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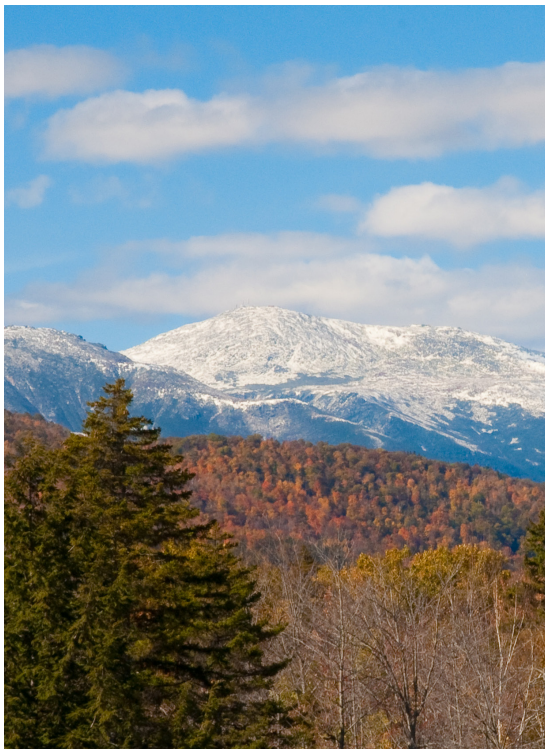
Tailwinds to headwinds: Navigating a shifting landscape in municipal bonds



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Key Takeaways

- Monetary and fiscal policy, financial stimulus, solid fundamentals, and low inflation drove a Great Compression among spreads between credit risk profiles over the last decade.
- Conditions are shifting, and what were once tailwinds may become headwinds for municipal bond issuers and investors.
- It is prudent for investors to consider how the changing winds of fiscal policy, monetary policy, and inflation will influence different risk profiles over the long term.

Mount Washington is the tallest mountain in the northeast United States and is notorious for its erratic weather. For 75 years, it was considered the windiest place on earth and recorded gusts of up to 231 miles per hour, which is equivalent to a Category 5 hurricane. On a typical day, depending on its direction, the wind can make your ascent either easier or substantially more difficult. Similarly, there are economic headwinds and tailwinds in the municipal market that can have the same impact on spreads. Over the past decade, strong tailwinds of easy monetary policy, abundant fiscal stimulus, and low inflation drove the market's required spread for credit risk tighter. In 2022, even after a meaningful sell-off in munis, credit spreads among risk profiles remain fairly compressed, even as tailwinds shift into headwinds.

For the better part of the last decade, the market acknowledged that credit risks lessened due to strong municipal balance sheets and consistent inflows. Amplifying external tailwinds, a lower overall yield environment perpetuated a hunt for yield that compressed credit risk spreads even further.

We've internally dubbed this post-Great Financial Crisis (GFC) environment the "Great Compression." However, many of those tailwinds are changing direction. Yet spread differentials remain relatively tight and merit longer-term consideration. In times like this, a high quality municipal bond portfolio built on independent forward-looking research can provide an additional measure of risk mitigation.

Intuitively, the spread between credit ratings is largely based on fundamentals, and admittedly fundamentals remain strong. However, while municipal balance sheets are resilient in the near term, it is prudent for investors to consider how the changing winds of fiscal policy, monetary policy, and inflation will influence different risk profiles over the long term.

As federal support moves out, predicting financial stress gets more complicated

As tailwinds become headwinds, credit spreads should more clearly distinguish between credits that are able to comfortably meet their future needs with internally generated resources absent fiscal policy support.

Federal action taken during the depths of the pandemic was unprecedented in regard to both breadth and magnitude. Local governments' self-sufficiency and long-term financial planning should be analyzed absent fiscal support.

The shift to less direct federal aid is happening at the same time the Federal Reserve (Fed) begins to transition into a tightening monetary policy cycle, with higher short-term rates and a decreasing balance sheet.

Inflation adds pressure to municipal planning

Of the shifting winds, inflation remains the biggest unknown with respect to the longevity of economic deterioration. In January, the Core Personal Consumption Expenditures Index rose 5.2 percent year-over-year (Y/Y), while the Core Consumer Price Index (CPI) rose 6.0 percent Y/Y. Inflation expectations are now the highest in decades. In a period of elevated inflation, municipal issuers would expect to see weakening of credit quality under multiple fronts including, but not limited to:

- Higher costs of necessary capital projects. Municipalities may choose to increase the amount of debt financing or draw down on cash on hand to absorb cost overages. Both options can ultimately begin to reduce credit quality over time.
- Wage pressures impacting day-to-day operations and resulting in higher pension liabilities due to increasing cost-of-living adjustments, where applicable.

- Revenue and expenditure mismatches among issuers subject to property tax caps. Property tax caps have the potential to limit a municipality's revenue-raising ability during a period of time when expenditures face no such limitations. This results in the need for additional revenues, reduced services, or reduction of reserves.
- Higher financing costs can delay sustainable long-term infrastructure projects in favor of short-term budget solutions.

While all issuers would be impacted, not all are equally equipped to navigate the changing landscape. Individual security analysis is required.

While it is important to acknowledge the inflation risks facing issuers, we also acknowledge the ongoing state of municipal finances. Thanks to a record influx of federal aid, many municipalities are in better shape than they were prior to the pandemic. However, this aid was not a long-term structural change and according to The National League of Cities almost 50 percent of all funding has been committed and budgeted.

The ability for the Great Compression to continue with these newfound headwinds would be an uphill battle, and the likelihood of a more profound decoupling among risk profiles is increasing.

Look back to frame future forecasts

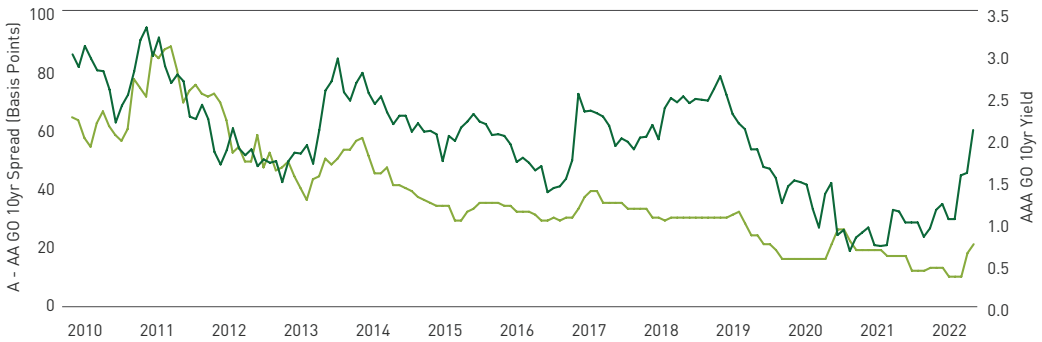
It is useful to examine historical data to consider how spreads changed post-GFC and where they may go post-pandemic.

The GFC ended in 2009 and municipal investors at that time required far more compensation for risk as many investors began to take sharper, differentiated views on underlying credit fundamentals rather than relying on insurance protection.

In 2010, as many markets focused on underlying credit fundamentals and continued to recover from the GFC, 10-year AAA municipal bonds traded in a wide range of 2.17 percent and 3.27 percent.[1]

While this is a higher range than current yields and may feel out of reach, the market is now just 8 basis points (bps) below the low end of this range, as of March 23, 2022. We are perhaps closer to post-GFC levels than the market appreciates. Nevertheless, despite the move in overall yields, credit spreads between risk profiles have not meaningfully adjusted for credit differentiation.

EXHIBIT 1: AAA GO 10-YEAR YIELD VS. A - AA GO 10-YEAR SPREAD



Source: Refinitiv TM3 as of March 23, 2022.

In 2010, the difference between 10-year AA and BBB municipals averaged nearly 170bps of additional spread. Coming into 2022, the spread was near the post-GFC tights of 45bps. While dramatic, we acknowledge the BBB market is a small percentage of the overall municipal market and highly concentrated. That said, in 2010, the difference between 10-year AA and A municipals averaged nearly 62 basis points of additional spread (see Exhibit 1). As 2021 came to a close, that spread was near post-GFC tights of 10bps.

Over the first two months of 2022, the market experienced significant uncertainty that sparked an emerging spread decompression. Even prior to Russia's invasion of Ukraine in late February, the markets were reacting to a more hawkish Fed, dramatically increased inflation expectations, and fiscal policy taking a back seat to geopolitical unrest.

Against this backdrop yields quickly moved higher as measured by AAA-rated municipal securities, spiking 105bps. The change in spread between AA-rated and BBB-rated GO municipal bonds during this selloff was more subdued. Year-to-date through March 23, 2022, spreads increased by only 10bps, now currently at 55bps. The spread between A-rated and BBB-rated GO munis has increased only 2bps. And, looking at more diversified rating categories, changes in the A to AA and AA to AAA spreads have been minimal, widening by 8bps and 9bps respectively.

The persistent tailwinds that contributed to the Great Compression eroded the premium investors required for risk. While periods of strong external support and strong balance sheets can be an advantageous environment to reasonably stretch for yield, navigating the reversal thereof is aided by independent fundamental credit research. Intentional decoupling from a tailwind mentality to traverse through the municipal market's developing headwinds is paramount to the success of today's municipal bond managers.

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FOOTNOTES:
1. All yield and spread data in this article is per Refinitiv TM3 as of 3/23/22.