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Municipal Bonds

With the wind at our back, we expect municipal credit to perform well in 2021

By: Cynthia J. Clemson | & Craig R. Brandon, CFA | January 21, 2021

Boston - Municipals wrapped up a historic year, with broad-market muni indexes up more than 4% in 2020. Thanks to unprecedented fiscal and monetary measures, the market largely recovered from the pandemic-induced liquidity crisis that sent prices plummeting in the first quarter.

Fiscal and monetary support

U.S. lawmakers ended months of negotiations on a second COVID relief package with a $900 billion spending bill in late December. While this does not provide direct aid for state and local governments, many sectors of the muni market are receiving funding — including education, mass transit, highways and airports. And the Federal Reserve intends to keep short-term rates near zero through 2023, continuing its monthly buying program of $120 billion in Treasurys and mortgage-backed securities.

Vaccine rollout and economy reopening

We expect Treasury and municipal interest-rate volatility to persist as markets adapt to new information about the worldwide fight against the coronavirus, rate-policy announcements from global central banks and emerging economic data. We will closely monitor the vaccine rollout and how the U.S. economy reacts during the reopening process, with the anticipation that a vaccine-led recovery could fuel higher GDP growth later in 2021.

Resilient and improving muni credit

While surging COVID-19 cases and further shutdowns may weigh on economic and job growth in the near term, we nonetheless expect muni credit to remain resilient. After surviving 2020 with better-than-expected revenue and only a minor uptick in defaults and bankruptcies, municipal issuers should face an improving credit landscape this year if that revenue trend continues.

Importance of credit oversight

During this period of uncertainty, we think that seasoned professional credit oversight is of the utmost importance. Municipal credit has not been immune to the pressures that the coronavirus pandemic exerted on the economy, and many sectors continue to face specific challenges. We believe these effects will play out on an issuer-by-issuer basis, depending on a credit's strength prior to this period. Issuers with strong balance sheets and proactive management teams can be resilient despite the economic hardship.

Wind at our back

With the backdrop of strong retail demand, improving economic conditions and continued fiscal support from the U.S. government, we feel that we have the wind at our back as muni investors. We are cautiously optimistic on municipal bonds, particularly the high-yield segment of the market.

Portfolio ballast

In our view, municipals can provide valuable ballast in a diversified portfolio. With equity markets near all-time highs, muni bond exposure may help buoy portfolios if equity markets pull back and investor appetite shifts to so-called safe haven assets, like certificates of deposit and money-market funds. And for investors subject to high federal and state tax rates, munis can offer more yield compared with their taxable counterparts.

Bottom line: We think that munis remain a valuable building block of a portfolio designed to help maximize after-tax income and return, but careful credit selection and positioning will remain critical.

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 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. As interest rates rise, the value of certain income investments is likely to decline. Investments involving higher risk do not necessarily mean higher 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.*

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