Time to Revisit Municipal Bonds

Municipal bond yields have reached multiyear highs and may potentially offer investors an uncommon opportunity.

Featured Contributors

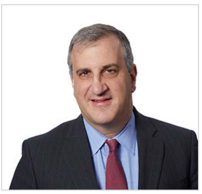

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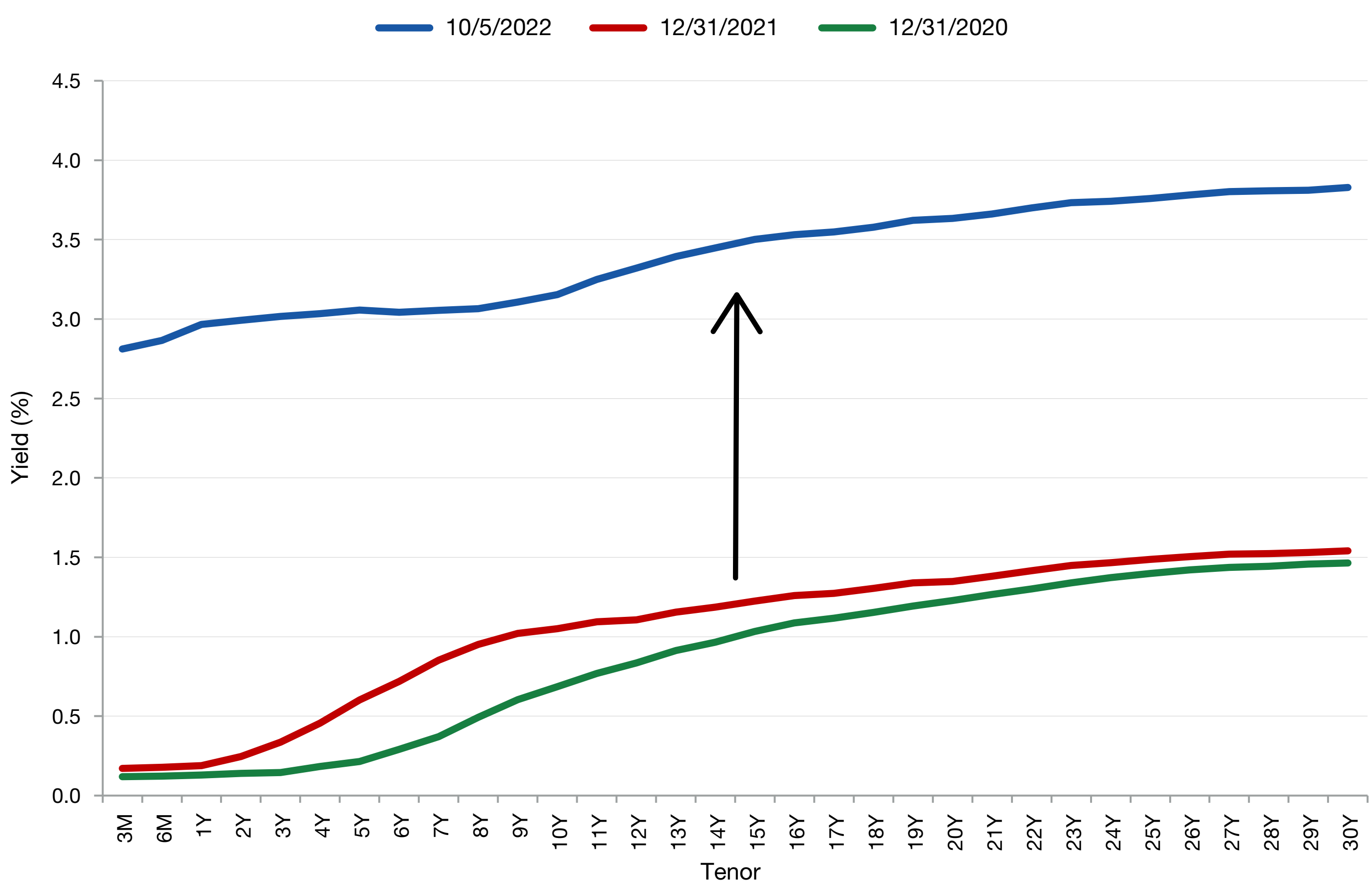
Figure 1. The Challenge for Munis in 2022: Rising Rates

Bloomberg AAA-rated municipal bond yield curves as of October 5, 2022, December 31, 2021, and December 31, 2020



Source: Bloomberg Index Services Limited. Data as of 10/05/2022. A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is no guarantee of future results.**

Municipal Bonds

Lord Abbett municipal bond experts, [Daniel Solender, CFA](), Partner & Director of Tax-Free Fixed Income, and, [Gregory Shuman, CFA](), Partner & Portfolio Manager, discuss the key factors affecting the municipal bond market at the start of the fourth quarter of 2022, and explain why higher starting yields and credit strength signal fresh opportunities in the asset class.

Key Points:

- The challenges of rising rates for the municipal bond market
- Municipal bonds' attractive entry-point yields
- Strong municipal bond credit trends and low defaults

Headwinds in 2022: Inflation, the Fed, and Rising Rates

Daniel Solender: This year, rising rates have impacted every segment of the municipal bond (muni) market. To illustrate the magnitude of upward rate moves, Figure 1 shows the AAA-rated municipal bond yield curve for the current period in 2022, as well as the yield curves at the end of 2020 and 2021. Yields on AAA municipal bonds skyrocketed in 2022, but even more striking is the comparison to the prior years. Rates overall from year-end 2020 to year-end 2021 moved very little at a time when investment inflows into the muni market were very strong.

In contrast to the last two years, muni bond yields surged higher across the curve this year, severely impacting the performance of the muni bond market. As of September 30, 2022, for example, the Bloomberg Municipal Bond Index has declined over 12% year-to-date as the yield on the index increased over 290 basis points since the end of 2021.

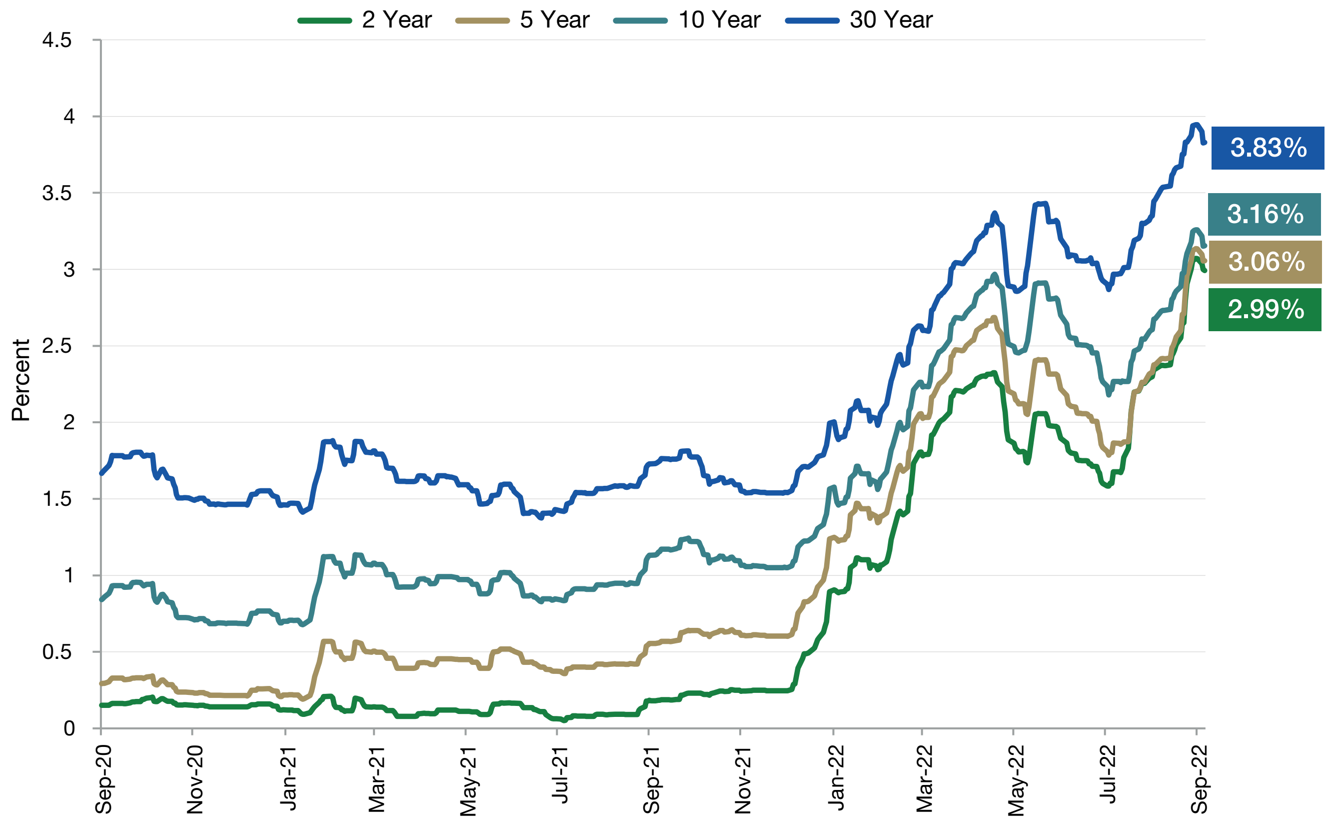
Clearly, a significant challenge in 2022 has been this historic rise in rates across all maturities, which may also have investors concerned about muni bond credit strength. However, we continue to see strong credit trends persisting across most muni sectors. The rapid and sizeable rise in muni bond yields this year is due to rising rates stemming from high inflation and the U.S. Federal Reserve's (Fed) rate hikes aimed at combating it.

Rate Volatility Hindering Demand

Rate volatility is also currently weighing on muni demand. In stable rate environments, like the latter half of 2020 and all of 2021, investment inflows into municipal bond funds were very strong. Although yields have increased to attractive levels and are even more appealing when considering their tax-exempt status, demand has not fully returned to the asset class this year, after record inflows last year. Looking at where rates are today (see Figure 2 on the next page), we think there's no reason why demand would not be strong again when rates stabilize, especially considering current muni credit strength and the relative value opportunity.

Figure 2. Higher Yields Suggest an Attractive Entry Point for Muni Bonds

Municipal bond yields by maturity for the period September 30, 2020, to October 5, 2022



Source: Bloomberg. Data as of 10/05/2022. This data is being provided for informational purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Past performance is not a reliable indicator or guarantee of future results.

Retail investors are a large and important investor-base of municipal bonds and tend to be more risk averse, especially during volatile market environments. A substantial steepening between 10- and 20-year maturities this year indicates demand has been stronger for short-term municipal bonds that are less sensitive to rising rates. Higher yields on long-term municipal bonds, however, are beginning to entice crossover investors, such as institutions, which may signal more optimism amid recognition of higher yields.

More Market Insights and Resources for Investors

Short Duration: Opportunities Emerging in a Challenged Environment

The Municipal Bond Opportunity in Three Charts

Q&A: An Update on Multi-Sector Investing in Today's Market

Rising Yields Add to the Appeal

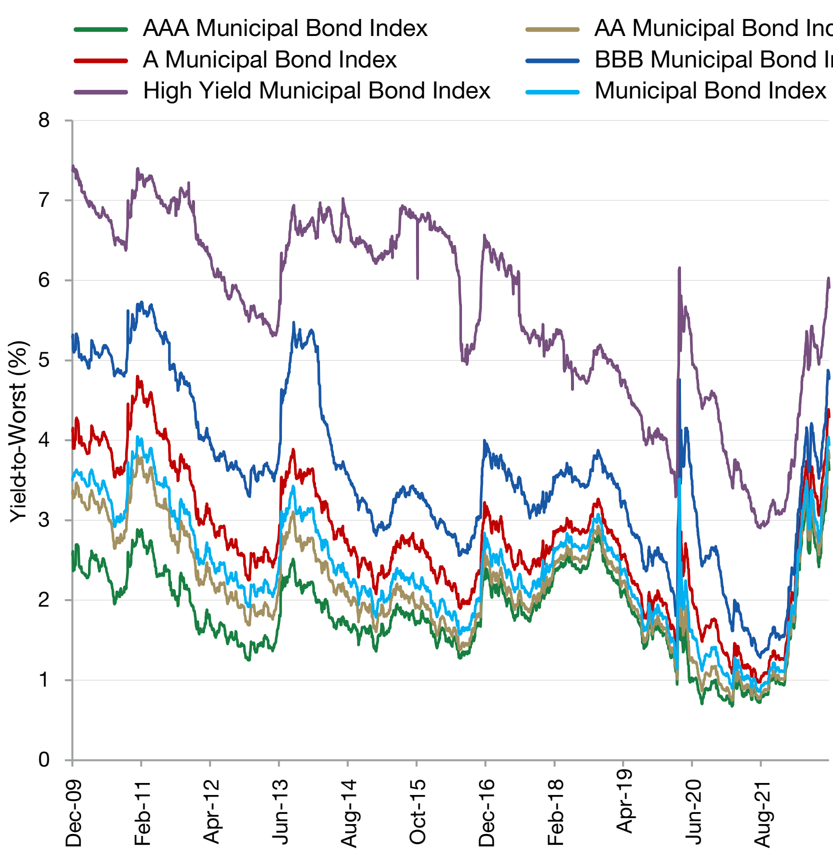
Gregory Shuman: For additional insight into the extent of the rate increases, Figure 3 shows the change in muni bond yields by credit-quality cohort, based on Bloomberg indices.

The largest increase in yields year-to-date has been among BBB-rated munis. The Bloomberg BBB-Rated Municipal Bond Index yield increased over 300 basis points (bps) since the end of 2021 to October 4, 2022. For perspective, BBB-rated municipal bonds have not reached that level of absolute yield since the taper tantrum of 2013.[1] In March 2020, during the pandemic-induced sell-off, BBB-rated munis reached a yield of 4.76%. The index yield as of October 4 was 4.77%.

The Bloomberg A-rated Municipal Bond Index yield has reached a level that was last reached in 2011, while the Bloomberg AA-Rated and AAA-Rated Municipal Bond Indexes last reached yields similar to those shown as of October 4, 2022, during the global financial crisis of 2008-2009. And lastly, the increase in the yield on the Bloomberg High Yield Municipal Bond Index is near the yield reached during the pandemic crisis in March 2020, a time of heightened uncertainty over the impact of a significant global event. Each quality segment of the Bloomberg Municipal Bond Index is touching up against yields that have not been reached in years.

Figure 3. Municipal Bond Yields Reach Multiyear Highs

Bloomberg Municipal Bond Index yields by credit quality (12/31/2009-10/04/2022)



Bloomberg Index	12/31/21 YTW	10/04/22 YTW	YTD Change
AAA Municipal Bond Index	0.94%	3.63%	+2.69%
AA Municipal Bond Index	1.01%	3.77%	+2.76%
A Municipal Bond Index	1.26%	4.29%	+3.03%
BBB Municipal Bond Index	1.55%	4.77%	+3.22%
High Yield Municipal Bond Index	3.11%	5.91%	+2.80%
Municipal Bond Index	1.11%	3.94%	+2.83%

Source: Bloomberg. Data as of 10/04/2022. YTW=yield-to-worst. Displays the Bloomberg High Yield Municipal Bond Index, Bloomberg BAA-Rated Municipal Bond Index, Bloomberg A-Rated Municipal Bond Index, and Bloomberg Municipal Bond Index. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is no guarantee of future results.**

As we have noted before, the challenging municipal market environment in 2022 has not been driven by municipal credit events. One of the main culprits for lower returns across credit qualities (see Figure 4) is the negative convexity of municipal bonds, and the fact that many bonds are extending duration to their final maturity as the bonds reach their coupon yield. For example, the Bloomberg High Yield Municipal Bond Index started 2022 with an effective duration of about 6.5 years. As of September 30, 2022, the index effective duration was about 10.6 years, which amounts to a four-year extension of duration due to the impact of rising yields.

Figure 4. Rare Negative Returns in 2022 Propelled by Rising Rates

Bloomberg Municipal Bond Index annual and year-to-date 2022 returns by credit rating

Index Returns by Rating	Muni Index	AAA	AA	A	BBB	HY Municipal
YTD to 09/30/2022	-12.13%	-11.71%	-11.62%	-12.55%	-14.93%	-16.03%
2021	1.52%	0.47%	0.92%	2.25%	4.85%	7.76%
2020	5.21%	5.51%	5.24%	5.27%	4.55%	4.89%
2019	7.54%	6.73%	7.12%	8.10%	9.94%	10.68%
2018	1.28%	1.05%	1.22%	1.34%	1.96%	4.76%
2017	5.45%	4.45%	4.96%	6.16%	8.74%	9.69%
2016	0.25%	-0.17%	0.05%	0.85%	0.35%	2.99%
2015	3.30%	2.73%	3.16%	3.71%	4.25%	1.81%
2014	9.05%	6.34%	8.22%	10.52%	14.47%	13.84%

Source: Bloomberg. Data as of 09/30/2022. Muni Index is the Bloomberg Municipal Bond Index. AAA, AA, A, and BBB is the Bloomberg AAA-, AA-, A-, and BBB-Rated Municipal Bond Indexes. HY Municipal is the Bloomberg High Yield Municipal Bond Index. **Past performance is not a reliable indicator or guarantee of future results.** Returns greater than one year are annualized. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Rising yields have had a similar impact on the duration of BBB-rated and A-rated municipal bonds, while AAs and AAAs have had less of an extension. These technical duration factors as rates rise, as well as the impact of outflows from muni bond funds, have caused the negative returns in 2022, as opposed to the implied risks regarding the fundamental credit quality of the bonds.

Reviewing Positive Credit Trends by Sector

State and local governments, which comprise approximately 30% of the muni market, started 2022 in a strong position as issuers built up excess reserves through robust tax revenues and large federal stimulus. These positive credit developments have bolstered governments' financial conditions as the U.S. economy slows.

The transportation sector has underperformed this year, but from a credit-quality standpoint, the sector continues to benefit from pent-up consumer demand following the pandemic and a broad-based recovery across multiple segments, including airports, toll roads, and mass transportation systems.

The industrial revenue sector covers many different corporate issuers. Many corporate issuers used the low-rate environment and growing economy to build strong balance sheets and extend bond maturities, alleviating liquidity pressures for a potential economic downturn.

Similarly, the higher education sector adapted operations to reduce expenses during the pandemic, while enrollment declines were less than anticipated. Balance sheets have also benefited from fiscal stimulus, positioning the sector well to weather recessionary challenges.

We are closely monitoring the healthcare sector due to expense pressures from inflation and labor shortages that are impacting not-for-profit healthcare systems. Importantly, we view these factors potentially impacting credit strength and credit downgrades, but not default for the majority of the sector. Healthcare systems have consistently dealt with a rapidly changing landscape over the last decade and are currently taking measures to adapt operations as they evolve.

A Historically Resilient Asset Class

Municipal bond defaults, while they do occur, have been very low relative to the aggregate size of the muni market and compared to corporate bonds (see Figure 5). Over the last 50 years, a period that has included seven U.S. economic recessions, defaults in the municipal bond market registered a cumulative average 10-year default rate of 0.2% across the full ratings spectrum versus a cumulative 10-year average of 10.6% for corporates.

Figure 5. Municipal Bonds Have Had Historically Very Low Default Rates

Average 10-year cumulative default rates, 1970–2020

Credit Quality	10 - Year Cumulative Default Rates	
Moody's Rating	Municipals	Corporates
Aaa	**0.00%**	**0.35%**
Aa	**0.02%**	**0.77%**
A	**0.10%**	**2.04%**
Baa	**1.09%**	**3.61%**
Investment Grade	0.10%	2.24%
Non - Investment Grade	7.11%	29.66%
All Rated*	0.16%	10.55%

Source: Moody's, "Moody's US Municipal Bond Defaults and Recoveries, 1970–2020," July 2021. Data show the average 10-year cumulative default rates of Moody's rated corporate and municipal bonds for a study covering the period 1970-2019. *Rating outlooks are not assigned to all rated entities. While municipal bonds are backed by municipalities, U.S. government securities, such as U.S. Treasury bills, are considered less risky since they are backed by the U.S. government. High-yielding, non-investment-grade bonds (junk bonds) involve higher risk than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment

A Final Word

It has been a challenging environment for municipal bonds due to persistent inflation and swift and substantial Fed rate hikes. Municipal bond funds have experienced record outflows in 2022 due to investors concerned over rising rates and the impact on the U.S. economy. These factors have caused muni bond yields to significantly increase across maturity and quality segments, while municipal credit has remained strong, particularly in certain sectors. We are focused on areas of potential risks, such as the healthcare sector, but those risks do not suggest increases in default, or that the historically very low default rate within municipal bonds will rise. As the Fed continues its battle against inflation, most municipal bond sectors are well positioned for an economic slowdown.

Higher muni bond yields have also been noticed by crossover investors that have begun to step into the market. We think inflows from retail investors will increase as interest-rate volatility gradually subsides. Combined with the resilience of the asset class and the potential for tax-free income, we think these higher yields enhance the appeal of muni bonds for long-term investors seeking attractive tax-free income.

[1]Taper tantrum of 2013 refers to Federal Reserve Chair Ben Bernanke's announcement in May 2013 that the Fed would start tapering asset purchases at some future date, which caused bond investors to start selling their bonds.

Important Information

Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

No investing strategy can overcome all market volatility or guarantee future results.

The value of investments and any income from them is not guaranteed and may fall as well as rise, and an investor may not get back the amount originally invested. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance.

Market forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

Equity Investing Risks

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

This material may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

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Glossary & Index Definitions

Convexity, a measure of the curvature in the relationship between bond prices and bond yields, illustrates how the duration of a bond changes as the interest rate changes. Negative convexity occurs when a bond's duration increases as yields increase; positive convexity occurs when a bond's duration rises, and yields fall.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. The **tax-equivalent yield** is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of the tax-exempt yield on a municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond to see which bond has a higher applicable yield.

The **U.S. Federal Reserve (Fed)** is the central bank of the United States. The Federal Open Market Committee (FOMC) is the monetary policy-setting arm of the Fed.

Index Definitions

Bloomberg Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. Bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two ratings agencies. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date.

Bloomberg AAA-, AA-, A-, and BBB-Rated Municipal Bond Indexes are subindexes of the Bloomberg Municipal Bond Index.

Bloomberg High Yield Municipal Bond Index is an unmanaged index consisting of noninvestment-grade, unrated or below BBB-rated bonds.

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