GUGGENHEIM

Municipal Bonds

Managing Through a Slowing Credit Cycle

Technical support may not be enough to sustain municipals' momentum as the economy slows.

Municipal credit fundamentals have improved for the last three years, thanks to double-digit growth in income taxes and sales taxes, but these tailwinds are unsustainable, and we see signs that the upswing in the municipal credit cycle is nearing its end. Some states have reported a decline in tax receipts and lowered revenue estimates as a result of the cooling economy. Counterintuitively, another sign that the credit cycle is nearing its end is the recent rating upgrades for high beta states Illinois and New Jersey. High beta credits such as these are the last to get upgraded in an upcycle because of their checkered histories—volatile revenue performance, inconsistent fiscal management, rating agency skepticism, etc.—and the first to get downgraded going into a downcycle for the same reason.

Nevertheless, tax exempt municipals have started strong in 2023 after a rollercoaster ride over the last year. Tax exempts returned 4 percent year to date through mid-April and have moved into positive territory on a trailing 12-month basis. Technical support played a big role in this performance. Tax exempt mutual funds experienced outflows for most of the quarter, but these outflows were offset by a 24 percent decline in new issuance through the end of March. Municipal obligors, dealing with both record tax receipts and unspent pandemic stimulus funding, have been reluctant to access the public markets. While seasonal factors should drive issuance higher going into the summer months, those same factors also increase principal and interest payments that are reinvested in the municipal market, buffering the impact from new deal volumes. Secondary trading conditions remain orderly as there are few signs of selling pressure. For example, dealer holdings of bonds maturing beyond 10 years have declined 25 percent versus the prior year and stayed well below the five-year average for most of the last 12 months. Bid wanted volumes—a barometer for mutual fund liquidity needs—declined by as much as 52 percent year-over-year during some days in March and April.

Due to positive technical support, the ratio of tax-exempt yields to Treasury yields has stayed rich—for example, the 10-year ratio is 68 percent, the low end of the 12-month range of 60–105 percent. Amid signs of a slowing credit cycle, we advise caution. In this environment, tax exempt investors should remain focused on reducing negative convexity while upgrading into higher-quality bonds.

By Allen Li and Michael Park

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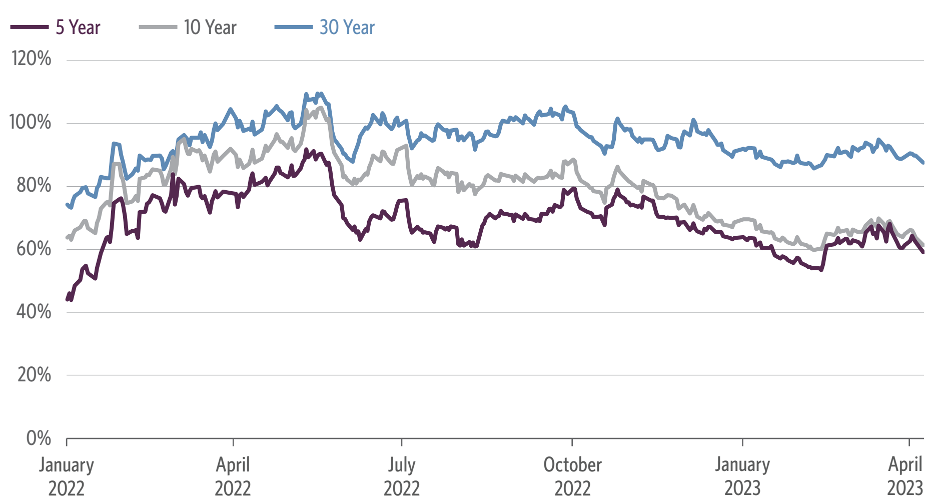
Lack of Muni Issuance Has Supported Sector Richness Relative to Treasurys

Tax Exempt Yield/Treasury Yield Ratios



Source: Guggenheim Investments, Bloomberg. Data as of 4.11.2023.

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