Municipal Bonds

What to Make of Recent Volatility in the Muni Market?

By: Evan Rourke, CFA | October 20, 2021

New York - If you were paying attention to the municipal bond market in 2021, you may have observed a drop in yields (and a corresponding rally in prices) at the end of the second quarter that continued into the third quarter. Depending on maturity, Treasury yields reached quarterly lows on either August 3 or 4. From there yields rose again modestly, then picked up momentum following the Federal Open Market Committee meeting in September.

To many investors, this V-shaped uptick in yields looked like another *V* word: volatility. And many investors responded to it the way they often do when volatility strikes: emotionally. But we think it's important to keep two things in mind: First, even if this were evidence of volatility in the muni market, it's important to avoid overreacting. That's when investors tend to make mistakes. And second, what if this isn't volatility at all? While it's possible the recent sell-off is the beginning of something larger, it's also possible the market is simply returning to a familiar equilibrium. We think the data may bear this out.

As we begin the fourth quarter, it's striking to see how little Treasury yields have changed since the end of the second quarter, as the first table shows:

Date	5-year Treasury yield	10-year Treasury yield	20-year Treasury yield	30-year Treasury yield
6/30/2021	0.89	1.47	2.03	**2.09**
9/28/2021	1.02	1.54	2.04	**2.10**
Net change	**0.13**	**0.07**	**0.01**	**0.01**

Source: Bloomberg, 9/28/2021

We think what drove the rally in bond prices in early August were concerns about the potential economic impact of the coronavirus's Delta variant. As those fears have begun to ease, the focus has shifted to Fed tapering and the future normalization of short rates, resulting in a mild bear flattening of the Treasury yield curve.

As the second table shows, munis look to have underperformed Treasurys in the third quarter, with yield rising and the curve steepening. Muni yields are taken from the Municipal Market Data (MMD) AAA Curve:

Date	5-year MMD	10-year MMD	20-year MMD	30-year MMD
6/30/2021	0.50	1.01	1.34	**1.52**
9/28/2021	0.50	1.11	1.45	**1.65**
Net change	**0.00**	**0.10**	**0.11**	**0.13**

Source: Thomson Reuters, 9/28/2021

The difference in performance may result from a clearer picture emerging of the changes Congress might make in the tax code. Munis had outperformed in the beginning of the year due to a strong demand for tax-exempt income. At least out along the curve, the move in the third quarter seemed to be toward normalizing the ratio of muni yields to Treasury yields, as the third table indicates:

Date	5-year ratio	10-year ratio	20-year ratio	30-year ratio
6/30/2021	56.2%	68.7%	66.0%	**72.7%**
9/28/2021	49.0%	72.1%	71.8%	**79.3%**
Net change	**-7.2%**	**3.4%**	**5.8%**	**6.6%**

Sources: Bloomberg, Thomson Reuters, 9/28/2021

The Fed maintains that the pace of economic growth and inflation will moderate over the next few quarters. The data seems to support that view. The Fed also sees a modest uptrend in rates, and we concur.

Bottom line: The uptick in volatility in the third quarter has resulted in a V-shaped period, but so far it hasn't taken us into new territory. We think investors should stay the course and not be disconcerted by a return to yields that were available earlier this year. With munis further out along the curve more fairly valued than they were in the spring, should the market overreact, we might even see a rare fourth-quarter buying opportunity.

All investing involves risk, including the risk of loss.

An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers.

The value of investments may increase or decrease in response to economic and financial events (whether real, expected or perceived) in the U.S. and global markets. As interest rates rise, the value of certain income investments is likely to decline. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Low rated or equivalent unrated debt securities of the type in which a strategy will invest generally offer a higher return than higher rated debt securities, but also are subject to greater risks that the issuer will default. Unrated bonds are generally regarded as being speculative.

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"Yields dropped, then rose again. Is it a sign of trouble brewing in the markets? Or just a return to equilibrium?"