Munis offer opportunity ahead of seasonal strength

BlackRock.

May update

- Municipals posted another month of negative total returns amid vastly rising interest rates.
- Supply-and-demand dynamics weighed on the market but should improve in the coming months.
- Valuations look increasingly attractive relative to other fixed income asset classes.



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Market overview

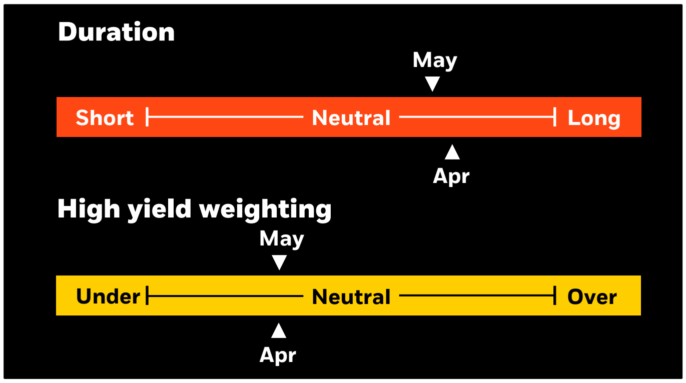
Municipal bonds posted another month of negative performance in April, bringing the year-to-date drawdown on par with some of the worst in history. Rising interest rates continued to weigh on the market as unbridled inflation led to heightened expectations for future policy tightening from the U.S. Federal Reserve via larger and more frequent rate hikes. However, lower volatility and attractive valuations helped municipals outperform comparable U.S. Treasuries. The S&P Municipal Bond Index returned -2.71%, bringing the year-to-date total return to -8.09%. Shorter-duration (i.e., less sensitive to interest rates) and higher-rated bonds performed best.

Supply-and-demand dynamics remained challenged in April. Outflows accelerated to levels not seen since the height of the pandemic, exacerbated by seasonal weakness surrounding Tax Day. Correspondingly, bid-wanted activity increased to nearly $1.7 billion per day as investors raised cash to meet redemptions. Issuance was elevated at $35 billion, 16% above the five-year average, and outpaced reinvestment income (from maturities, calls, and coupons) by nearly $7 billion.

Near-term performance will likely continue to be dictated by interest rates. However, we believe that municipals once again provide an attractive opportunity for investors. Seasonal trends are set to turn more historically favorable and supply-and-demand technicals should improve as outflows moderate from tax-time weakness and issuance turns net negative through the summer. In addition, attractive valuations have already spurred increased interest from crossover investors, which could help to stem the negative feedback loop in which the market has been stuck for most of 2022.

Strategy insights

We maintain a modest long duration stance on municipal bond positioning while targeting moderate cash balances. We favor intermediate maturities given that 89% of the full yield curve can be captured by extending out just 10 years. We prefer higher-quality bonds overall, with a neutral allocation to non-investment grade bonds.



Overweight

- Essential-service revenue bonds.
- Select highest quality state and local issuers with broadest tax support.
- Flagship universities and diversified health systems.
- Select issuers in the high yield space.

Underweight

- Speculative projects with weak sponsorship, unproven technology, or unsound feasibility studies.
- Senior living and long-term care facilities in saturated markets.

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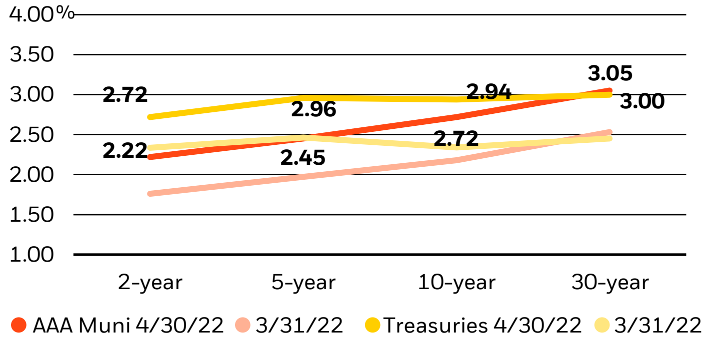
Credit headlines

Citing strong tax revenue growth and the prospect for larger reserve balances, Moody's upgraded the State of Illinois' credit rating to Baa1 from Baa2 in April. The agency also raised the state's rating last June, preceding S&P's upgrade to BBB from BBB- last July. These upgrades were the first for the state in two decades. In addition, the state passed its fiscal year 2023 budget in April, well before the July 1 deadline. This $46.5 billion spending plan increased revenue projections by $2 billion above the original February proposal. With municipal issuers benefiting from unprecedented emergency federal aid and a strong U.S. economy, Illinois' more favorable turn follows the March upgrades of other high-profile issuers, including the State of New Jersey, the City of Detroit, and Chicago Public Schools.

Following passage during a special session of the state's legislature, Florida Governor Ron DeSantis signed into law a bill providing for the dissolution, effective June 1, 2023, of Reedy Creek Improvement District (RCID) as well as several other special districts established before 1968. The pending dissolution raises many questions about the continuation of RCID's operations and the payment of its outstanding debt. Both Moody's and S&P assigned a "developing" outlook to the district's bonds, a relatively uncommon occurrence that indicates the uncertainty associated with RCID's status under the law. The State of Florida has covenanted that, while any debt remains outstanding, it will not alter or impair the district's ability to operate its debt-funded projects or to levy and collect the taxes or charges necessary for debt repayment. This covenant provides significant protection for bondholders and will be an important consideration in determining the ultimate outcome on the district's fate. Though the effective date of the dissolution is more than one year away, we expect the governor and legislature to provide additional details soon.

Municipal and Treasury yield movements



Sources: BlackRock, Bloomberg.

Municipal performance

	Apr '22	YTD
S&P Municipal Bond Index	**-2.71%**	**-8.09%**
Long maturities (20+ yrs.)	-4.68%	-12.28%
Intermediate maturities (3-15 yrs.)	-2.38%	-7.78%
Short maturities (6 mos.-4 yrs.)	-0.70%	-3.05%
High yield	-3.60%	-9.95%
High yield (ex-Puerto Rico)	-3.69%	-10.26%
General obligation (GO) bonds	-2.77%	-8.16%
California	-2.94%	-8.70%
New Jersey	-2.70%	-8.32%
New York	-2.78%	-8.60%
Pennsylvania	-2.83%	-8.01%
Puerto Rico	-2.85%	-7.19%

Sources: S&P Indexes.

Investment involves risk. *The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. There may be less information available on the financial condition of issuers of municipal securities than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. A portion of the income from tax-exempt bonds may be taxable. Some investors may be subject to Alternative Minimum Tax (AMT). Capital gains distributions, if any, are taxable.* ***Index performance is shown for illustrative purposes only. You cannot invest directly in an index. Past performance is no guarantee of future results.***

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