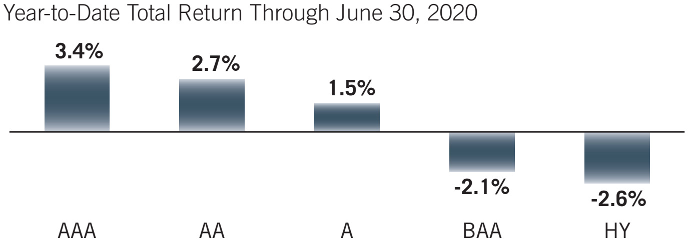
Municipal Bond Market

PERFORMANCE

The municipal bond market recovered well during the second quarter of the year, following a very volatile end to the first quarter. The Bloomberg Barclays Municipal Bond Index returned 2.72% for the three months ending June 30th, bringing the year-to-date return to 2.08%. While the municipal market has begun to benefit from investors' renewed interest in taking added risk, given improving economic indicators such as employment and consumer spending, it is still the highest quality bonds that have proven to be the best performers year to date. We continue to believe that higher quality municipal bonds offer reasonably good relative value. While investors are now being compensated more in credit risk spreads for owning the lowest-rated bonds, there remains tremendous uncertainty surrounding the credit metrics for this segment of the market due to the coronavirus and its future impact on the creditworthiness of many lower-rated municipal issuers.

PERFORMANCE BY QUALITY

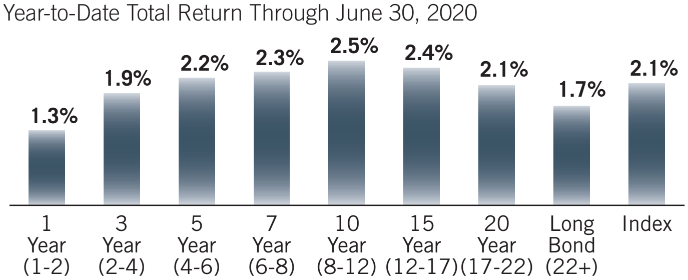
Bloomberg Barclays Municipal Bond Index
Year-to-Date Total Return Through June 30, 2020



Source: Bloomberg Barclays. **Past performance is no guarantee of future results.**

PERFORMANCE BY MATURITY

Bloomberg Barclays Municipal Bond Index
Year-to-Date Total Return Through June 30, 2020



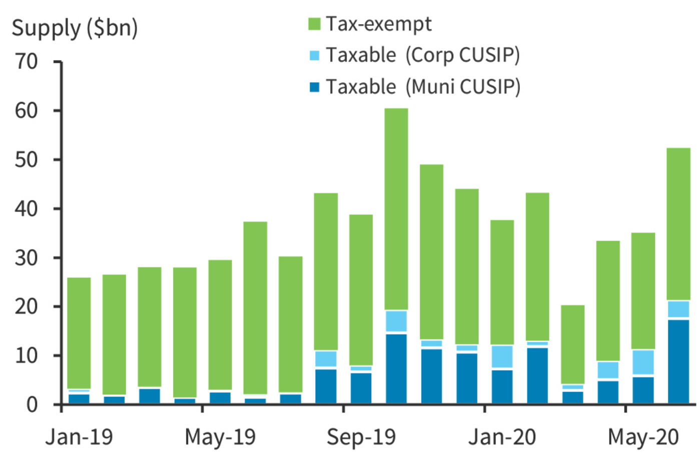
Source: Bloomberg Barclays. **Past performance is no guarantee of future results.**

TECHNICALS

As the second quarter began, "social distancing" became mandated and investors grew concerned about owning anything but the very highest of quality bonds. With fund complexes raising extraordinary amounts of cash to meet investor liquidity needs, the number of bonds offered surged and far exceeded demand. Fortunately, with municipal bond valuations exceptionally cheaper, the non-traditional buyer quickly appeared and provided support for the municipal bond market. Throughout the most volatile days early in the crisis, the municipal bond market never ceased to function with funds, individuals, and institutions all seemingly able to raise necessary cash.

Following the federal government's announcements of a variety of fiscal and monetary stimulus programs, the municipal bond market quickly eased its panic and the market's operations began to normalize. Demand for tax-exempt debt reemerged, with improved interest in lower-rated securities and longer-maturing bonds, despite ongoing uncertainties surrounding the municipal bond market due to the virus.

SUPPLY BREAKDOWN BY TYPE



Sources: SIFMA, Bloomberg, Barclays Research

Despite the challenging environment the market experienced in March and April from the pandemic, gross supply of municipal bonds still ended the first half of 2020 almost 25% higher compared to the first half of 2019. Although higher, overall municipal bond supply is being driven by taxable issuance, which is up approximately 300% compared to the comparable period last year. This higher level of taxable municipal bond supply is actually benefiting the technical market conditions for tax-exempt bonds as it is helping to keep tax-exempt supply very manageable, while creating more pre-refunded bonds. Municipalities are able to generate beneficial cost savings by advance refunding older and higher-cost tax-exempt bonds with new taxable municipal bonds. We expect this trend to continue in to the second half of 2020, especially if interest rates stay low and taxable credit risk spreads remain narrow.

FUNDAMENTALS

Investors of all types are wrestling with the negative credit impacts and risks associated with the virus on municipal bond issuers. After a prolonged environment whereby all credits seemed to improve in unison, the market has uniformly renewed its focus on credit. Municipalities had made solid fiscal progress during the long economic expansion, building rainy day funds and improving pension funding ratios, and appeared better positioned for an economic slowdown. Unfortunately, no municipality seems to have planned for the sudden and abrupt economic shutdown that took place as a result of the virus. Consequently, we are expecting challenging times ahead for municipal credit as a result of delays in tax collections and certainly loss in revenue as the economy came to a halt. While we expect the inevitable downgrades from the major rating agencies to expand and accelerate in the second half of the year, with some issuers experiencing possible disruptions in payments, we do not believe that most municipalities, especially the higher quality bonds (AAA-AA rated) that we primarily invest in, will experience payment interruptions or default. The federal government has injected large amounts of cash into state and local municipalities as part of the CARES stimulus package, and is discussing even more aid to those state and local governments most impacted from the virus. While it is uncertain how long the economy will remain in some version of lockdown or how long the virus will remain active in the world, we do anticipate revenues to improve as the economy opens across the country.

OUTLOOK

As we look ahead, we remain concerned about the impact of the coronavirus on municipal revenue collections, especially if the virus resurfaces and forces municipalities to re-instate “stay at home” mandates. As the federal government continues to step in to support the market’s function and issuer access to capital, tax-exempt income may become more valuable as the funding for any federal stimulus plan will likely result in higher tax rates once the pandemic abates. Again, higher-rated municipal issuers that provide essential services in the U.S. should fare better than lower-rated, less-essential issuers as default rates on investment grade rated municipal bonds have historically been very low. Negative headline news surrounding municipal credit will likely remain at the forefront, but historically in times like this, our higher quality investment strategy, distributed across multiple sectors of the market, has provided better relative performance.

Authored by:

The Newfleet Municipal Bond Team

Newfleet leverages the knowledge and skill of a team of investment professionals with expertise in every sector of the bond market, including evolving, specialized, and out-of-favor sectors. The team employs active sector rotation and disciplined risk management to portfolio construction.