A Brief Review of Municipal Bonds and Municipal Bond Closed-End Funds

2022 has had many headwinds for municipal bonds and closed-end municipal bond funds (CEFs). In fact, as of the end of June 2022, the Bloomberg Municipal Bond Index has posted its worst first half-year return since 1980 at -8.98%.

Following is a brief review of what's happened so far this year, and what we believe can happen heading into year-end.

One large contributing factor to this year's challenging performance has been the Federal Reserve's (Fed) hawkish stance and their multiple increases of the Fed Funds rate to 2.5% (from 0.25% at year-end). The recent 0.75% increases are the most aggressive increases by the Fed since 1994. Looking toward the remaining Fed meetings this year, Fed Funds Futures are predicting nearly another 5 additional hikes, elevating the target rate to 3.5%.

Municipal CEFs have enjoyed low costs of leverage for most of the last two years, as they had during the period between 2009 and 2015, following the Global Financial Crisis. However, leveraged CEFs have been negatively impacted with recent rate increases as they've seen borrowing costs increase significantly.

For instance, many muni CEFs use The SIFMA Municipal SWAP Index (SIFMA) as the reference rate for their cost of leverage. On December 29, 2021, SIFMA was at 0.10%. As of August 10, 2022, it has increased to 1.83%.

A move this significant has several effects. First, as a direct result muni CEFs need to pay more interest on their leverage, which draws from their net income. Next, a decrease in their net income increases the probability of a dividend cut and subsequently lower a fund's yield. In turn, lower yields can increase investors' desire to sell (because of lower income), which then can put downward pressure on a municipal CEFs trading price, thus returning its yield to more attractive level. Generally speaking, this is the cycle we believe the municipal bond market has anticipated and is why we have seen such poor performance in the first half of 2022.

The inverted U.S. Treasury yield curve is also impacting the municipal markets as investors look for indicators of an impending recession in the U.S..

Indeed, some of the U.S. Treasury yield curve spreads are the most inverted they've been since 2000- which signals a great deal of unrest regarding the near future. Simply put, an inverted curve is where the yield of a similar type of security is plotted against those of varying maturities. An inversion exists when the yield for a longer-dated point on a curve (e.g., a 10-year U.S. Treasury) is lower than the yield for a similar type of fixed income instrument of a shorter maturity (e.g., a 2-year U.S. Treasury). Inverted yield curves imply that there is more risk in the near-term than in the long-term.

Something that is not often mentioned is the state of the municipal bond yield curve. Although some points on the shorter end of the municipal yield curve are slightly inverted, according to Lord Abbett[1] the municipal bond yield curve has been consistently steeper than the U.S. Treasury yield curve. The reason for this has been long debated and is believed to happen due to several factors.

Possibly one of the most significant factors is municipal bond investor's general preferences and characteristics. Municipal bond investors are largely individuals and retail investors, comprising nearly two-thirds of investors. On the short end of the curve, the bonds are most compelling to those in the highest tax brackets as they look for capital preserving, tax-exempt income. Further out on the curve, the yields become more attractive and are bought by those in lower tax brackets. This supply and demand aspect has contributed to keeping the municipal bond yield curve's relative steepness over the years.

In terms of valuations, we think that a good and simple indicator of how expensive or inexpensive municipal bonds are is the percentage of their yield relative those of similar maturity U.S. Treasuries. As a general rule of thumb, we consider a yield spread for the 10-year AAA Muni vs. U.S. Treasury above 85% to be inexpensive and below 85% to be more expensive. For most of 2022, we've found that municipal bonds have been expensive relative to U.S. Treasuries. Currently, however, as of August 26, 2022, they're hovering just below at 83.6%.

Table 1. General Obligation (GO) Municipal Bond Yields vs. U.S. Treasury Yields

Term	GO AAA Baseline Yields	U.S. Gov't Treasury Yields	Spread (+/1 BPs)	Spread (%)
1 Yr.	2.255%	3.294%	(103.90)	68.5%
2 Yrs.	2.256%	3.438%	(118.20)	65.6%
3 Yrs.	2.251%	3.393%	(114.20)	66.3%
4 Yrs.	2.255%	3.324%	(106.90)	67.8%
5 Yrs.	2.262%	3.255%	(99.30)	69.5%
7 Yrs.	2.360%	3.156%	(79.60)	74.8%
10 Yrs.	2.544%	3.042%	(49.80)	83.6%
15 Yrs.	2.926%	3.081%	(15.50)	95.0%
20 Yrs.	3.100%	3.486%	(38.60)	88.9%
25 Yrs.	3.228%	3.451%	(22.30)	93.5%
30 Yrs.	3.299%	3.213%	8.60	102.7%

Bloomberg Finance, L.P.. Data as of 8/26/2022. The table above shows the difference in yield for comparable term General Obligation AAA municipal bonds versus U.S. Treasuries.

As recession worries intensify, demand for risk-off assets, such as municipal bonds, will likely rise. Combining this with their previously discussed healthier yield curve, municipal bonds and municipal bond CEFs can be an opportunity warranting further consideration. Looking into the second half of 2022, municipal bonds have made what we believe was an attractive rebound in July, posting a return of 2.64%.

With respect to municipal CEFs in particular, the first half of the 2022 can be summarized as being subject to a calculated and consistent selloff in municipal bond funds and their net asset values (or the value of their underlying assets). Because of this, we haven't seen as many attractive municipal CEF discount opportunities as we would like but we believe our patience will be rewarded in the long run.

Nevertheless, we have seen pockets of opportunity in periods of volatility. For instance, discounts on municipal bond CEFs widened intra-month in mid-June but then narrowed sharply not too long after.

Although 2022 has had challenges, the worst could be over for municipal bonds opening up some opportunities from tax loss selling going into year-end.

For other Karpus insights, please see our website.

Sources: Bloomberg Finance, L.P., Financial Times

[1] *Bragdon, Nicholas, Municipal Bonds: Opportunity at the Long End of the Curve (Lord Abbett, June 28, 2022) https://www.lordabbett.com/en-us/financial-advisor/insights/investment-objectives/municipal-bonds--nbsp--opportunity-at-the-long-end-of-the-curve.html*

Index definitions: The Bloomberg Municipal Bond Index covers the U.S. dollar denominated long-term tax-exempt bond market. As of 12/31/2021, the index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds. The SIFMA Municipal Swap Index is a 7-day high-grade market index comprised of tax-exempt VRDOs reset rates that are reported to the Municipal Securities Rule Making Board's SHORT reporting system. The index is calculated on an actual/actual basis and is published every Wednesday by 4 p.m. Eastern Time. The bonds going into the index are selected from all eligible bonds reporting data through the SHORT system that meet the index criteria as set forth by SIFMA. The index is calculated by Bloomberg as the calculation agent for SIFMA. More information about the index and criteria can be obtained from the SIFMA website. Prior to 8/20/14, Thomson Reuters was the calculation agent for the index. Data provided by Bloomberg Finance, L.P.

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