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Municipal Bonds

What does the recent rise in yields mean for muni bond investors?

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Boston - *After a dramatic backup in U.S. Treasury yields in late February and early March, are we entering a new bear market? Our fixed income investment experts present their views on the environment in a series of blogs, continuing with municipal bonds.*

February's sell-off in the municipal market was long overdue, in our opinion. But have yields become attractive again — or even cheap? The market is likely to take direction from central bank policy, inflation and growth expectations, and investor appetite. So we think it's worth keeping a close eye on mutual fund flows and supply.

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Market supply and demand technicals to watch

The new issue market has been manageable, to say the least, particularly within tax-exempt deals. Overall issuance of $30.6 billion last month was down 27% versus $42.0 billion in February 2020. That puts supply down 24% year-to-date compared to the first two months of last year.

While we continue to see new deals being met with demand, inflows into muni bond mutual funds have certainly slowed lately. According to Lipper, there were strong weekly inflows throughout January and the first few weeks in February, resulting in year-to-date inflows for muni mutual funds of $26 billion. However, primary data suggests that municipal fund flows turned negative last week for the first time in over 17 weeks, according to Jefferies.

One week certainly does not make a trend, but we would not be surprised to see a bit more volatility in flows given how much rates have risen over the past several weeks. Retail investors dominate the municipal market. Once an outflow cycle starts, it tends to move in long waves, which would likely put upward pressure on yields.

Factors driving yields to rise

Five, 10 and 30 year AAA muni yields started February at 0.22%, 0.72% and 1.38%, respectively. They rose 34 to 42 basis points (bps) to end the month at 0.56%, 1.14% and 1.80%, respectively. That puts muni yields back at early 2020 levels, before the pandemic hit the world's economy. If we see an increase in supply *plus* a decrease in fund demand, there could be another leg higher in yields.

However, given the rate movement in the market thus far, we think it may be time to consider putting new money to work. From here, we are closely watching any yield curve movements, changes to Fed policy and investor demand, as these three factors will likely drive all fixed income — including municipal — performance over the next few weeks.

Bottom line: We believe the sell-off in munis has presented an opportunity to invest at higher yields. For investors looking to put some cash to work, today's rate environment has recovered back to pre-pandemic levels, which may be appealing. But we appreciate that rates could still move higher, so keeping some cash or "dry powder" may also be prudent in case yields become even more attractive.

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. 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.