Value being restored in municipals

BlackRock.

Municipal May update

- Municipal bonds deviated from U.S. fixed income assets and posted negative performance in May.
- Issuance remained robust and increasingly pressured the market late in the month.
- We have started to selectively add duration but see several reasons to remain patient.



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Market overview

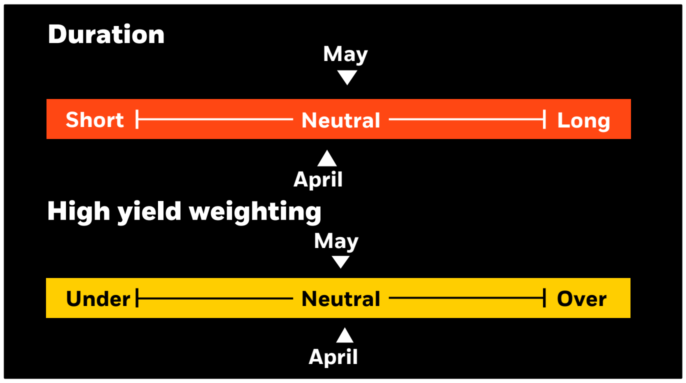
Municipal bonds deviated from their U.S. fixed income counterparts and posted negative performance in May. Weakening economic data, particularly early in the month, pushed interest rates lower, despite mixed messaging from the Federal Reserve. However, municipals underperformed comparable Treasuries, as the market struggled to absorb a deluge of issuance at historically tight valuations. The S&P Municipal Bond Index returned -0.24%, bringing the year-to-date total return to -1.40%. Barbell yield curve strategies and the high yield sector performed best.

Issuance remained robust at $45 billion, 31% above the five-year average, bringing the year-to-date total to $187 billion. As a result, April and May combined for their largest supply total since 2008, which caused increased indigestion as the month progressed. New issues were oversubscribed 4.2 times on average, below the year-to-date average of 4.4 times, but waned considerably in the latter half of the month with deals increasingly requiring price adjustments and restructuring. At the same time, fund flows remained mixed and inconsistent, as investors opted to remain on the sideline amid heightened volatility.

The sell-off has started to restore value to the asset class, but there are several reasons why patience is still warranted. First, while much improved, valuations are still below their longer-term averages. Next, we think issuance will remain elevated ahead of the election and negate some of the tailwind typically provided by seasonal net negative supply during the summer. Finally, we expect demand to remain subdued until the path of monetary policy becomes clearer and interest rates stabilize. Given this backdrop, we have started to selectively add duration, taking advantage of concessions in the new issue market.

Strategy insights

We advocate a neutral duration posture, albeit slightly longer than last month. We maintain a barbell yield curve strategy but are cognizant that intermediate bonds present more value post-correction. We prefer single-A rated credits, but think high yield offers an attractive risk-reward opportunity, given favorable structures and the ability to generate alpha through security selection.



Overweight

- States that primarily rely on consumption taxes
- Essential-service revenue bonds
- Flagship universities
- Select issuers in the high yield space

Underweight

- States overreliant on personal income taxes, especially California
- Speculative projects with weak sponsorship, unproven technology, or unsound feasibility studies
- Senior living and long-term care facilities
- Lower-rated private universities
- Stand-alone and rural health providers

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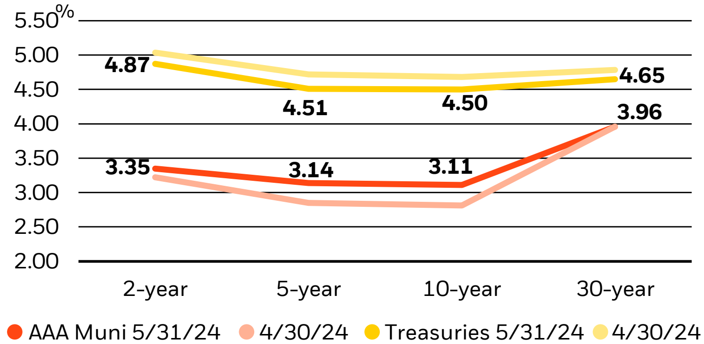
Credit headlines

Based on data from AM Best, in 2023, insurers experienced financial losses related to homeowners' coverage in 18 states. This situation posed a risk to the real estate market in those states, given that most homes are financed through bank mortgages that require borrowers to maintain homeowner's insurance. The escalating frequency and severity of natural disasters—such as wildfires in California, hurricanes in Florida and Louisiana, and hailstorms in the Midwest—have exacerbated the problem. Claims have surged due to rising labor and material costs for home reconstruction. Consequently, many insurance companies either terminated policies, raised premiums, or withdrew from problematic states. Homeowners, left with limited options, turned to state-run insurers of last resort, such as Citizens Insurance Agency in Florida, which witnessed its policy count grow from 500 thousand to 1.3 million between 2017 and 2023. We are monitoring this situation because housing values rely on accessible and affordable insurance, and municipalities are heavily dependent upon property tax revenues.

The Iowa Fertilizer Company, which issued one of the largest, high yield municipal financings (approximately $1.3 billion) in 2013 to construct a nitrogen fertilizer plant, is currently attempting to sell the plant to Koch Industries, one of its major competitors. These bonds were refinanced in 2022 with a guarantee from the parent company, OCI N.V. The bonds hold the lowest investment grade rating from all three credit rating agencies and could be refunded if the sale materializes. This sale is part of a broader strategic review by OCI, which anticipates generating $6.2 billion in net proceeds. However, the transaction has faced criticism from the Iowa agriculture sector, with concerns about increased concentration in the fertilizer market and its potential impact on competition and prices. The Iowa Farmers Union and other groups have urged federal regulators to block the sale, and the Federal Trade Commission is reportedly investigating the matter.

Municipal and Treasury yield movements



Sources: BlackRock, Bloomberg.

Municipal performance

	May'24	YTD
S&P Municipal Bond Index	**-0.24%**	**-1.40%**
Long maturities (20+ yrs.)	0.34%	-1.29%
Intermediate maturities (3-15 yrs.)	-0.74%	-2.05%
Short maturities (6 mos.-4 yrs.)	0.08%	-0.06%
High yield	0.72%	2.07%
High yield (ex-Puerto Rico)	0.67%	2.07%
General obligation (GO) bonds	-0.46%	-2.02%
California	-0.25%	-1.43%
New Jersey	-0.32%	-1.57%
New York	-0.25%	-1.68%
Pennsylvania	-0.26%	-1.27%
Puerto Rico	1.01%	2.01%

Sources: 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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