Why Income Investors Should Revisit Municipal Bond ETFs.

Investors should consider the opportunities in the municipal bond market and turn to related exchange traded fund strategies to diversify back into this fixed income category.

In the recent webcast, Munis Positioned to Shine in 2023, Michael Cohick, director of product management at VanEck; and Tamara Lowin, senior analyst, municipal bonds at VanEck, pointed out that municipal bonds now offer yields not seen in more than a decade, aside from a spike at the onset of the pandemic. Investors need to pay attention to these higher income levels as they consider portfolio positioning for 2023. In addition to attractive yields, supportive market dynamics, resilient credit quality, and important tax benefits make munis a key asset class to own.

The strategists argued that a difficult year in 2022 has resulted in the highest muni yields in over a decade and these highs may present a good buying opportunity for a variety of investors. Historically, municipals have experienced a strong recovery in years following large drawdowns, so this bond segment may be poised to shine in 2023.

The inverted yield curve could also point to better returns in 2023. In 2000 when the U.S. yield curve or 2-10 year slope was -49 basis points, the following year broad municipal bond market returned about 4.5%. More recently in 2019 when the year curve slope was -5 basis points, the following year's return for the broad muni market was 5.0%.

Meanwhile, yields in the munis market are much more attractive and are above their 10-year averages, with investment-grade munis showing a 3.5% yield and high-yield munis putting out a 5.9% yield.

Fundamentals could also support the muni outlook after a severely muted supply and massive fund outflows. On the demand side, we just saw $111 billion pulled out of mutual funds, ETFs, and money market funds belonging to the Municipal Bond Morningstar US Category Group in 2022. On the supply side, new issuance over 2022 was down 25% year-over-year and fell below the long-term average.

While the economy may be slowing, default risk remains low in the munis segment. Specifically, we only saw 52 municipal bond defaults in 2022 and the VanEck strategists projected that we are not likely to see a substantial increase in 2023 either. Many municipalities are flush with cash, with only Nevada seeing below 0% tax revenues generated over the rolling four quarters. Tax revenues in most states even outperformed pre-pandemic levels.

To cover the full spectrum of risk/reward opportunities in the munis space, VanEck offers a suite of municipal bond-related ETFs. For example, the VanEck Vectors Short Muni ETF (SMB), the VanEck Vectors AMT-Free Intermediate Municipal Index ETF (CBOE: ITM), and the VanEck Vectors Long Muni ETF (MLN) can help investors focus on varying points across the yield curve.

The VanEck High Yield Muni ETF (HYD) and the VanEck Short High Yield Muni ETF (SHYD) offer targeted plays on credit quality to focus on high-yield debt.

The VanEck HIP Sustainable Muni ETF (SMI), which debuted as the first exchange traded fund dedicated to green municipal bonds, seeks current income generally exempt from federal income tax by investing in investment-grade municipal debt securities that have been issued to fund operations or projects that support or advance sustainable development, as well as promote positive social and environmental outcomes.

The VanEck Vectors Municipal Allocation ETF (Cboe: MAAX) can provide maximum long-term after-tax return consisting of capital appreciation and income generally exempt from federal income tax. In pursuing long-term total return, the fund seeks to reduce duration and/or credit risk during appropriate times by allocating primarily to VanEck municipal exchange traded products that invest in tax-exempt bonds.

Lastly, the VanEck Vectors CEF Municipal Income ETF (XMPT) seeks to replicate the performance of the S-Network Municipal Bond Closed-End Fund Index (CEFMXTR), which is intended to track the overall performance of the U.S.-listed closed-end funds that invest in U.S. dollar-denominated tax-exempt market.

ETF TRENDS

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