MAR 2021

Investment Highlights

US Municipal Bond

WESTERN ASSET

Key Takeaways

- *The municipal market had another strong month in March as municipal yields moved lower despite the significant UST selloff. The Bloomberg Barclays Municipal Index returned 0.62% in March while the Bloomberg Barclays High Yield Municipal Index returned 1.08%. YTD, the broad Municipal Index has returned -0.35% compared to the High Yield index which has returned 2.11%.*
- *The tax-exempt muni asset class continues to outperform most taxable assets in 2021. YTD the Muni Index is down 0.35% (as mentioned above) whereas the Bloomberg Barclays US Aggregate Index is down 3.37% and the Bloomberg Barclays US Corporate Index is down 4.65%.*
- *Despite interest rate volatility, technicals remained favorable as 1Q21 net inflows to municipal mutual funds reached a record high. We remain constructive on the muni asset class as relative valuations remain favorable and we believe certain higher-beta segments offer value and would stand to benefit from a continued recovery.*

Market Review

The $1.9 trillion Covid relief bill made its way through Congress via the budget reconciliation process and was signed by President Biden in mid-March. The plan will send direct payments of up to $1,400 to most Americans, extends a $300 per week unemployment insurance supplement and expands the child tax credit. The bill also provides $350 billion to support state and local municipalities and nearly $20 billion for COVID-19 vaccinations. On the last day of the month, the White House released a fact sheet summarizing its infrastructure proposal which includes roughly $2 trillion in spending over eight years and would raise the corporate tax rate from 21% to 28% to fund it. Biden stated that the second part of his recovery package would be unveiled in a few weeks and this "human infrastructure" plan could include education, family care and health care proposals. Analysts believe there is a reasonable chance that some form of this plan will pass Congress but it will be tougher than it was to pass the Covid relief bill as some divisions are already apparent among Democrats.

The Federal Reserve (Fed) updated its economic forecasts during its March meeting, increasing its growth and inflation forecasts for 2021, to 6.5% and 2.4%, respectively, and lowered its unemployment forecast to 4.5%. However, changes to subsequent years' forecasts were much smaller, which was especially apparent for inflation where the 2022 and 2023 forecasts were moved up only marginally. During the month, the S&P 500 rose 4.6%, the yield on the 10-year US Treasury (UST) rose from 1.44% to 1.74%, and the front to intermediate segment of the yield curve steepened. WTI oil fell $2.10/barrel (-3.4%) to $59.50 and the US dollar was mixed but generally strengthened versus most developed market (DM) and emerging market (EM) currencies.

Municipal yields moved lower during the month despite the significant UST rate selloff. AAA muni yields declined 2 to 5 basis points (bps) while USTs increased 21-34 bps across the curve. Given the strong outperformance, muni/Treasury ratios fell significantly—the 5-year muni/Treasury ratio declined from 77% back down to 54%, near record lows. The tax-exempt muni asset class continues to outperform most taxable assets in 2021. In March, the Bloomberg Barclays Municipal Index returned 0.62% compared to -1.25% for the US Aggregate Index and -1.72% for investment-grade corporates. Year to date (YTD) the muni index is down 0.35%, compared to the -3.37% return for the US Aggregate Index and the -4.65% return for investment-grade corporates. Lower-quality munis continued to outperform in March, with BBBs returning 0.90% during the month compared to 0.66% for As, 0.58% for AAs and 0.52% for AAAs. BBB to AAA credit spreads tightened from 95 bps to 88 bps during the month.

Despite the interest rate volatility, technicals remained very favorable as mutual fund demand remained robust. Municipal mutual funds continued their inflows streak during the month—through March 31, net inflows over the month totaled $4.7 billion. First quarter net inflows totaled $31.7 billion, a record level. From a supply perspective, March supply was elevated with total municipal new-issue supply of $47.5 billion, increasing approximately 37% from the prior month's level. YTD total new-issue supply reached close to $111 billion, up 16% year-over-year (YoY). YTD tax-exempt new-issue supply was up 18% YoY. YTD taxable new-issue supply totaled $33 billion through the end of March (up 9% YoY).

State and local governments finally started receiving their hotly contested direct stimulus funding as Congress passed the $1.9 trillion American Rescue Plan Act relief package, which provides $350 billion of direct aid to states and local municipalities. In total, states will receive $195.3 billion and local governments will receive $130.2 billion. The majority of state funds will be distributed based on the overall share of unemployment. From the local government perspective, counties will receive $65.1 billion, metropolitan cities will receive $45.6 billion and small cities will receive $19.5 billion. Other municipal revenue sectors will also stand to benefit as the overall stimulus package targets health care, transportation, education and housing sectors. While revenues proved better than initially feared, not all states are impacted by the pandemic equally and budget stress is still evident in the declining state and local payroll figures. State and local employment is still down 1.4 million jobs from pre-pandemic highs, which should continue to constrain domestic and regional growth.

Data Sources: Thompson Reuters MMD, Bloomberg, and Barclays

Outlook

Despite the recent upward move in UST rates, Western Asset believes that long-term structural employment levels and the Fed's stated willingness to let short-term inflation rise above its stated 2.0% target will keep long rates anchored and is constructive on duration over the long term. In addition, our long duration position versus the benchmark is a hedge to potential volatility that could arise from any challenges to the global growth outlook. From a technical standpoint, we anticipate near-term demand could soften amid concerns of higher rates along with the tendency for high net worth individuals to fund tax bills from muni allocations in March and into May, given the extended tax filing deadline. From a supply perspective, we could see elevated new issuance amid the current rate volatility, and we remain focused on the progress of federal infrastructure policy and how that can shape tax-exempt and taxable issuance composition.

Western Asset's view is that while some entities will receive more federal aid than needed, the stimulus package will be supportive of lower-grade municipalities that face longer-term structural challenges. Rating agencies are also taking note, as the state of Illinois once again avoided a high-yield rating downgrade. Moody's affirmed its BBB- rating for the state while removing a negative watch, and Fitch affirmed its BBB-/negative rating, citing that the state's revenues have exceeded enacted budget expectations and stimulus measures that "may provide an immediate boost to state's fiscal resilience." We remain constructive on the muni asset class as we believe certain higher-beta segments offer value and would stand to benefit from a continued recovery.

Important Information

Past performance is no guarantee of future results. Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

Fixed income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls. High-yield bonds are subject to greater price volatility, illiquidity, and possibility of default. Certain investors may be subject to the Federal Alternative Minimum Tax (AMT), and state and local taxes may apply. Capital gains, if any, are fully taxable.

U.S. Treasuries (USTs) are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity. Unlike U.S. Treasury securities, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings are provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd. and typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. Investment-grade bonds are those rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined be of equivalent quality.

Franklin Resources, Inc., its specialized investment managers, and its employees are not in the business of providing tax or legal advice to taxpayers. These materials and any tax-related statements are not intended or written to be used, and cannot be used or relied upon, by any such taxpayer for the purpose of avoiding tax penalties or complying with any applicable tax laws or regulations. Tax-related statements, if any, may have been written in connection with the promotion or marketing of the transaction(s) or matter(s) addressed by these materials, to the extent allowed by applicable law. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Any information, statement or opinion set forth herein is general in nature, is not directed to or based on the financial situation or needs of any particular investor, and does not constitute, and should not be construed as, investment advice, forecast of future events, a guarantee of future results, or a recommendation with respect to any particular security or investment strategy or type of retirement account. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies should consult their financial professional.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE