Munis continue their rebound

July update
• The muni market continued its rebound in June, led by high yield and BBB credits.
• Supply-demand dynamics are likely to remain favorable in the near term.
• We seek attractive buying opportunities in sectors less impacted by the pandemic.

Market overview
Municipals continued their rebound in June alongside the re-opening of the domestic economy. The S&P Municipal Bond Index returned 0.78% for the month, bringing the year-to-date total return to 1.97%. The strongest returns came from the most liquid sectors of the high yield market (Puerto Rico and tobacco) and BBB-rated credits.

Supply picked up more than expected in June, with issuance of $48.7 billion – 31% above the month’s 5-year average. Taxable muni issuance was a major contributor to this acceleration. The seasonally typical net negative supply scenario did not emerge as issuance far outpaced the reinvestment of income from coupons, calls and maturities. However, as the focus shifted to the primary market, bid-wanted activity waned, providing some relief.

The increased supply was met with firm demand. Mutual funds, many of which were already holding elevated levels of cash, garnered $10.8 billion of inflows in June, making it the 4th best month for fund flows on record. At the same time, appealing muni-to-Treasury ratios and a robust supply of taxable issues attracted crossover investors to the muni market. As a result, the large amount of new issuance was easily absorbed.

We expect supply and demand dynamics to remain supportive for the near term. The attractive relative valuations and performance we are seeing today are likely to encourage continued demand, while July and August have historically been strong performance months. However, the potential for a second wave of contagion, the composition of additional fiscal stimulus, and the upcoming presidential election are fundamental uncertainties that we will be monitoring closely.

Strategy insights
We are maintaining a neutral stance on duration (i.e., interest rate risk) in our municipal bond exposure. While we continue to hold an overall high quality bias, we are tactically seeking to take advantage of opportunities in lower-rated credits offering attractive spreads within sectors less impacted by the COVID pandemic.

Duration
May | Jun
Short | Neutral | Long

Yield curve
Barbell strategy, preferring 0-5 and 20+ years

Overweights
• Higher quality states and essential-service bonds
• School districts and local governments supported by property taxes
• Flagship universities and strong national and regional health systems
• Select issuers in the high yield space

Underweights
• Speculative projects with weak sponsorship, unproven technology or unsound feasibility studies
• Senior living and long-term care facilities
• Small colleges, student housing, and single-site hospitals
• Credits highly correlated to hospitality, travel and leisure

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Credit headlines

High yield muni bonds continued to deliver strong performance, gaining 3.64% in June. The rally remains concentrated in strong-performing credits with reliable cash flows and excess debt service coverage, and highly liquid bonds such as Buckeye tobacco and Puerto Rico sales tax bonds, which had sold off sharply when mutual funds were forced to sell holdings to meet redemptions amid the market panic in March. We anticipate further upside as spreads compress for select names in the high yield municipal sector as investors scramble to source income in the ultra-low yield environment.

The transportation sector has begun to see some credit rating downgrades. Standard & Poor’s downgraded Dallas-Fort Worth Airport from A+ to A- and the Port Authority of New York & New Jersey from AA- to A+. Airports were the most exposed segment early in the shutdown. U.S. air travel fell to less than 5% of prior-year levels in April, causing significant volatility and spread widening in airport credits. Air traffic has since improved and investors have returned to the segment. We expect the recovery in these credits to result in issuers re-entering the market, leading to some spread tightening despite modest rating actions.

Most state budgets have been signed; however, as of July 1, of the 46 states with a new fiscal year beginning that day, four of them (MS, RI, SC, VT) had failed to pass their budgets on time, two (MA, PA) resorted to interim budgets, and one (NJ) extended its fiscal year, indicating difficulty in setting fiscal priorities within the traditional 12-month fiscal year period. Regardless of passage, the larger point is that the impact of the COVID-19 pandemic and economic shutdowns and re-openings have made it difficult to project revenues and expenses. Uncertainties include tax receipts from 2019 filings due July 15, the prospects for additional federal stimulus aid, and the amount and sources of borrowing needed to plug budget gaps.

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 taxable bonds. 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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