Market Bulletin

November 14, 2019

Municipal bond market: Technical tailwinds and favorable fundamentals

In brief

- Improving credit fundamentals, light tax-exempt supply and robust demand have driven the strong performance of municipal bonds (munis) in 2019. These dynamics are expected to continue.
- The passage of the Tax Cuts and Jobs Act ("TCJA") has shifted supply and demand dynamics in the muni market, resulting in increased demand from individuals, but less demand from institutions. The elimination of issuers' ability to advance refund has lowered new tax-exempt supply.
- Relative to Treasuries, munis provide a yield advantage on a tax-adjusted basis. Moreover, munis have historically been a better hedge against equity volatility when compared to corporate bonds given their higher quality bias.
- As the expansion continues, municipal bonds can provide investors with a source of stable income and portfolio diversification.

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Strengthening fixed income portfolios is a key part of late-cycle investing. In a low-yielding world, high tax bracket investors can find opportunities in the municipal bond market to improve portfolio quality and provide downside protection.

The key advantage of investing in municipal bonds is that the interest generated from coupon payments is exempt from federal taxes. Given this tax benefit, muni demand is largely driven by retail investors, particularly high income earners looking to offset their tax burden. Indeed, households and mutual funds account for 72%[1] of municipal bond holdings. Of this, close to 80% is owned by the top 10% in wealth[2].

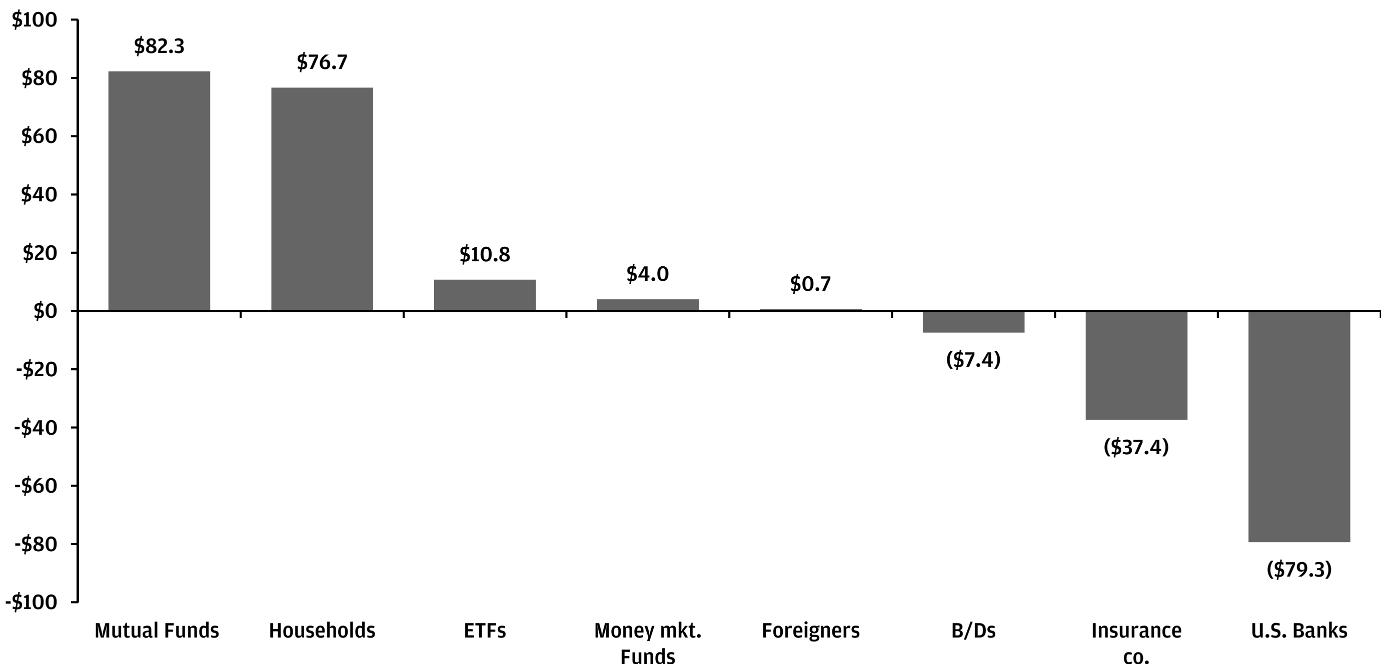
Tax reform: A technical tailwind

Tax policy changes have impacted both municipal supply and demand. On the demand side, the TCJA limits the state and local tax (SALT) deduction available to individuals, increasing the demand for tax efficient vehicles. Conversely, the reduction in corporate tax rates has enhanced the attractiveness of corporate bonds for financial institutions at the expense of muni debt. Still, as shown in **Exhibit 1**, demand from individuals has more than offset the weak demand from institutions since the first-quarter of 2018.

On the supply side, the TCJA removed the federal tax exemption in an advance refunding where issuers look to lower interest costs on outstanding higher interest debt. In an advance refunding, an issuer borrows money ahead of the nearest maturity or call date on an existing bond to pre-refund the future payment. The proceeds from the new issue are held in escrow, typically in Treasuries, in an amount sufficient to meet the interest and principal of the outstanding bonds. Previously, interest on the new debt was federally tax-exempt. Currently, issuers have to pay federal taxes on the debt used to advance refund a bond, reducing the incentive for them to do so unless interest rates are low enough to justify it.

Therefore, tax-exempt issuance declined by 23% in 2018 and is down 3.0% so far this year[3]. Unless tax-exempt advance refunding exemptions are brought back, supply is likely to remain in check. Together, tax-exempt supply constraints and strong demand are likely to remain a tailwind for holders of tax-exempt municipal debt.

EXHIBIT 1: Change in municipal holdings from Q1 2018 to Q2 2019
USD billions



Source: FactSet, Federal Reserve System, J.P. Morgan Asset Management. Data are as of November 8, 2019.

[1] SIFMA: U.S. Municipal Securities Holders Report – June 2019. Includes households, nonprofit organizations, mutual funds, money market funds, closed-end funds and exchange traded funds. Holdings are based on market value.
[2] Data from the Distributional Financial Accounts (DFAs) from the Federal Reserve System.
[3] SIFMA: U.S. Municipal Issuance Report. Issuance is through September 2019.

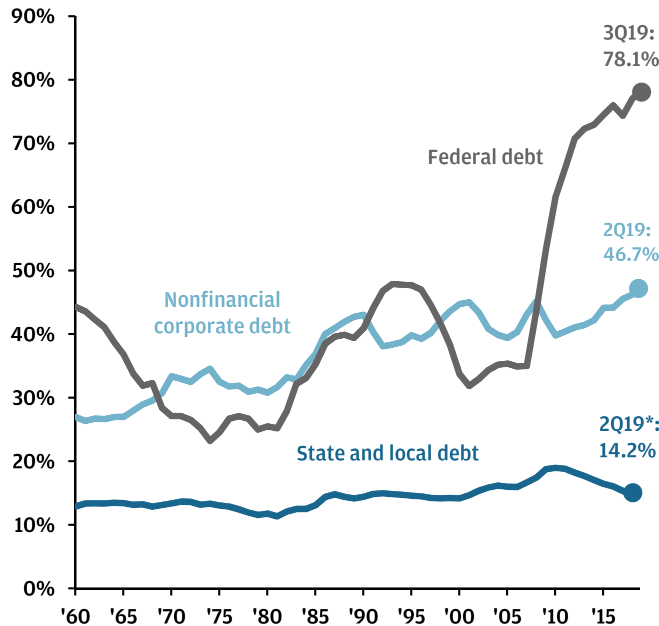
Improving fundamentals with isolated risks

Like taxable bond investors, credit risk is a key consideration for municipal investors. In our view, fundamentals look favorable given stable economic growth and easy monetary policy.

Going forward, fundamentals are likely to remain supportive for a number of reasons:

- **Balanced budgets:** state and local governments are required to balance their operating budgets, leading to more stable debt levels. As shown in **Exhibit 2**, state and local governments are far less indebted than corporations and the federal government.
- **Stronger rainy day funds[4]:** median fund balances have risen as a percentage of annual operating budgets from 1.6% in 2010 to 7.5% in 2019.
- **Default risks are limited:** over 90% of muni issuers are A-rated or better and cumulative default rates have remained below 1% for investment grade issuers even during economic recessions[5] .

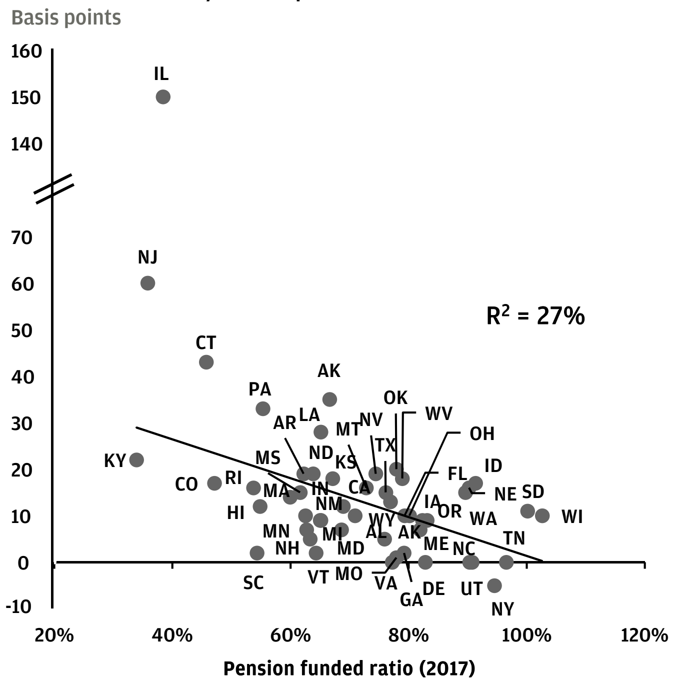
EXHIBIT 2: Federal and corporate debt far exceed municipal debt
% of nominal GDP



Source: BEA, CBO, Census Bureau, Federal Reserve, OMB, J.P. Morgan Asset Management. *Estimate for state and local government is from usgovernmentspending.com. Data are as of November 8, 2019.

While fundamentals are supportive, unfunded pension obligations pose a risk across states given state pensions tend to be one of the most intractable expenses across budgets. Therefore, states with severely underfunded pensions, like Illinois and New Jersey, are perceived as less stable, resulting in higher spreads **(Exhibit 3).**

EXHIBIT 3: State 10 year GO spreads
Basis points



Source: Pew Trusts, Thompson Reuters, J.P. Morgan Asset Management. Spreads are state general obligation (GO) yields over a benchmark municipal AAA-rated GO curve provided by Thomson Reuters and express the perceived credit risk. Spreads are as of November 8, 2019.

Moreover, state migration trends show that high-tax states, like Connecticut and Illinois, are seeing residents leave because of changes to tax law, putting an underfunded pension in an even worse position given this leads to a smaller base on which to tax[6]. However, these risks appear to be limited to a handful of issuers.

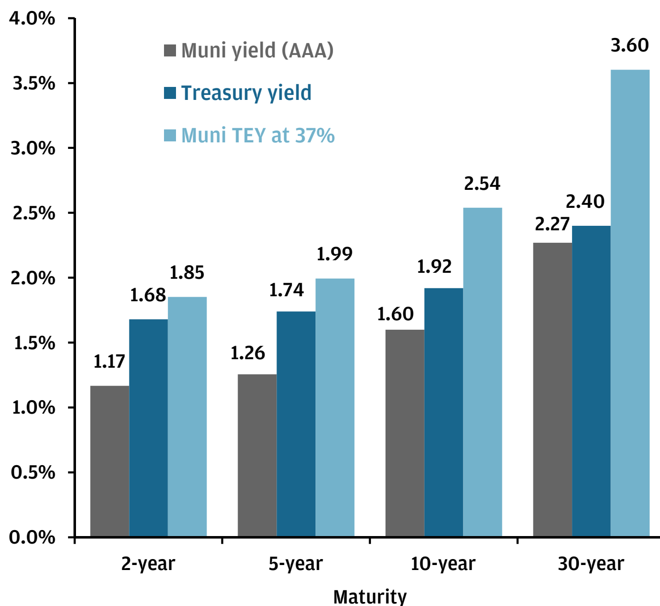
[4] NASBO: Fiscal Survey of States Report, 2019. Rainy day funds are funds reserved for periods of financial stress.
[5] Moody's Investor Services. Cumulative defaults are from 1970 to 2018. Ratings are based on Moody's rating scale and criteria.
[6] Census Bureau's State-by-state Population Estimate, 2018

Outlook

While sub-2% yields may not seem appealing, on a tax-adjusted basis, munis do provide a yield advantage across the curve relative to Treasuries, most notably at the long end. As shown in **Exhibit 4,** current tax-equivalent yields at the front end imply taxable rates close to 2%, while the back end of the curve sports a taxable yield of 3.6%, adjusting for the top income tax bracket.

As both the muni and Treasury curve are extremely flat, there is little income benefit in extending duration. Therefore, for investors looking for income, we'd prefer the intermediate part of the curve; for those looking to hedge, longer-dated high-quality municipals makes sense.

EXHIBIT 4: Munis offer a yield advantage over Treasuries
Tax-equivalent yield adjusted at 37% marginal tax rate

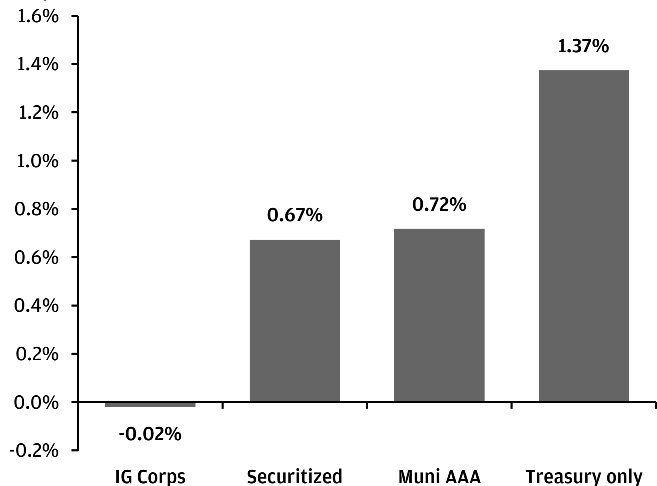


Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management. Municipal yields are based on data from the BVAL AAA Municipal curve. Yields are as of November 8, 2019. Data are as of November 8, 2019.

Muni debt also provides improved protection during periods of equity volatility when compared to other traditional fixed income sectors. As shown in **Exhibit 5,** over the past 20 years in months of bottom decile equity returns, top-rated municipals have, on average, provided better returns than investment grade corporate bonds and securitized products.

Historically, munis have exhibited lower volatility than both corporate and Treasury bonds as well[7]. Overall, the introduction of muni debt into client portfolios can help boost yield while improving downside protection, two important considerations during late-cycle.

EXHIBIT 5: Munis provide comparable returns in steep equity drawdowns
Average monthly performance in bottom decile equity returns, past 20 years



Source: Blomberg, FactSet, Standard & Poor's, J.P. Morgan Asset Management. Sectors shown are represented by Bloomberg Indices - IG Corps: Investment Grade Corporates; Muni AAA: Municipal Bond (AAA); Treasury only: U.S. Treasury - Government. Securitized: Securitized: Securitized - MBS & ABS & CMBS. Bottom decile equity returns over the past 20 years are months in which the S&P was down 5.71% or greater. Data are as of November 8, 2019.

[7] Based on 20 years of data using monthly returns.

Investment implications

- Tax reform is likely to continue to shape the market; strong retail demand and light tax-exempt supply should remain a tailwind for municipal debt.
- The credit outlook remains favorable: economic growth is likely to remain supported by resilient labor markets, a conservative stance across state budgets is helping to improve rainy day funds and default rates are likely to remain low. Moreover, risks around underfunded state pensions and migration trends are limited to a few states.
- Late cycle investing amidst historically low yields requires investors to seek out alternatives that can provide portfolio diversification and yield enhancement. Municipals can help boost taxable yields while providing adequate protection during periods of equity drawdowns.

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