

PUBLIC FIXED INCOME

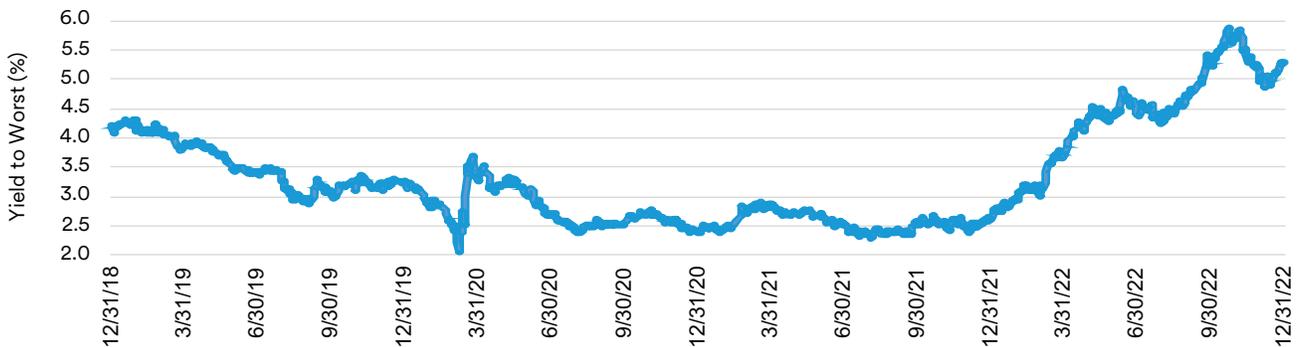
# Taxable Municipals

## Market Review and Outlook

December 31, 2022

The tide of higher rates, wider spreads, and negative returns finally turned in the fourth quarter (at least for now). Consecutive below-consensus CPI prints signaled that peak inflation may be in the rearview mirror, and that the Fed's campaign of aggressive rate hikes may soon be over. The perceived decline in policy uncertainty triggered a sharp increase in risk appetites. Both rates and spreads hooked lower, which helped quarterly returns turn positive for the first time this year, though not nearly enough to undo the damage from 425 basis points of cumulative rate hikes. The Bloomberg Aggregate-Eligible Taxable Municipal index returned 1.45% in the fourth quarter. While rates finished the quarter modestly higher, this was more than offset by tighter spreads and the carry from the highest yields on the index since 2011 (the index yield-to-worst peaked at 5.86% in late October). For the entire year, the index was down 18.1%. Relative to duration-matched Treasuries, the index posted an excess return of 1.43% in the fourth quarter and -1.77% for the entire year.<sup>1</sup>

Figure 1 | Yield on Bloomberg Aggregate Eligible Taxable Municipal Index



Source: Bloomberg



The fourth quarter continued to bring extreme volatility in rates as markets digested each new macro data point to divine the future path of Fed policy. The 30-year Treasury surged 60 basis points higher in the first three weeks of October, then sharply reversed course after the October CPI report, collapsing 95 basis points to the December low of 3.43%. The net increase for the quarter was only 18 basis points but the path to get there was far from direct. For the year as a whole the intra-month volatility seems like noise in context of the sharp upward climb of the 30-year Treasury from 1.90% on December 31, 2021 to 3.96% on December 30, 2022. Taxable Municipal spreads largely tracked rates in terms of both direction and magnitude. As rates climbed higher, investors demanded ever wider spreads to catch the proverbial falling knife of a long duration asset. However, as conviction in the narrative of peak rates increased, the appetite for high quality long duration assets at the highest yields in over a decade surged. The OAS on the Bloomberg Aggregate Eligible Taxable Municipal index peaked at 147 basis points on October 31st then rallied sharply with rates through the end of the year to close at 128 basis points – 11 basis points tighter for the quarter.<sup>2</sup>

The decline in rates from the peaks in October also set the stage for a rally in tax-exempts, which until then had been hammered by the largest outflow cycle in history. Fund flows historically have a strong negative correlation to the direction of rates as well as the magnitude of change. Accordingly, the inflection in rates raised expectations for a normalization in fund flows that would boost valuations. The other main driver was yield. On October 31st, the yield on the AAA BVAL tax-exempt curve in 30 years was 4.11%. That translates to a taxable-equivalent yield of almost 9% for individuals in high tax brackets. That's 9% for a AAA asset. Not surprisingly, at the first sign that the pain of ever rising rates may have stopped, valuations for tax-exempt securities snapped sharply higher. For example, the ratio of the BVAL AAA tax-exempt curve to Treasuries in 10 years plummeted from 85% to 68% in the quarter – well below the 5-year average of 88%. This translated to a quarterly return of 4.10% for the broad Bloomberg Municipal Bond index and a return of 3.05% for the Bloomberg 5 year (4-6) Municipal Bond index.<sup>3</sup>

**Figure 2 | BVAL AAA Municipal Yield as of Percentage of 30 Year Treasuries**

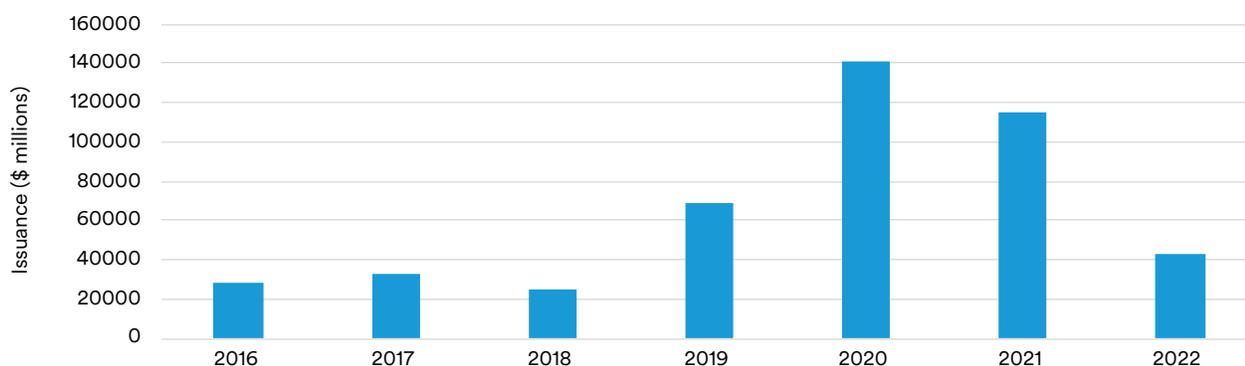


Source: Bloomberg

In our view, tax-exempt valuations now look extremely unattractive to investors subject to corporate tax rates. When the retail buyer is buying, it simply is not a fair fight for the corporate investor. Prices are being set by individual investors with much higher combined federal and state tax rates, and thus with a much larger benefit from the tax exemption. The longer end of the tax-exempt curve has lagged the magnitude of the rally in the more retail-focused 10-year part of the curve. This is because the primary buyers of long tax-exempts were either still experiencing outflows (mutual funds), or they got priced out by frothier valuations (insurance companies, banks, cross-over buyers). The 30-year ratio fell from 104% to 91%, ending the quarter modestly below the historical average of 98%.<sup>4</sup> At these levels, while not as rich as tax-exempts inside 10 years, we think the window of opportunity in long tax-exempts has largely closed for corporate investors, as taxable-equivalent yields no longer look nearly as compelling relative to taxable alternatives.

Total Municipal issuance totaled \$380 billion in 2022, which was down 21% compared to 2021. Disappointingly, Taxable Municipals were responsible for the bulk of the decline with a total of only \$57.8 billion issued including \$10.0 billion of Taxable Municipals with corporate CUSIPs. Year-over-year, Taxable new issuance declined by over 50% as significantly higher rates eliminated the opportunity to refund outstanding tax-exempt bonds with new taxable bonds.<sup>5</sup> Taxable advance refundings had represented a large share of Taxable Municipal issuance since Tax Reform. With a sharp rally in tax-exempts that should continue as fund flows stabilize or turn positive, we expect that municipal issuers will gravitate to the tax-exempt market to lock in the lowest cost of funds on new issues. Until and unless longer rates decline meaningfully, potential advance refunding transactions with taxable bonds are likely to remain out of the money for issuers and as such, the supply of these transactions is likely to remain depressed in the near term. Our estimate for Taxable Municipal issuance in 2023 is \$60 billion – similar to 2022 but well below the \$179.5 billion in 2020 and the \$139 billion in 2021.

**Figure 3 | Taxable Municipal Issuance**



Source: Bloomberg

We expect 2023 to be a much better year for Municipal returns. Admittedly, the bar was set exceedingly low in 2022. Our base case assumes that inflation continues to trend lower toward the Fed's 2% target and that the Fed hikes rates early then stays on hold through the rest of the year. We think the lagged and variable impact of 425 basis points (and counting) in rate hikes will start to crack the labor market and tip the economy tips into recession in the second half of the year. This is not necessarily bad for Municipals, a high quality asset class that typically performs well in weaker macro environments.

For Taxables, we expect wider spreads by the end of 2023. The starting point for valuations is not particularly attractive at an OAS of 128 basis points on the Bloomberg Aggregate Eligible Taxable Municipal index.<sup>6</sup> This is only three basis points wider than the average over the last five years.<sup>7</sup> We think Taxable Municipals will take cues from the larger and more liquid investment grade corporate market when the coming recession presents a more clear and present danger. Those cues will be in the form of wider spreads. However, we think the move wider in spreads will likely be capped at 145 basis points – about 20 basis points from current

levels and slightly below the recent peak of 147 basis in October. We expect Taxable Municipal spreads to hold in considerably better than investment grade corporates as the market starts to price in a recession for three primary reasons: the higher credit quality of the Taxable Municipal index (the average rating the broad Bloomberg Taxable Municipal index as of December 30th is Aa3/AA)<sup>8</sup>; favorable technicals based on our estimate of only \$60 billion of Taxable supply in 2023; and very solid municipal fundamentals heading into 2023. This will translate to significantly better excess returns for the Taxable Municipal index relative to the Investment Grade Corporate index, in our view.

In order to achieve positive returns, we expect that wider spreads will be offset by lower rates. We see the market narrative shifting from one of a soft landing and rate cuts in 2023 (Fed Funds Futures are pricing in almost two rate cuts in the second half of 2023)<sup>9</sup> to one that includes a recession and a Fed on hold as sticky inflation pressures push out the timeline to achieve the Fed's 2% target. In that scenario, we envision significant

further inversion in the 2s/10s curve as short rates unwind cuts currently priced into Fed Fund Futures while the longer end of the curve gets pushed lower by a flight to safety and expectations of rate cuts in the future. Another factor supporting returns will be the carry from an index yield of 5.29% as of December 30th, 2022.<sup>10</sup> By comparison, the starting point for yields was only 2.60% in 2021 and 2.39% in 2020.

Volatility will likely continue to be part of the script in 2023, which should create plenty of opportunities and better entry points for Municipals. One possible catalyst for volatility is resolution of the debate on recession and rate cuts. The market right now seems to be pricing the average of the two outcomes – but it has to be one or the other. There will be either a soft landing or a recession. The Fed will start cutting rates this summer or it won't. If we are correct that a recession is likely in 2023 but rate cuts are not, markets will reprice wider and this is likely to be noisy. Another potential catalyst is the possibility that something breaks (the unknown unknown) under the weight of massive rate hikes in such a short period of time. We hesitate to guess precisely what could break in 2023 but we do find ourselves asking, what are the chances that something doesn't break? Said differently, how likely is it that the outcome of a lightning quick transition from extreme accommodation to extreme tightening is something that resembles normal? We think not likely – keep some dry powder for opportunities in 2023.

### Endnotes

<sup>1</sup> Bloomberg

<sup>2</sup> Bloomberg

<sup>3</sup> Bloomberg

<sup>4</sup> Bloomberg

<sup>5</sup> Bloomberg

<sup>6</sup> Bloomberg

<sup>7</sup> Bloomberg

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<sup>10</sup> Bloomberg

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