

Monthly Municipal Market Update, December 2020

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by Team
of PIMCO

SUMMARY

- Municipal bonds gained more ground in December, with high yield, investment grade, and taxable muni bonds all posting positive returns for the year.
- Despite December's relatively light primary market calendar, 2020 saw record municipal issuance, driven largely by a surge in taxable supply.
- Bolstered by seasonal supply/demand dynamics and five consecutive weeks of fund inflows, municipal bond yields moved lower in December.

Figure 1: Market snapshot

	Muni yields (MMD AAA)			U.S. Treasury yields			Muni taxable equivalent**	
	Yield	MTD change	YTD change	Yield	MTD change	YTD change	Yield	Spread
2-year	0.14%	-0.01%	-0.90%	0.12%	-0.03%	-1.44%	0.24%	0.12%
5-year	0.22%	-0.01%	-0.87%	0.36%	0.00%	-1.32%	0.37%	0.01%
10-year	0.71%	-0.01%	-0.73%	0.92%	0.08%	-0.99%	1.20%	0.28%
30-year	1.39%	-0.02%	-0.70%	1.65%	0.07%	-0.73%	2.35%	0.70%

\$513.7B	+\$10.3B	+\$39.7B	5.21%	4.89%	-73 bps	-99 bps
YTD muni issuance	M/M muni issuance	YTD muni fund flows	YTD IG return	YTD HY return	YTD change in 10yr muni yield	YTD change in 10yr Treasury yield

*Figures for total municipal issuance and taxable municipal issuance include both municipal CUSIPs and not-for-profit corporate CUSIPs. **Taxable-equivalent yield assumes 37% federal income tax and 3.8% Medicare investment tax. Spread refers to spreading the municipal taxable equivalent yield against the U.S. Treasury yield.

Sources: Muni CUSIP Issuance: The Bond Buyer, including bond and note issuance. Not-for-profit corporate CUSIP issuance: PIMCO analysis of Bloomberg data. Yield and spread data: Thomson Reuters. Muni fund flows: Refinitiv Lipper. YTD IG return: Bloomberg Barclays Municipal Bond Index. YTD HY return: Bloomberg Barclays High Yield Municipal Bond Index. All data as of 31 Dec 2020 except for muni fund flows data which is as of 30 Dec 2020, and not-for-profit corporate CUSIP issuance which was sourced on 11 Jan 2021, but as of 30 Dec 2020.

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December Month in Review

Major U.S. equity indices rose to record highs in December, even as coronavirus infections continued to rise and other measures of U.S. economic health, including consumer spending and employment figures, printed at unfavorable numbers.¹ Despite a mixed short-term outlook, market participants appear to be gaining a more favorable long-term outlook as Americans begin receiving vaccinations and additional stimulus measures take effect. Meanwhile, the municipal market exhibited a continuation of seasonal dynamics, which began to take shape in November following the U.S. elections and have been characterized by relatively low supply and sustained demand.

In total, just \$30.7 billion of new municipal issuance came to market in December, with taxable debt accounting for nearly \$9.1 billion.* Even with the recent month's relatively light calendar, however, total municipal issuance in 2020 exceeded \$513.7 billion. This was driven in large part by the \$184.9 billion in taxable deals – issued under both municipal and corporate CUSIPs – that came to market throughout the year. 2020 was a banner year for municipal issuance, as both taxable and total issuance climbed to the highest levels on record.² Five consecutive weeks of municipal fund inflows in December also helped drive yields down by 1-2 basis points (bps) across the AAA Municipal Market Data (MMD), with the 10-year tenor closing the year at 71 bps.³

- December's FOMC meeting marked the Federal Reserve's final of the year. At the meeting, Fed policy

makers reinforced guidance set in previous meetings for supporting the economy with large-scale asset purchases (quantitative easing) and near-zero short-term rates. Fed officials affirmed that asset purchases are to remain at their current levels and frequencies “until substantial further progress has been made” toward the Fed’s broader employment and inflation goals. Additionally a survey of Fed officials points to short-term interest rates remaining near zero for at least three years.⁴

- Municipal bonds closed the year with an additional month of positive performance. The Bloomberg Barclays Municipal Bond Index returned 0.61% in December, while the Bloomberg Barclays High Yield Municipal Bond Index was up 1.87% and the Bloomberg Barclays Taxable Municipal Index gained 1.08%. Final returns for the year of 2020 for the three indices totaled 5.21%, 4.89%, and 10.52%, respectively.⁵
- Treasury yields, with the exception of some shorter tenors, largely moved in the opposite direction as municipal yields in December. While Treasuries closed out the year with positive performance, they underperformed municipals in the month of December, leading to further tightening in municipal/Treasury taxable-equivalent spreads.** At month-end, taxable-equivalent spreads equated to 11 bps at the one-year tenor (down from 13 bps), 1 bps at the five-year tenor (down from 3 bps), 28 bps at the 10-year tenor (down from 38 bps), and 70 bps at the 30-year tenor (down from 80 bps).⁶

Secondary market trade volume in December sprang back from its lowest level in more than a decade. Trades for the month totaled 657,000 (up from 549,000 in November) while par traded amounted to \$193 billion (up from \$159 billion).⁷

Muni technicals in focus: Munis remain resilient, and taxable munis are here to stay

In a month largely characterized by an influx of negative news related to the pandemic and its effects on the U.S. economy, markets closed the final days of the year on a slightly more positive note. Optimism surrounding a second stimulus bill and COVID-19 vaccine rollouts propelled major U.S. equity indices to record highs, even as the United States grappled with increasing coronavirus infection rates and economic weakness.⁸

As equities rallied, U.S. Treasury and AAA municipal yields experienced relatively little movement over the month. The U.S. Treasury yield curve underwent a bear steepener, with yields inside of three years flat or down by 2-3 basis points (bps), while yields at the 10-year tenor and beyond were up by 7-8 bps. Bolstered by seasonal supply/demand dynamics, the AAA MMD yield curve closed the month down by 1-2 bps at all tenors. The 10-year municipal/Treasury ratio closed out the year at 77%, only slightly higher than 2019’s final print of 75%.⁹

Municipals remained resilient through the final days of the year, with sustained demand for the asset class even as supply remained relatively low. Municipal funds experienced five consecutive weeks of inflows through December, carrying total muni fund flows for the year to \$39.7 billion.¹⁰ Municipal credit spreads tightened over the month, helping drive the Bloomberg Barclays Municipal High Yield Bond Index’s 1.87% return.¹¹ That said, municipal credit spreads remain wide relative to their pre-pandemic levels and relative to current corporate credit spreads.¹² Taxable munis, which accounted for nearly 36% of 2020’s total municipal issuance, look to remain a dominant theme in the coming year. JP Morgan and Citi are each projecting nearly \$200 billion in taxable sales for 2021, reinforcing the general belief that the recent surge in taxable issuance is part of a broader structural shift.¹³

Pivoting toward municipal credit, state and local governments were largely left out of the recently passed stimulus bill. Mayors and governors are now left hoping for additional pandemic relief under a Biden administration, as state and local government aid remains a Democratic priority. The prospects for such legislation have improved following Democratic victories in the Georgia Senate races. We do not believe the lack of federal aid to state and local governments will result in a wave of municipal defaults, although it does complicate budget decisions for municipal governments that are confronting uncertain economic conditions. The lack of direct federal relief likely means growing austerity measures on the part of state and local governments. We have already seen states cut back on spending for the first time since the global financial crisis, with General Fund spending in Fiscal Year 2021 declining by 5.5% from pre-COVID budget recommendations.¹⁴ This trend is likely to be exacerbated as states and cities craft budgets that currently assume no additional federal assistance.

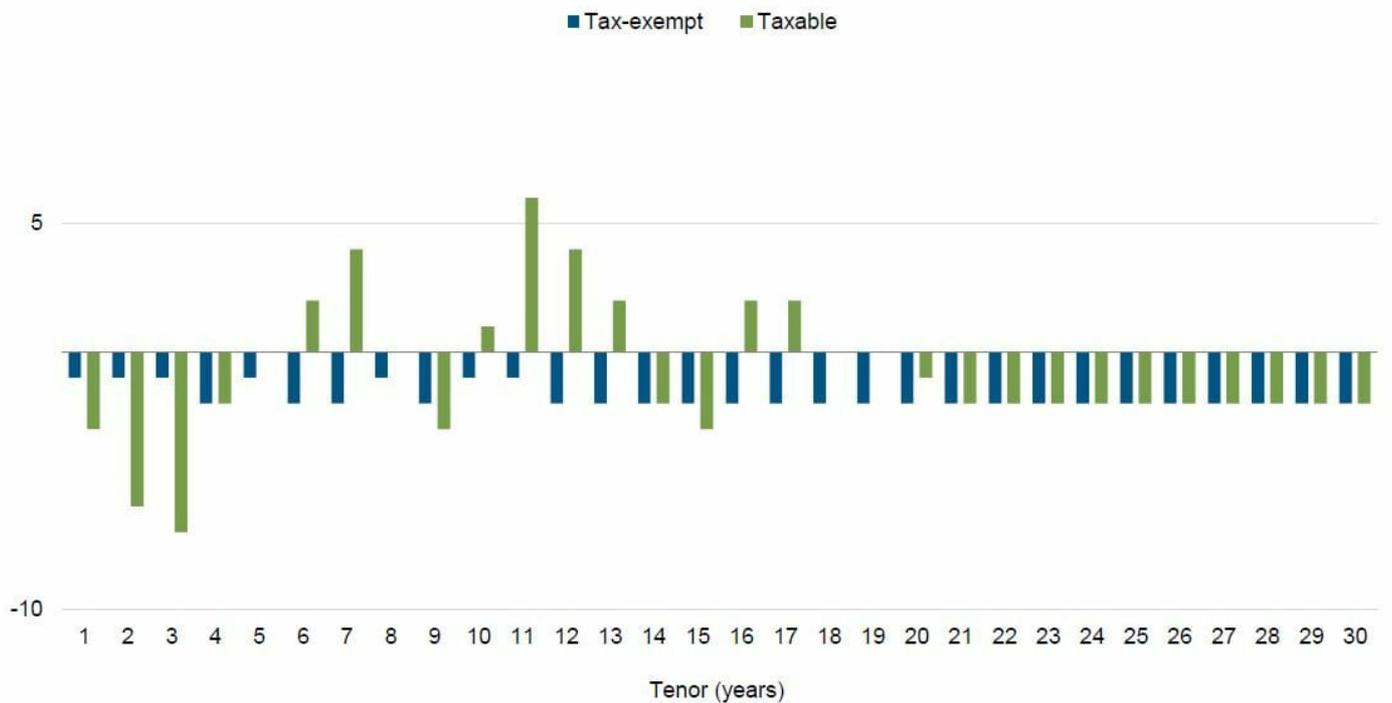
Despite falling well short of the most optimistic hopes, the stimulus bill does carry with it some bright spots for the municipal market. While not seeing any direct aid, state and local governments’ tax collections and economies will benefit indirectly from the relief provided to companies and individuals. Sectors such as airports should benefit, as airlines are slated to receive \$15 billion in aid, and hard-hit public transit districts that have seen broad ridership declines will receive \$14 billion in assistance.¹⁵ The bill also allocates \$82 billion in new relief for K-12 school districts and higher education.

Figure 2: Municipal/Treasury after-tax* spreads



Sources: Figure 2: Thomson Reuters TM3 MMD Interactive as of 31 December 2020. 2-year and 10-year average spreads calculated over the last five years, starting 4 December 2016. *Assuming a 37% federal income tax rate and 3.8% Medicare tax rate.

Figure 3: Month-over-month change in AAA MMD yields (bps)



Sources: Figure 3: Thomson Reuters TM3 MMD Interactive as of 31 December 2020

Figure 4: Market data

Municipal index returns

Muni returns	YTW	MTD	YTD
Bloomberg Barclays Muni Index	1.07%	0.61%	5.21%
Bloomberg Barclays 1-10 (1-12)	0.62%	0.39%	4.23%
Bloomberg Barclays Muni Short (1-5)	0.42%	0.20%	2.83%
Bloomberg Barclays High Yield Muni	3.82%	1.87%	4.89%

Source: Bloomberg Barclays as of 31 December 2020

Monthly municipal fund net flows (in millions)

Month	2020	2019	2018
July	\$9,495	\$8,976	\$3,176
August	\$10,546	\$7,778	\$1,856
September	\$6,174	\$4,873	(\$237)
October	\$5,733	\$7,151	(\$4,407)
November	\$5,934	\$8,542	(\$4,862)
December	\$8,263	\$8,988	(\$1,981)

Source: Investment Company Institute as of 6 January 2021. The most recent month's flows are based on weekly estimates and subject to change.

Average monthly visible supply (in millions)

Month	2020	2019	2018
July	\$13,401	\$8,289	\$8,822
August	\$14,758	\$12,677	\$10,245
September	\$14,675	\$11,945	\$7,939
October	\$18,426	\$13,984	\$8,848
November	\$9,288	\$15,460	\$7,218
December	\$7,952	\$11,295	\$6,331

Source: Bloomberg as of 31 December 2020

Secondary market activity (in millions)

Month	Average par of Bloomberg pick	Average daily bid wanted
Dec-19	\$10,752	\$529
Jan-20	\$11,017	\$597
Feb-20	\$7,481	\$582
Mar-20	\$8,901	\$2,036
Apr-20	\$4,329	\$1,118
May-20	\$4,249	\$699
Jun-20	\$4,225	\$563
Jul-20	\$2,365	\$434
Aug-20	\$3,197	\$544
Sep-20	\$4,359	\$563
Oct-20	\$3,471	\$700
Nov-20	\$2,737	\$479
Dec-20	\$2,572	\$536

Source: Bloomberg as of 31 December 2020

10-year municipal vs. 10-year Treasury yields

Day	Municipal	Treasury
11/30/2020	0.72	0.84
12/31/2020	0.71	0.92

Source: Thomson Reuters as of 31 December 2020

Monthly new issuance (in millions)

Month	2020	2019	2018
July	\$49,316	\$30,258	\$28,926
August	\$47,830	\$43,268	\$35,988
September	\$54,136	\$38,082	\$25,888
October	\$82,619	\$61,041	\$38,879
November	\$20,448	\$49,131	\$27,852
December	\$30,697	\$44,209	\$22,406

Source: Muni CUSIP issuance sourced from The Bond Buyer, including bond and note issuance, as of 31 December 2020. Not-for-profit corporate CUSIP issuance based on PIMCO analysis of Bloomberg data sourced on 11 January 2021, but as of 31 December 2020.

Monthly bond redemptions (in millions)

Month	Amount matured	Amount called
Jan-20	\$22,169	\$3,188
Feb-20	\$29,968	\$4,349
Mar-20	\$27,777	\$7,939
Apr-20	\$16,993	\$6,449
May-20	\$22,807	\$7,550
Jun-20	\$40,168	\$7,715
Jul-20	\$39,623	\$6,714
Aug-20	\$47,395	\$5,931
Sep-20	\$22,858	\$6,561
Oct-20	\$29,000	\$9,896
Nov-20	\$26,470	\$8,655
Dec-20	\$33,293	\$9,324

Source: Bloomberg as of 31 December 2020

Sector returns (in %)

Select sectors	December '20	YTD	2019
General Obligation	0.48%	5.49%	7.30%
Pre-Refunded	0.07%	2.76%	3.55%
Revenue	0.71%	5.31%	7.93%
Education	0.42%	5.39%	8.00%
Healthcare	0.91%	5.70%	8.69%
Industrial Development	0.64%	5.46%	8.44%
Lease-Backed	1.10%	5.04%	8.46%
Power	0.33%	5.40%	7.04%
Special Tax	0.65%	4.73%	7.82%
Transportation	0.97%	5.16%	7.89%
Water & Sewer	0.40%	5.86%	7.29%
HY Tobacco	1.64%	13.93%	11.60%
HY Puerto Rico	1.90%	10.68%	20.03%

Source: Bloomberg Barclays Index as of 31 December 2020

¹ Anna Hirtenstein, "Stocks Climb, Extending Record-Setting Rally," Wall Street Journal, 29 Dec 2020; Josh Mitchell, "U.S. Household Spending Drops for First Time in Seven Months," Wall Street Journal, 23 Dec Nov 2020

² The Bond Buyer: Primary Market Statistics - A Decade of Bond Finance, 31 Dec 2020; SIFMA: US Municipal Issuance, 7 Jan 2020; Bloomberg, 2 Jan 2021

³ Thomson Reuters TM3 MMD Interactive Data, 31 Dec 2020

⁴ Nick Timiraos, "Fed Reinforces Plans to Provide Open-Ended Stimulus to Spur Recovery," Wall Street Journal, 17 Dec 2020

⁵ Bloomberg Barclays, 31 Dec 2020

⁶ Thomson Reuters TM3 MMD Interactive Data, 31 Dec 2020

⁷ The Bond Buyer: Secondary Market Data, 31 Dec 2020; SIFMA: US Municipal Trading, 4 Jan 2021

⁸ Anna Hirtenstein, "Stocks Climb, Extending Record-Setting Rally," Wall Street Journal, 29 Dec 2020; Josh Mitchell, "U.S. Household Spending Drops for First Time in Seven Months," Wall Street Journal, 23 Dec Nov 2020

⁹ Thomson Reuters TM3 MMD Interactive Data, 31 Dec 2020

¹⁰ Refinitiv Lipper, 4 Jan 2021

¹¹ Bloomberg Barclays, 31 Dec 2020

¹² Thomson Reuters TM3 MMD Interactive Data, 31 Dec 2020

¹³ Peter DeGroot, Ye Tian, and Daniel Zheng, "2021 Municipal Market Outlook," 24 Nov 2020; Vikram Rai, Jack Muller, and Vedanta Goenka, "2021 Municipal Market Outlook - Faith," 9 Dec 2020; Bloomberg, 2 Jan 2021¹³

¹⁴ NASBO, "The Fiscal Survey of States, an Update of State Fiscal Conditions," Fall 2020¹⁴

¹⁵ Erik Wasson, Laura Litvan, and Billy House, "Massive Package of Virus Relief, Federal Funding Passes Congress," 21 Dec 2020¹⁵

Disclosures

Past performance is not a guarantee or a reliable indicator of future results.

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