Municipals aren't immune to volatility and uncertainty

BlackRock

March update

- Municipals posted their second consecutive month of negative performance in February.
- Outflows accelerated and acted as a drag throughout the month.
- Despite fading seasonal effects, interest rates are likely to drive near-term performance.



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Market overview

Municipals posted negative performance in February amid heightened monetary policy and geopolitical uncertainty. Strong economic data and the expectation that the U.S. Federal Reserve would aggressively withdraw support drove up interest rates early in the month before the escalating conflict in Ukraine spurred volatility into month-end. Attractive valuations helped munis modestly outperform comparable U.S. Treasuries. The S&P Municipal Bond Index returned -0.51% for the month and -2.89% year-to-date. The best performers were shorter-duration munis, which are less sensitive to interest rates, and strategies targeting both ends of the credit spectrum.

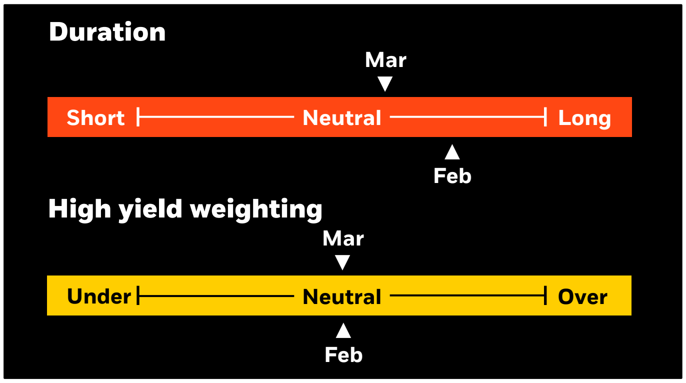
Demand remained soft, and February posted the largest net monthly drawdown in mutual fund flows since the pandemic-induced divestment in March 2020. Bid-wanted activity swelled to more than $1 billion per day on average and weighed on the market as investors raised cash to meet redemptions. Amplified headline and statement risk could promote continued outflows over the near-term.

Issuance was modest at $27 billion, 3% below the five-year average, bringing the year-to-date total to $54 billion. Reinvestment income (from maturities, calls, and coupons) outpaced new issues and created net negative supply of nearly $10 billion. Deals were oversubscribed 5.5 times on average, up from 2.7 times last month.

March has been the second-worst performing month of the year over the past five years as issuance usually spikes 16% month-over-month and the market moves to net positive supply. As seasonal dynamics turn less favorable, we expect to proceed with caution, although interest rate shifts and volatility may have more impact on total returns.

Strategy insights

We have shifted to a neutral-duration stance on municipal bond positioning and favor the intermediate part of the yield curve. We prefer an up in quality bias overall while adding select high yield credits amid more attractive prices. We continue to focus on defensive sectors and pay particular attention to bond structures, favoring those with higher coupons and shorter calls.



Overweight

- States and essential-service revenue bonds.
- School districts and local governments supported by property taxes.
- Flagship universities and diversified health systems.
- Select issuers in the high yield space.

Underweight

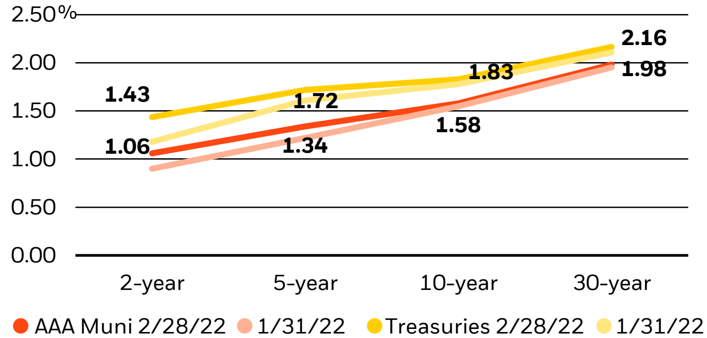
- Speculative projects with weak sponsorship, unproven technology, or unsound feasibility studies.
- Senior living and long-term care facilities in saturated markets.

Credit headlines

States and local governments still on solid fiscal footing
States and many local governments continue to experience strong revenue and reserve growth due to the recovery of own-source tax collections as well as successive federal emergency aid packages. While the war in Ukraine is not expected to have immediate or significant negative effects on credit fundamentals, higher energy prices could hurt consumer spending broadly and eventually become a headwind to economic growth and employment expansion. However, states with significant oil and gas production should benefit from higher energy prices. Meanwhile, tax cuts and program expansions are risks that could surface as own-source revenue growth is needed to offset federal aid depletion.

Rising inflation and energy prices may test utilities
Inflation has reached levels not seen in several decades, and increases in energy and fuel prices have been particularly sticky. We are closely monitoring the fallout from Russia's invasion of Ukraine and the potential longer-term impact on energy markets, the clean energy transition, and climate change public policy. Municipal utilities typically benefit from autonomous ratemaking, which allows them to adjust for rising fuel costs to preserve margin strength. While we favor this highly defensive revenue sector, if commodity prices remain elevated for a prolonged period, it could test affordability and political goodwill. In that event, utilities may not be able to raise rates to the extent needed to maintain balanced operations and credit metrics.

Municipal and Treasury yield movements



Sources: BlackRock, Bloomberg.

Municipal performance

	Feb '22	YTD
S&P Municipal Bond Index	**-0.51%**	**-2.89%**
Long maturities (20+ yrs.)	-0.82%	-3.97%
Intermediate maturities (3-15 yrs.)	-0.45%	-3.01%
Short maturities (6 mos.-4 yrs.)	-0.25%	-1.31%
High yield	-0.74%	-3.32%
High yield (ex-Puerto Rico)	-0.84%	-3.47%
General obligation (GO) bonds	-0.44%	-2.87%
California	-0.48%	-3.12%
New Jersey	-0.70%	-3.33%
New York	-0.51%	-3.09%
Pennsylvania	-0.53%	-2.78%
Puerto Rico	-0.08%	-2.08%

Sources: S&P Indexes.

Investment involves risk. *The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. There may be less information available on the financial condition of issuers of municipal securities than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. A portion of the income from tax-exempt bonds may be taxable. Some investors may be subject to Alternative Minimum Tax (AMT). Capital gains distributions, if any, are taxable.* ***Index performance is shown for illustrative purposes only. You cannot invest directly in an index. Past performance is no guarantee of future results.***

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