Muni Investors Scale Back

October 9, 2020

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Monthly 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.

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.

Outlook

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

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.

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