Opportunity for non-US investment in taxable US municipal bonds

Perspective from Franklin Templeton Fixed Income

May 2022 | Topic Paper

Executive summary

With an increase in issuance and market size, investors outside the United States are expanding their search for yield to a hitherto unexpected place: US municipal bonds. US municipal bonds offer generally higher nominal yields than comparable Treasury securities and lower default rates and price volatility than comparable corporate. As such, we believe US municipal bonds continue to offer a compelling opportunity to the non-US domiciled investor.

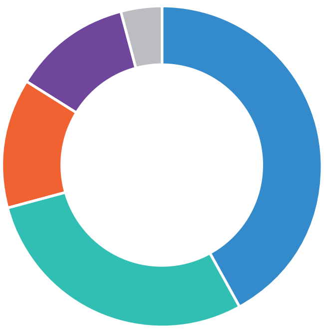
In this paper we will explore how an allocation to US municipal bonds by non-US investors can potentially provide another source of attractive, high-quality income to a portfolio while also diversifying from a credit standpoint. We believe partnering with an expert is critical, given the nuanced nature of the municipal bond market.

Introduction: US municipal bond market dynamics

US municipal bonds represent debt issued by a state or local government generally used to finance public services or infrastructure projects such as roads, schools, water and sewage systems, airports or energy transmission facilities. Bonds issued by a municipality to finance a public good are generally exempt from federal and local income taxes which increases the effective yield available to the US-based investor who is a taxpayer.

Exhibit 1: Composition of US municipal bond ownership

As of December 31, 2021



Source: Calculations by Franklin Templeton Investments using data sourced from the US Federal Reserve

US municipal bonds have generally been favored by US taxpayers, including high-net-worth individuals and select institutional investors in the United States, due to the bonds' tax-exempt status. Over 70% of the total amount of US municipal bonds are owned by individuals either directly or through mutual fund products. Additionally, over 20% is owned by institutions such as insurance companies or banks. Non-US investors and others make up the rest of the holders of munis.

Certain US municipal bonds are not exempt from taxation (taxable munis) and are more comparable to their corporate counterparts from a yield and spread perspective. Using the Bloomberg Taxable Muni Index as a representation of the market, the taxable municipal bond market represents approximately US$435billion of the total market size with over 9,800 issues. Although this market is smaller than the tax-exempt market, the market has been growing significantly more recently and we believe it presents an increasingly large opportunity set for investors.

Legislation passed by the US federal government in 1986 limited the types of bonds that were exempt from federal taxation to bonds that funded what could be considered an exclusively public good. A bond funding a project that substantially benefits a private entity, such as a sports arena, could no longer offer tax-exempt income to investors. This new class of taxable bonds is known as private activity bonds (PABs).

In addition, in February 2009, as part of the American Recovery and Reinvestment Act, former US President Barack Obama signed a law creating a new class of taxable municipal bonds known as Build America Bonds (BABs). Although these bonds are not tax-exempt, BABs included a federal subsidy in hopes of further boosting infrastructure spending. This subsidy has helped to offset the effect of taxation to the investor, making them especially attractive to foreign investors. State and local governments issued nearly US$200 billion worth of BABs before the end of 2010 when the program ended. These bonds proved popular with foreign investors as they offered attractive relative value and this has continued more recently with foreign investors increasing their holdings of munis by approximately $20B since 2018.

Given the tax reform legislation enacted in 2018, municipal issuers could no longer pre-refund their outstanding debt with tax-exempt issuance. However, issuers are able to pre-refund their outstanding bonds with taxable space under that legislation. Given the current interest rate environment, we have seen an increasing level of supply in the taxable space since the end of 2018, with 2020 setting a record for taxable muni supply with over $141B and 2021 maintaining the increased pace with almost $115B in taxable supply.

Exhibit 2: Market comparison

As of March 31, 2022

Index Name	Number Issues (Stats)	Market Value (USD MM)	Credit Rating	Yield to Worst	Option-adjusted duration	Option-adjusted spread
Bloomberg Muni	55,980	1,466,832	AA2 / AA3	2.60	5.55	N/A
Bloomberg Taxable	9,825	432,546	AA2 / AA3	3.48	9.35	0.96
Bloomberg US Corp	7,171	6,397,362	A3 / BAA1	3.60	8.15	1.16
Bloomberg Long Corp	2,730	2,428,000	A3 / BAA1	4.03	14.22	1.55
Bloomberg Global Corp	18,115	15,664,248	A2 / A3	2.94	6.91	1.13

Source: Bloomberg

Relative value considerations

With the growth in the market over the past several years, more investors, including non-US investors are continuing to expand their search with their fixed income allocations to include munis. Since these investors are not US taxpayers, the appropriate market to focus on is the taxable muni market which has higher nominal yields. When looking at relative comparisons to other sectors within fixed income, there are a few key elements to consider.

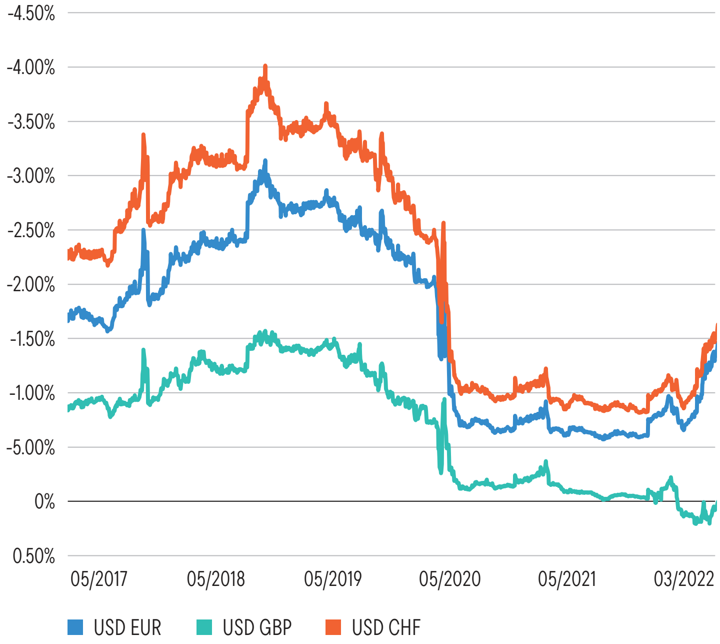
While municipal bonds are issued by a government entity to finance primarily public projects, corporate bonds, as the name implies, are issued by a corporation to fund any variety of business operations or expansion projects as deemed necessary by management. Since corporate bond issuers fund their debt payments through business operations rather than through tax revenue, as is the case with GO municipal bonds, corporate bonds are subject to greater credit risk, as any number of adverse conditions may affect the issuer's ability to service the bond. We have seen periods, as we have seen recently, where taxable munis have offered a higher yield than corporate bonds. This has occured despite the higher quality bias for the taxable muni issuers.

One additional benefit for some investors is the fact that an allocation to munis can represent a higher quality, longer duration allocation with attractive relative value. This, coupled with the fact that munis can play a diversifying role in a portfolio, especially when compared with an allocation to corporate bonds , can be particularly attractive for investors with longer duration liabilities they are looking to hedge like pension plans and insurance companies who have been active within the taxable muni space.

It is important for non-US investors to look at more regionalised comparisons, where we see a similar relationship between US municipal bonds and European corporate bonds as an example. In addition to generally lower credit risk, the valuations of US municipal bonds versus European corporate bonds on a hedged basis also currently look attractive, in our view.

Exhibit 3: Annual hedging costs (in bps)

May 22, 2017 – March 31, 2022



Source: Bloomberg, annualized 3M forward

Like the US market, the European market also tends to have the bulk of issuers in the A- or BBB-rated tranches while municipal bonds tend to be higher rated. Therefore, European focused investors stand to benefit through a competitive yield that is differentiated from European rates while maintaining exposure to a group of issuers that have tended to be less susceptible to broader credit cycle trends.

Hedging costs are an additional consideration for non-US investors looking at USD denominated assets like taxable munis. As we enter a period of financial tightening, particularly in the US, we are still seeing lower hedging costs than what we saw throughout 2018 and 2019 across a variety of currencies, adding to the favorable relative value even on a hedged basis. While we recognize these costs can vary and may weaken further, we think the relative value will remain as local USD yields continue to move higher as well.

Exhibit 4: Yield curves of US Treasury, US Tax-Exempt, US Taxable and US Corporate Bonds
As of March 31, 2022

Tenor	US Treasury	AAA Tax-Exempt Muni	AA Tax-Exempt Muni	A Tax-Exempt Muni	BBB Tax-Exempt Revenue Muni	AAA Taxable Muni	AA Taxable Muni	A Taxable Muni	BBB Taxable Muni	AA Corporates	A Corporates	BBB Corporates
2 years	2.42	1.78	1.87	2.06	2.76	2.50	2.60	2.72	3.70	2.42	2.52	2.90
5 years	2.48	2.03	2.13	2.32	3.06	2.79	2.92	3.03	3.85	2.84	3.07	3.52
10 years	2.33	2.23	2.41	2.53	3.33	3.00	3.15	3.38	3.82	3.17	3.40	3.90
30 years	2.46	2.60	2.91	3.00	3.81	3.02	3.44	3.81	3.94	3.58	3.70	4.11

Source: Bloomberg

Finally, when looking at option adjusted spreads, we see some interesting dynamics at play. Taxable muni excess returns were much stronger than US Investment grade corporates in 2021, however, more recently in 2022 we have seen taxable muni spreads continue to widen and not participate in the tightening we have seen in IG corporates. This has created a more attractive relative value environment currently.

A unique opportunity in green munis

In the municipal bond market, issuance of green bonds-which are bonds issued to help fund environmentally beneficial projects-has provided an attractive solution for investors interested in a muni strategy that also meets the criteria of an ESG related approach. With the growth in such strategies globally, a green muni allocation may be a unique consideration for investors looking to expand their ESG allocations in fixed income.

Issuance of green bonds in the muni space has been growing every year since the first issuance by the Commonwealth of Massachusetts in 2013. Utilizing the new Bloomberg Impact index series, the green muni market has doubled in size to be over $64B in size with an ever-expanding list of issuers totaling over 2,250 unique issuers. Growth more recently has been strong with over $25B muni green bonds issued in 2021. While a majority of issuance is in the tax-exempt space, we are seeing the green market experience what the broader market is seeing with more taxable issues coming to market. This growth has allowed for the market to mature to a level where investors can manage properly diversified portfolios focused on the sector.

Like the general muni market, the credit quality of municipal green bond issuers is tilted toward the higher quality area of the market with a majority of the outstanding bonds with issuers rated AAA and AA. From a sector perspective, a majority of the market is focused on the transportation and water & sewer sectors which one would expect for green offerings. However, as the market has expanded, we see bonds being issued by a wider variety of issuers in a broader array of sectors including healthcare, housing, and school districts.

Verification of green bond and projects remains a key component to implementing a green muni portfolio. To address the lack of labeling standards in the municipal green bond market, Franklin's research analysts and portfolio managers work together to identify and select authentic green bonds and avoid bonds that inappropriately have a "green bond" label or provide inadequate disclosure regarding the use of proceeds for the issue. While some bonds are independently labeled green, our team is required to verify that the use of proceeds are indeed for a green purpose. To do this, the team focuses on the intended use of funds for projects or programs and ensure we have confidence that the proceeds are being used for green purposes. Given the longer-term nature of muni projects, it is also critical to periodically review the use of proceeds to ensure they continue to be aligned with a green objective. If not, that holding would be sold out of the green strategy.

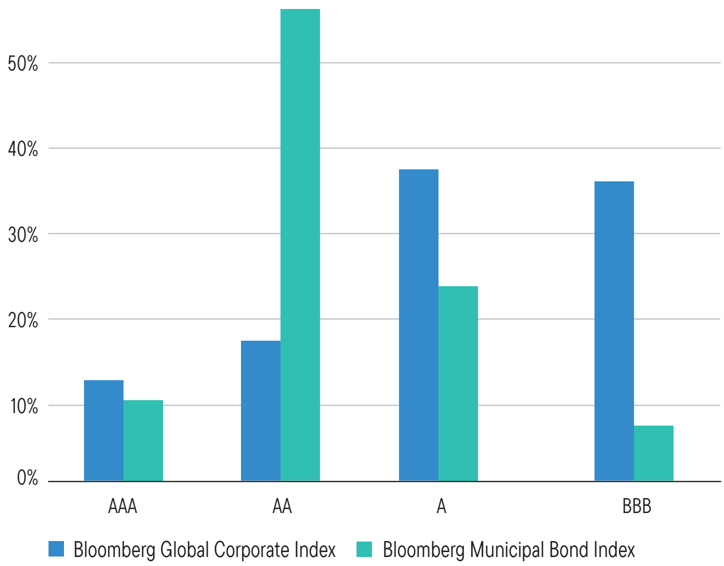
For investors seeking to align their fixed income goals with their environmental values, we believe muni green bonds may offer a compelling solution. Having a robust research process is critical to navigate this emerging space while ensuring the investments truly meet the green objective.

Outlook

After a long stretch of peace and tranquility through most of 2021, the municipal bond market has experienced persistent volatility to begin 2022. This volatility has been driven by high inflation levels, a more hawkish Fed, and a geo-political environment which is affecting the macro environment as well. As mentioned before, the taxable muni market tends have a longer duration profile which has been impacted by the significant move higher in interest rates. While this has impacted near term total return performance, it has created the stronger relative value environment we discussed earlier.

Fundamentals for municipal issuers have been generally stable and on a positive trend. As we enter budget season we are encouraged by the early signs we are seeing with balanced budgets, strong surpluses, and prudent spending plans. As a result of elevated interest rates, taxable muni issuance has declined year to date. We have also seen spreads widen like other asset classes and create an attractive entry point. As investors take advantage of these attractive yields and spreads, we believe spreads could compress from the somewhat elevated levels at hand now.

Exhibit 5: Credit rating distributions
Bloomberg Barclays Municipal Bond Index vs.
Bloomberg Barclays Global Aggregate Corporate Index
As of March 31, 2022



Source: Bloomberg

Accessing this market requires a partner with proven expertise

Although municipal bonds share many similar characteristics and can add stability to a well-diversified portfolio, it is important to remember that no two municipal bonds are identical and the range of issuers is broad. In fact, the US municipal bond universe was composed of over 50,000 issuers with over 1,000,000 total municipal bond issues. Franklin Templeton has over 40 years of experience navigating this complex universe, having managed municipal bond strategies since 1977. Today, we are one of the largest municipal bond fund managers and have approximately US$65 billion in municipal bond assets under management. This significant asset base is an advantage when negotiating terms for municipal bond transactions and finding opportunities to participate in new bond offerings. Our seasoned municipal investment professionals are critical to navigating the broad and diverse muni market. This includes 13 credit analysts who have an average of over 20 years of experience analyzing municipal credits.

Our relative value approach aligns fundamental credit assessment with relative value across multiple angles to determine investment opportunities. Because of the depth of the team, we have the ability to review and analyze every opportunity in the marketplace at a given time whether in the primary or secondary market. This experience also allows for quick decision making which can be vital in a market with a lower level of issuance like taxable munis.

In conclusion, we feel an allocation to municipal bonds by non-US investors may provide a high quality and differentiated fixed income exposure to a portfolio. We believe partnering with an expert is critical, given the nuanced nature of the municipal bond market and the current market conditions.

Key arguments for institutional investors

- Income at an attractive relative value
- Higher quality exposure vs Corporates
- Longer duration asset class to match liabilities
- Access to infrastructure related investments
- Expanding universe of green munis

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Because municipal bonds are sensitive to interest rate movements, a municipal bond portfolio's yield and value will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the portfolio's value may decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value.

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