Municipal Bonds

Strong Demand


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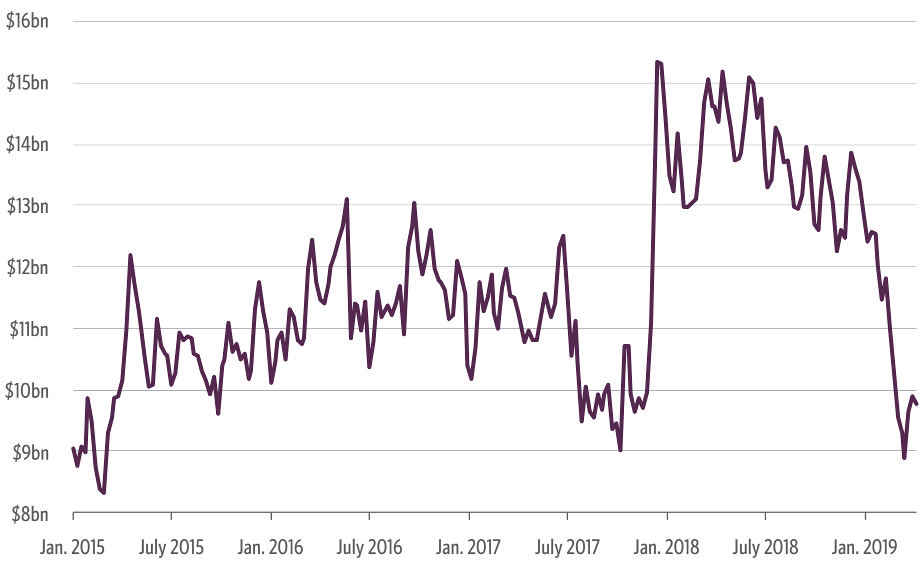
The rally in credit, retail demand, and subdued supply have tightened municipal bond spreads to historically rich levels.

At the end of the first quarter, 10-year and 30-year municipal-to-Treasury ratios were lower only 1 percent and 16 percent of trading days since 2000, respectively. Households, which represent 67 percent of the total market, according to SIFMA, prefer shorter maturities, which exacerbated the bull steepening of the tax-exempt AAA-rated benchmark curve. Further supporting performance, supply remained subdued as the municipal market contracted for the fourth straight quarter. Potential supply catalysts, such as federal infrastructure programs or the return of advanced refundings, have been met by cynicism and/or extended timelines.

Much of the municipal bond market frothiness was attributed to the inaugural year of the Tax Cut and Jobs Act's limit on state and local tax (SALT) deductions for individuals. In fiscal year 2017, nearly 11 million taxpayers deducted a total of $323 billion of SALT payments, deductions they would not have been able to take under the new rules that came into effect in fiscal year 2018. According to Bank of America Merrill Lynch, effective tax rates for top earners in California are expected to be 5.8 percentage points higher, on average, which considerably enhances the value proposition of tax exemption. Instead of typical seasonal outflows, the municipal market produced the highest volume of first quarter net inflows since Lipper began compiling the data series in 1992, reflecting heightened appetite for tax-exempt income. The surge in fund flows helped to drive dealer inventories to the lowest level since March 2015 (see chart, top right).

Undeterred by a broad range of hiccups and headwinds to credit fundamentals, tax-exempt muni spreads have compressed to historically tight levels with the lowest volatility since 2015 (see chart, bottom right). Spreads for 10-year A-rated and BBB-rated tax-exempt bonds reached 36 basis points and 70 basis points, respectively, the tightest levels in over a decade. Unrelenting spread compression in recent years suggests the municipal market has become increasingly reactive to moves in the Treasury market than to the credit profile of individual issuers. In a more adverse credit environment, we expect the market to return to reflecting individual credit fundamentals in valuations.

Dealer Inventories Declined Sharply in Q1



Source: Guggenheim Investments, Federal Reserve Bank of New York. Data as of 4.23.2019.

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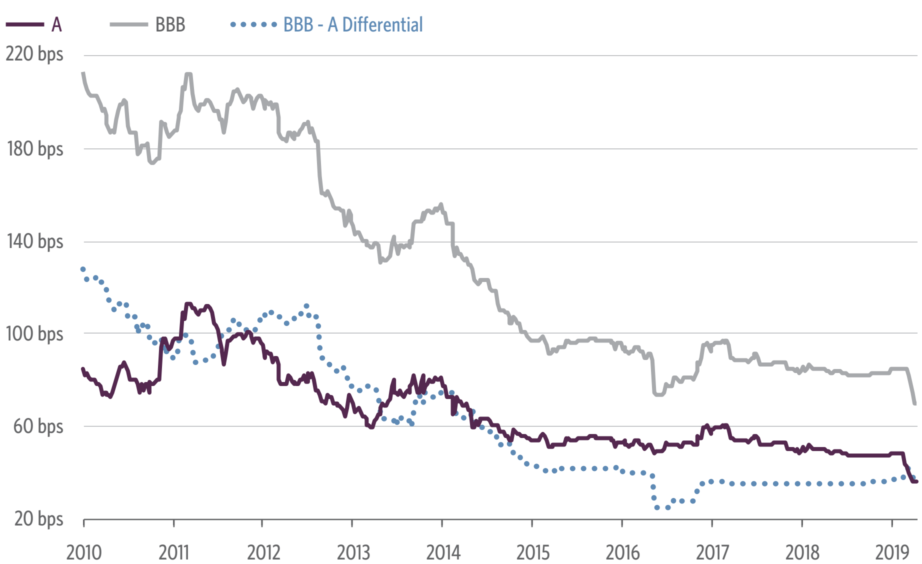
Tax-Exempt Muni Spreads Have Contracted to Historically Tight Levels



Source: Guggenheim Investments, Thomson Reuters. Data as of 4.23.2019.

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