

The Municipal Bond Market is Recovering from COVID-19

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SEI New ways.
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SEI Fixed Income Portfolio Management (SFIPM) manages fixed-income strategies for SEI's Managed Account Solutions (MAS).

- The municipal bond market was considered healthy to start the year, but like most other markets it has been sickened by the COVID-19 crisis.
- Yields have been volatile, liquidity has been scarce, and trading costs have been high, but the market seems to be improving following some intervention.
- We believe our high-quality municipal portfolios remain well positioned to meet client needs.

It has been reported that COVID-19 is hardest on those with pre-existing health conditions. But we have also learned that it can also severely impact even the healthiest, with no pre-existing conditions. The municipal bond market learned first-hand of this truth, as a healthy market rapidly deteriorated, growing violently ill as the coronavirus outbreak sent investors scrambling to raise cash and indiscriminately selling anything they could in a effort to raise cash.

Munis Tested Positive

Prior to the emergence of COVID-19 as a threat to the world economy, the municipal bond market was in peak physical condition, trading at historically rich valuations. That has changed.

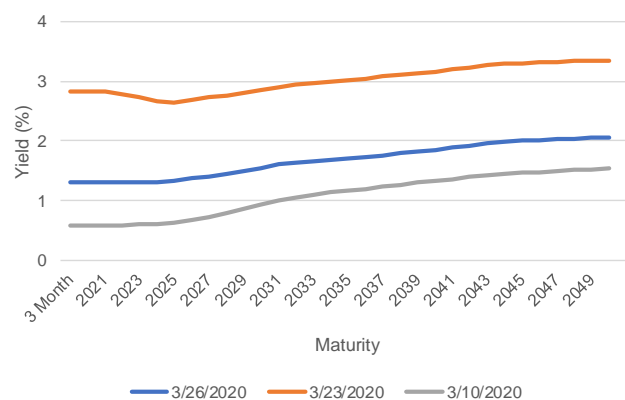
Recent municipal bond market volatility has been unprecedented. The magnitude of the municipal market selloff and subsequent rally since March 10, 2020 has been breathtaking. According to March 10 Bloomberg data¹, 1-year AAA municipal bond maturities were yielding 0.58% and 10-year maturities 0.93%. As the virus continued to spread, a herd mentality dominated fixed-income markets as investors sought to raise cash. Market liquidity was decimated. The front end of the yield curve came under immense selling pressure, sending 1-year AAA municipal bond yields 225 basis points (a basis point equals 0.01%) higher to 2.83% by March 23, 2020. The rest of curve followed, as 10-year yields climbed 193 basis points to 2.86%.

The Market gets some Medicine

As the old adage goes, markets stop panicking when policy makers start panicking. As signs of a massive federal stimulus package emerged, an even more violent

municipal bond market rally ensued. In the two-day period ending March 26, 2020 municipal bonds retraced about two-thirds of the value lost during the two-week selloff.

Exhibit 1: AAA Rated Municipal Bond Yield Curve



Source: Bloomberg, SEI

Bedrest has been Helpful...

It takes time to recover from any illness, but the rapid descent in yields witnessed during recent trading sessions suggests the municipal market's fever may be breaking. Throughout the worst of the market selloff, flows were dominated by sellers. According to Refinitiv Lipper U.S. Fund Flows reports, investors pulled a record \$13.7 billion out of municipal bond mutual funds in the week ended March 25, 2020. This exceeded the prior record of \$12.2 billion from a week earlier. More recently, market liquidity has shown tentative signs of improvement as a massive federal stimulus package coupled with attractive valuations brought buyers back into the market. There has been an increase in two-way

¹ Bloomberg Barclays Municipal Bond Index

flows that are indicative of a healthy functioning market. Nevertheless, the cost to buy and sell bonds as measured through bid-ask spreads remains abnormally high, so investors seeking to buy or sell bonds in the current market environment can continue expecting to pay elevated trading charges.

...but Symptoms Remain

Although the municipal market is showing signs of recovering, it continues to cope with residual effects from its recent illness. While the market as a whole has shown early signs of improvement, a bifurcated recovery appears to be taking shape. Specifically, municipal bonds issued from geographic locations that are virus hot spots and states with the highest number of COVID-19 cases continue to face more challenging liquidity conditions than those from less impacted locales.

Our Portfolios

A market disruption like the COVID-19 crisis has a tendency to shake investor confidence. While tighter liquidity conditions continue to exist, the investment rationale behind each of our municipal bond investments

remains intact. We note that certain geographic areas that have experienced higher rates of infection are experiencing more challenging liquidity conditions. Specific examples include King County, Washington and New York City, New York. We have also witnessed more challenging liquidity conditions for issuers from parts of New Jersey and California. It is our belief that the bond issues we have chosen to use for our municipal bond portfolios from each of these geographic areas have strong credit quality, and we remain confident in their ability to meet their obligations to investors.

There is still considerable uncertainty in the markets, and it would be premature to say that the worst is behind us. Nobody knows how this virus will progress. What we do know is that we have constructed our low-turnover strategies with highly rated, high-quality municipal fixed-income securities with the goal of delivering a stable, steady stream of consistent income. The municipal bond credits we purchase for our strategies have been thoroughly vetted. We do not know precisely how the COVID-19 situation will unfold, but we remain confident in the ability of our portfolios to deliver stable income investors expect.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice.

There are risks involved with investing, including loss of principal. Diversification may not protect against market risk. Bonds will decrease in value as interest rates rise. There is no guarantee that the income will be exempt from federal or state income taxes or the federal alternative minimum tax. Capital gains, if any, are subject to capital gains tax. No mention of particular securities should be construed as a recommendation or considered an offer to sell or a solicitation to buy any securities.

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