

PUBLIC FIXED INCOME

Taxable Municipals

Market Review and Outlook

September 30, 2021

Taxable Municipals navigated calmly and steadily through the rate volatility and the Fed policy uncertainty in the third quarter. The OAS on the Bloomberg U.S. Aggregate-eligible Taxable Municipal Index drifted within a narrow range of five basis points and ended the quarter two basis points wider at 87 basis points—just two basis points off the year to date and historical tightness of 85 basis points. For the quarter, the index posted a total return of 0.40% and an excess return of 0.17% relative to duration-matched Treasuries. This compares to an excess return of -0.15% for the Bloomberg U.S. Corporate Index. Revenue bonds outperformed GOs, with excess returns of 0.29% and -0.07%, respectively.ⁱ The steady performance in Taxable Municipals can be attributed to a combination of factors that include the constructive credit outlook for Municipals, modest issuance of Taxable Municipals (\$33.6 billion in the quarter including municipal issuers with corporate CUSIPs),ⁱ and the strong demand for high quality long duration assets in the global reach for yield.

Municipal Market Dashboard*

	9/30/2021	6/30/2021	Change
10-Year U.S. Treasury	1.49%	1.47%	0.02%
30-Year U.S. Treasury	2.04%	2.09%	-0.05%
Bloomberg Aggregate Eligible Taxable Muni Index OAS (bps)	87	85	2
Bloomberg U.S. Corporate Index OAS (bps)	84	80	4
Quarterly Taxable Municipal Issuance (\$Bn)**	\$34	\$37	-\$3

* Bloomberg

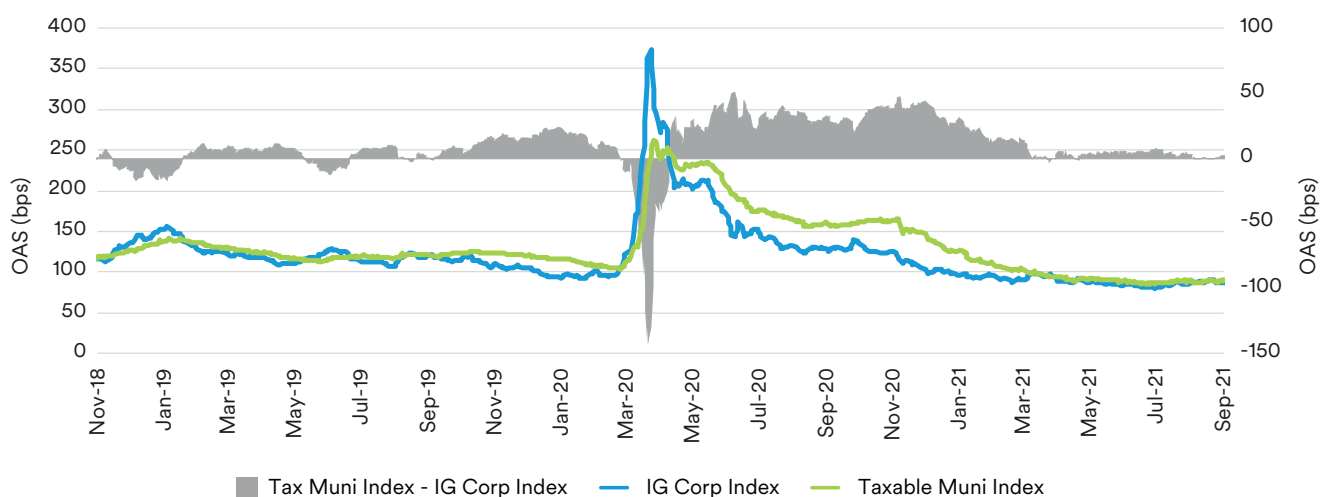
** J.P. Morgan. Includes Municipals issues with corporate CUSIPs.

Year to date, the OAS on the Taxable Municipal index tightened 40 basis points, resulting in excess returns of 5.45%.ⁱⁱ Taxable Municipals significantly outperformed investment grade corporate on a year-to-date basis, in large part due to the fact that the OAS on the Bloomberg U.S. Aggregate-eligible Taxable Municipal Index started the year 31 basis higher than the Bloomberg U.S. Corporate Index as very heavy new issue supply of Taxable Municipals in the fourth quarter of 2020 weighed on spreads.ⁱⁱⁱ For context, the average spread difference between the two indexes over the last three years is 14 basis points.^{iv} In terms of issuance, the supply of Taxable Municipals stands at \$98.5 billion through the end of the quarter. This trails the record year of taxable issuance in 2020 by 26%, driven by a decline in taxable advanced refundings of tax-exempt debt.^v Still, taxable issuance year-to-date is multiples higher than the average full-year issuance of Taxable Municipals over the previous five years. While we believe that the market has the capacity to efficiently absorb substantially higher supply, we view annual issuance above \$100 billion as a favorable outcome in terms of adding depth, liquidity, and opportunity to the Taxable Municipal market. Further, we strongly believe that taxable Build America Bonds (or equivalent) should be reinstated as part of President Biden's Build Back Better infrastructure plan.

Tax-exempt Municipals experienced somewhat of a correction in the quarter from historically rich levels, as the move higher in rates in September slowed the relentless inflows into tax-exempt funds. Ratios of AAA-rated tax-exempt municipals to Treasuries climbed well above the year-to-date lows, although they remain rich in a historical context. For example, the 10-year closed the quarter at 76%, which is sharply higher than the low of 54% set in February but still well below the three-year average of 91%.^{vi}

Low rates and tight spreads will likely prove challenging for returns in the fourth quarter, with Taxable Municipal spreads just two basis points off the historical tightness as of September 30th, and with rates on the 10-year still 26 basis points below our year-end target of 1.75%. Cross-market valuations indicate that Taxable Municipals are somewhat rich. As shown in figure 1, the Bloomberg U.S. Aggregate-eligible Taxable Municipal Index is only three basis cheap relative to the Bloomberg U.S. Corporate Index, as compared to the three-year average of 14 basis points.^{vii} Also, the confluence of important policy deadlines in December, which include the debt limit and the expiration of government funding, could lead to increased anxiety in the final days of the year and limit the market's appetite to add risk. Accordingly, the path of least resistance through the end of the year is for spreads to drift modestly wider, in our view. We are positioning to nudge down risk in the portfolio with an increased allocation to Treasuries and a lower beta relative to the index. At the same time, we reason that any spread widening in Taxable Municipal spreads is likely to be modest, particularly if rates gravitate toward our 1.75% forecast as sudden rate backups are consistently being met with renewed interest from yield buyers, both domestic and overseas. Also, our fundamental outlook for Municipals remains constructive. Declining COVID cases and a well-telegraphed Fed taper leave no clear catalyst to derail that outlook through the end of the year. We are prepared to be buyers of high-quality Taxable Municipals on a temporary backup in spreads.

Figure 1 | Taxable Municipals relative to Investment Grade Corporates



Source: Bloomberg

Endnotes

- i Bloomberg
 - ii Bloomberg
 - iii Bloomberg
 - iv Bloomberg
 - v J.P. Morgan
 - vi Bloomberg
 - vii Bloomberg
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² As of June 30, 2021. Includes all public fixed income assets managed by MIM. estimated fair value. Includes MetLife general account and separate account assets and unaffiliated/third party assets

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