Municipal Bonds: Potential for Attractive Total Returns

Summary

- As a result of market dislocation during the COVID-19 pandemic, municipal bonds currently offer a significant yield premium over similar-maturity Treasury bonds, creating the potential for attractive total return opportunities.
- The inverted relationship between muni bond and Treasury yields may persist in the near term as Federal Reserve policy has reduced Treasury rates, while widespread forced selling of muni bonds has contributed to pricing disparities.
- Economic risks facing muni bonds vary widely, depending on issuers’ sources of revenue — favoring active management to identify higher-quality bonds at attractive relative valuation.

Although market conditions have improved, persistent dislocation of the municipal bond market has created potentially attractive investment opportunities. Fear and uncertainty caused by the Covid-19 pandemic led to massive selling of muni bonds and a flight to the safety of Treasury bonds, distorting relative value. Weekly reporting muni bond mutual funds had a record $31 billion in outflows between March 1 and April 10, following 60 weeks of mutual fund inflows, leading to bond price declines. At the same time, the flight to safety has created acute demand for Treasury bonds, lowering their yields. As a result, muni bonds currently offer yields that are attractive on an absolute basis and relative to taxable bond yields, with potential for increased income levels and capital appreciation.

Market dislocation has inverted muni bond yields to a premium over Treasuries

Muni bond yields normally are lower than similar-maturity Treasury bonds to compensate for tax advantages: Muni bonds are mostly federal tax-free — and generally state tax-free for residents of states where the bonds are issued. As a result of the market dislocation, high-quality bonds are trading at yields significantly above corresponding Treasury yields. For example, high-quality 10-year muni bonds recently traded at a yield of more than 200 percent, or three times, the 10-year Treasury yield, compared with roughly 85 percent in more normal market conditions. After peaking in mid-March and despite a more recent downward trend, muni bonds have continued to offer yields ranging from 150 percent to more than 300 percent of Treasury yields, depending on maturity, as of 4/17/20 (Exhibit 1, below).
Exhibit 1: Muni bond yield premium over Treasuries

Yield Ratio: 10-year municipal bond vs. 10-year Treasury,
2/3/20 - 4/17/20

Note: Solid line reflects longer-term average 10-year muni bond yield; dotted lines reflect +/- 1 standard deviation from the average.
Source: Thomson Reuters, Bloomberg.

**Tax advantage increases muni bonds’ after-tax yield premium**

Yields on 10-year muni bonds, for example, have recently been roughly double the 10-year Treasury yield, or about 1.5 percent versus 0.75 percent. Considering muni bonds’ federal tax advantage, the equivalent taxable yield would be 2.38 percent — more than triple the 10-year Treasury’s taxable yield — for an investor in the highest, 37 percent tax bracket.

**Muni bond yield premiums may persist in a stressed market environment**

In theory, muni bonds’ yield premium should narrow and eventually disappear as relative-value investors drive up muni bond prices, causing yields to decline, and markets gradually normalize. However, several factors could delay a return to normal yield ratios. First, Treasury rates are less likely to rise in the near term as massive Federal Reserve intervention keeps rates low to support a weakened economy. Second, the muni market’s repricing of credit-risk, mutual fund cash outflows and impaired liquidity have kept yields above normal. Although the Federal Reserve’s quantitative easing has improved functional liquidity, trading conditions remain more difficult than before the pandemic. As a result, we believe that high-quality muni bonds offer relative value that is among the most attractive in fixed income.

**Muni bond risks vary widely depending on issuers’ revenue sources**

Are municipal bonds worth the higher risks imposed by the pandemic? We believe the unusual yield premiums reflect the market’s dislocation, rather than weaker long-term fundamentals. The federal
government’s $2.3 trillion economic aid program, including support for states and municipalities, is helping to ease economic risks. COVID-19’s impact varies widely across municipal sectors, depending on issuers’ sources of revenue. For instance, property tax-backed issues in localities with strong excess reserves, controlled pension obligations and essential service revenue-backed debt, could be expected to fare reasonably well in a downturn. State governments are facing pressure from higher spending for unemployment insurance and healthcare, combined with decreasing tax revenues — risks partly offset by federal aid. Issuers facing the most serious headwinds are likely to be those in oil-producing regions, healthcare providers and those associated with leisure activities, such as hotels, convention centers and stadiums.

**Glenmede’s active muni bond strategy maintains higher credit quality**

Wide variability in the pandemic’s expected economic impact favors an active management approach to identify opportunities across our investible universe. Glenmede’s Muni Intermediate strategy addresses risk by maintaining higher average credit quality, relative to its benchmark, a moderate level of interest-rate risk and ample exposure to liquid issuers and securities in unconstrained portfolios. The strategy maintains significantly higher AAA-rated exposure, relative to its benchmark, an average AA-rating and no issues below A (Exhibit 2). The strategy’s high-quality bias increased in early 2020, as yield premiums on lower-rated issues generally were insufficient to justify the additional risk.

**Exhibit 2: Glenmede’s Muni Intermediate strategy maintains high-quality bias**

Credit quality: Glenmede Muni Intermediate strategy vs. Bloomberg Barclays Municipal Bond 1-10 Year Blend Index, as of 3/31/20

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<thead>
<tr>
<th>Credit rating</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
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</thead>
<tbody>
<tr>
<td>Muni Intermediate strategy</td>
<td>28.52%</td>
<td>49.54%</td>
<td>21.94%</td>
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<tr>
<td>Benchmark*</td>
<td>17.88%</td>
<td>53.05%</td>
<td>22.15%</td>
<td>6.92%</td>
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<tr>
<td>Difference</td>
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<td>-3.51%</td>
<td>-0.21%</td>
<td>-6.92%</td>
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* Bloomberg Barclays Municipal Bond 1-10 Year Blend Index  
Source: Glenmede.

For more information, visit Glenmede.com.