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A Wild Ride Through Muniland.

Usually a relatively stable part of the market, munis have seen an uptick in volatility in the past several months.

Municipal-bond strategies saw record inflows in 2019, as investors poured a massive net $117 billion into open-end muni funds from the start of that year and through the first two months of 2020. That amount dwarfed the annual gains of each of the past 25 years, including the group's previous boom year of 2009, which brought in roughly $75 billion. Investors' fervent demand for munis was stoked by a variety of factors, including continued economic growth in many parts of the United States, which supported solid credit fundamentals and low default rates of muni issuers.

But that voracious appetite quickly disappeared as the coronavirus-driven sell-off got under way in late February 2020 and quickly spread beyond equities to most segments of the fixed-income markets. Astonishingly, a significant portion of the assets that poured into muni-bond funds since early 2019 took a little over 14 days to evaporate and with them went a year's worth of gains. Investors pulled a record $45 billion from muni funds in March 2020 (equivalent to four months of inflows from November 2019 through February 2020), resulting in the worst-ever organic growth rate–negative 4.9%–for muni-bond open-end and exchange-traded funds. Nearly a fourth of those outflows came from the high-yield muni Morningstar Category: The March 2020 median loss for a strategy in that group was 8.8% in March.

Muni fund portfolio managers report that what first started as a loss of interest in historically low-yielding muni bonds in late February 2020 turned to indiscriminate panic selling as investors rushed into cash by mid-March. At that point, the market's brokers' oversaturated inventories resulted in a liquidity crunch and a virtually frozen muni bond market, particularly on the short end of the muni yield curve. For the first time in history, the Federal Reserve announced plans to include the purchase of short-term muni bonds as a part of the federal CARES Act in late March, which helped markets return to more balance. Yet instability persisted.

April brought some normalcy back to the muni market. Outflows from muni-bond funds waned when some investor interest peaked again as muni prices remained low. Yet investors remained cautious as concerns grew for the longer-term fiscal health of all types of municipal entities. Indeed, these have been significantly affected by the unprecedented response to combating the coronavirus. It became apparent that the burden of providing much of the equipment and services needed would fall to the states at the same time that municipal revenues were drying up because of a severe economic slowdown. As of mid-May, many market participants expect continued stress as issuers struggle with unexpected revenue disruptions and budget pressures for the foreseeable future.

While few muni market segments remain unscathed to date, it's not surprising to note that strategies in the high-yield muni category saw more significant declines compared with their higher-quality counterparts through the most recent market turmoil. The riskier, low-quality fare that drove robust returns in the strong muni markets of 2019 got stung in 2020. Funds that loaded up on some of the market's riskier names and leveraged structures followed in that rollercoaster's tracks. While the high-yield muni cohort's results shone in 2019 with a median return of 9.4% for a distinct group of strategies in the category, its median loss was 14.2% from Feb. 20 through March 23, 2020. For some of the most aggressive funds in the category, losses reached closer to 20%. From Jan. 1 through April 30, 2020, results were better, but the average strategy was still down 8.6% over that time. Funds that focused on higher-quality offerings and that generally take less interest-rate risk fared better in 2020's market volatility. For example, the median loss for a distinct group in the muni national intermediate category was 9.2% from Feb. 20 through March 23, 2020, but a milder 2.6% from Jan. 1 through April 30, 2020.

Within their respective municipal categories, the same pattern held: Muni strategies with less risk tended to fare better compared with peers going into March 2020. In particular, Vanguard's conservatively positioned and attractively priced suite of muni funds held up relatively well in the market's recent stress. Vanguard Intermediate-Term Tax-Exempt (VWITX), which has a Morningstar Analyst Rating of Gold, and Vanguard Tax-Exempt Bond (VTEAX), for example, lost 8.6% and 9.0%, respectively, from Feb. 20 through March 23, 2020, while some of their more aggressive peers' losses were in the double digits. From the beginning of 2020 through the end of April, these funds are down roughly 1.7% each. Also, in the muni national intermediate category, Fidelity Intermediate Municipal Income (FLTMX) and T. Rowe Price Summit Municipal Intermediate (PRSMX) (both rated Silver) slid less than many category peers, down roughly 8.6% and 8.4%, respectively, over the height of 2020's volatility and down roughly 2.4% each from Jan. 1 through April 30, 2020. These strategies are run by well-resourced muni shops with strong management teams and deep analysts benches that aid in their value-conscious approach. Each has provided solid downside protection in previous bouts of market stress through a bottom-up research effort coupled with strong risk analytics and a focus on higher-quality bonds when populating the portfolios.

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May 18, 2020

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