Municipal Bond Market Commentary

Newfleet ASSET MANAGEMENT

A Virtus Investment Partner

Sector Assessment

FUNDAMENTALS

Fundamentals at the state level have softened as slowing revenue growth meets high fixed cost burdens, pension liabilities, and healthcare expenses. At the local level, fundamentals are generally solid due to rising property values and tax base.

TECHNICALS

Paltry inflows and inconsequential outflows during the quarter reflect the hesitancy of the market in the current environment.

VALUATIONS

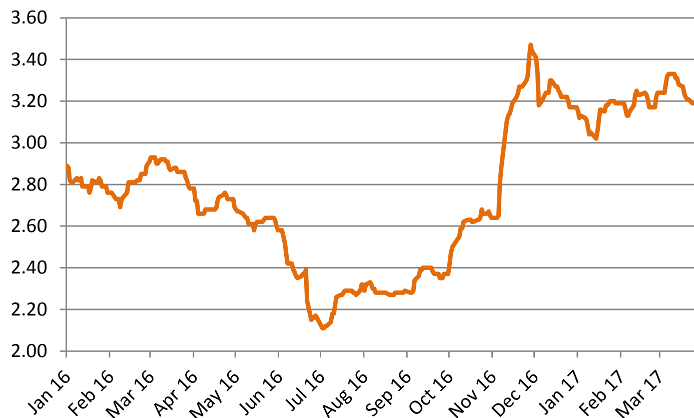
Municipal bonds continue to be in somewhat of a holding pattern until there is more clarity on tax reform.

Important Developments this Quarter

OVERVIEW

The tone of the municipal bond market turned positive in the first quarter of 2017 following a volatile end to 2016. Expectations of tax reform and infrastructure spending and their implications for the municipal bond market had weighed on the sector in the aftermath of Donald Trump's election. These concerns have at least temporarily subsided with the new administration's struggle to make progress on its campaign pledges. While investors remain tentative as they await clarity on Trump's legislative agenda, the Bloomberg Barclays Municipal Bond Index generated three months of positive returns to end the quarter up 1.58%. The yield on the 30-year AAA municipal bond ended the quarter at 3.20%, having touched a multi-decade low of 2.11% in early July 2016 and a recent high of 3.47% on December 1, 2016.

30-Year AAA Municipal Bond Yield (%)

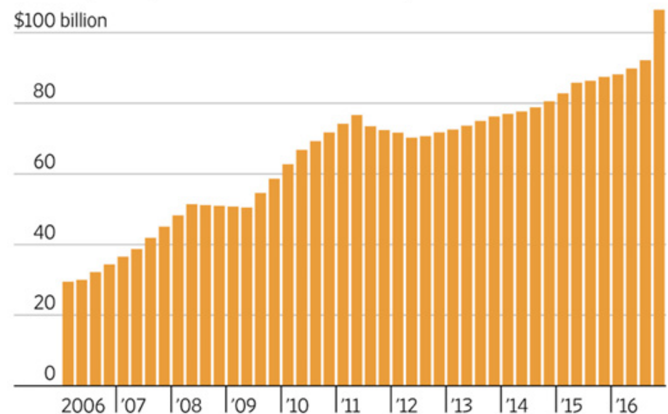


Source: Municipal Market Analytics

Technical conditions improved in the first quarter though they remain fragile. Issuance (supply) is likely to slow from levels in 2015 and 2016 when issuers were trying to stay ahead of Federal Reserve hikes and to refinance higher cost debt where they could. Now that the Fed has raised rates by a quarter-percentage-point, issuance likely will diminish as a decrease in the number of refunding deals will dampen supply. Issuance for refinancing purposes decreased from 40% of overall issuance over the past three years to 24% so far in 2017. Finally, another factor that may influence supply is Trump's infrastructure development plans. These plans appear farther out in the future than previously anticipated and may make issuers hesitant to act until there are more details on how the new administration will finance them.

On the demand side, mutual fund flows have been small but mostly positive in the first quarter. They had been vastly negative at the end of 2016 in contrast with substantial flows in the first half of the year. Uncertainty around tax reform, and its implications for the value of municipal bonds, is a significant factor driving fund flows. The ramifications of tax reform are particularly important if one considers the composition of demand for municipal bonds. While households continue to hold the bulk of municipal bonds, banks and insurance companies are a growing source of demand. If tax reform causes these entities to retreat from the municipal bond market, it could put downward pressure on the market. Another small but growing segment of the market are foreign buyers. According to Federal Reserve data reported in the Wall Street Journal, holdings of municipal securities by foreign investors increased 16% in the last quarter of 2016 for a total of $106 billion. While these buyers do not benefit from the tax advantage, they are attracted to the bonds' relative safety, longer duration, yield, and ability to provide diversification.

Quarterly Foreign Investment in U.S. Municipal Bonds



Source: Wall Street Journal, Federal Reserve

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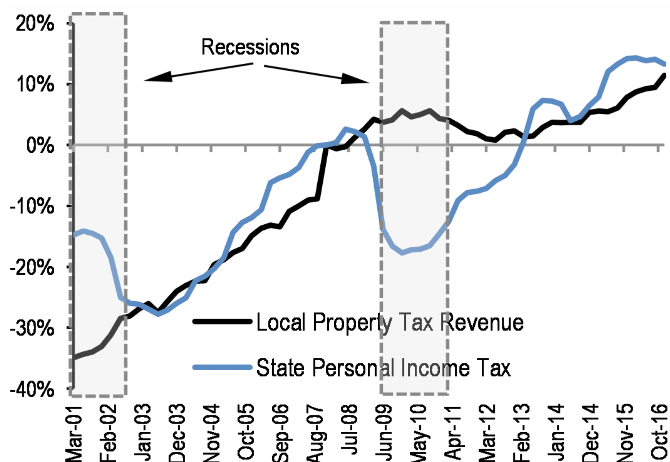
After being the worst performer in the fourth quarter of 2016, high yield municipal bonds reversed course in the first quarter of 2017 to be the best performer on a quality basis; tobacco led the way (+13%). By maturity level, issues in the five- to seven-year range outperformed as investors took refuge in the shorter end of the curve amid concerns of rising rates.

MUNICIPAL CREDIT

Fundamentals are fairly supportive at the local level as a result of rising home prices and improving property tax collections. In contrast, slowing revenue growth at the state level has taken a heavy toll on many states. The oil-producing states have been the hardest hit but other states have seen their revenues decline on lower income tax collections.

Many states continued to be challenged by rising pension and OPEB (Other Post Employment Benefits) costs that are diverting funds away from education, infrastructure, and other more traditional expenditures. States are forecasting weak revenue growth for fiscal year 2017. The impact from tax reform, yet unknown, as well as any resolution to healthcare reform will have a decisive impact on state budgets and state economies.

Total State and Local Tax Revenue Growth (%)



Source: Census Bureau, J.P. Morgan. YOY percent change.
As of December 31, 2016

LOOKING AHEAD

Our outlook for municipal bonds continues to be cautious as we monitor the development of the new administration's policies and assess their potential impact on the municipal bond market. The failure of Congress to repeal Obamacare suggests that tax reform and the enactment of other fiscal policies may be equally arduous and slow.

Among the topics we are watching, tax reform remains the critical issue and could have a meaningful impact on demand, especially from growing segments of the market such as banks and insurance companies. Infrastructure spending, with a long timeline to develop and implement, will affect the pace and magnitude of issuance. Though Congress failed to replace Obamacare, discussions remain in the background that ultimately may result in changes that have positive or negative consequences for the states. Finally, the Fed projects two more rate hikes in 2017, which will likely have an impact on bond yields.