MUNICIPAL BONDS - SHELTER FROM THE STORM?

Owning financial assets that are expected to perform differently – both within and across market cycles – has long been a hallmark of well-constructed investment portfolios. As US and global equity prices have tumbled -30% or more from their mid-February highs, investors have taken some (perhaps cold) comfort that the adverse impact on their portfolio values has been muted by holdings in other securities and investment strategies.

Allocations to income-producing taxable or tax-exempt bonds typically form the core portion of most investors' lower risk assets. In most market environments, market prices of diversified pools of bonds vary within very narrow bands; the periodic interest income generated on such assets further dampens the variability of periodic (day-to-day, month-to-month) total returns. But these attributes do not necessarily mean positive returns when stock prices are falling or produce short-term returns that entirely meet expectations as rising levels of stress crop-up in the global financial system. This paper briefly summarizes how the COVID-19 crisis has stressed both taxable and tax-exempt fixed income markets before turning its focus on the risks and opportunities present in the municipal bond market. We will similarly address the corporate bond and mortgage-backed securities portions of the taxable bond market in a future analysis.

Three Weeks of Rising Uncertainty

The sharp downward re-pricing of US and Global Equities that began on February 20 and accelerated into March initially spilled-over into the lower-rated (*high yield)* corporate bond market during the first week of March. The investment grade (more creditworthy companies) corporate bond market then came under pricing pressures a week later. Neither outcome was wholly out of character for these two sub-asset classes. High yield bond prices typically follow equity market trends (in industry-speak, stock and high yield bond prices are highly correlated). And prospective economic weakness increases credit concerns, leading to wider credit spreads (lower prices) even on top-rated corporate bond issuers. Across just 22 trading days, spreads on lower rated and investment grade bonds rose +750 basis points (to a yield of 11.70%) and +173 basis points (to a yield of 4.50%), respectively. By way of contrast, yields on 10-year Treasury declined from 1.46% to 0.76% across the same period.

To date, the pace with which the US corporate bond market has priced-in credit concerns has been similar to (for investment grade) or more rapid (for high yield bonds, spreads on which rose *only* +500 bp immediately following the Lehman Brothers bankruptcy in September 2008) than those of the Global Financial Crisis (GFC). In the earlier crisis, spreads continued to widen (prices continued to fall) in both bond market segments until early- to mid-December. And although returns on high yield bonds offered no shelter from the equity storm across those three months, diversified high quality bond portfolios comprised of Treasuries, corporates, and mortgage-backed securities helped investors conserve their capital.

Prices in the municipal bond market continued to rise through March 9. But thereafter, chiefly due to illiquid market factors explored below, prices experienced their worst-ever short term price decline. Additionally, investors in muni bond ETFs (in which MCCA does not invest client assets) were exposed to extremely wide discounts (e.g., over 5%) of these funds' market prices to their underling portfolio net values (NAVs). No small wonder that investors at large – and some of our clients – expressed concerns about this portion of their portfolios. By way of context: an unmanaged benchmark of municipal bonds also declined precipitously across the same 22-day post-Lehman bankruptcy period in 2008 discussed above before fully recovering late in the year.

Municipal Bond Markets: The Now

The municipal bond market has long been regarded as one of the least efficient segments of US capital markets. Although large (over $4 trillion of total value; $1.5 trillion excluding smaller issues not readily tradeable), it is extremely fragmented (over 55,000 individual securities). It is also the least diversified market by end-buyer. As reflected in the table below, nearly three-quarters of all municipal bonds are owned by individual investors, either outright or inside mutual funds (including ETFs and Closed-End funds). Corporate bonds, which offer investors a similar investment profile (i.e., a fixed rate of interest, repayment of principal at a known maturity date) have a much broader constituency of buyers, including insurance companies, banks, and pension funds.

Ownership of Securities (12/2019)

	Municipal Bonds	Corporate Bonds
Households	45.7%	9.2%
Mutual Funds	26.8%	29.5%
Insurance Cos	12.0%	29.8%
Banks	11.6%	11.5%
Broker/Dealers	0.4%	1.5%
State + Local Govt	0.3%	1.8%
Pension Funds	0.0%	14.4%
All Other	3.2%	16.8%

source:
Federal Reserve "Financial Accounts of the United States"

Investor concentration only manifests itself as a source of elevated risk in times of widespread crisis. At such times, an imbalance of bond supply (sellers) and demand (buyers) results in widening price discounts at which the very few other buyers are willing to purchase securities. And as these discounts widen and bond prices fall further, more investors panic sell, worsening the cycle. Industry data indicates that outflows from muni bond mutual funds totaled $12 billion last week alone, a total that was the highest since data collection began (1992) and more than twice the prior record.

As cited above, the current municipal bond sell-off is in many ways a reprise of the GFC. Then, as now, the Federal Reserve stepping into markets to provide as much liquidity to as many segments of the capital market as require it (to assure their functioning) has been tempering muni bond price volatility this week. [Absent central bank intervention, muni fund investors had a still-worse scare in April 1987, when the SEC stepped in to permit fund companies to suspend redemptions for several days.] In 2008, selling pressures abated by mid-October (the 22nd trading day); by December 31 the municipal bond market had rallied +5.9% and fully recouped its losses to finish all of 2008 with gains (+4.2%), thereby redeeming its reputation as a "shelter in a storm" against an equity market that did not bottom for another 9 weeks.

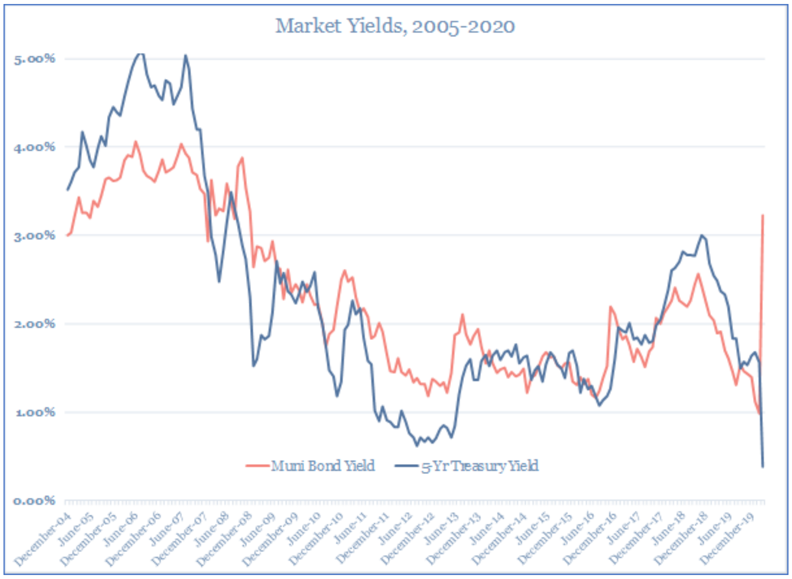
Municipal Bond Markets: The Near Future

Beyond the historical evidence that supports the idea that sharp price dislocations in the municipal bond market tend not to persist, the current relationship between muni bond yields and yields on comparable maturity Treasury securities is so far outside historic norms as to not be sustainable. For example, municipal bond yields are characteristically 15-25% lower than those on comparable maturity Treasury bonds (e.g., a muni bond maturing in 5 years may offer just 75-85% of the yield on a 5-Year Treasury). Net of the sell-off across the last two weeks, however, investors can now earn a massive yield premium on muni bonds. A 5-year AA-rated revenue bond currently yields 3.07%, nearly 10-times (or, nearly +2.70% higher) the yield on a 5-year Treasury (0.38% yield). Similar yield excesses across the entire municipal bond yield curve are expected to attract (traditional and non-traditional) buyers and, thereby, push up municipal bond prices.

Prospective Total Returns by Change in Market Yield

New Market Yield	3.50%	3.22%	3.00%	2.75%	2.50%	2.00%	1.50%
Yield Change	0.28%	0.00%	-0.22%	-0.47%	-0.72%	-1.22%	-1.72%
Return (Estimated)	-1.1%	0.0%	0.9%	1.8%	2.8%	4.8%	6.7%

Another compelling value proposition: the broad intermediate-maturity universe of muni bonds is now yielding 3.25%, **the highest such overall market yield since December 2008**. Were it not for investors' recency bias (the record negative returns of the past two weeks are a very fresh and bad memory), we suspect that many would be clamoring to add money to their municipal bond portfolios at these absolute and relative yields.



It would be somewhat reckless for investors to approach what appears to be an attractive risk/return tradeoff without giving some consideration as to what could go wrong or differently in 2020 in comparison to history. As they move beyond the immediacy of selling bonds (for clients needing to raise cash) or putting money to work at attractive prices in a re-liquifying the municipal bond market, our muni bond managers tell us that additional credit due diligence will need be paid to certain sectors and issuers in the municipal bond market. The economic impact of the COVID-19 crisis will create elevated financial stress on up to 20% of the market's sub-sectors. Issuers such as convention centers, student housing, ports and airports, retirement communities, and hospitals may face altered economics that exposes holders of their tax-exempt bonds to much greater risk than other segments of the muni bond market.

After what already seems like months and months of worries about the coronavirus' spread, about the economy slowing to a stop, and about investment portfolios in which there seemed little means of sheltering from the storm, the near-term outlook for investors' holdings of municipal bond securities seems – upon reflection and careful analysis – something about which to feel less concerned if not also somewhat optimistic.

Investment Strategy Group
Mill Creek Capital Advisors
March 24, 2020

DISCLOSURE