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APRIL 7, 2022

High Yield | Municipal Bonds

High Yield Municipal Bonds: Credit Fundamentals Still Strong, Now at Higher Yields

Boston - From January to March, the high yield municipal market posted the second-worst first quarter returns in 40 years, surpassed only by the first quarter of 2020 when the COVID pandemic hit. Now with stable municipal credit quality and higher absolute yields than at the beginning of the year, we are starting to see some value and better opportunities in the high yield municipal space.

Comparing first quarter challenges in 2020 and 2022

Lagging the Bloomberg Municipal Bond Index return of -6.23%, the Bloomberg High Yield Municipal Bond Index return of -6.53% was just short of the record first quarter loss of -6.9% in 2020. But after that drop in early 2020, the cumulative return of the high yield (HY) muni index was 12.6% over the next three quarters. In 2021, the HY muni index returned 7.8%, significantly outperforming the broader muni bond index return of 1.5%.

Robust municipal credit fundamentals and positive municipal market technicals justified the rally from May 2020 to December 2021. The latest quarter in the HY muni market presented a stark contrast to that, mostly due to a sharp change in muni market technicals.

In 2021, fund flows into HY munis hit a record $23.3 billion, equating to 16% of HY muni fund assets. Fund flows have now been negative for 12 straight weeks, for a total of $5.2 billion leaving the HY muni market. As investors withdraw money, these funds may be forced to sell bonds to meet redemptions, which has resulted in lower prices for many bonds in the market.

With outflows continuing, and municipal credit spreads still tight, we find it difficult to envision a return environment through the end of 2022 like the one we experienced in 2020.

Municipal credit spreads still tight

Coming out of the COVID driven muni sell-off in June 2020, muni high yield credit spreads were 400 basis points (bps) over the AAA scale. Soon thereafter, muni credit spreads began to tighten significantly and at year end 2021, muni credit spreads had tightened to just 158 bps. Ending the first quarter of 2022, HY muni spreads had only widened to 165 bps. Spreads are still tight, reflecting that this sell-off has been due to rising rates, not deteriorating credit quality.

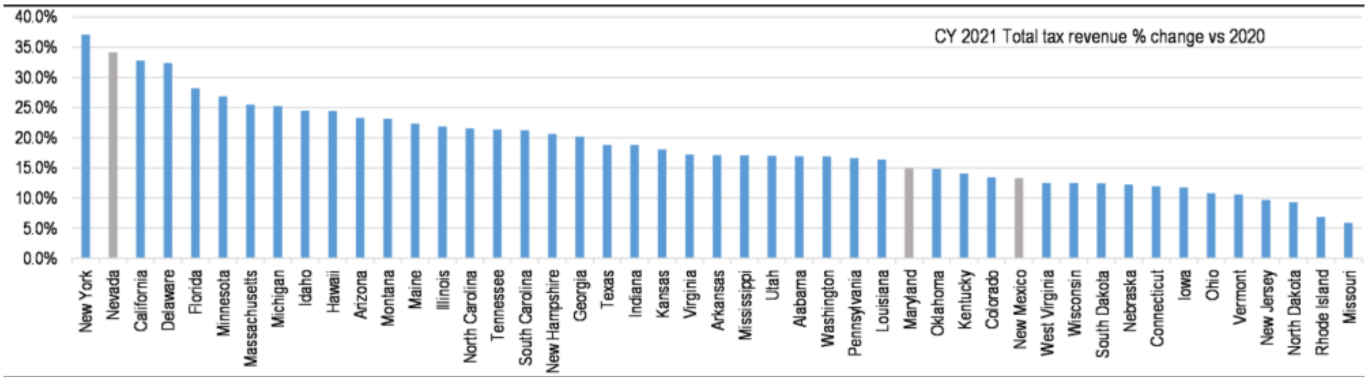
Municipal credit fundamentals stay strong

Despite the underperformance of the HY muni market in the first quarter, municipal credit fundamentals are currently strong:

Significant federal support. Three federal stimulus packages in 2020 and 2021 —$2.2 trillion CARES Act, $900 billion COVID Relief Bill and $1.9 trillion American Rescue Plan — injected almost $1 trillion of credit support into the municipal market. This aid helped stabilize municipal credit during the pandemic and set most issuers up for solid growth in 2021 and into 2022.

Record state revenues and liquidity. For the calendar year ended December 2021, state tax receipts increased by 19% from 2020. Calendar year 2021 tax receipts are up on average 18.6% versus 2020 and 16.6% versus 2019. The record revenues drove the largest state and local budget surpluses since 1941 —1.2% of GDP — and a new high for state rainy day funds of $113 billion.

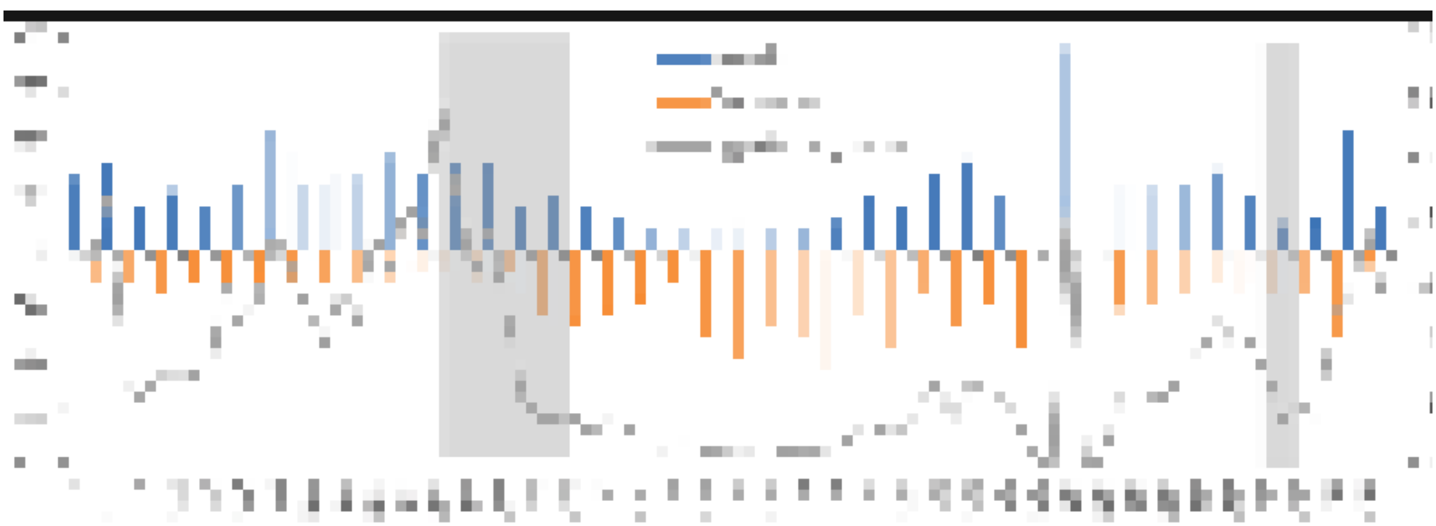
Change in calendar year tax receipts for 2021



Source: Individual state monthly tax reports, J.P. Morgan. Note: Oregon, Wyoming, and Alaska do not provide monthly tax data. Bars in gray indicate December data is not yet available and YTD period has been adjusted.

Credit upgrades outpacing downgrades. Upgrades have outpaced downgrades as overall credit quality has been bolstered by significant federal support and strong GDP growth. Last year was very positive from a credit ratings perspective: at credit rating agency Moody's, the upgrade to downgrade ratio was 2.7 to 1, while S&P upgraded 1.85 credits for every downgrade.

Municipal upgrades and downgrades in 2021



Source: Moody's Investors Service, J.P. Morgan. Gray shaded area indicates recessionary period (data not available prior to 2002 Q1).

Declining defaults. Significant stimulus funding and an improving economy pushed unique defaults down to 65 in 2021 from 86 in 2020. Defaults continued to decline in the first quarter of 2022, with 16 unique defaults, down from 23 during the same period last year.

Bottom line: While spreads remain tight from a historical perspective, after the significant sell-off in the first quarter, yields are now more attractive than they were to start the year. On December 31, 2021, the 10-year High Yield Municipal Index yielded 2.61%. On March 31, 2022, that yield had increased 46% to 3.82%. As the Federal Reserve is starting to raise the federal funds rate, we are mindful that muni credit fundamentals could become more volatile. Even so, we are beginning to see pockets of value and opportunity at these levels.

Bloomberg High Yield Municipal Bond Index is an unmanaged index of non-investment grade municipal bonds traded in the U.S.

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