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A Tale of Two Muni Markets:

Finding Value in Taxable Municipal Bonds

Baird Funds

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Overview

For investors in lower income tax brackets, or perhaps entities which pay no income tax at all (IRAs, pension plans, etc.), a recent boost in issuance of taxable municipal debt has enhanced the attractiveness of taxable municipals relative to other taxable fixed income sectors. According to Bloomberg Barclays data, credit spreads for the Intermediate Taxable Municipal sector widened 49 bps YTD through November relative to Intermediate Corporates. Not only have valuations improved relative to taxable corporate bonds, but the higher average credit quality of municipals also provides an appealing way to enhance credit quality and diversify risk late in an economic cycle with little or no yield sacrifice. While the current opportunity in taxable municipals doesn't yet rise to that of the post-crisis Build America Bond (BAB) era of 2009-10, if issuance remains elevated, as we expect, and relative valuations attractive, we will continue to add exposure where appropriate.

Boost in Taxable Supply

Through November, nearly $59B of taxable municipals was issued, making this the highest year of taxable municipal borrowing since 2010. Many will recall the BAB issuance period when, between April 2009 and December 2010, $182B of taxable BAB debt was sold. BABs provided municipalities with a federal subsidy to help lower their interest cost. The current taxable supply carries no such federal subsidy, yet taxable borrowings may exceed $70B by year end and some believe issuance could rise as high as $100B next year. Although taxable municipals are a relatively small segment of the much larger tax-exempt market—just 12% of the total outstanding supply—issuance YTD represents 15% of total municipal supply and by some estimates could rise as high as 25% of total supply next year.

Although there are several factors driving the increased taxable borrowing, a big driver was the passage of the Tax Cuts and Jobs Act (TCJA) of 2017 which eliminated most tax-exempt refundings. For municipalities that want to take advantage of today's low interest rate environment, the only option for refinancing tax-exempt debt well ahead of a call date, is to issue taxable debt. Given the low borrowing rates currently available, an estimated one-half of all taxable municipal borrowing this year has been used to refinance older, higher-yielding tax-exempt debt; even allowing for taxable interest rates the municipality still realizes a cost savings.

The balance of the taxable debt issuance has been driven by two forces. The first is strong demand from both domestic and international taxable buyers searching for higher quality yield. Having a more diverse investor base of both domestic and global buyers in the municipal market is healthy for municipalities issuing the debt and enhances liquidity for those who purchase it.

The second driver is a desire by some municipal issuers to have more flexibility in how they expend the borrowed funds. For example, an airport which has retail shopping and dining must be careful not to violate IRS rules regarding the use of the proceeds between a public purpose and private enterprise if they are issuing tax-exempt debt. By issuing taxable debt, this concern goes away and offers the airport more flexibility.

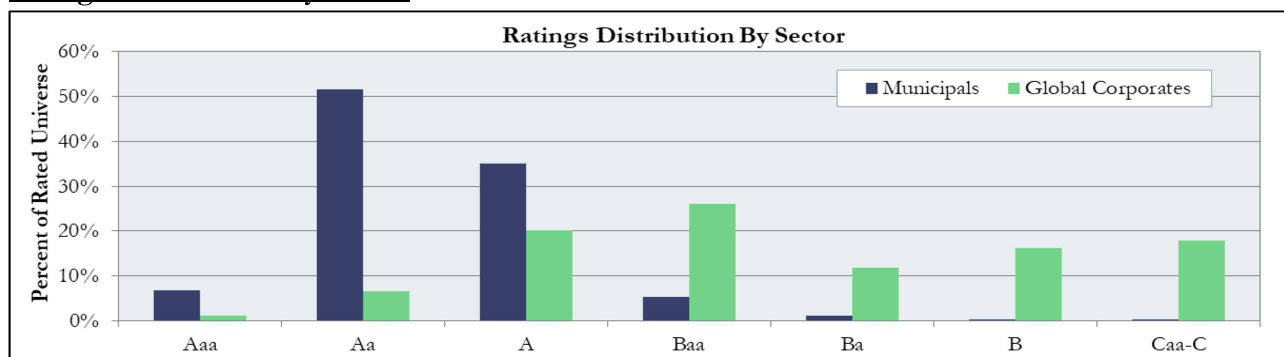
Diversification Benefits of Taxable Municipals

Investors may also be driven to taxable municipals because of the diversifying benefits the sector offers relative to other taxable sectors. One key difference between the municipal market and other taxable sectors is the favorable technical (supply/demand) backdrop for the municipal market. Unlike either U.S. Treasury/Agency debt or corporate debt, both of

which have grown in size since the financial crisis, total municipal debt outstanding is virtually unchanged since 2009. A roughly equal amount of municipal debt has matured or been called away as has been issued over that time, due in part to the reluctance of municipalities to take on additional debt. Although tax revenues have risen steadily since the crisis, instead of borrowing, municipalities have worked to close structural budget deficits, shored up reserves, and focused on meeting rising pension and health-care related costs. The result is a relatively modest level of net new borrowing in the municipal market.

Another diversification benefit of the municipal market is the higher average credit quality of the sector relative to corporates. As shown in the next graph, municipal ratings skew much higher than corporate debt.

Ratings Distributions By Sector:



Source: Moody's ratings as of year-end 2018

The higher average rating of municipals is supported by both recent and historical default data. Nearly 10 years after Moody's adopted a global scale for its municipal ratings, which sought to put municipal ratings in line with corporate debt, Moody's own data illustrates that a dramatic difference in default probabilities between the two market sectors still exists. For example, from 2009 through 2018, Moody's 10-year default rate for A-rated corporate debt was 2.1%, more than 20X the 0.1% default rate of A-rated municipals. The following chart shows similar results across all of the rating agencies. In fact, the average default rate for investment grade municipal debt over the 10-year period ending 2018 was 0.1% vs. 2.2% for corporates.

Ten-Year Cumulative Default Rate % (as of 2018 study):

Municipals	Moody's	S&P	Fitch	Average
AAA	0.0%	0.0%	0.0%	**0.0%**
AA	0.0%	0.0%	0.0%	**0.0%**
A	0.1%	0.1%	0.1%	**0.1%**
BBB	1.1%	0.8%	0.8%	**0.9%**
BB	3.7%	4.7%	5.6%	**4.7%**
B	17.9%	10.9%	1.9%	**10.2%**
CCC-C	25.8%	40.5%	15.4%	**27.2%**
Investment Grade	0.1%	0.2%	0.1%	**0.1%**
Speculative Grade	7.5%	9.0%	5.9%	**7.5%**
All Rated	0.2%	0.3%	0.2%	**0.2%**

Corporates	Moody's	S&P	Fitch	Average
AAA	0.4%	0.8%	1.5%	**0.9%**
AA	0.8%	1.0%	0.1%	**0.6%**
A	2.1%	1.8%	1.5%	**1.8%**
BBB	3.7%	4.3%	3.2%	**3.7%**
BB	15.5%	14.4%	9.1%	**13.0%**
B	34.3%	26.4%	13.1%	**24.6%**
CCC-C	48.2%	56.6%	41.5%	**48.8%**
Investment Grade	2.3%	2.5%	1.9%	**2.2%**
Speculative Grade	28.8%	23.5%	13.0%	**21.8%**
All Rated	10.1%	11.0%	4.1%	**8.4%**

Source: Moody's, S&P, Fitch, and JP Morgan Securities

It is broadly recognized that a different methodology exists for rating municipals and corporates given the fundamental differences between the two sectors. Key among them is the virtual monopolistic authority most municipalities have in

setting tax and revenue rates. If ratings were based solely on the probability of default, nearly all traditional municipal debt would likely reside in the AAA and AA rating categories. Instead, to help investors discern the relative credit strength within the municipal market the full ratings spectrum is utilized. Understanding this, investors can more fully appreciate the benefits municipals provide in a broadly diversified fixed income portfolio.

Late-Cycle Benefits

The U.S. economy is now in its longest post-WWII expansion, moving into its 11th year in the summer of 2019. While recession risks remain modest, we are clearly later in the economic cycle. Therefore, diversifying into municipals, which tend to lag the economic cycle relative to corporate credit, is a prudent risk management opportunity. Even after corporate revenues and earnings peak, tax revenues are typically slower to decline. Property taxes, for example, lag the economic cycle as property reassessments may not occur for up to three years after a downturn in prices. Sales and income tax revenues also tend to lag declines in employment and federal spending often rises during a slowdown to help offset otherwise weak economic activity. Finally, it's worth noting that the U.S. economy is relatively robust compared to the rest of the developed world and the revenues that back municipal debt are domestic-oriented, rather than globally influenced. A slowing global economy tends to have less direct impact on municipal revenues than many sectors of the corporate market.

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Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risk such as interest rate risk, regulatory risk, reinvestment risk, credit risk, inflation risk, call risk, default risk, political risk, tax policy risk and liquidity risk. In a rising interest rate environment, the value of fixed-income securities generally decline and conversely, in a falling interest rate environment, the value of fixed income securities generally increase. Municipal securities investments are not appropriate for all investors, especially those taxed at lower rates.