
Municipal Markets Continue To Feel The Pressure This Year, Yet Fundamentals Remain Stable.

The municipal bond market has not been immune to bouts of volatility hitting the markets this year, but there are still pockets of opportunity, according to Franklin Templeton Fixed Income's Director of Municipal Bonds, Ben Barber. He points to improving technical conditions, stable fundamentals and inexpensive valuations that make the asset class look compelling.

Historic levels of volatility in the municipal (muni) bond market so far this year has caused investor concerns over market conditions. A more hawkish sentiment from the US Federal Reserve has led to higher yields across fixed income sectors, causing many retail investors to reduce their muni holdings in search of shelter from anticipated higher volatility.

As in previous updates, we wanted to provide an outlook and review on three major components of the muni markets that continue to create opportunities for active managers within the muni market, despite the challenging environment.

Technical conditions in the market have improved for tax-exempt investors as the year has progressed, yet outflows of funds from the sector persist. Primary issuance has slowed through the summer. Reinvestment of dividends and refundings have caused increased demand for new bond issuance. The market typically witnesses additional new supply in September and October, which can provide investors with new opportunities to put cash balances to work.

Total net flows of funds were negative in the month of August, driven by a selloff from exchange traded funds (ETFs) toward the end of the period.1 Additionally, mutual funds saw outflows during the month, although to a lesser extent.

- Outflows have been concentrated in longer-duration, investment-grade products. In contrast, there have been positive monthly net flows into intermediate investment-grade products.2

As of the end of August 2022, year-to-date (YTD) total issuance was down 14% relative to 2021. This is primarily due to a 42% decline in taxable muni issuance, as higher interest rates have made taxable refundings uneconomical for most issuers.3 In contrast, tax-exempt issuance is only lower by 5% YTD.4

Fundamentals across the muni market are generally stable. However, there are some sectors, such as certain segments of transportation and health care, that have been affected by operating cost pressures including from labor challenges. We continue to monitor the impact of rising interest rates, inflation, the end of federal COVID-related aid, as well as labor market and wage concerns on muni issuers' financial conditions.

Taking a deeper dive into the market, multifamily housing has traditionally performed well in a rising rate environment. As purchasing single-family homes become less affordable, more households are forced to rent with increasing rental payments. From mid-2006 to mid-2009, the average single-family home price nationwide plummeted nearly 24%.5 Over the same period, the median national rental rates increased 5.6% annually on average.6 However, vacancy rates did not materially increase helping to support property values of multifamily housing units.

Meanwhile, high levels of Inflation and higher wage demands continue to increase labor costs for hospitals and Continued Care Retirement Communities (CCRCs), pressuring operating margins to levels not seen since the height of the pandemic. However, elective surgeries are rebounding, which is providing support to hospital bottom lines.

- Fees from airports, ports, and toll roads are steadily increasing, while public transit systems are still experiencing lulls in ridership. Increased traffic and higher fares due to inflation have benefitted toll roads, airports and ports, which have been performing well.
- Underwhelming farebox revenues from public transit continues to pressure operating margins. Fortunately, many public transit systems have alternative funding streams such as receiving revenue from a portion of state sales taxes.

Security selection will remain critical to relative performance in the current market environment. Historically, our muni bond team has been very active in periods of volatility, and this period is no different. As shifting credit fundamentals begin to cause stress in certain areas of the market, we believe our research and portfolio management teams are well positioned to identify potential winners and losers.

Valuations on the long end of the muni-bond maturity curve remain reasonable to us, while the short end has become relatively expensive compared to earlier in the year.

- The 10-year muni-to-Treasury yield ratio was relatively flat over the month, ending August at 82%, while the 30-year ratio increased to 102%.7
- Muni taxable-equivalent yields remain attractive compared to other options available to retail investors. Considering the lower default characteristics and higher after-tax income, we believe the municipal sector remains a compelling choice for clients seeking risk-adjusted returns.

Given the combination of strong fundamentals, cheaper valuations, and the potential of improved technicals, the Franklin Templeton Municipal Bond team feels that the sector can provide strong risk-adjusted returns moving forward. Our team remains active in the market, finding pockets of opportunity that we think will allow our portfolios to be positioned for a strong recovery.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested.
Because municipal bonds are sensitive to interest rate movements, a municipal bond portfolio's yield and value will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the portfolio's value may decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value.

by Ben Barber of Franklin Templeton, 9/27/22