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Municipal Bond Market Insight | April 2024

Embracing Higher Yields Amid the Fed's Uncertain Timing

Key takeaways

» The market entered 2024 with six rate cuts priced in, with the first expected as early as March. At quarter end, markets are only pricing in three cuts, the first commencing in June.

» Though ratios are off their richest levels, they may still cause investors to pause ahead of April muni supply pressure, tax time selling and elevated Treasury yields.

» The trend of higher issuance should continue into April, where the forecasted amount is in the $30 billion to $35 billion range, potentially bringing year-to-date gross issuance to roughly $95 billion.

» Although the challenges facing the commercial real estate sector are very real, especially for regional banks and related securities, the potential impacts to the credit quality of US cities appear rather manageable.

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General market update

If we look only at the first and last day of March, the yield on the 10-year Treasury seemed to have moved minimally. However, a significant amount of volatility took place in between, with the 10-year rate falling as low as 4.08% and jumping as high as 4.33%. Yields drifted back to higher levels as a continued string of strong economic data and inflation prints resulted in the market paring back rate cut expectations. The market entered 2024 with six rate cuts priced in, with the first expected as early as March. At quarter end, markets are only pricing in three cuts, the first commencing in June. The Fed further supported market sentiment, leaving rates unchanged during their March meeting and indicating no change in their three-cut forecast for this year. The higher-for-longer narrative is continuing a bit longer on the back of a strong economy, resulting in risk-on trades performing well and credit spreads tightening for the month.

Looking at the taxable muni space, the Bloomberg US Aggregate Index ended the month with a return of 0.93%, while the Bloomberg US Corporate Index returned 1.29% for March. Higher-quality Treasuries underperformed those two taxable counterparts, with the Bloomberg US Treasury Index returning 0.64%. Tax-exempt munis underperformed higher-quality taxables, with the Bloomberg Muni Index ending the month with a basically flat return of less than 0.1% for the month. Though ratios are off their richest levels, they may still cause investors to pause ahead of April muni supply pressure, tax time selling and elevated Treasury yields.

Supply

Municipal supply for the month of February came in at $36 billion, slightly higher than the five-year average for the same month. The trend of higher issuance should continue into April, where the forecasted amount is in the $30 billion to $35 billion range, potentially bringing year-to-date gross issuance to roughly $95 billion. Though higher supply and elevated Treasury rates should create an environment for further weakness in munis, we have yet to see if demand slows down materially. Redemptions may remain elevated into April as well, especially for tax-related selling. Larger new-issue deals for March included the Dormitory Authority of the State of New York, the State of California, New York City's Metropolitan Transit Authority and the State of Washington.

Figure 1: Fixed income returns as of March 28, 2024

	MTD return	YTD return
Bloomberg Muni Index	0.00%	-0.39%
Bloomberg US Treasury Index	0.64%	-0.96%
Bloomberg US Aggregate Index	0.92%	-0.78%
Bloomberg US Corporate Index	1.29%	-0.40%

Source: Bloomberg, 3/28/2024. For illustrative purposes only. It is not possible to invest directly in an index.

Past performance is no guarantee of future results.

Figure 2: AAA municipal yields as of March 28, 2024

Year	Current	MTD change	YTD change
2-year	2.97%	+23 bps	+45 bps
5-year	2.54%	+10 bps	+26 bps
10-year	2.51%	+5 bps	+23 bps
30-year	3.68%	+9 bps	+26 bps

Source: Thomson Reuters Municipal Market Data, 3/28/2024. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Figure 3: US Treasury yields as of March 28, 2024

Year	Current	MTD change	YTD change
2-year	4.62%	+0 bps	+37 bps
5-year	4.21%	-3 bps	+37 bps
10-year	4.20%	-5 bps	+32 bps
30-year	4.34%	-4 bps	+31 bps

Source: Bloomberg, 3/28/2024. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Market opportunity

The first quarter now in the books, and market sentiment has moved decidedly toward the Fed's guidance regarding future rate cuts since December. We think now is a good time to discuss a topic that often gets lost in the mix until something thrusts it into the forefront of municipal bond investors' minds: credit quality.

Given the broad range of economic outcomes for the next 12 to 18 months, investment-grade (IG) municipal bonds appear well-positioned to handle whatever scenario unfolds. Negative economic impacts from pandemic-driven dislocations have been minimal for states, local governments and essential service issuers (water, sewer, electric). At the same time, largely untapped federal stimulus funds have bolstered coffers that were already flush due to relatively conservative budgeting and stable revenues during the pandemic window.

This isn't to say we haven't heard concerns along the way. In fact, one of our clients' top questions relates to US cities' exposure to commercial real estate (CRE). It's easy to observe sparsely occupied office buildings, vacant retail storefronts and even lighter mass-transit passenger volumes. But this is where context and perspective can go a long way.

Municipal bond issuers have proven remarkably resilient over the last 50 years. According to a Moody's Municipal Bond Default Study published last summer, the average five-year cumulative default rate since 2013 for the IG municipal sector is just 0.08%, consistent with the entire study since 1970. Municipal credit quality is very different and materially stronger than corporate credit quality: The average five-year cumulative default rate for corporates is 7.8% since 2013 and 6.9% since 1970, and municipal bonds tend to be higher rated, with a median rating of Aa3 (AA-) versus Baa3 (BBB-) for corporates. The market saw only one rated muni default in 2022 on account of a specific project, and Moody's has yet to see a rated default due to natural disasters.

But these statistics don't answer today's CRE questions. Although the challenges facing the sector are very real, especially for regional banks and related securities, the potential impacts to the credit quality of US cities appear rather manageable. In the most basic sense, that manageability stems from the old saying that the only sure things in life are death and taxes. Property owners will eventually pay property taxes. The amount due relates directly to the assessed value, which can decline, but it's very unlikely to be zero.

A much larger revenue driver for most cities is residential property taxes, at 60% for the median of a 15-city sample, according to a 2023 S&P report. CRE property taxes came in at 39%, with office space being a subset of that 39%. Even within that subset, stable demand for Class A office space may offset losses from older and less desirable buildings.

That same S&P report continues:

Despite the challenges facing commercial real estate due to return to office trends, we do not expect a broad-based decline in general obligation credit quality among large US cities, particularly those with a foundation of strong credit characteristics and the capacity to proactively manage emerging risks.

The report adds that many cities aren't subject to property tax rate caps or may levy well under their statutory cap. This means a drop in assessed CRE value doesn't necessarily result in a direct loss of tax dollars. The tax burden can shift to other classes of taxpayers, including residential property owners.

On a final note, a mid-2023 JPMorgan report finds many of the cities with the highest office vacancy rates are highly rated. Topping the list is San Francisco, followed by Houston, Dallas, Denver and Austin. But San Francisco receives only 6% of its total revenues from CRE. This brings us back to our original statement: IG munis appear well-positioned to handle whatever scenario unfolds. For more information about the general state of muni credit quality, see Eaton Vance's State of the States report.

Key economic data

Change in nonfarm payrolls (Feb.)	275K
Unemployment rate (Feb.)	3.9%
Core CPI–YoY change (Feb.)	3.8%
Core PCE–YoY change (Feb.)	2.8%
Average hourly earnings–YoY change (Feb.)	4.3%
Real GDP annualized (Q4 2023)	3.4%

Source: Bloomberg, 4/3/2024.

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Economic outlook

The Fed's progress against inflation appears to have stalled over the short term. Month-over-month declines in the rate of Core PCE growth have slowed at 2.8%, above the Fed's target. The labor market has remained strong, with nonfarm payrolls beating estimates in February by 75,000 jobs. Unemployment has ticked higher to a manageable 3.8%, and fourth-quarter GDP growth was revised higher to 3.4% from 3.2%.

This backdrop has allowed the Fed to be patient. Chair Jerome Powell reiterated on April 3 that while recent inflation figures are higher than expected, the overall picture hasn't changed. Powell added that it would still be appropriate to begin lowering rates at some point this year.

The market seems to finally believe this messaging. Fed funds futures currently price in slightly less than three 25-basis-point cuts to the overnight rate by year-end, down from an expected six cuts at the beginning of the year. The timing of the first rate cut has moved further into the year and is now line with the Fed's messaging. As of today, we don't expect the first full cut until July 31.

Heightened market reactions to incoming economic data are likely to continue in the interim, increasing volatility across fixed income markets. US Treasury yields have reached new highs for the year as investors grapple with changing economic projections. Until economic activity slows, we're likely in a wait-and-see mode from the Fed. Both investors and the Fed will closely monitor the new data in their respective efforts to predict timing.

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