



## 2021 Municipal Bond Outlook

The early days of the pandemic sent the historically stable muni market into disarray. Liquidity collapsed, and as investors had no one to sell to, prices fell dramatically. Luckily, swift action on the part of the Federal Reserve restored liquidity and stabilized the market. Still, concerns lingered about how the pandemic and ensuing economic shutdown would impact municipalities, and many feared we would see a wave of defaults.

Fast forward to the end of 2020, and these dire predictions never materialized. As of December 2020, there had been only 13 more defaults than in all of 2019, and the vast majority of defaults were munis that were non-rated or below investment grade. The municipal bond market, as represented by the Bloomberg Barclays Municipal Bond Index, was up 5.2%, marking the seventh straight year of positive performance.

The muni market demonstrated its resiliency in 2020 and enters 2021 in a strong position. That said, there are still challenges. As the economy continues to improve, the finances of municipal bond issuers will as well, but the biggest unknown in all of this remains the coronavirus. Covid-19 continues to spread in many parts of the country, slowing economic activity. While the vaccine is a game-changer, logistical hurdles have slowed the distribution, and it may be well into the summer before sufficient immunization levels are reached.

Despite the potential challenges facing the muni market, munis remain attractive when compared to other fixed-income investments, especially for investors in higher tax brackets. After-tax yields for municipal bonds were higher than Treasuries and corporate bonds for investors in the 32% federal tax bracket and above, according to a Bloomberg report. The tax benefits of muni bonds may be particularly important in 2021 as state, local, and potentially even federal tax rates are expected to increase to make up for the revenue lost during the pandemic.

Even for investors in a lower tax bracket, taxable munis are attractive. The interest in-

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come from most municipal bonds is exempt from federal income taxes, and potentially from state income taxes as well. Some bonds, however, pay interest that is subject to income tax. Even these taxable muni bonds may be attractive in 2021, because they carry a higher yield, but without taking on too much additional credit risk.

Fixed income as a whole carries a high level of uncertainty in the coming year, and we recommend keeping durations low and adding credit risk only in moderation. This is especially true in the muni market, where investors should also carefully consider the sector and issuer as well.

At the state government level, things should be relatively stable. State tax revenue has proven to be much more stable than expected. Projections in March 2020 were that tax revenues could fall by as much as 25%, but they have fallen just 1% on average according to a study from JPMorgan Chase. States also have a variety of options at their disposal to help balance their budgets, and most states entered the crisis with strong reserves and “rainy day” funds, meaning they should be able to weather the crisis. We do not expect to see defaults at the state level, but there may be credit downgrades, and a state’s credit rating falling below investment-grade could roil the market.

At the local level, most governments rely on property taxes for revenue. The real estate sector has fared extremely well during the crisis and property values have continued to climb throughout the pandemic. Investors should be more cautious of local governments that rely on sales tax or taxes from tourists as their primary source of revenue.

Looking at special obligation bonds, many are likely to be risky. Healthcare muni bonds, for example, are likely to underperform. The entire industry was hard hit by the coronavirus crisis, not only because it led to high labor and equipment costs, but because hospitals had to halt profitable elective procedures. Transportation has been similarly hard hit, as revenues from airports, toll-roads and mass transit have fallen precipitously. Higher education’s prospects are split. Private institutions are riskier, because they are reliant on tuition, whereas public colleges may fare better because they receive state funding. All of this may change, of course. The vaccine rollout may allow normal business to resume more quickly, or another round of stimulus, particularly if it includes direct aid to state and local governments, could allow these sectors to shore up their finances. With so many unknowns, however, caution is warranted.

Still, there are many reasons to be optimistic about muni bonds in 2021. Net supply is expected to turn negative, as bonds maturing or getting called away outpaces new issuances. This will drive up prices as more investors chase fewer bonds. Uncertainty remains high, but the prospects for muni bonds in 2021 are much brighter than they were in 2020.