Capital Group

Municipal bond market update: Recent volatility may create longer term value

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CAPITAL GROUP®

Investment insights
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Municipal bond market update: Recent volatility may create longer term value

Greg Ortman, investment director, municipal bond strategies

Neil Amirtha, investment product manager, municipal bond strategies

Aditi Gupta, investment specialist, municipal bond strategies

Key takeaways

- Yields for municipal bonds moved above those of comparable taxables – even without factoring in potential tax advantages.
- The market selloff appears to be driven by investors raising liquidity, rather than stress among issuers.
- Emphasizing higher quality municipals appears prudent for now, but we're seeing compelling value develop across sectors.

Fixed income markets have been extremely volatile in recent weeks. U.S. Treasury yields across the curve moved materially lower with unprecedented speed. In addition to the intense volatility, U.S. Treasuries – usually one of the world's most liquid markets – have seen a marked deterioration in liquidity.

Municipal bonds typically yield less than Treasuries, but that relationship has flipped. Treasury yields have moved lower than AAA-rated municipal bonds of comparable maturity. Ratios of municipal bond yields to U.S Treasury yields have reached levels not seen since the financial crisis.

Municipal bond credit spreads have also been volatile. The flight-to-quality at the onset of market volatility related to COVID-19 initially pushed spreads tighter. However, BBB-AAA municipal spreads soon reversed course and widened to 149 bps as of March 20. Liquidity conditions tightened and investor sentiment took a turn for the worse in early March – ending a 60-week-long period of inflows of investor money into municipal bond funds.

Selling was widespread across all sectors and maturity segments as investors looked to raise liquidity wherever they could. A combination of higher base rates and increases in credit spreads have led municipal bonds to lag Treasuries.

Despite this underperformance, municipal bond spreads have not widened as much as corporate spreads. As of March 20, year-to-date returns for the Bloomberg Barclays Municipal Bond Index and Bloomberg Barclays High Yield Municipal Bond Index were –7.53% and –15.35%, respectively. In comparison, the Bloomberg Barclays U.S. Corporate Index and Bloomberg Barclays U.S. Corporate High Yield Index recorded returns of –10.58% and –18.11%, respectively.

While volatility may well continue in the near term, these market moves are creating favorable longer term value. Municipal bond yields now look very attractive on a nominal and after-tax basis. Broadly, investment-grade municipal bonds are out-yielding the Bloomberg Barclays U.S. Aggregate Bond Index and, indeed, investment-grade corporate bonds. High-yield municipals also offer attractive yields on a risk-adjusted basis.

We should have greater clarity on the likely impact of COVID-19 on state and local municipalities in the coming weeks. Social distancing is becoming more prevalent, resulting in the closure of local businesses and cancellation of events.

Further impacts to local economies and, therefore, municipal credit may be felt if economic activity is paused too long and unemployment starts to increase. We expect muni credit quality to deteriorate for one or two quarters and then rebound.

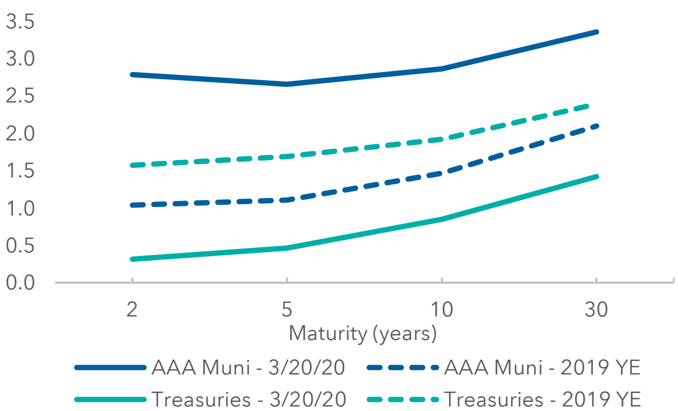
Municipal bonds have, historically, been a resilient asset class offering lower volatility, low default rates, low to negative correlations to equities, and attractive tax-exempt income.

The market selloff appears to be driven by investors raising liquidity and is not a result of issuers experiencing imminent funding stress. That said, we believe it's prudent for investors to maintain a higher quality positioning in this market environment. Exposure to municipal bond duration also appears attractive as ratios will likely normalize over time.

Some investment managers that had been comfortable taking on significant credit risk in the past year to earn only incrementally higher bond yields may face elevated redemptions.

In contrast, we think current market volatility will present many attractive opportunities for risk-aware active investors like Capital Group. The municipal bond market is broad and diverse, and our analysts are already beginning to identify compelling value across sectors.

Yield curves (%)



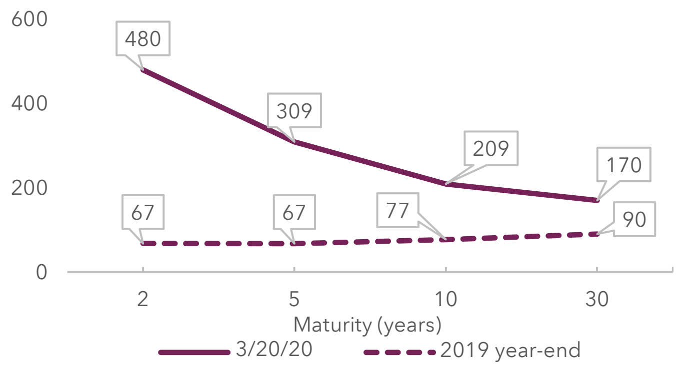
Change in yields (bps)

Maturity (years)	2	5	10	30
Munis	+174	+155	+140	+126
Treasuries	–126	–123	–107	–97

Comparative yields

	Yield to worst (%)	Tax-equivalent* YTW (%)
IG Muni	3.51	5.93
HY Muni	6.13	10.35
US Aggregate	2.18	
IG Corporate	4.58	
HY Corporate	10.93	

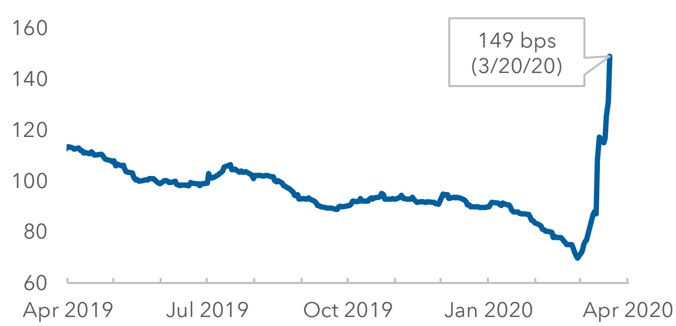
Muni/Treasury ratios (%)



Change in ratios (%)

Maturity (years)	2	5	10	30
	+412	+242	+132	+80

BBB-AAA municipal spreads (bps)



*Tax-equivalent yield: Highest tax rate assumes the 3.8% Medicare tax and the top federal marginal tax rate for 2019 of 37%.

Source: Bloomberg & Morningstar Direct. Data as of 3/20/2020. Index proxies: Bloomberg Barclays Municipal Bond Index (IG Muni); Bloomberg Barclays High Yield Municipal Bond Index (HY Muni); Bloomberg Barclays U.S Aggregate Index (US Aggregate); Bloomberg Barclays U.S. Corporate Index (IG Corporate); Bloomberg Barclays U.S. Corporate High Yield Index (HY Corporate).

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