

Bond Market Match-Up: U.S. Corporate vs. Muni Bonds

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The U.S. corporate and municipal bond markets seemed to be neck and neck in terms of total return performance for the first three quarters of 2017. However, distinct characteristics of both markets that have played key roles in driving performance could cause performance to vary significantly going forward.

Let's take a look at some of the potential performance drivers and differentiators.

Coupon cash flow: As of September month-end, investment-grade tax-exempt municipal bonds tracked in the S&P National AMT-Free Municipal Bond Index had an average coupon of 4.61% vs. the average coupon of 3.72% of the bonds in the S&P 500®/MarketAxess Investment Grade Corporate Bond Index.¹ In a low-yield and low-expected-return environment, municipal bonds offer higher-interest-rate cash flow that is tax-exempt.

Advantage: municipal bonds.

Yield: Investment-grade tax-exempt municipal bonds on average have yielded 2.03% vs. higher-yielding taxable investment-grade corporate bonds. However, looking at it from the perspective of taxable equivalent yield (TEY), municipal bonds have recently been at higher yields than their corporate bond equivalents.² Please refer to table on next page.

Advantage: municipal bonds.

Duration: Investment-grade corporate bonds from the companies of the S&P 500 are tracked in the S&P 500/MarketAxess Investment Grade Corporate Bond Index. Their average duration has been over 7.75 vs. an average of 4.8 for investment-grade municipal bonds tracked in the S&P National AMT-Free Municipal Bond Index.³ In general, in a rising rate environment the lower duration favors municipal bonds.

Advantage: municipal bonds.

Market size: U.S. corporate bonds that are index-eligible tend to be very large issues. The market size of the corporate bond market tracked in the S&P 500 Bond Index, a broad index, is over USD 4.5 trillion.⁴ The broad S&P Municipal Bond Index tracks over USD 1.77 trillion of the USD 3.8 trillion municipal bond market.⁵ The larger corporate bond market tends to be more liquid.

Advantage: corporate bonds.

¹ S&P Dow Jones Indices, Sept. 2017.

² S&P Dow Jones Indices, Sept. 2017.

³ S&P Dow Jones Indices, Sept. 2017.

⁴ S&P Dow Jones Indices, Sept. 2017.

⁵ Federal Reserve, June 2017.

Diversity and number of bond issues:

The nearly 100,000 bond issues tracked in the S&P Municipal Bond Index illustrates that the municipal market has many smaller and less frequent issuers than the corporate bond market. This can result in secondary market liquidity being significantly less for municipal bonds than bonds in the corporate bond market. Municipal bond buyers typically demand a higher yield for this illiquidity, called a “liquidity premium.”

Advantage: corporate bonds.

Headline risk: Municipal bonds are heavily a retail product and as a result, retail sentiment can play a

big role in market performance. Real fiscal challenges in both large and small municipalities add to the risk already impacting the market from issuers in Puerto Rico, Illinois, and Connecticut. The corporate bond market has been enjoying a period of lower historical default rates while the municipal bond market has been wrestling with the largest default in its history—Puerto Rico.

Advantage: corporate bonds.

New issue supply: Supply of new issue corporate bonds is on a high pace as compared to last year and demand remains strong with many new issues being over-subscribed

(more buyers seeking bonds than bonds being sold). While demand for municipal bonds has continued to be extremely strong, new issue supply has remained lower than in previous years.⁶ However, there are some larger municipal bonds on the calendar for sale. Supply is something to keep an eye on for both markets.

Advantage: TBD.

Tax code changes: Early days, but the impact of potential tax code changes on both of these markets could be a major factor in performance.

Advantage: TBD.

TABLE 1: SELECT BOND MARKET INDICES AND THEIR CHARACTERISTICS

	Broad Benchmark Indices		Indices Designed to be Investable	
	S&P Municipal Bond Index	S&P 500 Bond Index	S&P National AMT-Free Municipal Bond Index (Investment Grade)	S&P 500/MarketAxess Investment Grade Corporate Bond Index
Total # of Bond Issues:	99,465	5,188	11,414	1,001
Total Market Value:	\$1.772 Trillion	\$4.515 Trillion	\$718 Billion	\$1.726 Trillion
Par Weighted Average Coupon:	4.53%	4.09%	4.61%	3.72%
Par Weighted Average Price:	102.43	105.37	108.23	104.18
Yield to Worst:	2.21% 3.65% TEY*	3.11%	2.03% 3.36% TEY*	3.14%
Modified Duration:	4.76	6.96	4.8	7.76
Year-to-Date Total Return:	4.28%	4.82%	4.42%	5.04%
% Market Value That is High Yield	6.7%	8.7%	0%	0%
Notes:	Includes high-yield bonds and bond issues from Puerto Rico, Virgin Islands and Guam.	Includes only fixed-rate debt of companies in the S&P 500. Also includes high-yield bonds.	Excludes bond issues from U.S. territories as well as higher-risk revenue bond sectors such as housing and tobacco settlement bonds.	Includes only the most liquid bonds of the S&P 500 Bond Index.

*Taxable Equivalent Yield using an assumed federal tax rate of 39.6%

Source: S&P Dow Jones Indices, LLC. Data as of Sept. 29, 2017. Table is provided for illustrative purposes. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

⁶ S&P Dow Jones Indices, Sept. 2017.

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