MSRB
Municipal Securities Rulemaking Board

APRIL 2023

First Quarter 2023 Municipal Securities Market Summary

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Introduction[1]

In the first quarter of 2023, the municipal bond market experienced a dramatic decrease in volatility, trade count and new issue volume plus a return to inflows into tax-exempt mutual funds. Tax-exempt and Treasury bond yields also declined slightly during the quarter.

This is in contrast to 2022, when the municipal bond market experienced many significant events highlighted by dramatically higher interest rates and volatility, record outflows from tax-exempt mutual funds and a record number of trades for individual municipal bonds.[2]

Impact of the Recent Bank Failures on the Municipal Bond Market

The March bank failures caused a significant increase in volatility in the equity and Treasury markets. Stock indices and Treasury yields had large swings on a daily basis. However, the impact on the municipal bond market was much less significant. Although the banking crisis impacted volatility for tax-exempt rates, yields did not rise or fall nearly as much as they did in the Treasury market. But concerns in the banking sector may have had an impact on new issue volume, as increased volatility in the Treasury market could have increased the difficulty of bringing deals to the market.

Concerns in the banking sector did not seem to have any material impact on the secondary tax-exempt markets. However, changes in the banking sector must continue to be monitored because of potential negative impacts on the short-term and long-term municipal bond market.

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1 The views expressed in the research papers are those of the author(s) and do not necessarily reflect the views and positions of the MSRB Board and other MSRB staff.

2 *See* "2022 Municipal Market Year in Review," Municipal Securities Rulemaking Board, January 2023.

For example, if some banks were forced to liquidate their tax-exempt bond portfolios, there could be a corresponding increase in tax-exempt yields and volatility. Even if banks do not sell the bonds in their current portfolios, it could impact the municipal bond market if they reduce their demand for tax-exempt bonds going forward.

Yields

The first quarter of 2023 started with tax-exempt yields 160–260 basis points higher than in the beginning of 2022. Figure 1 shows the changes in benchmark tax-exempt yields and Treasury bonds for select maturities in the first quarter. Benchmark tax-exempt yields declined 20–36 basis points while Treasury yields declined by 9–41 basis points during the quarter. The Muni/Treasury Ratio (M/T) remains low, especially on the short end of the yield curve (53% in 1 year), making tax-exempt yields unattractive relative to yields available in the Treasury market. Tax-exempt benchmark yields also remain inverted. Pressure on short-term rates was reflected in the Securities Industry and Financial Markets Association (SIFMA) Swap Index, which closed on March 29 at 3.97%. The index was as high as 4.35% on March 22, the highest level since the onset of the pandemic in 2020.

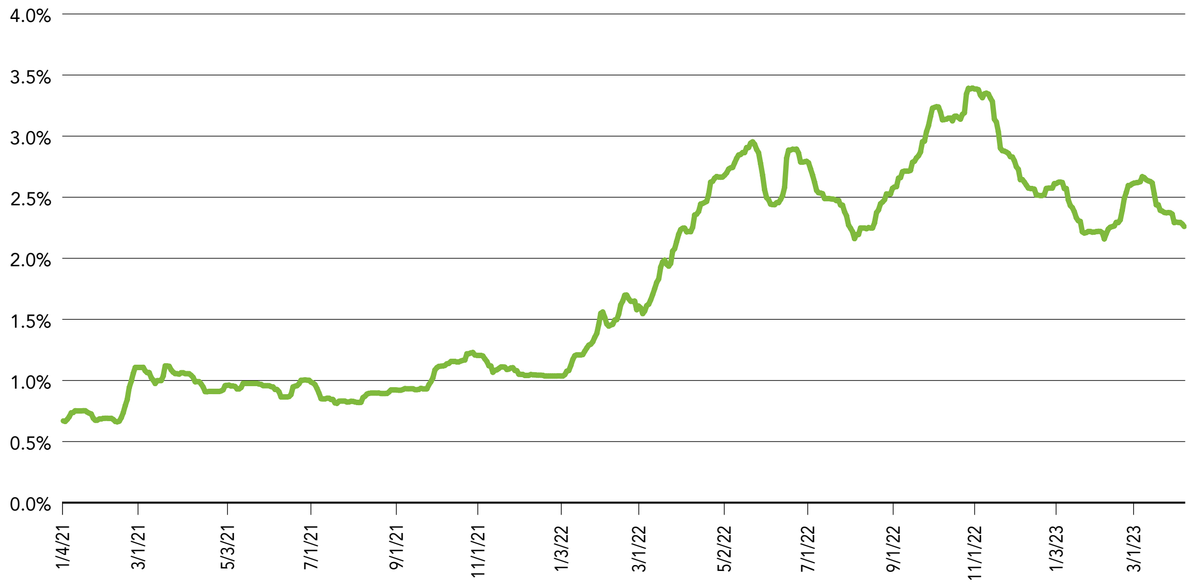
Figure 1. Bloomberg BVAL® AAA Callable and U.S. Treasury Yields

Year	BVAL 03/31/23	TSY 03/31/23	Muni/TSY Ratio	BVAL YTD Change in BPS	TSY YTD Change in BPS	BVAL 12/31/22	TSY 12/31/22
1	2.452	4.64	53%	-35	-9	2.801	4.73
2	2.389	4.06	59%	-27	-35	2.655	4.41
3	2.282	3.81	60%	-28	-41	2.561	4.22
5	2.202	3.60	61%	-33	-39	2.534	3.99
10	2.260	3.48	65%	-36	-40	2.624	3.88
20	3.054	3.81	80%	-20	-33	3.256	4.14
30	3.314	3.67	90%	-25	-30	3.565	3.97

Sources: Bloomberg Finance L.P., U.S. Department of the Treasury

Tax-exempt 10-year yields began the year at approximately 2.60%, declining significantly in January and bottoming out at 2.16% in early February before climbing back to 2.67% on March 2 (see Figure 2). Starting on March 3, the market rallied, and 10-year benchmark yields ended the month at 2.26%. Figure 2 shows the 10-Year Callable BVAL yield from the end of 2021 through March 2023. Although both tax-exempt and Treasury rates declined in the quarter, tax-exempt rates were significantly less volatile on a daily basis.

Figure 2. Bloomberg BVAL 10-Year Callable Yields, January 2021–March 2023



A moderate at best new issue calendar coupled with decreased selling pressure from tax-exempt mutual funds enabled the market to rally and yields to decline in March. Demand from individual investors was also solid, but nowhere near the level seen in 2022.

Trade Volume

Although total trade count for the first quarter of 2023 increased 12% compared to the same period in 2022, it decreased 27% compared to the record volume in the fourth quarter of 2022.[3] Interestingly, although trade count rose in the first quarter of 2023 compared to the same period in 2022, the par amount traded in the first quarter of 2023 actually declined by 1%. Trade count with slightly lower par amount traded potentially reflects a decrease in trading by institutions so far in 2023. The par amount of bonds traded in the first quarter of 2023 compared to the fourth quarter of 2022 declined 25%, in line with the reduced number of trades.

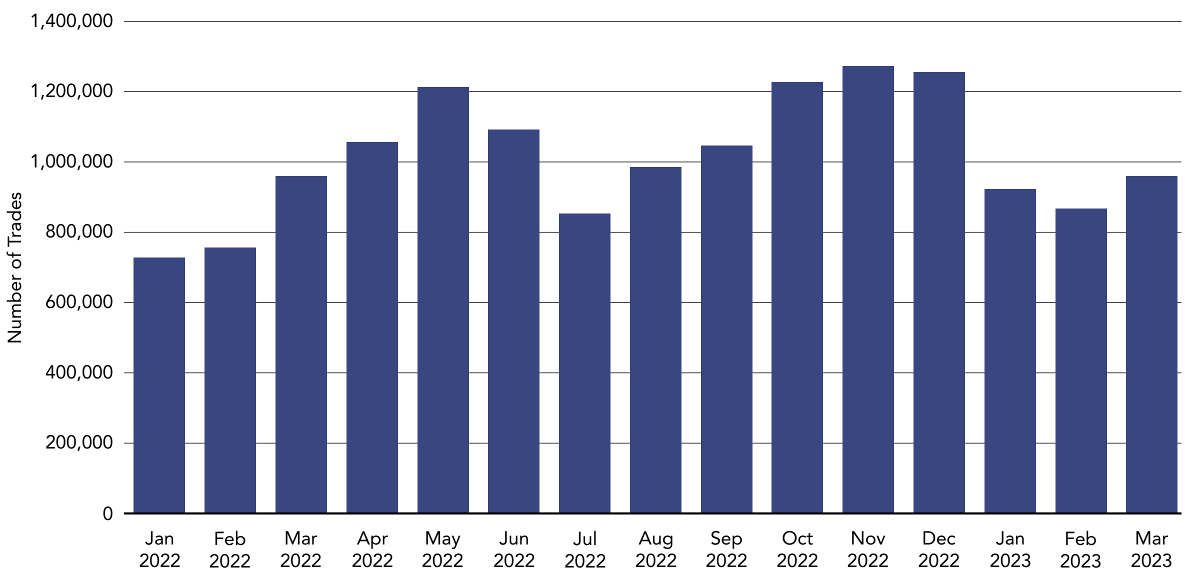
Trade count in 2022 started off slowly in the first two months and then experienced unprecedented volume for the final 10 months of the year, culminating in a record number of trades in the municipal bond market. Trade count in the last quarter of 2022 was aided by higher interest rates and investors executing tax-loss swaps to realize losses in their portfolios. As we moved to the new year, the pressure to enter into tax-loss swaps dissipated. Yields also declined in the quarter and stand significantly lower than tax-exempt rates stood in late October 2022. This overall decrease in trade count is consistent with previous MSRB research showing higher interest rates leading to higher trade counts because of increased participation from individual investors.

3 The MSRB's analysis excludes trading in variable rate securities and commercial paper.

Figure 3 shows monthly trade count from January 2022 through March 2023. Trade count surged during most of 2022, especially in the fourth quarter, then decreased from those record levels in the first quarter of 2023. Although all types of trades decreased significantly in the first quarter compared to the fourth quarter of 2022, the number of sales by investors experienced the largest decline, down 32% compared to 27% for all trading. This was also true in terms of par amount traded, where sales by customers were down 33% compared to the overall decline of 25% for all trades. These trends are consistent for trades of $100,000 or less as well as for trades of $1 million or more. The larger decrease in sales by customers likely reflects a significant decrease in tax-loss swaps in 2023 as well as a return to inflows into tax-exempt mutual funds, decreasing the need for mutual funds to sell bonds.

Although trade count decreased substantially from the previous quarter, it increased 12% compared to the first quarter of 2022 despite a 4% decrease in the number of customer sales. This increase is due to exceptionally low trade volumes in January and February 2022. As mentioned previously, trade count picked up dramatically in March of 2022 and continued for the duration of the year. Par amount traded decreased by 1% compared to the first quarter of 2022 despite the increase in the number of trades.

Figure 3. Monthly Municipal Market Activity, Fixed-Rate Securities, January 2022–March 2023

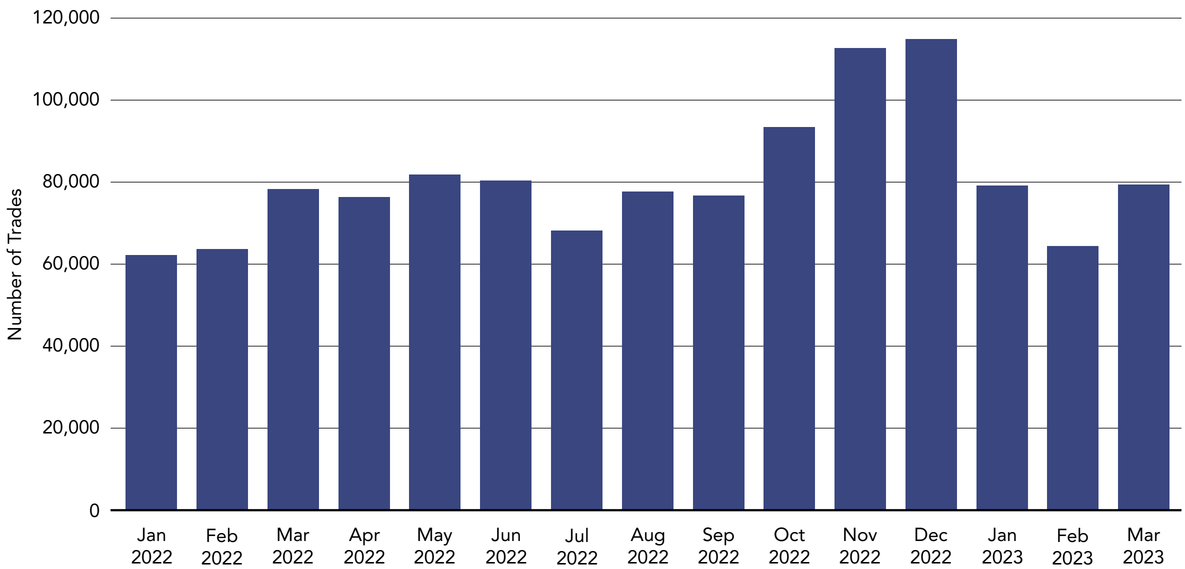


Trading on Alternative Trading Systems

Alternative Trading Systems (ATSs) continue to be a primary source of liquidity for individual investors and an increasing source of liquidity for institutional investors. For the first quarter of 2023, trading on ATSs continued to account for 58–60% of all inter-dealer transactions.

As mentioned in an August 2022 MSRB report, ATSs have increasingly become an important source of liquidity for institutional investors as well as individual investors. Figure 4 shows the number of customer trades with the dealer of an ATS. The number of trades peaked in November and December of 2022 at more than 110,000 trades each month. In the first quarter of 2023, that number dropped to about 223,000 trades, or an average of 74,000 trades per month, but the drop is in line with the decrease in all customer trades. For the quarter, transactions with dealers of ATSs accounted for 14% of all customer trades.

Figure 4. Institutional Customer Trades Executed on ATS, January 2022–March 2023



Mutual Fund and Exchange Traded Fund Flows

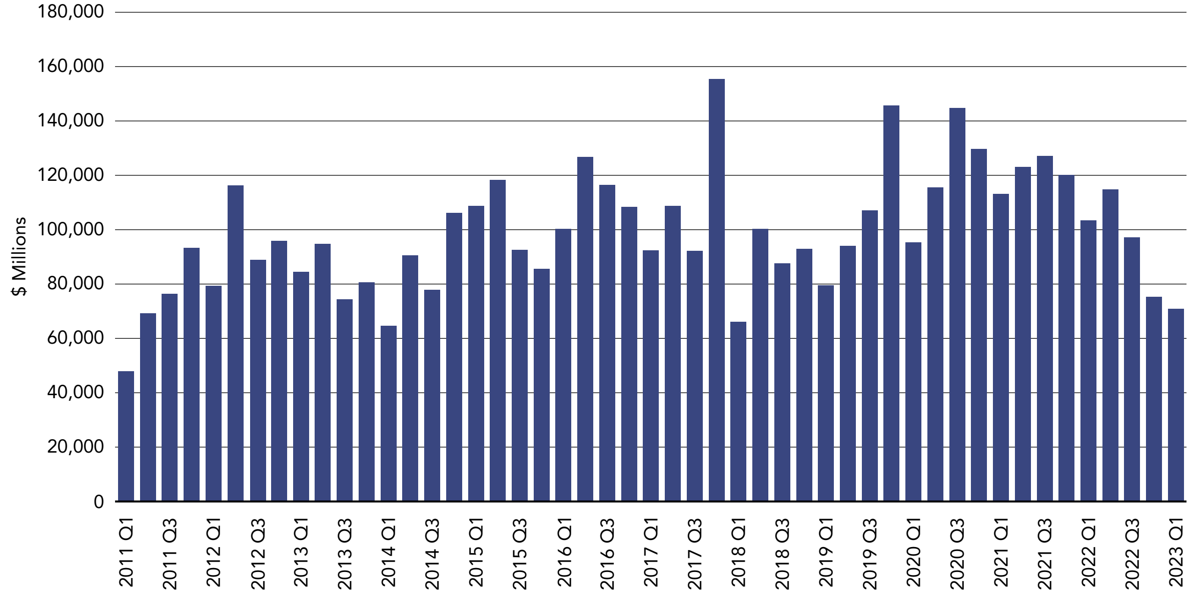
In 2022, the unprecedented outflows from tax-exempt mutual funds of approximately $140 billion was one of the major stories in the municipal bond market. Throughout the first quarter of 2023, tax-exempt mutual funds have seen modest inflows of about $8 billion. Mutual funds saw steady inflows through the middle of February, however, concerns about inflation and the direction of interest rates caused modest outflows in the second half of the quarter. Tax-exempt exchange traded funds (ETFs), which saw inflows of about $28 billion in 2022, have seen very small net outflows for the first quarter. It is believed that some investors redeemed mutual funds in the fourth quarter of 2022 to realize losses and a portion of that money made its way to tax-exempt ETFs. It is possible that some of the money that went into ETFs in 2022 is slowly returning to tax-exempt mutual funds. Although it is advantageous for the market to not see the kind of outflows experienced in 2022, the modest inflows likely limited the demand for tax-exempt products by mutual funds in the first quarter.

New Issue Volume

Total new issue volume for the first quarter was $75.5 billion. As Figure 5 shows, new issue volume in the first quarter of 2023 was lower than any quarter except for a few instances in the last nine years. (The fourth quarter of 2022 and the first quarter of 2023 are the lowest consecutive quarters for issuance since the fourth quarter of 2013 and the first quarter of 2014.) This represents a significant decline in new issue volume considering that 2020 and 2021 saw volume in excess of $480 billion and even 2022 saw total new issue volume approach $400 billion despite the large increase in rates. Decreasing new issue volume is not surprising, as higher interest rates increase the cost of borrowing for issuers and make savings from potential refundings less attractive.

Compared to the first quarter of 2022, total new issue volume was down 27%, with refunding volume down 32% and new money volume down 21%. Similarly, taxable volume dropped 31% and tax-exempt volume was down 25% vs the first quarter of 2022.

Figure 5. Municipal Market Issuance, 2011–2022



Source: Refinitiv

Conclusion

Key developments in the municipal bond market in the first quarter include:

- Lower tax-exempt yields,
- A decrease in trading volume compared to record levels in 2022,
- A return to inflows (although light) into mutual funds,
- Significantly lower issue volume compared to recent years, and
- A muted impact from concerns in the banking sector, despite increased volatility in the Treasury and equity markets caused by the bank collapses in March.

Tax-exempt bonds enter the second quarter at unattractive levels compared to the Treasury market, especially on the short end of the curve, bolstered by steady demand and a significant decrease in new issue supply.

ABOUT THE MSRB

The Municipal Securities Rulemaking Board (MSRB) protects and strengthens the municipal bond market, enabling access to capital, economic growth, and societal progress in tens of thousands of communities across the country. The MSRB fulfills this mission by creating trust in our market through informed regulation of dealers and municipal advisors that protects investors, issuers and the public interest; building technology systems that power our market and provide transparency for issuers, institutions, and the investing public; and serving as the steward of market data that empowers better decisions and fuels innovation for the future. The MSRB is a self-regulatory organization governed by a board of directors that has a majority of public members, in addition to representatives of regulated entities. The MSRB is overseen by the Securities and Exchange Commission and Congress.

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