2023 municipal bond outlook: Could this be a comeback year?

January 24, 2023

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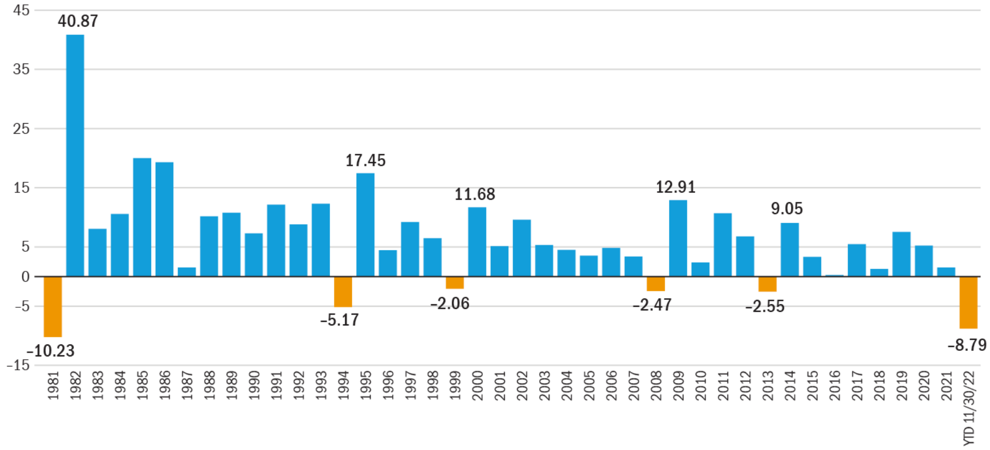
We're optimistic about this year's municipal bond market. Here's why.

Investors can find higher income at lower prices
There's a lot going for the municipal market as we head into 2023. Higher starting yields mean more income for investors. This income could help mitigate the potential negative impact of any future rate hikes. And investors are earning this higher income at very attractive prices (valuation). Spreads were incredibly narrow at the beginning of 2022 — meaning munis were relatively expensive. Following the broad market sell-off, spreads widened, and yields are now significantly higher than at the beginning of 2022. Investors can earn attractive tax-equivalent yields — at levels not seen in years and, in some cases, at deeply discounted prices.

Municipals bonds have a history of strong rebounds
Calendar year returns (%)



Sources: Bloomberg and Columbia Threadneedle Investments. Data as of November 30, 2022. Municipal bonds are represented by the Bloomberg Municipal Bond Index, which is an unmanaged index composed of investment-grade municipal bonds. **Past performance does not guarantee future results.** It is not possible to invest directly in an index.

Technicals are favorable, with demand outpacing supply
The current supply/demand imbalance benefits municipal bond investors. Higher interest rates have pushed up the cost of issuance. As a result, supply has declined 20% year to date. We expect a combination of seasonality and political dynamics will work to keep supply low as we head into 2023. The months around the end and beginning of a year are frequently low supply months. Following midterm votes, newly elected officials are

typically less likely to start their terms with heavy new issuance activity. On the demand side, as we approach the end of the Fed's tightening cycle, investors are becoming more comfortable jumping back into the market. We believe it makes sense to do this sooner rather than later as the market can move quickly and, with limited supply, it's going to become harder to get invested.

Strong fundamentals mean munis better positioned to weather an economic slowdown

A potential economic slowdown in 2023 is less likely to significantly impact the municipal market as fundamentals remain solid. Pandemic-related fiscal stimulus has propped up local and state balance sheets and credit quality. Moreover, because municipals are considered a high-quality asset class with low default rates, they typically outperform other asset classes in a recession. However, in the case of a deeper recession, certain sectors will be more at risk — like those with weakened issuers that have not received stimulus aid or do not have yields to support them. Lower rated high-yield credits will also likely be more at risk than traditional higher quality munis. In a recessionary environment, a higher quality bias and credit selection will be important. Quality in this case, means not only AAA or AA rated general obligation bonds, but also higher quality issuers within certain sectors.

We see attractive opportunities across the municipal market, particularly in longer duration bonds

Buying opportunities exist across the municipal market — especially in those areas that sold off the most in 2022, such as longer term bonds with a lower coupon structure. From a sector perspective, this includes toll roads, hospitals and airports. These bonds sold off more broadly than state and local issuance which typically has a shorter maturity or higher quality bias. Longer duration munis are expected to benefit from a flattening of the yield curve during a recession or slowing economy. That should drive their outperformance relative to their shorter counterparts.

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