5 Reasons to Invest in Municipal Bonds Now

These are the times that try investors’ souls. In the wake of the COVID-19-induced plunge in capital markets, the term “safe haven” has gone by the wayside. Still, there remains a historic buying opportunity for investors who know where to look—and we are looking mightily at investment-grade municipal bonds.

A silver lining among the dark clouds

In a normal (pre-COVID-19) world, stocks do not move in lockstep with bonds—the latter of which are often relied upon to offset volatility in the former. In this “Bizarro World,” however, the standard rules don’t apply. The bond markets—just as panic-driven as the stock market—have seen a broad selloff. We believe high-quality, or investment-grade (IG), municipal bonds have been indiscriminately sold, effectively tossing out the baby with the bathwater. To that we say, not so fast. In fact, the current market volatility has created an historic buying opportunity within the municipal bond market.

First, let’s take a quick look at the recent lay of the land. Mutual funds and other investors have recently been forced to sell their highest-quality and most-liquid assets to meet redemptions and margin calls. In many cases, that means high-quality general obligation municipal bonds or those backed by Treasuries have been sold in large quantities and are seeing historic spreads between buyer’s bids and sellers’ asking prices. The selloff grabbed the attention of bargain-hunting retail as well as institutional investors, such as Asian insurers, that jumped in and then out again to grab safe yield at “sale” prices. Even before the dust settles, there are a number of reasons to consider IG munis as an important part of a well-diversified portfolio:

1. **They stand up well to their bond brethren.** The pre-pandemic general rule was that IG yields were less than that of U.S. Treasuries—considered the safest asset in the world as they are backed by the full faith and credit of our federal government. It was a tradeoff investors were largely willing to make in exchange for tax-exempt yields. Now, though, it is the opposite: AAA-related muni yields are practically double that of Treasuries [1.07% vs. 0.63%] in 10 years.
Investment-grade municipal bonds—has the baby been tossed out with the bathwater? A historic opportunity to invest in the second-safest asset class next to U.S. Treasuries means it’s worthy of a closer look from yield-thirsty investors.

**Important note:** It must be stressed that the focus in this article is on investment-grade, highly rated municipal bonds. High-yield, or speculative, munis are a horse of a different color. These are lower-quality issuers, which are likely to feel serious pain over the coming months and more severe underperformance versus investment-grade municipals is likely. For reference, investment-grade municipal bonds have returned approximately –0.21% from March 1 to April 14, 2020, compared to high-yield municipal bonds at –11.6%. All things considered, the degree of underperformance in high-yield municipals is relatively mild and could worsen.

2. **They’re still healthy overall.** Municipal fiscal health is strong generally speaking, as many came into 2020 with cash balances higher than they have been in decades. For reference, the average long-term default rate for municipalities is less than 0.29%. Yet, you cannot paint all municipals with the same broad brush. Credit quality varies greatly depending on location and sector. Certain state and local governments are feeling the economic impacts worse than others, weighing down local budgets. Broadly, there will likely be lower income and sales tax revenue, due to soaring unemployment benefit payouts.

3. **The feds have their back.** Credit has surely deteriorated more in sectors and geographies that have been especially hard hit. Fortunately, the Federal Reserve recently announced a flurry of accommodative measures. It will expand its Money Market Mutual Fund Liquidity Facility to accept highly rated municipal bonds maturing in less than a year. This move is meant to help money market funds facing redemptions that might otherwise need to sell assets for a loss. Expanding the facility should provide support for the asset class and stave off both liquidity and default concerns.

From an industry perspective, we continue to see value in select state and local general obligation and revenue bonds, health care, and higher education. Mass transit authorities, hospitals, and airport obligors have understandably been most affected. From a geography perspective, we like California, Massachusetts, Texas, and Maryland general obligation bonds. New York State is suffering acutely from the economic ravaging and limitations on global travel. It also has $165 billion in revenues—but there is $5 trillion on the balance sheet now and we don’t believe the federal government would allow it to default. In general, state and local government economies will still be impacted based on the depth and duration of mitigation (stay at home) efforts. In the meantime, the stimulus bill provides state and local governments with $150 billion in relief; the Fed has announced it will buy municipal short-term debt direct from select municipal issuers; and the Fed now has the legal authority to buy additional municipal credits as well.

4. **They present value for both taxable and tax-exempt investors.** Typically, municipal bonds yield a discount to Treasuries because of their preferential tax status. For example, during the fourth quarter of 2019, five-year munipicals yielded 74% compared to a Treasury note of similar maturity. As of April 14, 2020, that figure jumped to over 200% (Figure 1 on page 3). This creates an opportunity
for tax-exempt investors (crossover buyers) to invest in munis even without the tax benefits.

5. **They don’t lean left or right.** The near- to mid-term future for munis seems largely unaffected by November’s presidential election. The future for munis as an asset class is just as bright, whether Joe Biden or President Trump prevails, as retaining higher marginal tax rates and increasing infrastructure spending should be a credit positive. We anticipate any changes to take pace at a slow, evolutionary pace rather than a drastic, revolutionary overhaul.

**Next steps**

We believe it’s a critical time to rebalance portfolios to reflect recent events and the longer-term fallout as far as risk tolerance, asset allocation, and other important planning considerations. IG municipals can be incorporated into portfolios in a number of ways—individual issues, open-end or closed-end mutual funds, exchange-traded, or separately managed accounts (SMAs), as well as laddered portfolios with staggered maturities.

Remember that all municipal bonds are not created equally. Credit quality has never been more important and investors will want to leverage deep research capabilities and experience when selecting credit exposures.

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