MUNICIPAL BOND MARKET UPDATE

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GW&K INVESTMENT MANAGEMENT

VIDEO TRANSCRIPT

Jeffrey Devine, Municipal Research Analyst: Hello, I'm Jeff Devine. I work here at GW&K in the Municipal Research Department, and I'm joined by my colleague Kara South — she is a muni bond portfolio manager — and we've been fielding some client questions that we feel are important to address.

So, Kara, the first question we have is in regards to the challenging year it's been for the municipal market. What are some of the drivers behind that negative performance?

Kara South, CFA, Municipal Bond Portfolio Manager: Yes, it's been a challenging year for the muni market, as it has been for all fixed income markets. In fact, it's been one of the worst bond markets that we've had in over 40 years. It's been a rate driven sell-off, that's been due to the high levels of inflation and aggressive Fed policy that we've seen. So really no matter where you've been invested in fixed income you've had negative total returns this year, with the longer your duration the worse your performance.

And there's been a couple drivers of why performance has been so negative. One is the rapid rise that we've seen in yields in a relatively short period of time. So if you look at muni yields, they're up 150 – 200 basis points across the curve in an 11-month period. The other factor is just the low-rate environment that we started the year in.

If you look at the 10-year AAA muni yield, it was close to 1% when we started the year. When you look at a bond, there's really two components of return. There's your coupon, which is fixed and set at the time of issuance, and then there's your price return. And that price return is going to fluctuate based on changes in interest rates, although you'll ultimately get par at maturity, unless there's any sort of credit impairment.

In the past we have seen periods, for example in 1994, where we've seen a rapid rise in yields, but what was different at that time versus now was the higher starting yield, which offset some of that negative price impact.

More recently in the market we have seen stronger performance. Part of that has been driven by the direction of Treasury yields and part of that has been driven by supply being constrained. So again, recent performance has been stronger, but hasn't been enough to offset that negative year-to-date number.

Jeff: Right, and in fact, November year-over-year supply was down 47% and at $20 billion, it was one of the lightest months we've seen in decades, and given our expectations of a light calendar as we move into 2023, we really think that sets up a pretty favorable technical environment and should support the market going forward.

The second question we have is, with the potential for a slowdown in economic growth, are you concerned about municipal credit?

Kara: Fundamentals within the muni market remain very healthy. We've seen strong revenue growth and a record level of reserves. I think what's different now versus, say, the 2008 – 2009 time period is just the level of federal support and stimulus that was received during the pandemic. And that really enabled municipalities to shore up their balance sheets and make additional pension contributions. That's not to say that if we do go into a slower economic period that we won't see a decline in revenue growth, but our view is that the starting point is very strong.

So through the first half of the year we're at 16 to 1, meaning 16 upgrades for every one downgrade, which just shows you the positive credit trajectory we saw coming into this period.

Jeff: I think a great example within that is Illinois and New Jersey. These are two of the lowest-rated states that have seen multiple upgrades and multiple positive outlooks by the major rating agencies over the last couple years.

One area of the market to monitor, though, is the health care space. This is an area that has seen some pretty intense labor pressure and overall cost pressure. With that said, I think it's worth noting that at GW&K we really like to focus on these large single- and multi-state systems that have good balance sheets and really are able to withstand some of this credit pressure on them.

And then finally, Kara, the last question we have: Is now a good time to invest in municipals?

Kara: So the good news is that the pain of this year will be a benefit going forward in terms of higher yields and better expected returns. As a long-term investor, you actually want interest rates to rise, and the reason for that is because you are able to invest your income at higher and higher yields, which improves your effective return over time. In fact, that reinvestment rate is typically your largest component of return.

The other thing to keep in mind is the difference between stocks and bonds. With bonds, you're ultimately going to get par at maturity, like I mentioned, unless there's any sort of credit impairment — so that's regardless of the price path that it takes to get there. And when you buy a bond, you lock in the yields at the time that you purchase it. So, periods of negative performance are going to be offset by periods of positive performance until it ultimately converges to the yield you purchased it at.

We have seen muni yields come off their recent peak, but our view is that it's still a very good entry point. If you look at yields, they're still twice the level that we started the year at. If you look at the 10-year AA muni yield right now at 2.75%, if you adjust that for an individual or investor in the highest income tax bracket, it comes out to a little over 4.5% — so a very good yield for a high-quality asset class.

Jeff: Yes, and one of the big themes this year really has been the mutual fund outflows that we've seen. Retail investors really getting spooked by the negative performance and having bought bonds at low yields really selling them into a rising yield environment. But, with that said, we think that this presents a really good opportunity for us to buy cheap bonds for our clients and capture those higher yields.

Hopefully that addresses some of the questions that we've been receiving, and Kara, thank you for joining me.

Kara: Thank you.