Quick Thoughts

Positioning for a timely opportunity in munis

Strategist views
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The Institute gathered Jennifer Johnston, Director of Municipal Bond Research, Franklin Templeton and Robert E. Amodeo, CFA, Head of Municipals, Western Asset Management, to discuss opportunities and concerns across municipal bonds.

Below are my key takeaways from our discussion:

Municipal bonds are displaying unusually strong fundamentals. The backdrop of local fiscal conditions is solid, contributing to the strength of muni bonds in the current environment. State and local governments have been able to replenish cash reserves as a result of three things: large capital inflows from the Federal level throughout the pandemic, tax receipts that have exceeded pre-pandemic levels and moderate spending. There has been less municipal bond issuance compared to the pre-pandemic period, creating a scarcity of muni bonds.

Some unexpected areas are creating headwinds for muni bond valuations:

- **Commercial real estate.** The shift to more remote work has impacted the office space sector and the businesses that support office spaces in downtown areas. This has led to lower assessed valuations, producing less property taxes. It is also felt in less transit use and funding. Other businesses in office areas may close, thus reducing tax revenues.
- **Labor market.** The strong labor market is a headwind in muni markets as it has created difficulty for states and municipalities to hire. Specifically, it has been difficult to hire nurses in health care and senior living settings, causing those organizations to rely on more expensive contract and travel nurses. It has also been difficult to hire some government administration roles with shortages of auditors leading to delayed financial reporting in some states.
- **Inflation.** Rising costs eat into operating costs and margins. On the capital side, costs increases are making projects and project financing more expensive. There is some benefit that comes from inflation for municipalities—as goods, sale prices and wages increase, so do the tax revenues for the locality.

There are different offerings across different coupon levels. It may be that a project has multiple muni bonds issued with differing coupons (interest rates) and very similar investment features. This could produce sizable income differences for an investor. It is important to evaluate the total return of a muni bond, identifying the coupon, but also the anticipated bond value and any tax penalties.

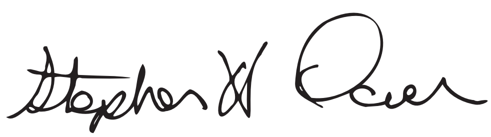
It's not too late to take advantage of the investment opportunity. There are still opportunities in munis even as rates have climbed and credit spreads have widened since last fall. These opportunities require careful analysis to identify the underlying value of the investment and the structural features of the offering.

Individual investors have many reasons to consider increasing muni exposure in their portfolio. For taxable assets, the after-tax return is particularly attractive relative to other fixed income investment choices. It may make sense to move from cash to well-researched muni bonds at this time. Munis in the five-year to 20-year range are particularly attractive, in our opinion. With careful analysis, an investor can create a better mix of credits than in corporate bonds. And the historic default rate of munis has been lower than corporates.[1]

Show caution in certain sectors. The strong labor market is having an impact on operating margins in health care and especially senior living. Mass transit has not fully recovered due to a shift to working from home so research is necessary to ensure that revenue is diverse enough to weather the changes in ridership. Also, rider fares do not back all mass transit bonds; sales taxes, state aid or payroll mobility taxes back some of them. The other sector where caution is warranted is small, private liberal arts colleges. The combined effect of a smaller number of graduating students going to college and COVID have impacted these colleges. An unprecedented number of small, private colleges have closed in New England, in particular.

The regional banking crisis has had minimal impact on the overall muni market. Regional banks hold about 15% of all muni bonds. At this time, holdings from Silicon Valley Bank (SVB) and Signature Bank are being sold out of the banks' holdings as part of their restructuring. Bonds were purchased in the secondary market without a noticeable price impact. It is not clear if regional banks will consistently hold the same allocation to munis in the future and if this will have an impact on the market.

What is clear is that despite uncertainty in the macro outlook, we believe municipal bonds are very attractive investments, especially on an after-tax basis. Investors need to conduct detailed analysis to identify the right sector, coupon, maturity and other characteristics to find the best opportunities.



Endnotes

1. Source: ICE BofA Indexes, as of May 2023.

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All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested.

Because municipal bonds are sensitive to interest-rate movements, a municipal bond portfolio's yield and value will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the portfolio's value may decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value.

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