BlackRock

Muni investors scale back

October update

- Muni investors hit the pause button amid heightened uncertainty last month.
- Taxable muni bonds are meaningfully contributing to robust issuance.
- We expect increased volatility and a possible glut of issuance in the near term.



Peter Hayes, Head of the Municipal Bonds Group
James Schwartz, Head of Municipal Credit Research
Sean Carney, Head of Municipal Strategy

Market overview

The municipal market was nearly stagnant in September, with the S&P Municipal Bond Index returning just 0.02% for the month. Uncertainty around fiscal policy and the pending U.S. presidential election left investors reluctant to put their cash to work in the muni market. Performance was relatively strong in muni bonds with short and intermediate duration (i.e., low to medium levels of interest rate risk) and barbell credit strategies (i.e., exposure to both low- and high-quality bonds). Year-to-date, the asset class has gained 3.18%.

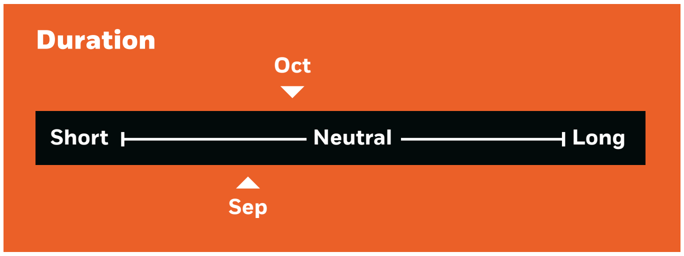
Muni supply remained robust with issuance at $52 billion — the largest amount on record for the month of September. Taxable municipal bonds accounted for a significant 34% of issuance in September, drawing continued firm demand from both foreign and institutional investors. Consequently, tax-exempt issuance was much lower than advertised at just $34 billion, allowing it to be easily absorbed by traditional retail buyers.

Fund flows remained positive but decelerated over the month, mostly in long-term and high yield funds. Waning demand was also evident in the new-issue market, which saw lower overall subscription rates and better investor discipline among credits with increased idiosyncratic risks. However, as fiscal stimulus negotiations re-intensify and Democrats expand their lead in the polls, the focus on fundamentals may soon shift toward expectations for higher taxes and increased need for tax-exempt income.

We anticipate increased volatility in the coming months, and a pull-forward of issuance ahead of the U.S. election that is similar in magnitude to the pull-forward experienced in December 2017 ahead of tax reform.

Strategy insights

We currently hold a neutral stance on duration (interest rate risk) in our municipal bond exposure, but we think the pickup in new issuance will likely provide some good buying opportunities. 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.



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

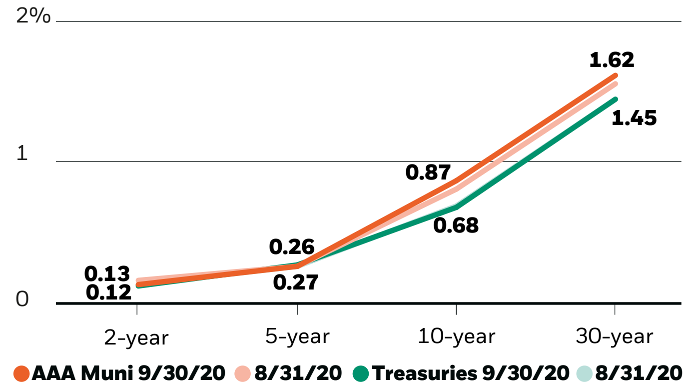
USRMH1020U-1358363-1/2

Credit headlines

New York's dual downgrades. In a move that was generally expected at some point, on October 1, Moody's downgraded both New York City and New York State general obligation bond ratings to Aa2 from Aa1. Certain state-supported credits, such as personal income tax and sales tax bonds, were also downgraded to Aa2 from Aa1. In addition, Moody's lowered their ratings to Aa3 from Aa2 for several agencies that are supported by city- and state-backed appropriations. The agency maintained a 'negative' outlook for the city, but upgraded its outlook for the state to 'stable.' Moody's cited the fiscal challenges resulting from the pandemic in its rating downgrades. Further one-notch downgrades are possible, especially in 2021. Much depends on the course of the pandemic and any subsequent treatments, as well as the longer-term effects of work-from-home trends that may depress real estate values and tax collections over a longer period of time. Current or post-election stimulus aid and an eventual vaccine could meaningfully alter New York's economic and fiscal conditions.

Metropolitan Transportation Authority. Despite a Moody's downgrade to 'A3' from 'A2' and persistently negative headlines regarding its large operating deficits, the Metropolitan Transportation Authority (MTA) successfully sold its $900 million transportation revenue bonds in mid-September, with strong investor demand allowing syndicates to bump yields lower during pricing. One or more agencies may downgrade the credit in the next few months as well as in 2021, but given the MTA's critical purpose in supporting the metro New York City economy, it is likely that federal, state and/or city support will eventually materialize. As is the case with New York City and State, the MTA's fiscal rebound is dependent on the course of the pandemic and subsequent economic activity.

Municipal and Treasury yields



Sources: BlackRock; Bloomberg.

Municipal performance

	SEP 2020	YTD 2020
S&P Municipal Bond Index	**0.02%**	**3.18%**
Long maturities (20+ yrs)	-0.05%	3.28%
Intermediate maturities (3-15 yrs)	0.05%	3.56%
Short maturities (6 mos-4 yrs)	0.08%	2.08%
High yield	0.20%	1.71%
High yield (ex-Puerto Rico)	0.30%	1.40%
General obligation (GO) bonds	-0.03%	3.89%
California	0.01%	3.32%
New Jersey	-0.16%	2.18%
New York	-0.21%	1.96%
Pennsylvania	0.15%	3.38%
Puerto Rico	-0.33%	3.38%

Source: 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.***

OE32007T-1020

BlackRock.