Municipal Market Update
March 14, 2022

Conflict In Ukraine Increases Fed's Challenges

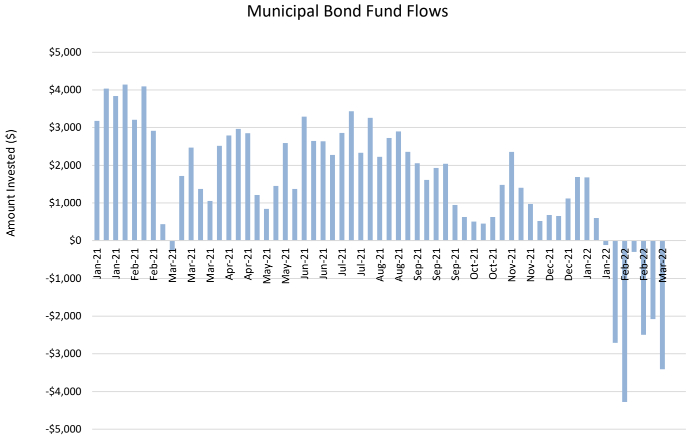
The Ukraine-Russia conflict is top of mind for many investors. Market volatility has risen substantially across U.S. fixed income and equity markets. This conflict will exacerbate the Federal Reserve's (the Fed) most pressing challenge (i.e., controlling inflation), while likely limiting the magnitude of its ability to act due to a softening global economy.

A year ago, the municipal bond market was just coming off historic low rates, inflation was moderate, the Fed had net monthly purchases of $120 billion and indicated that short-term rates would likely not increase until after 2023. Furthermore, municipal bond fund flows were positive and stayed positive for the balance of 2021, the ratio of tax-exempt debt to an equivalent U.S. Treasury was low, and oil was trading near $60 per barrel. The wind was at your back if you were issuing municipal debt.

Today the winds are shifting for municipal issuers as we will detail below, but by most historical standards it's currently still an attractive time to issue debt.

Inflation: On March 10, 2022, the Labor Department's Consumer Price Index (CPI) was released for February and the 12-month increase was 7.9% before seasonal adjustment. Economists were hoping to see this trend moderate with improvements to global supply chains and what's known as the "base effect" (CPI jumped to 4.2% in April 2021, so April 2022 would be starting from an elevated measure), but the Ukraine-Russia conflict has sent oil and other commodity prices soaring and has added to supply chain disruptions. Inflation will be higher for longer.

Municipal Flow of Funds: As the following chart indicates, we have now experienced six consecutive weeks of net municipal bond outflows after 2021 only saw one week of net outflows. Specifically, the Investment Company Institute reported $3.502 billion of municipal mutual fund outflows and only $92 million of municipal ETF inflows for the week ended March 2, 2022.



Value of Tax-Exemption: The ratio of the 10-year Aaa tax-exempt municipal and the 10-year U.S. Treasury was 92% on March 11, well above the trailing 12-week average of (77%) and 2021's average of approximately 67%, showing a weakening value of tax-exemption for issuers.

MMD Bond Yields: Interest rates on municipal bonds continue to edge higher across the yield curve. This is represented by the following chart which provides Municipal Market Data (MMD) AAA yields since the start of 2020 for 5-year, 10-year, and 20-year maturities.

MMD Bond Index January 2020 - Current

Economic Growth: Higher energy and commodity prices due to the Ukraine-Russia conflict are expected to lower economic growth in the U.S. and Europe in 2022, and Europe is expected to be affected more because of its higher reliance on expensive energy imports. On March 8, 2022, S&P Global Ratings trimmed this year's growth estimate for the U.S. and Eurozone by 0.7% and 1.2%, respectively.

Federal Reserve's Challenge: The Fed is now facing the challenge of tightening monetary policy, (i.e., increasing interest rates, lowering demand, lowering the rate of price inflation), while economic growth at home and abroad is slowing, and a nuclear-armed Russia invades Ukraine. Move too slow and the Fed risks inflation increasing in magnitude and permanence. Move too fast and the Fed risks adding to the reduction in economic growth. Investors will be looking for guidance from the Fed later this week after the Federal Open Market Committee meets on March 15-16.

The Bright Side: While we are facing many challenges, long-term municipal borrowing rates are still quite attractive. To put long-term rates into perspective the Bond Buyer's 20 Bond General Obligation Index (an estimate of the yield that would be offered on 20-year G.O. Bonds by an Aa-rated issuer), has spent the last 7 weeks rangebound between 2.33% and 2.53%, which is only slightly above 2021's average rate of 2.18%, and well below 2019's pre-pandemic average rate of 3.42%.

PMA is dedicated to staying up to date on market trends and will be ready to guide you through a dynamic and evolving market. If you have any questions about the municipal bond market in general or your specific bond issue, please feel free to contact a PMA advisor below.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