPI printed at 1.3%, up from last month's 1.0% gain. Food prices rose 1.0% MoM (10.4% YoY) while energy prices rose 7.5% MoM (41.6 % YoY), making up nearly half of the month's inflation.

From a market technicals perspective, municipal demand remained weak, as municipal mutual fund flows recorded $1.4 billion of outflows for the month, according to Lipper, bringing year-to-date (YTD) outflows to a record $80.6 billion. However, July's outflows were the lowest of the year with two weeks of reported inflows, signaling a potential slowing of the record negative demand trend. July total municipal new-issue supply decreased 26.7% YoY to $27.4 billion. Total issuance YTD of $239 billion is 13% lower than last year's levels, with tax-exempt issuance of $196 billion at the same level as last year and taxable issuance of $42.7 billion 45% lower YoY. In addition to lower YoY issuance, this summer's elevated redemptions have contributed to negative net supply levels, supporting market technicals.

While strong investment returns and improved contributions from state and local governments helped pension funding in fiscal year (FY) 2021 (ending June 30), FY2022 has brought challenges for plan sponsors. Negative market returns, estimated to be -7% for a typical pension plan by S&P Global, are well below the actuarial assumed returns of +6-8% required to fund unfunded pension liabilities. Additionally, higher inflation increases future benefits as they are typically indexed to CPI. All told, state pension systems are expected to give back the vast majority of 2021 gains as the estimated aggregate funded ratio fell to 70% in FY2022, according to Wilshire Advisors. Rising unfunded pension liabilities result in higher actuarially required contributions from plan sponsors (state and local employers). Municipalities that participate in lower funded plans will face a more difficult task, already navigating rising contribution schedules and elevated fixed costs which could coincide with an expected economic slowdown.

With recent Federal Reserve (Fed) rate hikes in mind, it is important to consider structural benefits of the municipal asset class. Tax-exempt municipal bonds tend to outperform taxable fixed-income over the full course of rising-rate cycles. When considering the fact that the municipal tax-exemption becomes more valuable at higher nominal interest rates, it is not surprising that municipal yields, over time, move higher at a slower pace than taxable bond counterparts. Additionally, if the US enters a recession and corporate spreads widen significantly, the defensive characteristics of the tax-exempt asset class may benefit from a flight to safety.

Outlook

As the Fed raises rates to combat inflation and domestic growth moderates, Western Asset expects state and local revenue growth to slow. However, considering record reserve balances combined with pandemic support that can be allocated through 2026, we believe municipalities are in a strong position to manage through economic volatility.

While demand for municipal debt has been challenged YTD, the value of the municipal tax-exemption increases as interest rates move higher. This has supported a favorable after-tax relative value proposition for municipal debt and could spur demand from income-seeking investors subject to high marginal taxes. Meanwhile, we expect negative net municipal supply to be driven by limited new issuance and seasonally elevated coupon and principal redemptions, which could further improve market technicals.

While this has been an uncomfortable year for municipal bondholders thus far, we believe it is important to recognize that we experienced comparable maximum drawdowns before, which have been often more than offset by comparable rebounds that have contributed to a longer-term favorable value proposition of the asset class.

Data Sources: Thompson Reuters MMD, Bloomberg, and Barclays

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