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Municipal Bond Market Continues to Face Risks.

While fixed-income seekers scramble to find attractive yield-generating opportunities in this lower-for-longer rate environment, bond ETF investors have looked to municipal bonds to supplement their portfolios, but the muni market is not without its risks.

"Munis are relatively attractive, but not absolutely. While they continue to enjoy an after-tax yield advantage across the entire yield curve, they face several risks from an absolute perspective," Joe Kalish, chief global macro strategist at Ned Davis Research, said in a note.

Specifically, Kalish underscored the fiscal stalemate in Washington. If additional fiscal support stalls in Congress, some states, cities, and projects could face funding problems.

"That's why we would stick to the higher-rated munis for now," Kalish said. "In fact, lower quality munis have failed to make up the relative performance drop since the beginning of the pandemic."

Municipal securities are near their lowest yields compared to their duration in over the past 20 years.

"Although we are not looking for yields to move very much in the near-term, the yield cushion is tiny relative to the interest rate risk," Kalish said.

Municipal bond supply was also at a record high and fairly strong even before Labor Day. On the other hand, demand has been on the decline. Meanwhile, the continued supply from the Treasury and corporate sectors will also pressure munis as a source of income.

Kalish pointed out that dealers have been de-risking, paring their inventories, and increasing liquidity risk. Cash levels among funds, though, remain relatively high.

Lastly, seasonal factors are negative over the next couple of months and have pressured the muni market.

Looking ahead, some analysts even predicted that the muni market could suffer from downgrades. Prices across most of the market remain at or near pre-pandemic highs even as borrowers' finances have grown weaker, the Wall Street Journal reports. Moody's Investors Service already lowered its outlook to negative on all muni sectors except for housing-finance agencies and water, sewer, and public power.

"It's amazing that we've sustained six months of being shut down to some degree with very minimal rating actions," Lisa Washburn, a managing director at Municipal Market Analytics, told the WSJ.

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