
The Municipal Bond Market's Strong Fundamentals Could Prevent a Repeat of 2008.

Investors have found few safe havens amid 2022's rocky economic ride. The flow of COVID-era stimulus programs–which buoyed economic growth for the better part of the last two years–are now being withdrawn.

In the wake of that ebb, most asset class returns have eroded. And yet, many state and local governments used the growing tax revenues and fiscal stimulus from the past few years to shore up fiscal positions. The result? A municipal bond market whose strong fundamentals appear to have left it prepared for the uncertain market to come.

The yin to the muni market's yang

There's no doubt that 2021 was an exceptional year for muni investors. Interest rates were low, credit spreads were tight, and bonds rallied. Nevertheless, that result was far from the expectation at the start of the cycle. Back at the outset of 2021, many municipalities expected major revenue declines. In preparation, they battened down the hatches and slashed expenses.

The revenue declines never materialized.

Instead, federal government-funded relief–in the form of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, and the American Rescue Plan Act (ARPA)–helped fill local coffers. At the same time, home prices and wages continued to rise, lifting revenues from property taxes and wages.

Then 2022 swept in, bringing with it a flurry of financial turbulence that brought financial markets back from their extreme valuations. Munis faltered, along with most asset classes. Still, markets move in cycles. This year's turnaround, when viewed through a wide-angle lens, reflects that cyclical nature. COVID-era monetary policy and fiscal stimulus programs are reversing. Subsequently, interest rates are rising toward historical norms. In short, the economic snapback of 2022 is carrying muni bonds into a period of normalization.

Still, municipalities are fiscally fit

Many state and local governments deployed COVID-era stimulus to fortify themselves against future downturns by building rainy day funds and funding pension obligations. Going forward, tax revenues are likely to remain stable, as real estate assessment values won't fall at the same rate or extent as a slowing housing market.

The combination of those previous and future revenue sources isn't just good for municipalities—they're also positive for their investors. As autumn gets underway, average municipal yields are at their highest levels in 10 years. It's a high-quality asset class (more than 85% of the market is rated A or higher, according to our analysis of market data) with a strong fundamental risk profile, particularly compared with corporate bonds.

Current valuations, particularly among longer-term issues, are close to those of Treasuries, which are generally subject to federal income taxes. Muni bond interest, by contrast, isn't taxed at the federal level. And states don't tax the interest on bonds they issue to their residents. That means that today's munis are paying investors a more elevated tax-exempt income than taxable equivalents.

Note that although the income from a municipal bond fund is exempt from federal tax, you may owe taxes on any capital gains realized through the fund's trading or through your own redemption of shares. For some investors, a portion of the fund's income may be subject to state and local taxes, as well as to the federal Alternative Minimum Tax.

Despite talk of a downturn, the muni market future's is still bright

With signs we may be heading towards a recession, munis–particularly those in the high-quality space–appear ready to weather the storm. A recession will inevitably lead to some revenue drop-offs, but many municipalities will face those headwinds from a strong fundamental position. The combination of low debt and sufficient cash can act as a buttress against a downturn.

In fact, munis are in much better shape than they were in 2008 before the global financial crisis. Back then, many U.S. states were facing budget shortfalls, some of them quite severe.

That's far from the case for many of today's local governments, which is great for investors. At Vanguard, for example, we're actively upgrading the quality of our muni portfolios while repositioning for the higher interest rate regime we appear to have entered.

Despite widespread financial turbulence, muni observers are witnessing a market that's as attractive as it's been for decades. Rates are up and high-quality credit is readily available. At the same time, municipal bonds are relatively inexpensive on the basis of both fundamentals and historical norms. It could be a great time to get in on this attractive asset class—but only if you intend to stay for the long haul.

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