Municipal Bond Marketplace

By the Loomis Sayles Municipal Bond Team

MUNICIPAL BOND MARKET COMMENTARY

Municipals rallied sharply in the fourth quarter helping to mitigate some of the performance damage that occurred during a tumultuous year for fixed income investors. As the Federal Reserve embarked upon a notable tightening of monetary policy, yields surged to their highest levels in over a decade, before rallying more than 60 basis points in the final 10 weeks of 2022. Strong performance during the quarter helped the municipal market to claw back roughly a third of its year-to-date losses from the market lows that were reached in October. Nevertheless, the market generated its worst calendar year total return performance since 1981. Municipals fared relatively better than other high quality, fixed income alternatives, outperforming both Treasurys and corporates during the quarter and over the full year. Municipal index yields rose by more than 240 basis points during 2022 and, while likely painful for bondholders to endure, the rate rise leaves the market with greater income producing potential and possibly better downside protection at current valuations. The Fed has raised policy rates by 4.25% over the past 10 months, and the Committee has indicated expectations of raising them another one-half to three-quarters of a point before pausing and maintaining the target level until they are confident that inflation is firmly under control. Inflation has been decelerating but Fed officials believe an overheated labor market will need to cool before price pressures convincingly abate.

The past year's steep rise in rates sharply curtailed supply in the new issue market. Overall issuance fell by more than 22% from the prior year's pace driven principally by a sharp deceleration in taxable issuance (off more than 57%), as well as a decline in exempt issuance (more than 12%). The only sector experiencing higher issuance were financings subject to AMT (rose by 35%) which was largely driven by a surge in airport issuance. The move in rates also precipitated a record outflow cycle from municipal mutual funds that faced net redemptions in all but a handful of weeks in 2022. In total, the outflow cycle amounted to more than $146B of net redemptions that nearly erased the entirety of the preceding inflow cycle that totaled $149B of net purchases. These two factors, lower issuance and heavy fund redemptions, contributed to a strongly bifurcated performance across the municipal curve. The intermediate curve flattened sharply with the spread from 2-years to 10-years inverting slightly at year-end, while the slope of the curve from 10-years to 30-years steepened aggressively to nearly 100 basis points.

(Continued on the next page)

				TRAILING RETURNS AS OF DECEMBER 31, 2022				
Index Data	Duration	Quality	Average Yield	Quarter	1-year	3-year	5-year	10-year
Municipal Bond Index	6.14	AA-	3.54	4.10%	-8.53%	-0.77%	1.25%	2.13%
Taxable Municipal Index	8.03	AA-	5.25	1.45%	-18.11%	-2.97%	0.41%	2.47%
US Corporate Index	7.08	BBB+	5.43	3.63%	-15.76%	-2.88%	0.45%	1.96%

Source: Bloomberg
Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.

Past performance is no guarantee of future results.

MUNICIPAL BOND MARKET COMMENTARY (CONTINUED)

Policy tightening over the past year has begun to manifest itself in slower growth, and inflation has decelerated from its highs. The Fed has indicated that it will continue to apply the brakes until this past year's surge in inflation has been thoroughly worked out of the system. There were unusual non-economic factors that contributed to the price surge, the war on Ukraine and pandemic related supply-chain disruptions, but the latter has mitigated substantially. The Fed will likely bring inflation to heel by maintaining a sufficiently restrictive monetary policy to engineer a reduction in aggregate demand. Fed Chair Powell has stated that pursuing such a policy will result in short-term economic pain, but that not doing so would result in greater pain over the long-term. While we feel confident the Fed will be able bring down inflation, it may be difficult to guide the economy to a soft-landing, in our view. The municipal market seems in a stronger position than it has been in previous late cycle periods. Credit fundamentals appear sound across most sectors, nominal yields have been higher, downside mitigation has improved and liquidity conditions appear stable. We believe the market is currently positioned to hold up well in the event of an economic downturn.

SECTORS AT A GLANCE

	WEIGHT (%)	AVG DURATION (YRS)	YIELD (%)	CREDIT QUALITY
Transportation	16.06	6.51	3.80	A
Local GO	14.63	6.42	3.38	AA
State GO	12.99	4.96	3.09	AA
Special Tax	9.40	6.56	3.47	AA
Hospital	9.10	7.38	4.18	A
Water & Sewer	8.49	6.12	3.35	AA
Leasing	6.78	6.54	3.57	A+
Education	6.26	6.62	3.52	AA-
Prerefunded	4.77	2.30	2.75	AA
Electric	4.59	5.73	3.43	A+
IDR / PCR	4.38	5.27	4.25	A-
Housing	2.54	9.32	4.13	AA
Resource Recovery	0.02	7.13	3.70	AA-

Source: Bloomberg Municipal Bond Index as of 12/31/2022

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SECTOR SPOTLIGHT

Our municipal credit analysts have been carefully watching fundamental developments to the sectors they follow. Here we discuss their outlook for the airports sector.

AIRPORTS

Our current outlook for the airport sector is 'moderately improving'. Domestic leisure travel has climbed to above pre-pandemic levels, yet room remains for continued recovery of business and international travel. Pent up demand and flexible work arrangements should help keep demand for air travel strong, despite slowing economic growth and inflation's eating into consumer discretionary spending. Although capacity constraints (aviation supply chain and labor shortages) may be detrimental to enplanement growth, prospects for stronger airline profits likely improve airline wherewithal to make continued payments to airports.

Additionally, TSA throughput levels* at airports have hovered in the 92%-102% vicinity since late summer, while FY2022 credit metrics (coverage, leverage, days cash, etc) have generally improved relative to 2021 and 2019.

Source: Bloomberg

WHY CONSIDER LOOMIS SAYLES FOR ACTIVELY MANAGED MUNICIPAL BOND STRATEGIES

- Integrated portfolio management and credit research consisting of experienced investment professionals specialized across the municipal bond markets.
- Bottom up security selection driven by credit research can help to find undervalued issues and avoid issues that are overvalued or poised for downgrade.
- After a rigorous credit process, the team evaluates prospects for after-tax return, including AMT considerations as well as state, local and federal tax rates, to maximize tax-exempt income and tax efficiency.
- Investment ideas are evaluated on potential return versus contribution to portfolio risk.
- Overall portfolio risk is actively managed within defined ranges to pursue market opportunities.

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DISCLOSURE

KEY RISKS

Municipal Risk, Credit Risk, Issuer Risk, Interest Rate Risk, Liquidity Risk, Derivatives Risk, Leverage Risk, Counterparty Risk, Prepayment Risk, Extension Risk and Management Risk.

Investing involves risk including possible loss of principal

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