FRANKLIN TEMPLETON

December 2020

Outlook for US Municipal Bond Investing

Among Municipal Bonds, Credit Is King, Research More Important Than Ever

"Looking ahead to 2021, we continue to believe that municipal bonds can provide benefits for the tax-sensitive investor. In a post-COVID environment, the underlying creditworthiness of municipal bond issuers will continue to drive returns. Our robust credit research process allows us to navigate through these volatile periods and to position our portfolios well in pursuit of superior risk-adjusted returns."

Ben Barber, CFA
Senior Vice President
Director, Municipal Bond Department

Franklin Templeton Fixed Income

Favorable Technical Conditions Remain in Place

Since the record outflows from the municipal (muni) bond market in March 2020, we have seen many investors return to the market as they look for strong tax-adjusted returns. These flows have been met with limited net supply in the tax-exempt market. We expect demand to remain high, supporting overall muni bond valuations. Muni issuers are increasingly turning to taxable muni bond structures that provide them with the ability to refund previous issuance at low borrowing costs. We have seen more investors entering the market for taxable muni bonds, which should help the overall sector to expand. It is our view that, despite the ongoing pandemic, a second COVID-related market disruption is unlikely to unfold in the muni bond market. In the event of increased market volatility, we are positioned, in our view, to take advantage of risk/reward mismatches in both the primary and secondary markets by utilizing our strong liquidity positioning and robust credit research process.

Analyzing the 2020 US Elections

Although national elections have significant impacts on the overall muni bond market, we feel that "down ballot" races, including state and local elections, have larger implications on the credit climate in which each muni bond issuer operates. The 2020 federal elections appeared to show that neither political party has been given a strong mandate. With Republications maintaining their majority in the Senate, as we await a runoff for two seats, and improving their minority position in the House of Representatives, it will be difficult for President-elect Joe Biden to enact a number of his larger, more progressive policies. The muni bond market is currently more focused on the size and timing of additional fiscal support from the federal government. Muni bond issuers have been advocating for direct support, including grants to bridge the gap in current and forecasted budgets. We anticipate an additional round of support to municipalities and states, but it will likely be smaller than the stimulus bill the Democrats initially passed in the summer.

When analyzing elections at all levels, we look to understand sentiment changes, sense political priorities, and prepare for the outcomes so we can take advantage of any potential opportunities. State and local elections are important because some types of bonds require voter approval. Many state and local governments put tax measures on the ballot and, of course, elected officials govern state and local governments, approving budgets and providing government services. Therefore, we learn a lot from state and local elections. In this election, we saw some measures succeed and others fail. As an example, several large bond measures passed, but a measure to change Illinois' income tax from a flat to a graduated tax failed, as did a change to how commercial property is assessed in California.

COVID-19 and the Credit Environment

Although most muni bond issuers entered the current pandemic crisis in good overall fiscal shape, the length and breadth of the pandemic—and the speed of economic recovery, which has not been uniform across all regions and sectors—will have significant impacts not only on the short-term prospects of muni bond issuers, but also on their long-term viability. In the COVID-19 world, the creditworthiness of issuers and their ability to maintain access to capital markets have been the main drivers of performance in the market. Looking into 2021, we do not anticipate this changing materially.

The impact of state shutdowns earlier in 2020 has had wide-ranging implications for most muni bond issuers. Although revenue from tax receipts and usage fees has increased modestly as states have reopened, a significant portion of muni bond issuers are still anticipating large budget deficits over the next several fiscal years. Municipalities and states that entered the period with overstretched budgets are seeing these issues amplified. In many instances, states, counties and localities have balanced budget processes in which running structural deficits is not permitted; they are looking to both increase revenues, from tax increases or federal government support, and cut their cost outlays. To avoid dramatic initial budget cuts, some issuers have implemented budgets that rely on either additional federal government support or stronger tax receipts. In the absence of these by mid-year, some states will have to reduce spending levels further to bring their budgets back into alignment.

Increasing taxes on the underlying populations will have a positive effect on revenue in the short term, but it cannot be viewed in a vacuum. Overburdening taxpayers can lead to significant changes in demographic patterns, where individuals move away from higher tax areas and toward cities and states that have lower all-in costs. This can exacerbate underlying fiscal issues, as fewer taxpayers are left to fund operations and service government debt. When looking at tax rates, we incorporate the total ability to pay from the taxpayer standpoint to identify those areas that could have limited elasticity of demand at higher tax rates.

Uncertainty Begets Opportunities

Looking into 2021, we still see the underlying credit fundamentals of muni bond issuers as the primary determinate of relative value. Our dedicated muni bond credit research team is focused on identifying sectors and issuers that have strong credit fundamentals that can weather the current downturn. Additionally, we are ready to take advantage of misspricings in some of the more challenged areas of the market, such as sectors and issuers where the investing public appears still tentative but the prospects for improving prices look constructive due to government support, essential function, and/or a lack of understanding of the underlying security. We believe robust credit research and security selection will be key drivers of success in the muni bond market in 2021.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Because municipal bonds are sensitive to interest rate movements, a municipal bond portfolio's yield and value will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the portfolio's value may decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value.

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