Bond Case Briefs

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Why the Next Year Is Great for Muni Investors.

In today's high rate environment, understanding the impact of high rates on bonds, particularly municipal bonds, makes a difference between capturing alpha opportunity or simply taking on additional risk. Tom Lydon, vice chairman of VettaFi, dove into the current environment and outlook for muni investors with David Hammer of PIMCO and Matthew Norton of AllianceBernstein at VettaFi's Fixed Income Symposium.

Today's macro environment remains complex, and David Hammer, municipal bond portfolio manager at PIMCO, described all the major factors the firm continues to track. These include the directionality of monetary policy and how that plays out on the credit cycle, and inflation.

Within munis specifically, the current macro environment impacts aspects such as tax collection, while inflation benefits particular sub-sectors such as multi-family housing. Interest rates also play a specific role in volatility within bonds and munis.

"We found over that over long periods of time, interest rate volatility is actually a good predictor of inflows and outflows into the muni market," Hammer explained. Given the reduced liquidity in munis in today's markets, flows currently have an outsized impact on muni prices.

"Top-down, things look pretty good in our view for the muni market," Hammer said. The positive outlook isn't solely because of expected performance in a shallow recession, but for how "munis perform in the tails." Municipal bonds carry lower default risk than many of the broader bond asset classes. In a slowing economic environment when default risk rises, munis offer the potential of greater stability.

Finding the Pockets of Opportunity Within Munis
70% of attendees believe that municipal bonds are a better choice than government bonds for taxable accounts in the next 12 months.

"We certainly agree that municipal credit is very attractive," said Matt Norton, CIO for municipal bonds at AllianceBernstein. "The balance sheets of most state and local governments are in the best shape that they've ever been."

That said, AB predicts a slowing environment which will affect municipal bond demand. Munis remain most popular with individual investors. Retail investors largely haven't come back into bonds in the rising rate environment, creating an environment of wider spreads. "We haven't seen credit spreads tighten relative to where the fundamentals should be."

Muni sectors that AB finds attractive currently are those with cash flow, such as charter schools, multi-family housing, and, increasingly, healthcare. "We think the valuations are attractive right now," Norton explained.

Looking further afield, PIMCO believes that Puerto Rico holds high opportunity post-bankruptcy, given future credit spread tightening.

In the scenario of a soft landing, Norton believes munis still look appealing. “Municipalities… tend to not have these big debt maturity walls. They tend to have liquidity built into deals.” Most prominent is their ability to adjust tax rates that lead to lower defaults over time.

Mitigating and Balancing Risk in Municipal Bonds
There are sectors of munis that currently are higher risk both now and in the coming months. Senior living facilities are less attractive currently and looking ahead, with a high likelihood of increasing defaults. Hammer believes this sector is actually the highest default sector within municipal bonds. Another sector to watch includes municipal transportation as federal COVID loans come to an end. However, Hammer anticipates releveraging as opposed to defaults in this arena.

When looking to add more interest rate or credit risk in portfolios, Norton acknowledged the changing macro environment’s impact. “If you would have asked me six months ago, I would have had a different answer. My answer right now is both.”

“The impact of the regional banking crisis creates some opportunities in the muni market,” Hammer said. The yield curve is one major way to play the current environment. PIMCO currently employs a barbell strategy with muni bonds in both short-duration and long-duration munis with the ability to roll down the curve.

Muni Investors Should Seize Opportunity Now
Municipal bonds remain somewhat of an outlier in regards to flows and credit spreads within fixed income as bond prices rally. “Municipal credit remains on the wide ends of its band in terms of cheapness,” Norton said. Given that the majority of muni investors are retail investors, flows are likely to come flooding back into munis as rates fall in the next year, narrowing spreads.

Active management within munis allows for better potential capture of the pockets of opportunity while avoiding the risk pitfalls. Hammer views today’s environment as highly conducive to active management.

“It’s a target-rich environment. The lack of liquidity is pretty good for active managers. We’re excited about the future opportunities with a really positive credit fundamental backdrop,” Hammer explained.

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