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Municipal Bonds | Outlook

2023 Investment Outlook: Municipals

By: EV Forward | December 14, 2022

Technicals, Technicals, Technicals

KEY POINTS

1. Technicals, technicals, technicals are the three most important factors driving the market for municipals.
2. Having mostly ignored the Fed in 2022, the market needs to pay more attention to what policymakers do in 2023.
3. As a high-quality, duration-driven asset class correlated to U.S. Treasurys, munis could outperform in a recession.

What We Are Seeing

When we look at the investment landscape, what we see — in aword — is *undervalued:* While all fixed income asset classes realized negative total returns in 2022, municipals enter 2023 at historically low valuations.

After fourth-quarter tax loss selling subsides with the start of a new calendar year, we expect net flows into the municipal asset class in January.

With very low issuance providing fewer bonds to trade in the secondary market, unless issuance increases in January, a turn of flows from negative to positive could quickly push up valuations of municipals early in the year. Strong technicals are likely to drive outperformance in the first quarter.

If we think about factors that others may overlook, we would note that most market participants agree that municipals should outperform in 2023.

We consider munis attractive relative to other asset classes on an *after-tax basis*; with the Bloomberg Municipal Bond Index yielding 3.61% as of November 30, and assuming a top federal tax rate of 40.8% (including the tax on net investment income), the muni index yields 6.10% versus the Bloomberg U.S. Corporate Bond Index yield of 5.36%

In addition, the corporate index has 48.9% exposure to BBB credit, while the muni index has only 6.3% exposure to BBB, so munis could outperform even more if expectations of a U.S. recession materialize in 2023.

What We Are Doing

For our positioning in high-quality duration, we are moving from an underweight in 2022 to an overweight in 2023. After duration generally underperformed credit in 2022, and given the potential for a U.S recession in 2023, we are generally structuring our portfolios for a rally in duration assets with high credit quality.

Among sectors that present opportunities in such a *flight to quality* environment, high-quality general obligation bonds or dedicated tax-backed and essential service sectors —such as water and sewer and higher education — may outperform.

Airport bonds, whose coupon payments are exempt from federal income taxes but not from the federal alternative minimum tax (AMT), are the most attractive sector on a valuation basis in our view.

In the lower-rated part of the market, credit selection will be particularly important in a potential recessionary environment. With careful analysis, we believe certain hospitals and healthcare systems could be opportunities in a sector that we expect to underperform overall.

What We Are Watching

The biggest challenge is managing unexpected interest rate moves across fixed income. Although we have high conviction that technical factors in the municipal market will be positive in 2023, there is clearly risk given the uncertainty around interest rates driven by Federal Reserve policy.

We are watching our duration risk versus our peers very carefully in 2023.

Beyond the widely cited market forces at play, we believe that technicals are especially critical for munis.

Overall, the fixed income market's outlook is generally inconsistent with communications from Fed policymakers. In our opinion, to get more clarity and confidence in the 2023 outlook, what will be most important would be for fixed income markets to align with the Fed's policy message.

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Bloomberg Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

Bloomberg U.S. Corporate Bond Index is an unmanaged index that measures the performance of corporate securities issued in the U.S.

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