# The Week in Muniland

March 21, 2022

## Better Market Tone

- Muni yields rose this week in anticipation of the Fed's first rate hike since 2018. However, following the Fed's announcement, muni yields actually began to fall from their mid-week highs. For the week, the muni yield curve flattened with yields higher by 7–13 basis points (b.p.). The Bloomberg Municipal Bond Index returned –0.51%, while the Bloomberg Muni High Yield Index returned –0.42%.

  - **Why it matters:** Stability in the muni market toward the end of the week was welcomed. Investors are waiting for some sense of stability before they more fully invest the sizable amounts of cash sitting on the sidelines. Many dealers who were extremely light on their balance sheets were replacing risk, which provided a strong market tone. Toward the end of the week, as liquidity improved, it was a good time to tax loss harvest and reposition portfolios a bit further out along the yield curve. Investors should be mindful to be harvesting losses and rotating into higher yielding bonds…it's a win-win for the client.

- With AAA municipal yields higher by 84 b.p. to 115 b.p. since the beginning of the year and credit spreads wider by 25 b.p., investors are asking the question, is now the time to invest in munis?

  - **Why it matters:** Our thoughts are prefaced with the fact that no one can predict the absolute level of yields accurately or effectively over time. The Fed has "inside" information and they can't get it right. Although we can look at certain factors and draw conclusions. For example, the 10-year AAA muni yield now stands at 1.93%, which is 90 b.p. higher (Don't expect a repeat over the next 3 months) relative to January 1, 2022. The taxable equivalent yield is 3.26%. Credit spreads *(Display 2)* have widened although municipal credit fundamentals are as strong as they have been since prior to the financial crisis. Municipals are also fair value to cheap relative to US Treasuries *(Display 3).* Through this lens you would determine that, yes, now is a much better entry point to enter the muni market versus just 3 months ago. With ongoing geopolitical turmoil, it's time to be a patient investor and feather in investments until the market exhibits a bit more clarity.

- The Federal Open Market Committee raised its benchmark interest rate by 25 basis points and signaled that it is likely to continue raising rates at every meeting well into at least the second half of this year, and made clear that it will begin to reduce the size of its balance sheet soon.

  - **Why it matters:** We anticipate the committee will raise rates by a total of an additional 150 b.p. this year, with at least one of those hikes (probably June) likely to be a 50 b.p. increase. The pace of tightening will likely slow in 4Q and into 2023–2024 as growth and inflation both slow and the Fed assesses the impact of tightening on the economy. We expect that the economy will withstand the tightening and allow for growth to continue and rate hikes to follow over the next couple of years, albeit at a slower rate, eventually reaching a terminal rate of approximately 3.25% in 2024. In the near term, we expect the Fed to announce the start of balance sheet reduction at its May meeting, alongside another 25 b.p. rate hike.

## Positioning for Today's Market

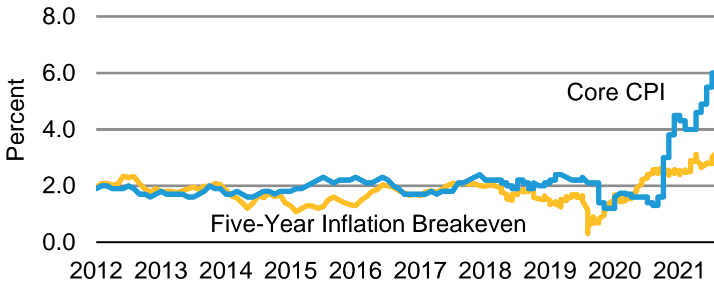
- **Inflation Protection:** Given current inflation breakevens, a small position in explicit inflation protection is reasonable *(Display 1)*

- **Interest-Rate Risk:** As yields have increased, target neutral duration versus the appropriate benchmark

- **Credit Risk:** Own credit to protect against rising interest rates and inflation *(Display 2)*

- **Taxable Bonds:** Eliminate US Treasury position given munis have become fair value *(Display 3)*

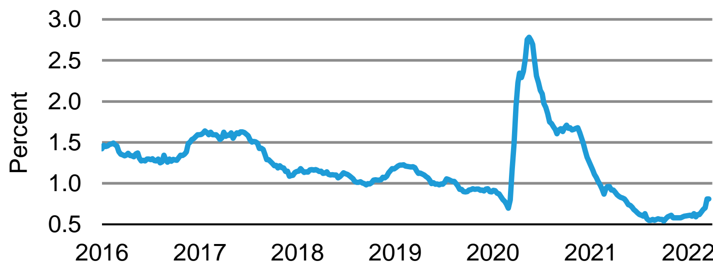
### Display 1: Core CPI vs. Five-Year Inflation Breakeven




Break-even inflation at 3.48% indicates that the market expects core CPI to drift lower over time.

Core CPI through February 28, 2022; five-year inflation breakeven through March 18, 2022
Source: Federal Reserve Bank of St. Louis and AllianceBernstein (AB)

### Display 2: BBB Municipal Credit Spreads

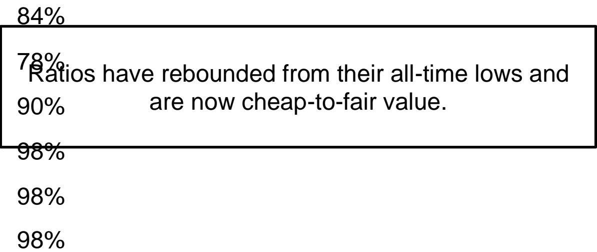



BBB credit spreads are through pre-COVID-19 levels. However, owning midgrade and high-yield bonds can provide protection against rising interest rates and inflation.

Through March 18, 2022
Source: Bloomberg and AB

### Display 3: AAA Muni/US Treasury Ratios

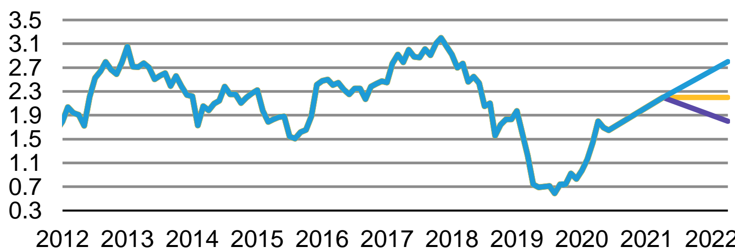
| | January 5, 2022 | March 18, 2022 | Five-Year Average | Average |
|---|---|---|---|---|
| Two-Year | 36% | 70% | 83% | 84% |
| Five-Year | 44% | 75% | 77% | 78% |
| 10-Year | 64% | 91% | 89% | 90% |
| 15-Year | 65% | 96% | 97% | 98% |
| 20-Year | 64% | 86% | 97% | 98% |
| 30-Year | 73% | 96% | 97% | 98% |

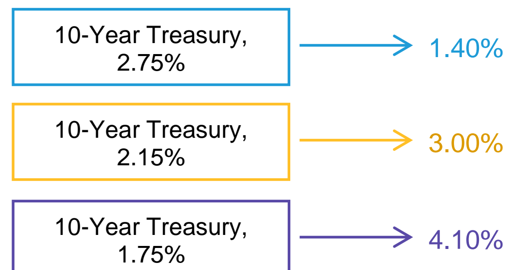



As of March 18, 2022
Source: Municipal Market Data and AB

### Display 4: Expected 12-Month Municipal Returns Scenario Analysis

10-year US Treasury yield (percent)




**Past performance and historical analysis do not guarantee future results.**
Display reflects expected returns of a five-year duration intermediate municipal portfolio under three scenarios: 10-year US Treasury yields rise to 2.75%, remain the same or decline to 1.75% over the next 12 months.
Through March 18, 2022
Source: Bloomberg and AB

**A Word About Risk**

**Market Risk:** The market values of the Portfolio's holdings rise and fall from day to day, so investments may lose value. Interest-Rate Risk: Fixed-income securities may lose value if interest rates rise or fall—long-term securities tend to rise and fall more than short-term securities. The values of mortgage-related and asset-backed securities are particularly sensitive to changes in interest rates due to prepayment risk. **Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or principal—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered, and the bond's value may decline. **Inflation Risk:** Prices for goods and services tend to rise over time, which may erode the purchasing power of investments. **Foreign (Non-US) Risk:** Investing in non-US securities may be more volatile because of the political, regulatory, market and economic uncertainties associated with such securities. These risks are magnified in securities of emerging or developing markets. **Currency Risk:** If a non-US security's trading currency weakens versus the US dollar, its value may be negatively affected when translated back into US-dollar terms. **Diversification Risk:** Portfolios that hold a smaller number of securities may be more volatile than more diversified portfolios, since the gains or losses from each security will have a greater impact on the Portfolio's overall value. **Derivatives Risk:** Investments in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments and may be more volatile, especially in a down market. **Leverage Risk:** Trying to enhance investment returns by borrowing money or using other leverage tools magnifies both gains and losses, resulting in greater volatility. **Municipal Market Risk:** Debt securities issued by state or local governments may be subject to special political, legal, economic and market factors that can have a significant effect on the Portfolio's yield or value. An investor cannot invest directly in an index. **Investment and Insurance Products:** Not FDIC insured I Not a bank deposit I Not insured by any federal government agency I No bank guarantee I May lose value

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