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IT MAY BE TIME TO ACTIVATE YOUR MUNI BOND PORTFOLIO



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Key Takeaways

- Following the Great Financial Crisis, during a period of ultra-low interest rates, the municipal bond market was characterized by low absolute yields with limited opportunities to add value through active management such as yield curve positioning or extending duration.
- Following the COVID-19 pandemic, loose monetary and fiscal policy minimized credit differentiation and diminished the value of fundamental credit analysis.
- During those years, municipal bond investors—reluctant to part with bonds in their portfolios that were bought in a higher yield environment and had embedded gains—may have turned to more passive, buy-and-hold approaches.
- As economic conditions shift and monetary policies change, we are seeing more divergence amongst issuers and opportunities to add value through credit selection.
- We believe investors can do better now in the current environment with a more active approach to municipal bond portfolio management.



Perhaps the greatest disadvantage of passive and laddered portfolios is the lack of active management of maturities. Typically, ladder strategies set bond maturities at 6- or 12-month intervals over 5- or 10-year periods. Proceeds from maturing bonds are reinvested in new bonds added to the long end of the ladder's maturity structure, regardless of the relative value in that particular area of the curve.

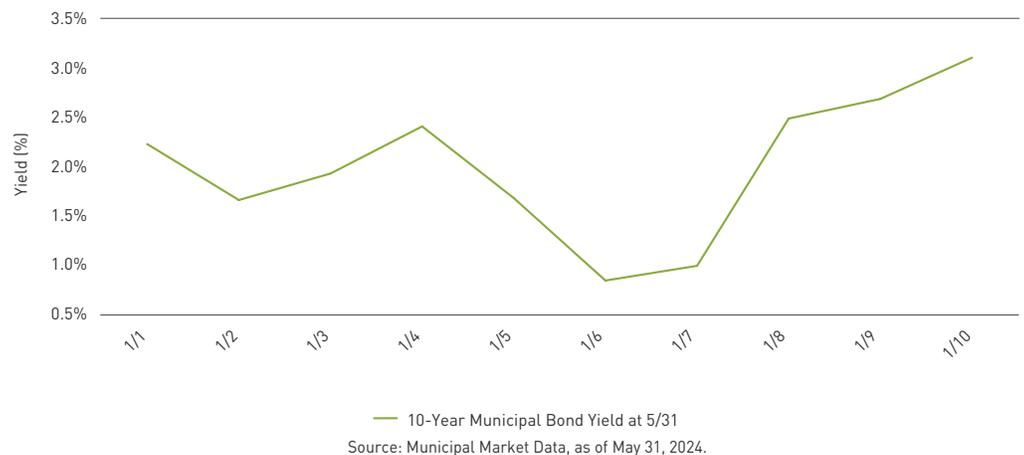
In effect, this laddered or passive portfolio management approach minimizes—if not fully ignores—the duration of each bond in the portfolio and its impact on the portfolio's average duration. Duration provides a measure of interest rate risk exposure, which is continually changing during the life of a bond.

Investment conditions in the municipal market began to change as the Federal Reserve (Fed) began raising interest rates in 2022 to stem inflation. While active portfolio management adapts when market conditions change, passive laddered approaches can be restrictive in their approach.

Four key changes occurring in the municipal markets over the last two years—higher yields, an inverted yield curve, more credit differentiation, and increased liquidity—help to highlight the contrast between active and passive approaches.

Higher yields: Absolute yields are higher in 2024 than at any time during the last decade (See Figure 1). Higher absolute yields can offer the opportunity to capture higher income across the curve.

FIGURE 1: MUNICIPAL BOND YIELDS INCREASED, AS THE FED RAISED RATES



We expect yields to remain high for longer, as the Fed is delaying a move lower in rates because inflation remains above its 2 percent target and unemployment remains low.

Changes in the shape of the yield curve: The yield curve inverted in the middle of December 2022 and remains inverted as of May 31, 2024. With higher yields available to investors at the short and long ends of the curve than in the middle or belly of the curve, we feel that active management of yield curve positioning is very relevant again.

For example, an inverted yield curve can offer opportunities to capture higher yields through a barbelled maturity structure that overweights holdings on the shorter and longer ends of the curve. In addition, a barbelled structure can provide accelerated reinvestment opportunities (in the form of both purchase/sale swaps and maturities) when rates rise, allowing for a greater ability to potentially build income.



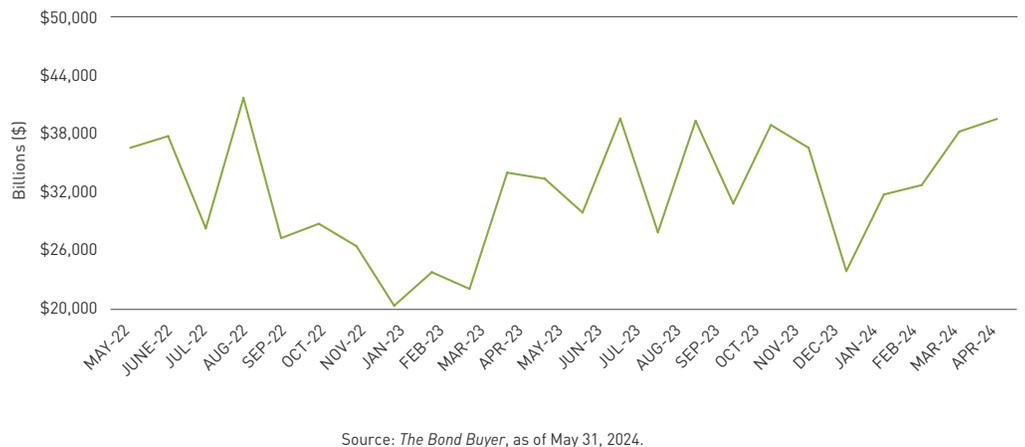
FIGURE 2: A MUNICIPAL YIELD CURVE INVERSION EMERGED IN DECEMBER 2022, PERSISTED, AND DEEPENED



Ladder strategies are limited in their ability to implement a barbelled structure due to the nature of their maturity structure and approach. A ladder’s equally weighted maturity schedule often forces purchases into a specific area of the yield curve, which can limit an investor’s response to market opportunities. Conversely, as rates fall, a professional manager can assess the various risks to the income stream and structure portfolios accordingly.

Market liquidity and bond issuance: The pace of municipal bond issuance has accelerated in 2024. Increased liquidity in the market offers opportunities to find value through trading strategies. In addition, higher bond issuance in the primary market results secondary market flows and spread widening which we view as an opportunity. Laddered approaches may unnecessarily confine consideration of new bonds to a limited opportunity set defined by a specific maturity term.

FIGURE 3: AFTER CRATERING IN 2022 DURING COVID-19, AND AN ERRATIC 2023, ISSUANCE IS TRENDING HIGHER IN 2024



In addition, the rise of electronic trading and the growth of separately managed accounts is helping to further increase liquidity and lower transaction costs. As a result, it may be less expensive to capture the additional income and value opportunities available in today’s market that we have described here.



CAPTURING INCOME THROUGH TAX-LOSS HARVESTING

We believe tax-loss harvesting (TLH) is one such opportunity important to capturing value in bond investing. TLH, or alternatively tax-loss swapping, involves selling one or more bonds in which an investor has unrealized capital losses and using those harvested losses to offset capital gains and increase the income generated by the portfolio.

If there are remaining losses after offsetting gains (in other words, net losses), an investor may also apply the losses to offset ordinary income. Investors also may be allowed to carry forward for tax purposes in future years additional net losses above this limit.¹

CAPTURING RELATIVE VALUE THROUGH CREDIT DIFFERENTIATION

As the municipal market has adapted to a higher rate environment, the expiration of federal aid associated with the COVID-19 pandemic, and increased issuance, opportunities have increased to capture higher relative value based on credit differentiation across issuers and sectors.

The municipal market entered 2024 with credit conditions characterized by strong liquidity, a less-weak hospital sector, modest debt burdens, sturdier pension fundamentals, and rising residential real estate values (See Breckinridge's [2024 Municipal Market Outlook](#)). Ratings upgrades outpaced downgrades again in 2023, and default rates remain low in 2024. However, we expect that fundamentals may weaken modestly in 2024, especially for state and local governments, as the sector's excess savings is peaking, and several of market's largest issuers must now tackle deficits stemming from wage pressures, slowing revenue, unexpected migration, and rising willingness risk (the willingness of tax payers to fund higher levels of debt).

CONCLUSION

Active portfolio managers, who are less constrained across maturity exposures than laddered/passive strategies may benefit from increasing opportunities in today's municipal market conditions. Those changes include higher yields, changes in the shape of the yield curve, increased liquidity in the form of higher bond issuance, and greater dimensions of credit differentiation. A passive approach characterized by a buy-and-hold strategy can result in unintended bets on the direction of interest rates. In our view, active management has several advantages that could translate into higher after-tax returns for investors.



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FOOTNOTES:

1. Based on 2024 federal tax guidelines, which are subject to change.

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