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Munis in a new light

How the pandemic response is causing investors to rethink municipal bonds

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Things are not always what they seem. This is proving true in the municipal bond market, where a perception shift is underway that carries profound implications – and opportunities – for investors. What has become acutely clear over the last 16 months is that the conventional wisdom around risk and return in municipal bonds is ripe for some fresh perspective.

KEY TAKEAWAYS

- The pandemic has underscored that, counter to conventional wisdom, revenue bonds are often less risky than their perceived higher-quality general obligation (GO) counterparts.
- We believe the most attractive segment to generate tax-advantaged yield today is in lower-rated investment-grade (A to BBB) revenue bonds; not traditional high-quality GO bonds.
- Revenue bonds can often provide a significant yield gain with a less than commensurate increase in default risk.
- The municipal bond market is poised to perform well in 2021 and beyond, with unique pockets of relative value.

"Pandemunium" averted

The early pandemic view in 2020 was that municipals would take a thrashing as tax collections plunged, COVID-19 related expenditures spiked, and financial distress would spur a wave of defaults. Although state and local governments were indeed hit hard by lockdowns, defaults remained low. This was principally due to three factors:

1. **Fiscal stimulus from the $2 trillion CARES Act and $1.9 trillion American Rescue Plan.** The latter was a municipal market game-changer that provided $350 billion of direct aid to state and local governments, which directly bolstered economic growth and indirectly supported a range of municipal issuers.
2. **Resilient tax revenues.** Tax revenues fell less than feared as stimulus swelled, boosting disposable income which, in turn, supported consumer spending. The tax base was further aided by stable house prices and a strong stock market.
3. **New policy tools.** The Federal Reserve (Fed), which offered to accept municipal bonds as collateral on loans to money market mutual funds, also introduced the Municipal Liquidity Facility to provide up to $500 billion in credit to state and local governments whose revenues dropped during the pandemic.

In aggregate, combined state and local revenues fell slightly less than $1.7 billion in 2020, according to the Tax Foundation. The $350 billion from the American Rescue Plan will more than offset the revenue declines and in places where revenue did not decline, the aid comes on top of an already better-than-expected starting point. Accordingly, credit risk for municipal bonds has been scaled back significantly.

More favorable conditions in 2021

While we cannot yet refer to the pandemic in the past tense, the picture is improving with each passing day as active cases decline, COVID-19 vaccinations climb, and recovery conditions improve. With reopening underway, supported by continued monetary and fiscal stimulus, economic activity is on the mend and the U.S. economy is set to grow by around 6% this year.

This strong economic backdrop, coupled with a large investment in infrastructure, is helping to strengthen the outlook for tax revenues, user fees on toll roads and ports, and airport revenues as travel recovers. It is sobering to recall that there was open talk of letting states default a year ago, whereas today, states including Illinois and Connecticut have seen their credit profiles improve. Remarkably, California reported a $75 billion fiscal surplus for their current fiscal year.

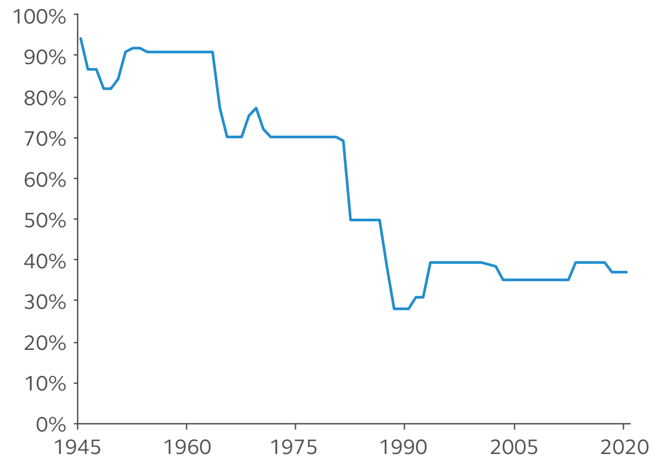
Twin tailwinds: infrastructure and taxes

Municipal bond issuers stand to benefit from the infrastructure package embedded in the American Jobs Plan (AJP) proposed by the Biden administration, which would invest a targeted $2 billion in infrastructure across the U.S. over the next eight years. The plan would provide meaningful and widespread support across a variety of municipal sectors, which would facilitate the refurbishment of existing infrastructure and the construction of greenfield projects.

Unlike the pandemic-stimulus bills, the AJP and American Families Plan will need to be paid for – at least partially – via higher taxes. For retail investors, who comprise the lion's share of municipal bond purchases, this will augment the need for the tax-advantaged income that these investments offer. It is worth recalling that we are still near secular lows for personal tax rates, which have fallen from a high of 86% post-WWII to 37% today. While the full extent of the tax changes are not final, there is little doubt about the ultimate direction.

Moreover, corporate buyers represent a not-inconsiderable share (about 20%) of the market. The proposed corporate tax hike to 28% from 21% should also drive institutional demand among these investors for tax-exempt investments, yet another technical factor in favor of the municipal market in the days ahead.

Exhibit 1: U.S. personal tax rate post-WWII
Highest marginal personal income tax rate, 1945-2020



Source: Tax Policy Center, Principal Global Investors.
Data as of April 30, 2021.

Inflows are at record-setting levels

These drivers have not gone unnoticed and the desire for exposure to stimulus-sensitive assets and concern over taxes have contributed to record municipal inflows in 2021. According to Refinitiv Lipper Alpha, municipal bond funds attracted nearly $42 billion of inflows through mid-May, roughly the same as all of 2020. Flows are likely to remain high in the months ahead as investors continue their flight to assets that stand to benefit from infrastructure stimulus and pay a more attractive yield than U.S. Treasurys.

The opportunity in revenue bonds

The prevailing wisdom on municipal bonds has always been to buy the highest-quality bonds (using AAA credit ratings as a proxy), assuming these securities offer the best value and, importantly, the greatest security.

However, it seems clear in the wake of COVID-19 and its associated lockdowns, that revenue bonds are even more resilient than many investors realized.

Revenue bonds are often less risky than GOs

Traditional municipal investors often buy GOs because they believe that they are less risky. The idea is that while citizens need to pay their taxes, they are under no compulsion to use a specific toll road, bridge, or other asset for which there may be alternatives. In reality, the pandemic has shown us that revenue bonds are incredibly robust. For example, the Los Angeles International Airport and the Long Island Railroad saw traffic plummet during the pandemic (the latter by 98%), yet their bonds were downgraded by only one and two notches, respectively. Despite experiencing the most unprecedented and rapid demand destruction in modern history, the result was modest, brief downgrades while maintaining their perfect payment records.

Infrastructure stimulus should make revenue bonds more attractive than GO bonds

The American Recovery Act has reduced the need for municipalities to issue debt. Accordingly, the proposed infrastructure bill, if passed, should likely increase revenue bond issuance at the expense of GO bonds.

Revenue bonds sit atop the capital structure

It is worth pointing out that revenue bonds have structural protection sitting atop the capital structure. This is not the case in GO bonds, where bondholders are subordinated to pensions. The underfunding of pensions remains a long-term issue and did not disappear with the stimulus.

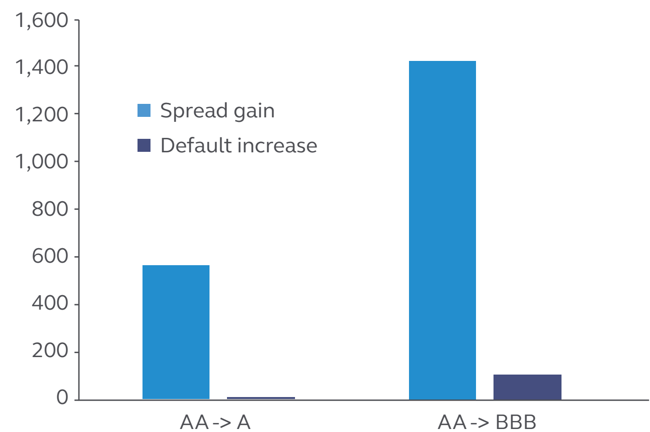
Seek lower-quality credits in today's market

Lower-quality bonds can provide a significant gain in spread with little increase in default risk

Stimulus and the V-shaped recovery have led to credit improvements across the board, with the Bloomberg Barclays Municipal BBB TR Index now inside of pre-pandemic levels. Investors can get a cumulative yield pick-up of 1,400 basis points over U.S. Treasurys with only a 100 basis point increase in default risk

Exhibit 2: Lower quality munis have upside

Cumulative change in spreads and defaults by municipal credit quality, bps, 2011 - 2020



Source: Bloomberg, Principal Global Investors. See disclosures for index descriptions. Data as of December 31, 2020.

Lower-quality municipal bonds have attractive yields compared to high-quality municipal bonds

Today, high-quality municipal bonds are very richly valued, as the relative-value ratio for a 10-year AAA municipal bond has gone from 81% to 51%, approaching all-time highs. In fact, high-quality municipal bonds are even pricey relative to investment-grade corporate bonds.

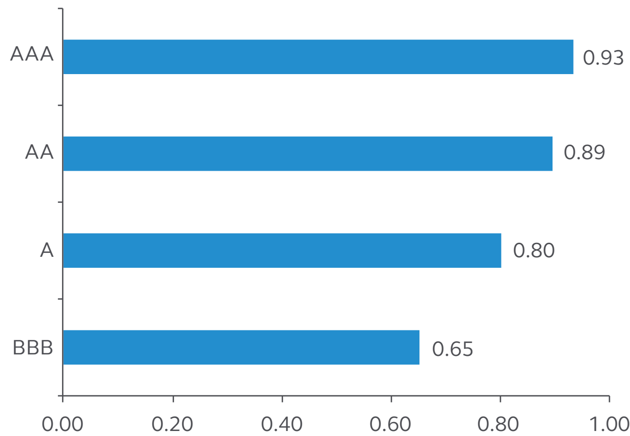
Lower-quality municipals have a yield and correlation advantage

The higher coupons associated with lesser-quality municipal bonds provide higher after-tax income and a cushion to absorb higher rates. In the first quarter of 2021, BBB-rated municipals returned 1.28% as compared to a return of -0.65% for AA-rated municipals.

In addition, the long-term correlation of municipal bond yields to the yield on the 10-year U.S. Treasury drops as credit quality decreases. Today, the correlation goes from 93% for AAA-rated municipal bonds to 65% for BBB-rated municipals.

Exhibit 3: The lower the credit quality, the less correlated to U.S. Treasurys

By credit quality, March 31, 2006 - April 30, 2021



Source: Bloomberg, St. Louis Federal Reserve, Principal Global Investors. See disclosures for index descriptions.
Data as of April 30, 2021.

Modest headwinds remain

A meaningful SALT cap reduction is possible, but unlikely

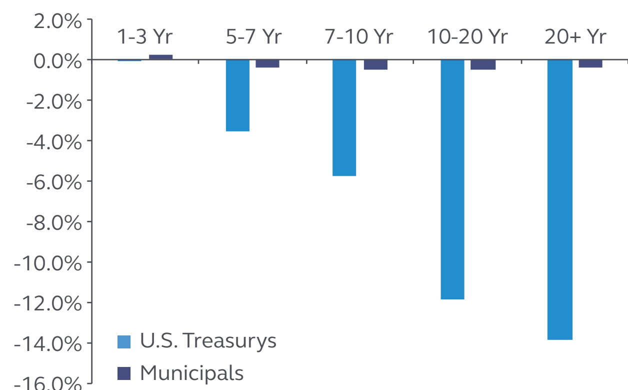
The State and Local Tax (SALT) cap, with its $10,000 allowable deduction per taxpayer, was introduced by the Trump administration in 2017. While not an infrastructure issue itself, the repeal of the SALT cap is being used as leverage by some in Congress for support of President Biden's proposed infrastructure bill. Removal of the SALT cap deduction would lower tax bills, thereby reducing the need for tax-advantaged income that municipal bonds provide. However, removing the deduction is expected to deprive the government of $380 billion in revenue through 2025—an amount that would need to be made up somewhere. Therefore, the likelihood of a SALT cap deduction meaningful enough to impact the municipals market is relatively small but cannot be fully discounted.

In addition to taxes, all eyes are on inflation, with price pressure concerns contributing to the climb in Treasury yields from 0.92% to around 1.45%, since the start of the year. The recent rise in inflation should prove transitory, permitting the Federal Reserve to remain patient and unwind asset purchases at a gradual pace. Investors should expect the 10-year U.S. Treasury to reach approximately 2% by year-end, close to fair value, and stabilize near that level.

It is notable, however, that municipal bonds have outperformed treasurys through the recent rising rate environment. In the first quarter of 2021, U.S. Treasurys greater than 20 years in duration lost 13.9% in price, yet municipals greater than 22 years in duration lost only 0.47%. So while interest rate risk is elevated for the entire fixed income spectrum, munis appear more resilient to the upward pressures.

Exhibit 4: Munis have been resilient to rising rates

Total return of municipal bonds and U.S. Treasurys, by maturity, 1Q 2021



Source: Bloomberg, St. Louis Federal Reserve, Principal Global Investors. See disclosures for index descriptions.
Data as of April 30, 2021.

Positioning munis in portfolios

In light of current trends and the market outlook, we believe municipal bonds should be considered a core component of investors' fixed income portfolios. These unique bonds offer exposure potential to high-quality cash flow generating assets, tax-advantaged income, attractive yield, and strong capital protection.

Moreover, investors considering this asset class would do well to consider the relative merits of lower-rated revenue bonds. Not only do these provide a meaningful increase in yield, but they do so while providing a margin of safety, often comparable to or even exceeding higher-rated GO bonds.

Index definitions

Bloomberg Barclays U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

Bloomberg Barclays Municipal AAA TR Index is a subset of the Bloomberg Barclays U.S. Municipal Index, containing only AAA rated bonds.

Bloomberg Barclays Municipal AA TR Index is a subset of the Bloomberg Barclays U.S. Municipal Index, containing only AA rated bonds.

Bloomberg Barclays Municipal A TR Index is a subset of the Bloomberg Barclays U.S. Municipal Index, containing only A rated bonds.

Bloomberg Barclays Municipal BBB TR Index is a subset of the Bloomberg Barclays U.S. Municipal Index, containing only BBB rated bonds.

Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. A portion of the income from municipal bonds may be subject to state and/or local taxes, and it may be subject to federal alternative minimum tax (AMT) for certain investors.

Important Information

Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.

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