Opportunities in Muniland

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With the 10-year U.S. Treasury yield nearly doubling over the past four months, the bond market has experienced its worst selloff since the early 1980s. Municipal bonds have not been immune to the substantial drawdowns across the fixed income universe. After posting positive annual total returns for the previous eight consecutive years, the Bloomberg U.S. Municipal Bond Index has plunged by 8.96% year-to-date through April 30.

While the challenging performance environment for municipal bonds has been painful for investors, the risk/reward relationships within the sector appear much more balanced today compared to the past several years. For a number of reasons, we believe the municipal bond market currently provides compelling opportunities for new investments, as discussed in more detail herein.

Opportunity #1

AAA municipal bond yields have risen significantly and are now approaching their 10-year highs.

Since the end of last year, the average yield on 10-year AAA-rated municipal bonds has rapidly climbed from 1.1% to 2.7%. Prior to this recent jump in yields, there were only two other brief periods over the past decade where rates on this cohort exceeded 2.5%. The first period occurred during the infamous "taper tantrum" in the second half of 2013. The second instance was confined to a brief two-month window during the fourth quarter of 2018, as market participants braced for a series of potential rate hikes from the Federal Reserve (Fed) that ultimately did not materialize.

This latest upward move in yields has also been fueled by rate hike expectations, with interest rate futures fully pricing in another 200 basis points of tightening by the end of 2022. Based on the forward guidance provided by Fed Chair Powell at the May 4 Federal Open Market Committee (FOMC) meeting, it seems likely that bond yields have already priced in the bulk of the policy rate increases that the central bank will

Muni Yields Approaching 10-Year Highs

AAA 10-Year Municipal Bloomberg Index Yield (%) | 4/3/2012 – 4/29/2022 | Source: Bloomberg Finance, LP

ultimately deliver. To the extent that the fed funds rate eventually peaks in the 2.5% to 3.0% range at the conclusion of this tightening cycle, municipal bond yields may not increase much further from their current levels and could decline from here if the Fed moves less aggressively than the bond market presently expects.

Opportunity #2

Wider municipal credit spreads appear attractive relative to improving credit fundamentals.

In addition to the notable improvement in municipal bond yields in absolute terms, tax-advantaged rates have increased meaningfully relative to U.S. Treasury yields. Municipal credit spreads have widened in sympathy with the broader selloff in risk assets, despite the overall improvement in credit quality across the sector. Over the past five years, the ratio of 10-year AAA municipal yields to 10-year Treasury yields averaged 88% and generally fluctuated between 80% and 90%. After briefly falling to 60% last April, this ratio steadily climbed to 95% at the end of March and remained elevated at 92% as of April 30, 2022.

While concerns over a slowing economy have weighed on the sector, the spread widening in municipal bonds appears to be overdone given the positive trends in credit fundamentals across state and local government issuers over the past 12 months. Sales tax revenue has broadly recovered, and in some cases now exceeds pre-pandemic levels. As real estate values have increased significantly, property tax revenues are on the rise. In addition, a cumulative $500 billion in financial aid was distributed to state governments as part of the federal stimulus packages in 2020 and 2021.

Over the coming months, we expect investors will more fully appreciate the structural benefits of municipal credit compared to corporate credit, and spreads will retrace some of their recent widening. It is also worth noting that consecutive quarterly losses in the municipal sector are rare. Over the past 20 years, there have been only two instances in which the Bloomberg U.S Municipal Bond Index posted back-to-back negative total returns.

Opportunity #3

Closed-end municipal bond funds are trading at much deeper than normal discounts relative to their net asset values.

As leveraged instruments, municipal bond closed-end funds have been particularly hard hit by the recent dislocation in yields, with year-to-date losses in the 15% to 20% range common across the sector. While it is not unusual for these securities to trade at a discount to their net asset value (NAV) for a variety of reasons, the magnitude of the deviation from NAV has become unusually large. When bond yields eventually stabilize, we expect investor sentiment to improve for closed-end funds backed by investment-grade bonds, given their combination of high dividend yield, strong credit quality, and potential for capital appreciation as the discount to NAV narrows.

The EquityCompass **Municipal Income Enhanced Portfolio (MIEP)** includes a 14% allocation to municipal closed-end funds, spread across five separate securities. Investors seeking diversified exposure to the closed-end fund sector at a compelling entry point should take a closer look at the characteristics and risk profile of MIEP—an actively managed portfolio with an emphasis on risk mitigation during a period of extreme bond market volatility. Please refer to our most recent MIEP Fact Sheet and Commentary for further information.

About EquityCompass

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The EquityCompass team of professionals represents deep industry experience in security analysis, capital markets, and portfolio management. We are committed to a consistent investment process that relies on enduring principles, sound empirical reasoning, and the recognition of a dynamic investment environment with a global reach.

James J. DeMasi, CFA joined EquityCompass in July 2019 as a Senior Portfolio Manager for the Core Fixed Income Portfolio, Municipal Income Enhanced Portfolio, and co-manager of the High-Dividend Portfolio. Prior to joining the team, Jim served as the Chief Fixed Income Strategist at Stifel, Nicolaus & Company, Incorporated for 12 years. At Stifel, Jim created investment portfolio and risk management strategies for the firm's institutional fixed income clients. He published several periodic strategy reports on the fixed income markets, including Bond Market Weekly and Alpha Advisor. Previously, he spent five years at Legg Mason as a fixed income strategist and 13 years at the Federal Deposit Insurance Corporation (FDIC) in bank supervision. His FDIC career included roles as a bank examiner, bond analyst, and senior capital markets specialist. Jim has a B.S.B.A. in Finance from West Virginia University. He is also a CFA charter holder and member of the Baltimore Security Analyst Society.

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The Bloomberg U.S. Municipal Bond Index measures the performance of the U.S. municipal bond market. It is composed of approximately 1,100 bonds; 60% of which are revenue bonds and 40% of which are state government obligations. The BVAL Muni AAA Yield Curve 10 Year is the baseline curve for BVAL tax-xempt munis. It is populated with high quality U.S. municipal bonds with an average rating of AAA from Moody's and S&P. The yield curve is built using nonparametric for of market data obtained from the Municipal Securities Rulemaking Board, new issues calendars, and other proprietary contributed prices. The volatility of the indices identified in this report may be materially different from the volatility of the model portfolios presented by EquityCompass. Indices are unmanaged, do not reflect fees and expenses, and are not available for direct investment.

*Total assets combines both Assets Under Management and Assets Under Advisement as of April 30, 2022. Assets Under Management represents the aggregate fair value of all discretionary and non-discretionary assets, including fee paying and non-fee paying portfolios. Assets Under Advisement represent advisory-only assets where the firm provides a model portfolio and does not have trading authority over the assets.

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Additional Information Available Upon Request

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