YIELD, CREDIT, AND VALUATION: THE CASE FOR MUNICIPALS

JULY 2022

Time to Take Another Look at Municipals?

Attractive investment opportunities often become clear only in hindsight as investor sentiment and risk appetite tend to wane amid turbulent times. The first half of 2022 certainly qualifies. Equities and bonds have been slammed by a surge in inflation, an abrupt shift in monetary policy, and growing recession fears. A counterintuitive characteristic of the capital markets is that demand usually falls at times when asset prices are weak, while investor cash is more eagerly deployed when market values are relatively high. **This year's municipal market fits the pattern, as evidenced by YTD net mutual fund outflows of -$76 billion**, a first half record, and 25 consecutive weeks of negative flows.

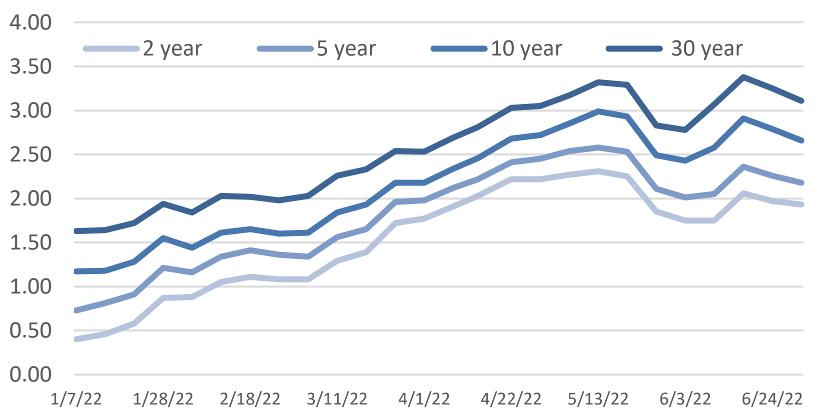
Our recent brief, "Transitioning from Turbulence to Opportunity" addressed the root causes of what has been a difficult year for tax-exempt bond investors, as well as outlining reasons why current conditions may offer a more favorable entry point. **We recommend advisors and investors take another look at their allocation to investment grade municipals**, **a case based on higher yield levels, strong credit quality, and attractive relative valuation.**

Higher Yields Suggest Opportunity

Nominal yields have surged over the first half of 2022 with 10-year AAA municipals rising from 1.03% to 2.66% and 2-year bond yields increasing from a paltry 0.40% to 1.93%.[1] Simply put, a market repricing since year-end 2021 has created an ability for investors to put new and reinvested cash to work at much higher yields. High quality municipals may now represent an attractive option for those seeking tax-advantaged income with very modest credit risk.

The short end of the municipal curve has already priced in 175 basis points of additional Fed Funds rate hikes. Although recent Fed guidance has emphasized a willingness to take Fed Funds well beyond today's 1.50-1.75%, much of the impact of Fed tightening on the shorter end of the curve has already likely been incurred. **Although further yield increases are certainly possible, significant downside prospects from this point appear muted and we see considerable value at current levels.** A slowing economy that could be approaching recession may give the Fed room to slow the pace later this year and into 2023.

Municipals Have Repriced Across the Curve (% Yield)



Source: MMA

Don't Forget About Tax Equivalents

Moving a bit further out in maturity, **consider where intermediate municipals stand on a tax-equivalent yield (TEY) basis.** Excluding potential state tax exemptions on in-state bond issues, 10-year AAA municipal yields of 2.66% translate into 4.22% for an investor at the top 37% Federal tax bracket. Looking at our Intermediate Municipal composite as of July 1st, a 2.88% YTM translates into 4.57% on a TEY basis at the same Federal rate despite yields receding in recent days from earlier in June. YTW on a TEY basis stands at 4.00%. **Given how low bond yields were for an extended period prior to 2022, today's market offers healthy, AAA rated, tax-advantaged income.**

Municipal Credit Quality Remains Strong

Yield comparisons across asset classes introduce a corresponding need to carefully evaluate risk. As an advisor that only purchases investment grade bonds, we are highly attuned to credit quality and security specific analysis is always warranted. That said, **we feel the income available on investment grade municipals has become appealing given strong issuer credit quality.** The surge in municipal yields experienced YTD has been a function of inflation and interest rates, not credit weakness.

State and local municipalities have benefited from substantial pandemic era aid, robust tax revenues, and prudent budgeting. At the state level, general sales taxes increased 18.5% in Q1, while individual income tax payments rose by a healthy 18.7%.[2]. Local governments are much more dependent on property taxes, a revenue source that typically lags economic conditions by about two years. ATTOM, a provider of real estate records and property data, reported that the average tax on single-family homes in the US increased by 1.6% in FY21, while home prices across the country rose by 16% YoY.

1. As of July 1, 2022
2. US Census Bureau

This suggests that tax assessments are likely to adjust upwards, producing increased 2022 property tax revenue. Revenue bonds are backed by the income generated by the project a bond is funding. Quality varies widely although we are finding many revenue bond issuers with strong credit profiles while seeking to avoid those with less stable financial pictures.

Impairment and/or default risk is a consideration in any bond investment; however, **municipals have historically experienced extremely low default rates on both an absolute basis and relative to investment grade corporates.** In fact, Moody's reports a 0.09% cumulative 10-year rolling annual default rate among all investment grade municipal issues from 1970-2021 and a miniscule 0.02% rate among AA rated issues.

Average Cumulative Municipal Default Rate (rolling 10 years)	
Rating	Default Rate
Aaa	0.00%*
Aa	0.02%
A	0.10%
Baa	1.06%
Investment Grade	0.09%
All Rated	0.15%

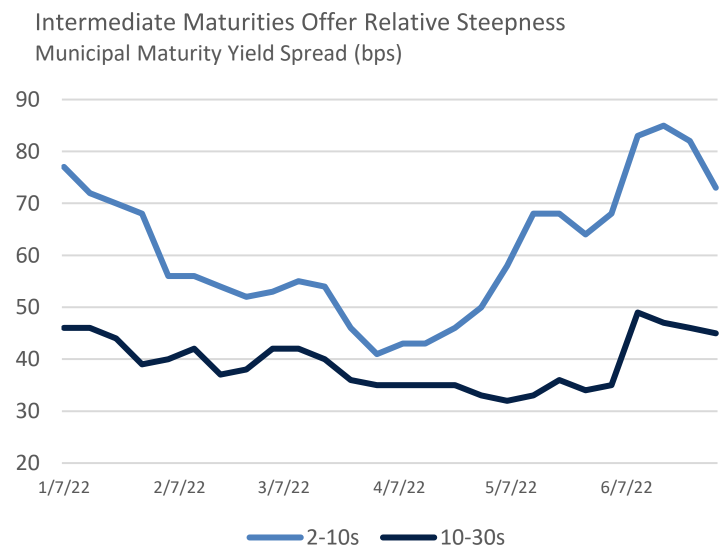
Source: Moody's Investors Service, "US Municipal Bond Defaults and Recoveries, 1970-2021"

* represents a de minimis value

Searching for Relative Value

A common and often cited means of comparing high grade municipals and USTs lies in the AAA Muni/UST yield ratio. A higher ratio suggests greater potential relative value in municipals given that bond prices and yields are inversely related. **After fluctuating in the 60s and 70s for the majority of 2021, the 10-year ratio stood at 92% as of July 1st.** The 2-year AAA Muni/UST ratio has increased even more rapidly, rising from 33% at year-end 2021 to a current level of 68%. Although municipal and UST yields have both receded of late largely due to economic concerns, Muni/UST ratios ended the first half of 2022 higher relative to earlier in the year and longer-term averages.

After a period of flattening, we see attractive relative steepness in the intermediate maturity portions of the curve as persistent recession fears have constrained longer maturity steepness. To that point, the spread between 10s and 30s sat at 46 basis points as Q3 began, as compared to 82 basis points between 2s and 10s.



Source: MMA

Premium Bonds Offer Appeal

Buying bonds above par value has long been a core element of our investment process. Our rationale centers on their greater cash flow, reduced interest rate sensitivity, more limited extension risk, protection against de minimis tax, and what is often enhanced marketability and liquidity relative to comparable discounted issues. We feel premium bonds are particularly well suited to today's environment given spotty tax-exempt market liquidity, while their higher income streams are beneficial as we reposition portfolios to take advantage of relative value opportunities.

Active Management Can Uncover Value

Proprietary research drives our investment process, as we look for creditworthy issuers whose bonds trade at attractive prices. **Volatile markets can be challenging, but a positive element is that they often create technical imbalances and sentiment shifts that an active manager can capitalize upon.** As market conditions change, we engage in security specific analysis and carefully evaluate yield curve structure and sector value as a means of informing our investment decisions.

At Appleton, we work collaboratively with advisors and investors with distinct risk tolerance, time horizon, income needs, and tax situations, and tailor portfolio strategy accordingly. Regardless of a client's specific needs, we see this as an opportune time to consider adding to municipal portfolio allocations.

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Accessibility and communication are important in any environment, although these attributes are especially valuable during uncertain and volatile times. Appleton Partners is committed to sharing our market and portfolio management perspectives as developments unfold. We hope these briefs are helpful and invite you to reach out to us directly and/or visit www.appletonpartners.com/Insights for additional commentary and insights.