Municipal Bonds

Unwavering Demand


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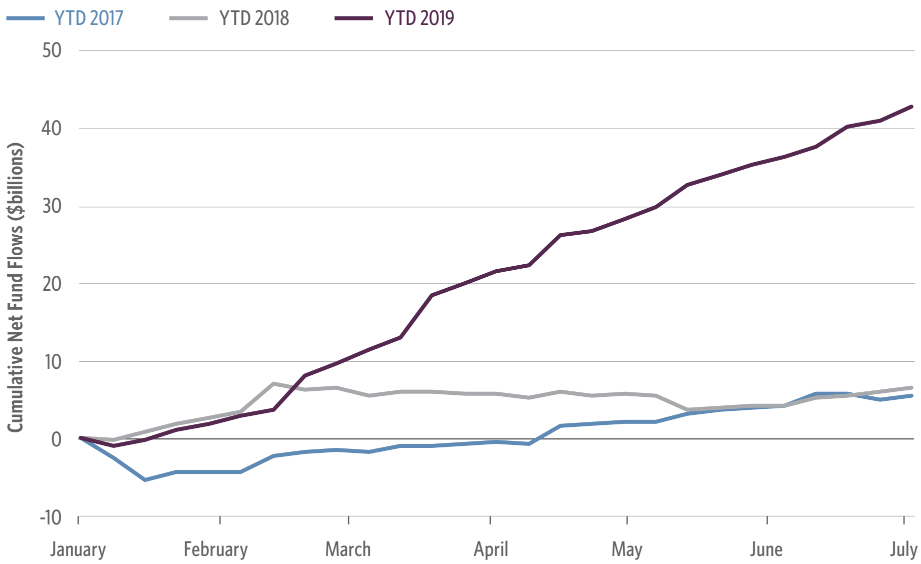
Negative credit headlines did not diminish investor appetite for municipal bonds.

Municipals performed well as a safe-haven asset class amid geopolitical and trade tensions, modest economic data, and dovish Fed policy expectations. In the second quarter of 2019, tax-exempt municipal bond yields rallied, prompting spreads and municipal-to-Treasury yield ratios to reach new multi-decade rich levels. In the second quarter, 10-year and 30-year municipal-to-Treasury ratios averaged 76 percent and 89 percent, respectively, below the previous quarter's averages of 80 percent and 98 percent. For the year-to-date period ending July 10, Lipper reported 27 consecutive weeks of net fund inflows amounting to a record-setting $48.8 billion (see chart, top right).

We expect this year's theme of supportive supply-demand dynamics to continue through the summer as the municipal market experiences seasonal negative net supply. According to Citigroup, investors can expect an influx of $185 billion of returned capital (i.e., coupon payments, calls, and bond maturities), which would surpass the three-year trailing average of approximately $167 billion. At the current pace of only $28 billion of monthly new issue supply, municipal investors may face a challenging reinvestment environment. Issuers continue to enjoy favorable borrowing conditions in terms of costs, covenant provisions, and even coupon structures. For example, issuance of sub-5 percent coupon bonds increased to a record high of 46 percent of total supply, up from 38 percent in 2018; these lower coupon bonds offer much less liquidity because of possible negative tax consequences, unique to tax-exempt bonds, in a rising rate environment.

Meanwhile, investors' unwavering demand was epitomized by idle reactions to negative credit headlines. Most notably, the U.S. First Court of Appeals upheld a ruling that upended a key structural protection of special revenue bonds, which account for roughly two-fifths of the outstanding municipal bond market. The Court ruled that debtors are permitted, but not required, to make debt service payments during bankruptcy proceedings, which would provide a form of automatic stay protection from bondholders. Subsequently, Moody's and Fitch highlighted 13 issuers vulnerable to downgrades, but this action did not precipitate any unusual pricing volatility (see chart, bottom right). Although low volatility has permeated most asset classes including municipals, we did not envision that such highly visible tail risks would be largely ignored. While municipal buyers' risk tolerance continues to grow, investors should take the opportunity to shift portfolios to higher quality when possible.

Cumulative Municipal Fund Inflows Hit a Record High of $48.8 Billion in July



Source: Guggenheim Investments, JPMorgan, Lipper. Data as of 7.10.2019.

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Investors Shrugged Off Court Ruling That Could Freeze Debt Service Payments

Source: Bloomberg, Moody's, Fitch. Data as of 7.19.2019. *Basket includes 10 issuers vulnerable to rating downgrades related to potential treatment of special revenues bonds, as highlighted by Moody's and Fitch.

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