The muni market cools off

September update
• The robust recovery in muni bonds finally lost steam in August.
• Issuance remains strong but rising uncertainty has tempered demand.
• A lack of clarity around fiscal aid will likely exacerbate near-term volatility.

Market overview
After a strong three-month recovery, the muni market took a breather in August, with the S&P Municipal Bond Index returning -0.24% for the month, but leaving year-to-date performance still strong at 3.16%. All-time low yields, uncertainty around additional fiscal support, rising interest rates and less favorable supply-demand dynamics weighed on the market in August. Longer-dated bonds were particularly pressured toward month end as a shift in the Fed’s mandate spurred higher inflation expectations.

Issuance remained relatively high for the month of August at $41.3 billion. Supply continued to outpace reinvestment of income from coupons, calls and maturities, negating the net negative supply that typically occurs at this time of year. In the secondary market, bid-wanted activity increased over the month while dealer inventories hovering near multi-year lows signaled a weaker appetite for muni bonds among the broker community.

Investor flows into municipal bond funds remained net positive but waned in the later part of the month as valuations became stretched and fundamental concerns resurfaced after Congress broke for recess without agreeing on a stimulus bill. New issues were oversubscribed by a lower rate in August (4.0x) versus the year-to-date average (5.9x), dragged down by weakness in the last two weeks of the month (2.3x).

We foresee increased volatility in the months ahead and anticipate that a less favorable supply and demand dynamic will likely act as a drag on the market in the near term. We believe that clarity around the size and scope of additional federal stimulus is necessary to alleviate uncertainty and ease investor concerns.

Strategy insights
We maintain a short duration stance (i.e., a below-neutral level of interest rate risk) in our municipal bond exposure given stretched valuations and the potential for increased volatility in the coming months. We continue to hold a bias for higher quality assets overall and continue to advocate careful security selection as the impact of the pandemic varies across market segments.
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.

Credit headlines

The inability of Congress to reach an agreement over providing another round of fiscal aid is causing concerns that cities and states are ill-equipped to address an estimated $1 trillion of budgetary shortfalls. We believe support is forthcoming, but the amount may be significantly lower than market expectations ($250–500 billion). However, most municipal issuers have ample capacity to meet their obligations without federal assistance.

Spurred by Congressional inaction and the pandemic’s effect on government revenue receipts, some prognosticators are painting an unrealistic picture of widespread distress across a market that has tens of thousands of issuers. This view is overly simplistic and ignores not only strong state and local credit fundamentals, but also the enduring strength and diversity of an asset class composed mostly of high-quality revenue bonds.

State governments have broad powers to recover lost revenues and cut spending to balance their budgets. Most municipal governments are highly rated and have the ability to incur debt until revenues recover. Issuance has spiked in recent months as borrowers take advantage of low rates to reduce their interest expense. Large lower-quality borrowers have tapped into the Fed’s Municipal Liquidity Facility to cover operating costs at lower rates than those available in the traditional muni bond market.

Speculating the time and amount of additional fiscal aid is difficult, thus we suggest focusing instead on security selection with a bias toward sectors less impacted by the pandemic and higher quality state and local governments. Investors seeking higher returns in areas most affected by the shutdown, such as hospitals, airports and universities, should look for liquidity and market presence. In the general obligation and dedicated tax space, an issuer’s willingness to make tough financial decisions is crucial, especially if fiscal aid does not come or is inadequate.

Municipal and Treasury yields

Sources: BlackRock, Bloomberg.

Municipal performance

Source: S&P Indexes.

Investment involvement. 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.

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of September 8, 2020, and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and nonproprietary sources deemed by BlackRock to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. There is no guarantee that any forecasts made will come to pass. Any investments named within this material may not necessarily be held in any accounts managed by BlackRock. Reliance upon information in this material is at the sole discretion of the reader.

© 2020 BlackRock, Inc. All Rights Reserved. BLACKROCK is a trademark of BlackRock, Inc. All other trademarks are those of their respective owners.

Prepared by BlackRock Investments, LLC, member FINRA.

Not FDIC Insured • May Lose Value • No Bank Guarantee