Market Update from Thrivent

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Municipal bonds show signs of opportunity

Out of all the asset classes in the markets, many people consider the U.S. municipal bond market to be quiet and staid, even boring. But that hasn't been the case lately. Municipal bonds, called "munis" for short, were hit hard, like many financial assets, when the coronavirus that causes COVID-19 circled the globe. As the pandemic spread in the U.S., local economies around the country slowed abruptly, affecting revenue streams for a wide variety of municipalities and related entities. The impact has been uneven across geographies and sectors. However, the resulting upheaval in municipal bond markets has now presented attractive investment opportunities for investors.

How do municipal bonds work?

Before we delve into the details, let's cover some basic information. The U.S. municipal bond market is where states and local governments, as well as certain tax-exempt entities, raise capital for governmental functions and capital improvements. The income is federally tax-exempt to the bond buyer, which enables the issuer to pay a lower rate of interest to investors.* Governmental units accessing funding in the "muni market" can pledge their general obligation (i.e. power to levy taxes) to repay the bonds.

Muni issuers include states, cities, counties, and school districts. The muni market also encompasses entities that pledge the revenue stream from a project or facility, such as airports, toll roads, nonprofit hospitals, water and sewer providers, certain electric utilities, nursing homes, colleges and universities, to name a few. Muni buyers usually fall into three main categories: banks, insurance companies and individuals. They invest via mutual funds, separately managed accounts, or direct purchases.

The pandemic's affect on the muni bond market

So, what happened to this market to make it more exciting? For starters, 2020 began as a continuation of 2019, with large, steady cash inflows into municipal bond funds. The U.S. economy was strong, and the unemployment rate was low, allowing many municipal bond issuers to improve their financial condition. Investors were more concerned about finding bonds than the price they paid for them. As a result, credit spreads – a form of risk premium – were narrow, meaning investors were compensated less to take risk.

Enter into this placid scene the novel coronavirus. By mid-March, it became obvious that this virus was a pernicious threat. The muni market began to see record cash outflows, rather than the regular cash inflows that had persisted for more than a year. Many ETFs and mutual funds, especially the ones that employ leverage, were forced to sell some of their holdings, creating price pressure which then lowered net asset values. The market for newly issued bonds dried up. Beginning on March 10th and continuing for nine business days, investors panicked and the muni market was in free fall.

After this gut-wrenching pandemonium, the Federal Reserve and U.S. Congress swung into action, lowering the Federal Funds rate to practically zero and creating the Coronavirus Aid, Relief and Economic Security Act (CARES Act), which helped support muni bond issuers. Later, the Fed created the Municipal Lending Facility (MLF). By demonstrating concrete support for many types of muni issuers, these actions improved confidence in the muni market, allowing most of the market to recover its equanimity. (It's important to note the "most," because the muni market is dominated by high-quality credits with solid balance sheets that very rarely, if ever, default on their bond obligations.) As a result, the prices of many bonds issued by the highest quality credits have even returned to levels that existed before the crisis.

However, there is another, smaller corner of the muni market with lower-grade credits and less-steady financial conditions that has displayed reduced, but continued, volatility. This is typically referred to as the high-yield muni market. The prices of bonds issued in this corner of the market are still substantially lower than pre-COVID-19 days.

Economic slow-down affects municipal bonds

Where does that leave us? At this stage, with many states having issued "stay at home" orders and global trade reduced, the U.S. economy has sustained considerable damage. Tax revenues are lower and many people are out of work. Travel has been dramatically reduced, hospitals have ceased elective surgeries, schools of all types have moved to online education, and people are not enjoying as many meals out or their usual entertainment pursuits.

This decrease in economic activity has also had an impact on municipal bond issuers. Some might need to dip into their rainy-day funds or other financial reserves. Many will receive funds from the Federal Government through the aforementioned CARES Act provisions. And some will need or desire to raise capital through bank loans or by issuing new bonds.

The market for high-grade credits is again open for business, allowing those entities who wish to borrow money the ability to do so. In the event high-grade credits are unable to borrow at "normal" rates (the Fed's choice of words), the Fed's MLF program stands ready to loan money for up to three years. The greater risk for these high-grade borrowers is a credit rating downgrade, not default.

In the high-yield muni market, issuers are at a higher risk of default if the economy stays weak for too long. However, the high-yield muni market itself is a collection of very different types of issuers who can't be painted with the same broad brush. It's important for investors in high-yield munis to do thorough research into their credits' financial condition and the legal terms of the bond indentures. For instance, how much liquidity—such as Days Cash On Hand (DCOH)—did these entities have at their disposal? In addition, did the indenture create and fully fund a debt service reserve fund? And what security interest has the bondholder been given? These details are of the upmost importance.

It also will be key to watch the local economy these issuers function in. When and how quickly does the area reopen for business? Are people going back to work or languishing on unemployment? Are students planning to attend college or university in-person and live on campus? In essence, how able and comfortable are people resuming the lifestyle they had before COVID-19? While the answers to these questions are important for all muni investors, they are especially important to high-yield investors. Since high-yield issuers have fewer financial options, generating consistent, sufficient income is essential to their ability to repay their debts.

Options for investors in the muni market

In general, the muni market offers compelling value for investors, especially those in higher marginal tax brackets. Municipal bond yields across the maturity spectrum are generous when compared to U. S. Treasury securities. (High-grade muni yields are currently anywhere from 150-500% of the U.S. Treasury, depending on the number of years to maturity.) If an investor believes that tax rates will increase in the future, these relative valuations are especially attractive now.

For tax-sensitive investors who prefer steady income and lower price volatility, the high-grade muni market may be an appropriate and attractive option. Suitable investments could include:

- Well-run states and local governments, especially those that have managed their pension programs well,
- In-demand colleges and universities with large endowments,
- Utility systems with many and varied customers,
- Hospital systems with a good payor mix and a healthy operating margin, and
- Critical transportation infrastructure.

For those tax-sensitive investors who are willing to take more risk for the potential of greater capital appreciation, the high-yield muni market is full of opportunity. A word of caution is appropriate, however. While the high-yield market offers many opportunities, it also entails the risk of potential and sizable principal loss. Some examples of these potential investments might be:

- Small governmental entities reliant on a single source of tax revenue,
- Colleges that rely on revenues from athletic programs to balance their budgets,
- Stand-alone hospitals in areas where many people are unemployed or lack health insurance,
- Senior living facilities that need to fill empty rooms, and
- Any project that entails large groups of people gathering together in close quarters (stadiums, convention centers, etc.)

For these investments, the proverbial devil will be in the details. And in this type of environment, working with a professional asset manager is critical.

For all muni market investors, the long-term health and growth of the U.S. economy will be vital to continued success. It will take some time to recover from this pandemic, but if people earn money, spend money, travel, pay their taxes and utility bills, go to school, and go to the hospital for ailments other than just COVID-19, the muni market will happily go back to being a quiet corner of the fixed-income universe.

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*While the interest earned on a municipal bond are usually federally tax-exempt, any capital gains distributions, as well as realized capital gains from selling the bonds, may be taxable. Some issues may be subject to state and local taxes and/or the federal and state alternative minimum tax (AMT).

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recommendation of any particular security, strategy or product. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance.

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