Municipal Rebound? Yes, We've Seen this Movie Before

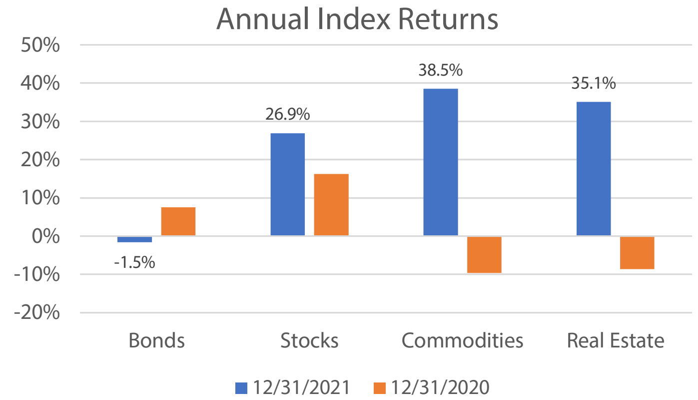
With rising levels of inflation and a surging economy in 2021, bonds unsurprisingly underperformed a wide swath of higher risk assets in 2021. In fact, the Bloomberg Aggregate Bond Index lost 1.5% last year, the worst return for the index since 2013, after returning 8.7% in 2019 and 7.5% in 2020 (Figure 1). On the other hand, stocks commodities and real estate each returned more than 25% last year. While this might have led one to believe that January would begin to lift fixed income boats, the relentless inflationary battle suggested otherwise.

January turned out to be the 6th worst month of performance for bonds over the past 30yrs. The broad bond index lost another 2.1% as investors braced for a series of Fed hikes to combat inflation. Municipals suffered as well, with outflows leading to widening percentages of Treasury levels and the 8th worst month of performance over the past 30yrs and the worst January on record, down 2.7% (Figure 2). In fact, municipal yields rose nearly twice as much as Treasuries over the past month. For example, 10yr exempt yields rose by 52 bp while 10yr Treasury yields rose by 27 bp (Figure 3). Much of this move was a welcomed event as the asset class held at rich levels for much of 2021. The low percentages of Treasury kept all but the highest tax bracket individuals out of the tax-sheltered market. The sell-off took munis from an excessively rich level to a modestly attractive position.

Short-term Performance Expectations

The question becomes, how are munis likely to perform in this cycle from short- and long-term perspectives? From a short-term

Figure 1: Bonds underperformed most asset classes in 2021…



Source: Bloomberg Aggregate Bond Index, S&P 500, Refinitiv Commodity Index, Dow Jones Real Estate Index, HilltopSecurities

Figure 2:…and followed this with one of the worst monthly performances over the past 30yrs in January.

Aggregate Bond

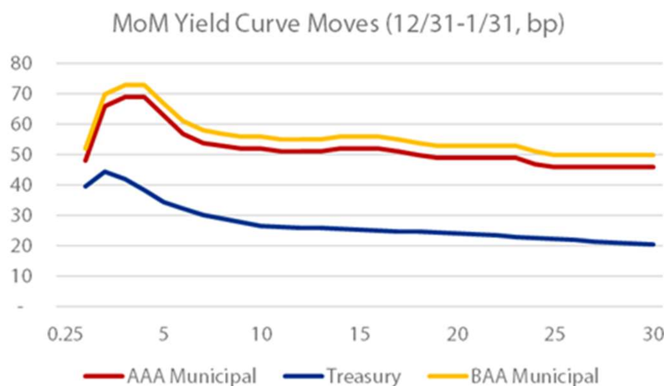
Dates	Return
7/31/2003	-3.4%
4/30/2004	-2.6%
3/31/1994	-2.5%
11/30/2016	-2.4%
10/31/2008	-2.4%
1/31/2022	-2.1%
5/31/2013	-1.8%
2/26/1999	-1.7%
2/29/1996	-1.7%
2/28/1994	-1.7%

Municipal Bond

Dates	Return
9/30/2008	-4.7%
2/29/2008	-4.6%
3/31/1994	-4.1%
11/30/2016	-3.7%
3/31/2020	-3.6%
7/31/2003	-3.5%
6/28/2013	-2.8%
1/31/2022	-2.7%
2/28/1994	-2.6%
4/30/2004	-2.4%

Source: Bloomberg, HilltopSecurities

Figure 3: Municipal yields jumped nearly twice that of Treasuries in January…



Source: MMD, Bloomberg, HilltopSecurities

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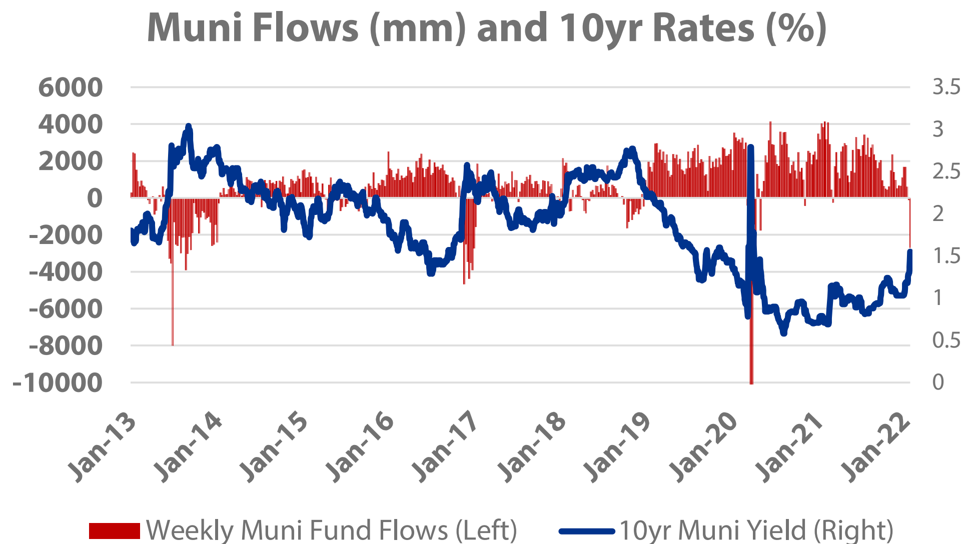
perspective, the greatest concern is that fund flows continue in a negative pattern. We have only experienced two negative weeks of flows according to ICI data, with a likely third negative week building currently. The municipal market experienced outflows of $2.7 bn last week, the largest outflows since April of 2020 when COVID was shutting down the economy (Figure 4).

Figure 4:…as municipal funds felt nearly $3bn in outflows over the past couple of weeks. However, the sector has historically performed brilliantly following such a difficult period.



Source: ICI, MMD, HilltopSecurities

However, flows have stabilized the past couple of days and January/February are typically positive months for flows and performance from a seasonal perspective. The positive seasonal patterns are partially due to heavy reinvestment proceeds (coupon, principal payments) that come into the market during this period, with approximately $45 bn to be reinvested from cash flows in January and February. Funds should be flush with cash and therefore less likely to need to liquidate bonds to meet investor demands for cash. Finally, institutional accounts are stepping into the mutual fund and ETF demand gap. The higher yields are pulling profitable banks and insurance companies with typical tax rates ranging from 21-29.6% off the sidelines and taking demand from the taxable municipal space. These two patterns suggest that, although we could continue to see a modest amount of near-term weakness, the major underperformance of this asset class is likely in the rearview mirror.

Longer-term Performance Expectations: Fund Flows

From a longer-term perspective, municipals typically bounce back from these periods of underperformance with an extended period of outperformance. After the Detroit bankruptcy mid-2013, municipal bonds lost 2.8% that June. However, they bounced back earning nearly 12% from September 2013- December 2014. Similarly following Donald Trump's election, with expectations for a large tax cut, munis lost 3.7% in November of 2016. Yet following large adjustment outflows, the sector recovered and provided investors with nearly 6.5% return over the coming 9-month period despite the follow through with lower taxes. The most extreme example that most investors remember well was following the COVID shut down. Munis lost 3.6% in March of 2020 yet returned nearly 6% for the balance of the year.

Longer-term Performance Expectations: Fed Hikes

Regarding Fed rate hikes, munis have outperformed Treasuries over each of the four significant hiking cycles. Figure 5 shows the performance patterns. Perhaps the two periods closest to what we could experience today are the recent hiking cycle from December 2015 through December 2018 and February 1994 through February 1995. The recent cycle was characterized by a smooth and controlled rate hiking cycle. The Fed hiked rates 9 times raising Fed funds from.25% to 2.50% over the period. Beginning from a similarly low level of absolute rates, munis only rose 75-80% of the move in Treasuries, with absolute percentages of Treasury stable. In the much different cycle of 1994-95, the Fed caught the market off-guard and moved rates higher very quickly. It hiked rates from 3% to 6% in 7 unique rate hikes. Muni percentages to Treasuries widened marginally; however, municipal yields only rose only a bit more than half of Treasuries. As we have seen this move before from both rate hikes and fund flows performance perspectives, we suggest that investors begin to add tax exempt bonds to portfolio purchases over the coming months.

Figure 5: In each of the significant Fed hiking cycles over the past 30yrs, municipals have outperformed Treasuries.

			Basis Point (bp) Rate Move					
	Fed Funds (%)		5yr Maturity		10yr Maturity		Muni % of Treasury Move	
	Begin	End	Treasury	Muni	Treasury	Muni	5	10
12/15-12/18	0.25	2.5	93	72	49	37	78%	76%
6/04-6/06	1	5.25	126	73	51	17	58%	33%
6/99-5/00	4.75	6.5	91	74	50	49	82%	98%
2/94-2/95	3	6	244	140	189	120	57%	64%

Source: ICI, MMD, HilltopSecurities

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