Municipal Market Update: Rising Rates
First Quarter 2022

Muni Yields Widen in Q1

Tax-exempt investors will likely see some price erosion in their bond portfolios after a significant shift to higher yields in the month of January. It was the worst January on record for the municipal bond market. Historically speaking, January is usually one of the better performance months of the year, supported by elevated coupon cash flow and maturities on January 1st. Those technical factors failed to emerge this year. Whether this was a result of a more hawkish Fed remains a question. Regardless, cash outflows in the municipal asset complex were a headwind for most of January. A fairly robust new issue calendar coincided with these outflows which set up for a meaningful correction in tax-exempts for the month. The two slides below show first the extent of the benchmark AAA yield shift, as well as the current AAA – U.S. treasury ratios.

	A GO-AAA	B GO-AAA	
Term	1/31/22	12/31/21	Spread (+/- BPs)
1 Yr	0.682	0.189	49
2 Yr	0.905	0.245	65
3 Yr	1.032	0.337	69
4 Yr	1.150	0.456	69
5 Yr	1.249	0.602	65
7 Yr	1.411	0.853	56
10 Yr	1.576	1.051	53
15 Yr	1.720	1.224	50
20 Yr	1.843	1.349	49
25 Yr	1.960	1.488	47
30 Yr	2.003	1.541	46

	A GO-AAA	B Treasury		
Term	1/28/22	1/28/22	Spread (+/- BPs)	Spread (%)
1 Yr	0.670	0.720	-5	93.1
2 Yr	0.893	1.199	-31	74.5
3 Yr	1.021	1.410	-39	72.4
4 Yr	1.139	1.542	-40	73.9
5 Yr	1.238	1.630	-39	75.9
7 Yr	1.400	1.744	-34	80.3
10 Yr	1.565	1.785	-22	87.7
15 Yr	1.711	1.876	-17	91.2
20 Yr	1.834	2.144	-31	85.6
25 Yr	1.951	2.140	-19	91.1
30 Yr	1.994	2.085	-9	95.6

Some of the changes in the curve are notable. Investors can capture 3x more yield in 3 years than the beginning of the year. In 5 years, an investor can capture more than double the yield that was available to start the month. In 10-15 year part of the curve, yields have increased by nearly 50%. Yield on our newly constructed portfolios is almost 2x of what it was just a month ago.

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Spike in Yields

This spike in tax-exempt yields is likely to catch the attention of many municipal bond investors. With the widely expected Fed Funds rate hike still 45 days away, and the pace of the rate hikes weighing on investors' minds, we are likely to see the outflow persist. We do not expect this outflow cycle to last for an extended period of time. Our approach in the near-term is to continue to be selective for both new issue and secondary market purchases.

There are other positive factors to consider at this time. Tax-exempt investors have more opportunity to add yield to their portfolios. The yields shown in the previous graph reflect the AAA levels. Yields in the AA and A categories offer more yield to investors. We are finally seeing widening in credit spreads, which is a welcome development. One major positive for state and local governments is they are in much better fiscal shape than they were two years ago. Wage inflation, increased state tax revenues, and elevated housing prices (which means higher assessed values and property taxes) are all contributors to underlying credit improvement.

The sell-off in January was very similar to the price erosion we saw at the outset of the Covid pandemic. The Federal government provided support to state and local governments at that time which led to a furious rally. The facts on the ground this time around are different. However, with the fiscal health of municipalities, as well as the sizeable amount of cash sitting on the sidelines, we think it will only be a matter of time before the market stabilizes and finds support from investors. In addition to the benefits of diversification, we still think that municipal bonds continue to offer attractive opportunities for taxable investors.