Municipal Bonds

Positioning for Technical Headwinds

We prefer non-index taxables due to tight valuations in tax-exempt munis.

Both tax-exempt and taxable municipal bonds continue to perform well on a total return basis, but we expect tax-exempt valuations to widen as technical headwinds increase. State budget deficits are widening as federal COVID-related stimulus funding winds down.

Sector Commentary

- Municipals returned 1.4 percent for the year through mid-November despite a 45 percent increase in new issuance. Tax exempt/Treasury yield ratios are lower over the last 12 months.
- We are entering the seasonal lull for principal and interest payments, averaging $47 billion per month from October–December compared to $64 billion during the summer.
- New issues have averaged more than $10 billion per week since early September. We expect net supply growth to push tax exempt/Treasury yield ratios wider from current levels.
- Taxable municipal spreads continue to grind tighter but have lagged investment-grade corporate bonds. At the index level, taxable spreads are 18 basis points tighter on the year, resulting in a 1.9 percent total return through mid-November. Issuance increased 6 percent year over year to $30 billion, and demand for quality long duration paper remains steady.

Investment Themes

- At current ratios and spreads, we prefer non-index taxables over tax exempts due to tight valuations in exempts. We caution against focusing solely on the high taxable equivalent yields, as current valuations provide limited buffer against technical headwinds.
- Federal COVID stimulus funding to state and local governments has wound down, exposing budget deficits at issuers that allocated the nonrecurring money for recurring expenses. The financial shortfall at Chicago Public Schools, and the accompanying discussions about taking out a short-term loan to pay for salary and benefits, demonstrate the need for prudent long term planning. We expect more issuers to weigh tough tradeoffs in the next 12–18 months.

By Allen Li and Michael Park

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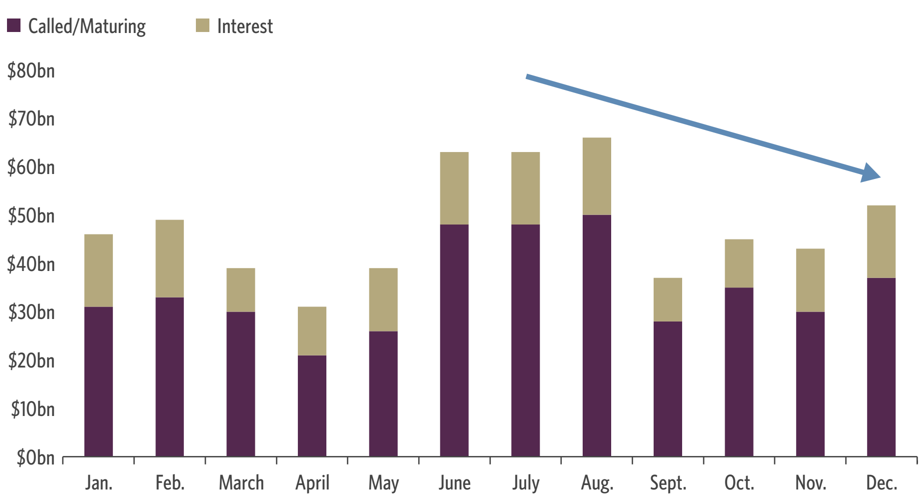
Munis Are Entering a Seasonal Lull for Principal and Interest Payments



Source: Guggenheim Investments, Bank of America. Data as of 9.30.2024.