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Municipal Bonds

2022 Outlook: Stay Active to Capitalize on Municipal Bond Opportunities


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Boston - Heading into 2022, investors in municipal bonds may be questioning how to prepare for another year of uncertainty.

After a record-breaking year for municipal mutual fund inflows, what might keep the flows going in 2022? Could recent infrastructure legislation — already passed and still under negotiation — raise muni issuance? How would potential changes to SALT,[1] BABs,[2] pre-refunding[3] and tax rates impact the muni landscape? What are yield-seeking muni investors to do when high yield spreads are so tight?

Recognizing what we know now, and what we don't know yet, we aim here to provide some viewpoints.

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Municipal mutual fund flows have big shoes to fill in 2022

We saw record flows into muni mutual funds in 2021. LIPPER reports that through November 24, $96.1 billion went into muni funds — the largest amount on record since data tracking started in 1992 (Exhibit A). The appetite for tax-exempt yield, the threat of higher taxes on the horizon and the unprecedented stimulus from the Federal Government have all fueled the strong demand from investors.

We anticipate that inflows could continue into the new year as:

- Tax rates — both personal and a potential new "surcharge" — are expected to move higher, making the tax-exempt nature of the asset class even more appealing.
- Tax-exempt pre-refundings have so far been left off the table as part of any Infrastructure package, which could decrease the amount of new supply.

With room for infrastructure improvement across the U.S., we think the IIJA is a strong step forward in helping to alleviate many of the most serious problems. Municipalities will likely be eager to put the money to work, albeit spread out over multiple years. We expect that will play for some time to come — especially if negotiations around expenditures and revenues in the budget reconciliation bill can be resolved, which would allow the passage of the Build Back Better (BBB) legislation to come in early 2022.

Opportunities and risks in the year ahead

Again, valuations in the muni market are mostly stretched, so we think investors would be better served by staying defensive on duration and credit. We still see potential opportunity in sectors that show wider spreads, such as hospitals and transportation. But generally speaking, taking a defensive stance is our view for 2022.

Taxable munis have been a major theme over the past couple of years and could once again prove to add value in portfolios as:

- Taxable equivalent yields on tax-exempt munis are below taxable yields on several parts of the yield curve.
- If tax rates rise, corporations and insurance companies could be buyers of taxable munis once again.
- Build America Bonds 2.0 have been left out of infrastructure negotiations so far, but as long as rates remain low, municipalities should continue to use taxable muni issuance for putting program funding to work.

Bottom line: We are cautiously optimistic on munis in 2022. Staying active and ready to capitalize on any market dislocations or opportunities could be vital in the months ahead. We appreciate that the rate environment is challenging. But in the face of expected increases in tax rates, likely rate hikes from the U.S. Federal Reserve and continued uncertainty around COVID-19 and broader market volatility, we believe that municipal bonds should remain an important and diversified component of a suitable investor's portfolio.

1. Eliminating the $10,000 cap on the state and local tax (SALT) deduction could shift demand in high-tax states from in-state municipal issues to portfolios that are more diversified across the U.S.

2. Reviving a permanent government subsidy —similar to Build America Bonds (BABs) created by the Obama/Biden administration back in 2009 — could help the taxable muni market grow. That temporary program was responsible for $181 billion in taxable muni issuance before expiring in December 2010.

3. Allowing issuers to again refinance tax-exempt muni bonds with tax-exempt munis would likely increase tax-exempt supply relative to taxable issuance.

RISK CONSIDERATIONS

Investing entails risks and there can be no assurance that any strategy will achieve profits or avoid incurring losses.

Municipal Bonds *- 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. Investments in income securities may be affected by changes in the creditworthiness of* *return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Debt securities are subject to risks that the issuer will not meet its payment obligations. 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.*