

# Muni bonds push higher

## May update

- Munis posted another strong monthly return amid falling rates and favorable market dynamics.
- Seasonal weakness typical of mid-April was averted due to the delayed tax-filing deadline.
- Although valuations appear rich, economic and political themes look positive for municipals.

## Market overview

Municipal bonds posted strong performance in April, with the S&P Municipal Bond Index rising 0.80% for the month, bringing year-to-date total return to 0.54%. Interest rates rallied lower, while the muni market continued to benefit from a favorable supply-demand backdrop and improving fundamentals. Valuations continued to richen with muni-to-Treasury ratios in the intermediate and long end of the curve pushing closer to the all-time lows set in February. Longer duration and lower quality bonds were the stronger performers in April. Conversely, tobacco bonds struggled on news of the U.S. Food and Drug Administration (FDA) considering a ban on menthol and a lower nicotine level in cigarettes.

Issuance was moderately elevated in April at \$35 billion, down -22% from the robust levels in March, but 21% above the 5-year average. Week-to-week volatility in the new-issue calendar avoided consecutive weeks of significantly above-average supply, putting less stress on the market. New issues were oversubscribed by 7 times on average.

Strong demand continued unabated in April. Aided by the delayed tax filing deadline, the market avoided seasonal fund flow weakness typically experienced in mid-April and saw consistent and robust inflows throughout the month. Long-term funds once again garnered the bulk of inflows.

While muni bond valuations look unattractive from a historical perspective, we maintain a constructive view of the asset class over the long term. We believe municipal fundamentals will continue to benefit from a combination of economic reopening, substantial fiscal aid and a focus on infrastructure. Although infrastructure details are yet to be finalized, it seems possible that higher tax rates will drive increased demand for muni bonds.



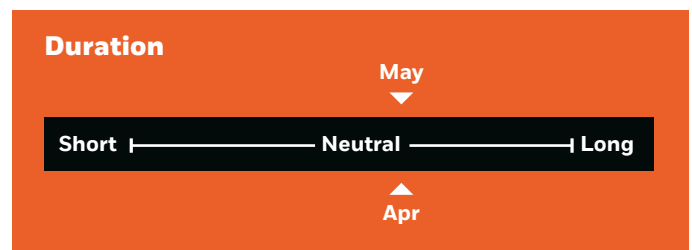
**Peter Hayes**, Head of the Municipal Bonds Group

**James Schwartz**, Head of Municipal Credit Research

**Sean Carney**, Head of Municipal Strategy

## Strategy insights

We maintain a neutral stance on duration (interest rate risk) within a barbell yield curve strategy. We continue to hold a preference for lower-rated credits, revenue bonds and sectors that have been more impacted by the pandemic such as transportation, travel-related (hotel tax, airport, etc.) and health care.



## Yield curve

Barbell strategy, preferring 0-5 and 20+ years

## Overweight

- Higher quality state and essential-service bonds
- School districts and local governments supported by property taxes
- Issuers that should benefit from the re-opening of the economy
- 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

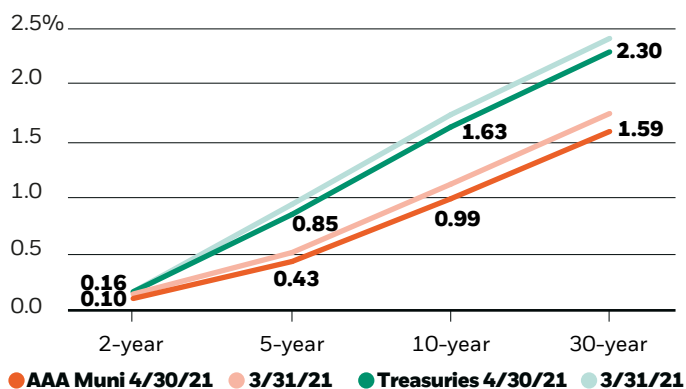
## Tobacco hits turbulence

Municipal bonds secured by tobacco settlement revenues, which represent 1% of the muni market and 12% of high yield muni bonds, posted the strongest performance across muni sectors in 2020, with a stellar 15.6% return for the year. From the start, it appeared that 2021 was going to be another strong year for the sector given the tailwinds of lower-than-expected declines in tobacco consumption and strong demand for high yield bonds.

However, the sector began facing pressure in April, when the FDA announced that it is considering a ban on menthol and a reduction of nicotine levels in cigarettes. Banning menthol could lead to a drop in tobacco consumption if users opt to quit smoking rather than switch to traditional cigarettes. Since menthol represents 30% of U.S. cigarette sales, the ban could result in a negative impact on cash flows for tobacco bonds — albeit this would likely take several years to be implemented.

Of more imminent concern for tobacco bondholders is a potential increase in the federal excise tax on cigarettes. Should Senator Durbin's bill gain traction, the tax may double to \$2.11 per pack, which is projected to cause a 5% decline in cigarette sales. A tax increase could be passed more quickly than the possible changes to FDA regulations. Since the tax bill announcement on April 19, the S&P Municipal Bond Tobacco Index is down almost 1%. A continuation of selling pressure could create value opportunities, and thus we will be watching this situation closely.

## Municipal and Treasury yield movements



Sources: BlackRock; Bloomberg.

## Municipal performance

	APR 2021	YTD
<b>S&amp;P Municipal Bond Index</b>	<b>0.80%</b>	<b>0.54%</b>
Long maturities (20+ yrs)	1.37%	1.36%
Intermediate maturities (3-15 yrs)	0.72%	0.26%
Short maturities (6 mos-4 yrs)	0.17%	0.30%
High yield	1.27%	3.06%
High yield (ex-Puerto Rico)	1.23%	3.15%
General obligation (GO) bonds	0.73%	0.14%
California	0.79%	0.26%
New Jersey	1.00%	1.29%
New York	0.94%	0.76%
Pennsylvania	0.83%	0.69%
Puerto Rico	1.43%	2.49%

Source: 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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