THE BOND BUYER

Munis outperform UST selloff, ratios plummet

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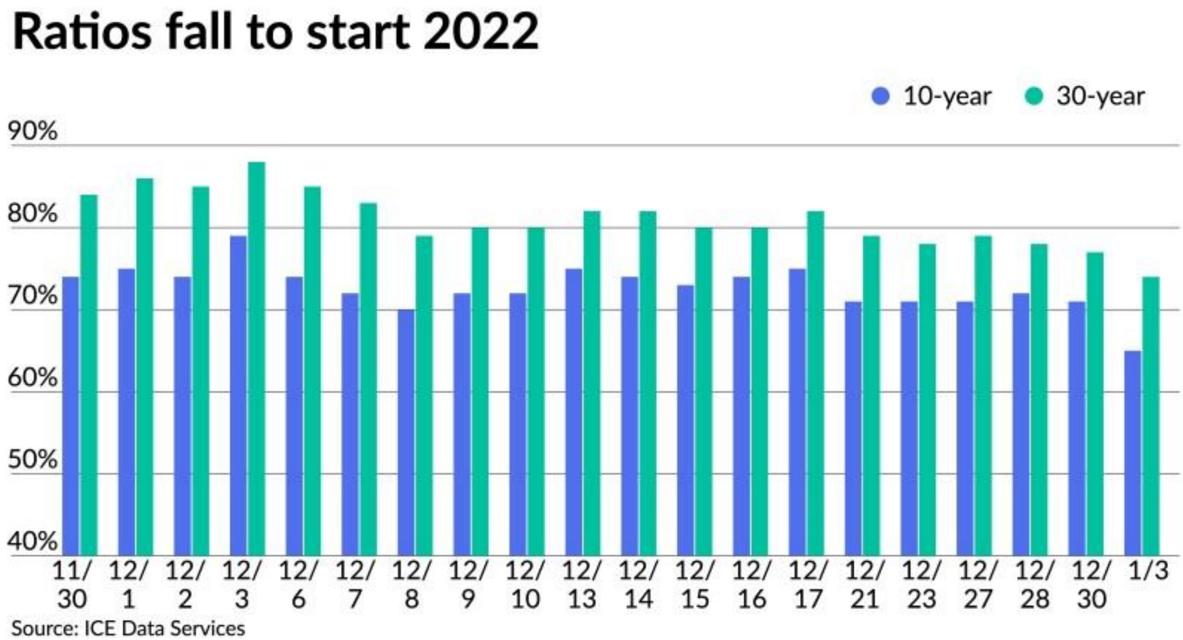
The U.S. Treasury market sold off in double-digits to start 2022 and equities were better on Monday while munis saw a softer tone, but most triple-A yield curves only saw a basis point cut in spots.

Municipal to UST ratios fell on the moves in UST. The five-year was at 44%, 64% in 10 and 74% in 30, according to Refinitiv MMD's 3 p.m. read. ICE Data Services had the five at 43%, the 10 at 65% and the 30 at 73%.

Treasury and equity volatility was constant in December and munis were mostly static, ignoring the moves in other markets. Municipals have largely decoupled from UST since the March 2020 COVID-led market dislocations, but the disconnect was more pronounced in the latter half of 2021, leading to big outperformance of taxables.



"Though top-line returns were more muted in 2021 vs. 2020, on a tax-adjusted basis, exempt municipals massively outperformed many taxable options at a fraction of the duration exposure for portfolios," said Eric Kazatsky, senior municipals strategist at Bloomberg Intelligence. "Even the 5.65% return of the China Aggregate index was left in the dust by high-yield munis, both on a regular and tax-adjusted view."

The 10-year U.S. Treasury rate climbed 17 basis points in December to finish 2021 at 1.51%. It rose 12 bp on Monday. The 10-year UST sat at 1.634% on Monday. Munis moved by a basis point since Dec. 1.

Persistent inflation concerns that forced a bit of a U-turn from the Federal Reserve hasn't help matters, Kazatsky said. "The rising rates created an overhang for Treasuries' index performance, as well as that of taxable munis."

"However, as we start the year, the issue at hand isn't a quicker taper by the Fed, but rather the direction of the current wave of the pandemic," Kazatsky said. "Though we don't expect Omicron's spread to derail the U.S. economy, the impact of canceled flights, postponed trips and closings of small businesses due to lack of staffing could slightly mute 1Q growth."

The supply demand imbalance continues to start off the year. Bond Buyer 30-day visible supply sits at $5.57 billion.

The primary this week is light. The Los Angeles Department of Airports and the Virginia Small Business Financing Authority will kick off the calendar on Thursday with the only two deals of size.

The Airports Department (Aa3/AA-/AA-/) will price $503.22 million consisting of $346.215 million of private activity AMT subordinate revenue bonds 2022 Series A, serials 2026-2042, terms 2045, 2049, and $157.005 million of non-AMT subordinate revenue bonds 2022 Series B, serials 2026-2042, term 2048. Ramirez & Co., Inc. is lead underwriter.

The Virginia Small Business Financing Authority will price $583.545 million of Elizabeth River Crossing Opco, LLC, project forward delivery senior lien revenue refunding bonds (//BBB/). BofA Securities will run the books.

Forward delivery bonds saw an uptick in 2021, largely as another alternative to tax-exempt advance refundings. CreditSights said forward delivery bonds hit $16 billion in 2021, more than double the $6.7 billion a year prior. "Unsurprisingly, 90% was for refunding bonds, with additional 5% for refunding and new money combined," CreditSights said.

Secondary trading

Secondary trading was light. North Carolina 5s of 2023 at 0.22%. Maryland 5s of 2023 at 0.26%. Ohio 5s of 2024 at 0.38%. Maryland 5s of 2025 at 0.49%-0.48%.

North Carolina 5s of 2028 at 0.81%. Charleston County, South Carolina, 5s of 2029 at 0.94%. Washington Suburban Sanitation District 5s of 2030 at 1.02%.

Connecticut 5s of 2032 at 1.27%. New York Dorm PITs 5s of 2032 at 1.21%. Los Angeles MTA 5s of 2032 at 0.97%.

Indiana Finance Authority green 5s of 2034 at 1.19%. District of Columbia 5s of 2035 at 1.23%. Indiana Finance Authority 4s of 2037 at 1.45%.

AAA scales

Refinitiv MMD's scale was little changed save for December to January roll: the one-year steady at 0.17% and 0.27% in 2023 (+3). The 10-year rose one to 1.04% and the 30-year up one to 1.50%.

The ICE municipal yield curve showed yields were slightly weaker: 0.16% in 2022 and 0.29% in 2023. The 10-year up one to 1.05% and the 30-year yield up one to 1.50%.

The IHS Markit municipal analytics curve was steady: 0.16% in 2022 and to 0.25% in 2023. The 10-year at 1.01% and the 30-year at 1.49% as of a 3 p.m. read.

Bloomberg BVAL was saw one to two basis point cuts to scales: 0.17% in 2022 and up one to 0.23% in 2023. The 10-year was up one to 1.05% and the 30-year up two to 1.50%.

Treasuries sold off while equities were better.

The five-year UST was yielding 1.361%, the 10-year yielding 1.634%, the 20-year at 2.059% and the 30-year Treasury was yielding 2.030% at the close. The Dow Jones Industrial Average was up 246 points, or 0.68%, the S&P was up 0.64% while the Nasdaq gained 1.20% at the close.

Slower growth, inflation expected

The new year will likely usher in slower growth and continued inflationary pressures, analysts said.

"We now expect U.S. real GDP to grow by just 2.5% in the first quarter following a more than 7% annualized surge in the fourth," said David Kelly, chief global strategist at JPMorgan Funds. Job gains "could see a sharp slowdown in January before recovering later in the quarter as the pandemic eases," he added. "This temporary slowdown in activity, combined with the dampening effect Omicron is having on demand around the globe, should reduce overall inflation pressure entering 2022."

But, that doesn't mean inflation will disappear. "We still expect core personal consumption deflator inflation to run well above the Federal Reserve's 2% long-term goal throughout 2022."

And if Omicron's impact on the economy remains mild, the Fed will end its asset purchases by mid-March "and begin a series of quarterly, 25-basis point federal funds rate hikes starting in June," Kelly said.

Wilmington Trust's Investment Committee agreed. "We expect inflation measures to remain elevated in coming months due to base effects and supply disruptions, keeping the Fed on track for a first rate hike in the second half of this year."

But they "expect the path of hikes to be shallow, as we look for inflation to decelerate later in the year as supply chain and base effects ease."

Growth in 2022 should be at "a solid, above-trend pace," with downside risks from COVID "dampening" consumer spending, "stubbornly high inflation, and a more hawkish Fed."

Wilmington sees inflation slipping to 3% by mid-year, and the "10-year Treasury yield will move toward 2%."

Economic growth has “cooled” from the second quarter, noted Wells Fargo, with “knotted supply chains, labor shortages, intensifying inflation, fewer additional stimulus dollars and a resurgence of the pandemic” mostly to blame.

“Our current forecast is for Q1 is 3.8%,” said Wells Fargo Securities Senior Economist Mark Vitner. “I would say there is some downside risk to that number given the surge in COVID cases and further delay of the return to the office.”

Plus, he expects a slowdown in consumer spending growth.

“That said, the drivers of economic growth have shifted more toward production, which is less likely to be impacted by COVID in Q1,” Vitner said.

These projections were quite different not so long ago, JPMorgan’s Kelly noted, as “prospects for a quick end to the pandemic and a combination of very easy monetary and fiscal policy suggested that the economy wouldn’t slow enough going into 2022, with inflation and interest rates potentially spiraling higher.”

And while Omicron and Federal Reserve tapering, with expectations of rate hikes, “are pumping the brakes on the U.S. economy,” it remains to be seen, he said, “whether this braking pressure is about right, allowing the economy to coast to a soft landing and an extended expansion or whether the economic drag might prove too much, leading to a more dramatic and less happy outcome.”

While Omicron “is clearly much milder than earlier variants,” Kelly said, it is “also, by far, the most contagious of the variants and this has led to very widespread illness across the country,” leading to activities being limited, “hitting demand in the leisure, entertainment, travel and restaurant industries.”

With more people catching COVID, albeit mild cases, expect “widespread absenteeism in early 2022,” he said, “applying a significant drag to the economy in the first quarter, following a very strong fourth quarter.”

By state, all but one of the 50 states “posted a more moderate rate of real GDP growth in Q3 compared to the previous quarter, as supply chain bottlenecks, intensifying inflation, labor shortages and a resurgence of the pandemic weighed on economic activity,” Vitner, Wells Economist Charlie Dougherty and Economic Analyst Nicole Cervi said. “Delaware was the only state to see real GDP accelerate in Q3.”

While the leisure and hospitality sector continues to recover, they said, it “is still running well below pre-pandemic levels in most states.”

In data, construction spending grew 0.4% in November, less than the 0.6% gain expected by economists polled by IFR Markets, but the October gain was raised to 0.4% from 0.2% and September's number was revised to a 1.0% jump from a 0.1% dip.

Year-over-year construction spending grew 9.3%.

More issuance projections

Heading into 2022, Pat Luby, senior municipal strategist at CreditSights, estimates $480 billion of total issuance, with increases in both tax-exempt and taxable borrowing. This includes $362 billion of non-taxable bonds, including traditional tax-exempt plus bank qualified and alternative minimum tax bonds, and $118 billion of taxable bonds.

Additionally, he estimates a total of $235 billion of refunding bonds, including $81 billion of taxable and $154 billion of non-taxable bonds.

"Estimating new issue supply requires assumptions about the conditions of the municipal, treasury and corporate bond markets, as well as the nature of demand, economic conditions and the legal and political environments," said Luby. "Because of the sensitivities to market conditions, actual refunding issuance could be much higher or lower than we estimate."

For instance, if spreads on taxable investment-grade bonds narrow, demand for taxable municipals may rise, resulting in greater issuance. And if issuers refund a higher percentage of bonds than expected, this might increase non-taxable issuance while decreasing taxable borrowing. The number of advance refunding bonds might be reduced if forward-delivery bonds are increased, Luby said.

Because the capacity to refinance older bonds is dependent on market circumstances, the rate at which new bonds are issued may fluctuate as rates change.

Issuance of new money bonds, though, will be less sensitive to changes in market conditions, according to Luby.

"Due to the depth of demand from investment grade taxable bond buyers, we would not be concerned if taxable municipal supply exceeds our expectations," he said.