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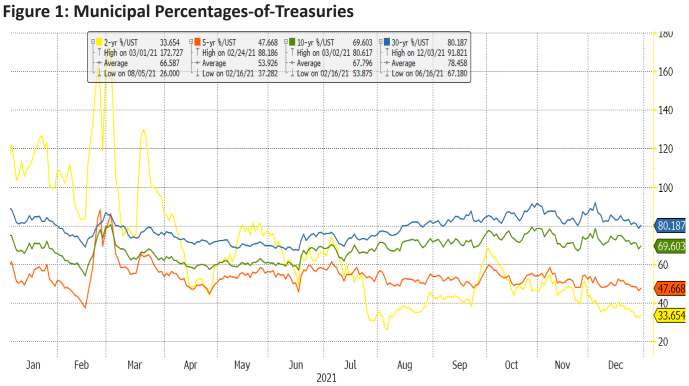
Does the municipal market know something other markets do not? Or is it perhaps the Treasury market that is in-the-know? Either way, something does not quite add up when looking at the front-end of the curve. There, municipal percentages-of-Treasuries are not just rich; they are downright out-of-whack. Consider, for example, that the 2-year AAA municipal percentage-of-Treasury ended the year at 33.65%. At such a low level, the taxable equivalent yield on the municipal bond at the maximum 40.8% tax rate would be well-below that of a matched-maturity Treasury. So much for an illiquidity discount.

Figure 1: Municipal Percentages-of-Treasuries

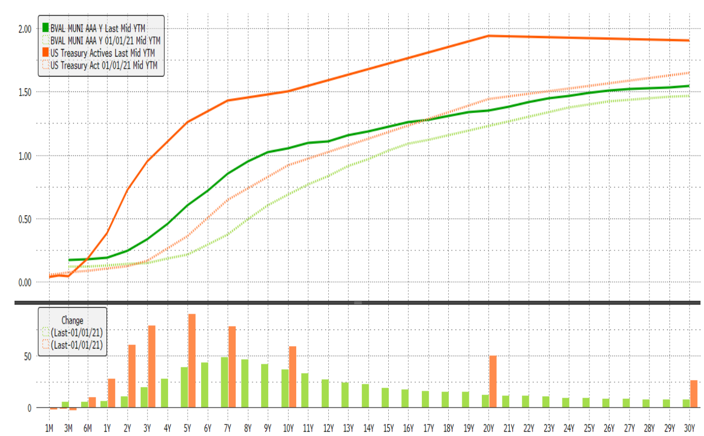


Source: Bloomberg

So, what gives? Maybe it is that the Treasury curve has gotten ahead of itself in pricing in interest rate hikes. Or maybe it is that, despite all the evidence to the contrary, the municipal market has not given up on the prospect of broad-based tax increases that would cause a repricing of taxable equivalencies, thereby justifying current lofty valuations. Our guess is neither of these explanations, alone, hit the mark. Rather, with the Federal Reserve having adopted a more hawkish tone in the 4th quarter by announcing an expedited taper timeline and calling for three interest rate hikes in 2022 (and a total of eight hikes by the end of 2024), we would argue that the real reason the two markets appear to be telling different stories is that Treasuries are taking the Fed at face value, whereas municipals are behind the curve.

Whatever the reason for the disconnect, it is hard to make a case for there being much compelling value in short municipal paper at the moment. That is not at all to say there is no value to be found in the asset class, as stands. There is value; one just must venture a bit further out on the curve to find it. Even there, percentages-of-Treasuries do not exactly scream cheap, with the 10-year and 30-year AAA municipal spots at 69.60% and 80.19%, respectively. With more policy clarity coming out of the December FOMC meeting, though, our expectation is for short municipal yields to rise as the municipal curve flattens and re-aligns with the Treasury curve. Should such a scenario play out, relative valuations could be looking at better days as we head into 2022.

Figure 2: Municipal vs. Treasury Yield Curves



Source: Bloomberg

While current relative valuations, in general, may be nothing to write home about, it is worth keeping in mind that today's tight valuations are a byproduct of yesterday's strong returns. And such was the case in 2021, with the Bloomberg Municipal Bond Index posting a 1.52% total return. This, too, sounds a paltry figure at first, but was quite a coup considering that municipals were the only investment-grade domestic fixed income asset class to post a positive total return for the year. Equally impressive, they did so in a year where the yield on the 10-year Treasury rose 64%, from .91% to 1.51%.

Figure 3: 2021 Fixed Income Return	
Municipal	1.52%
US Aggregate	-1.54%
US Treasury	-2.32%
Corporate	-1.04%
CMBS	-1.16%
ABS	-0.34%
U.S. MBS	-1.04%

*Source: Bloomberg Indices

For the third year in a row, the long-end of the municipal curve outperformed the front-end, with the 5-year (4-6), 10-year (8-12), and Long Bond (22+) slices of the broader index returning .34%, .96%, and 3.17%, respectively. In a departure from the previous year, the returns of lower-rated securities bested those of higher-rated ones, with the Aaa, Aa, A, and Baa slices of the index returning .47%, .92%, 2.25% and 4.85%, respectively. Revenue bonds outperformed general obligations, 1.86% to 1.01%.

Figure 4: 2021 Municipal Market Returns

Municipal Bond Index	1.52%
GO Bond Index	1.01%
State GO	0.92%
Local GO	1.10%
Revenue Bond Index	1.86%
Electric	1.01%
Hospital	2.72%
Housing	0.94%
IDR/PCR	1.43%
Transportation	2.40%
Education	1.70%
Water & Sewer	0.82%
Resource Recovery	-0.47%
Leasing	2.41%
Special Tax	1.68%
Aaa	0.47%
Aa	0.92%
A	2.25%
Baa	4.85%
5 Year (4-6)	0.34%
10 Year (8-12)	0.96%
Long Bond (22+)	3.17%

*Source: Bloomberg Indices

The outperformance of lower-rated securities in 2021 was not exactly a surprise. It was a story sown in the wake of all the post-pandemic stimulus funds that flowed to the asset class going back to last year, including the CARES Act, American Rescue Plan, and other measures targeted towards specific sectors. These funds effectively shored up the credit quality of the municipal market, giving lower-quality securities the cover to run. The same can be said for the outperformance of revenue bonds versus general obligations. Thanks again to all the stimulus and a general re-opening of the economy, even the most pandemic-impacted revenue sectors (airports, hospitals, higher education, transportation) have regained most, if not all, the ground they lost since the Spring of 2020.

As 2021 comes to a close, the credit quality of the municipal market ends on a high note and remains strong, overall. With that said, as the likelihood of meaningfully higher individual tax rates has declined and the passage of the Build Back Better plan, watered-down or otherwise, has been called into question, this may be about as good as it gets for the asset class for the time-being. That is not by any means to suggest it is downhill from here. We are just inclined to believe that the recovery story has largely played out and that 2022 returns will be driven more by duration and carry than a return to the mean.