Parametric

Municipal Bond Market Insight | September 2023

Muni Yield-Curve Inversion: Attraction or Distraction?

Key takeaways

» Fixed income markets took a step back in August as interest rates moved higher.

» As interest rates touch decade-and-a-half highs and the Fed telegraphs the end of this rate-hiking cycle, we encourage investors to consider longer-duration municipal and corporate bond exposure for their portfolios.

» September brings with it the high likelihood of stronger supply and weaker demand, creating an opportune window to acquire high-quality tax-exempt bonds in the intermediate-to-long end of the muni curve.

» The next Fed meeting on September 20 is likely to produce no change to the overnight rate. Attention has shifted to the November 1 meeting.

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General market update

Fixed income markets took a step back in August as interest rates moved higher. The Bloomberg Municipal Bond Index returned -1.44%, underperforming the US Treasury Index, which finished down -0.52%. Corporate investment-grade (IG) bonds finished the month with a return of -0.78%, and the S&P 500® declined -1.59%. There was no Fed meeting in August, but all eyes are on the September 20 meeting, when the market currently expects no increase in the overnight lending rate.

After the most extreme period of interest rate increases in more than 40 years, we're approaching the federal funds rate peak for this cycle. Longer-term fixed income exposure has historically outperformed cash when looking at the 12-month returns following the end of rate-hiking cycles since the late 1980s. As interest rates touch decade-and-a-half highs and the Fed telegraphs the end of this rate-hiking cycle, we encourage investors to consider longer-duration municipal and corporate bond exposure for their portfolios.

Supply

Tax-exempt issuance in August came in at $35 billion, 15% higher than August 2022. Gross issuance for the year to date has come in at $240 billion, 13% below the same period in 2022. It's quite typical for issuance to ramp up before year's end. Given continued fund outflows in the municipal market, any additional supply that demand can't digest may put more pressure on yields. The month's largest deals included the States of California and Michigan, New York City, and the Washington Metropolitan Area Transit Authority. Certain key states have experienced sharp primary market supply declines YTD relative to last year, including Massachusetts (-43%), Florida (-36%), and New York (-33%).

Figure 1: Fixed income returns as of 8/31/2023

	MTD return	YTD return
Bloomberg Muni Index	-1.44%	1.59%
Bloomberg US Treasury Index	-0.52%	0.70%
Bloomberg US Treasury Index	-0.52%	0.70%
Bloomberg US Corporate Index	-0.78%	2.76%

Source: Bloomberg, 8/31/2023. 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 8/31/2023

Year	Current	MTD change	YTD change
2-year	3.14	+0.14	+0.54
5-year	2.88	+0.22	+0.36
10-year	2.93	+0.36	+0.30
30-year	3.88	+0.37	+0.30

Source: Thomson Reuters Municipal Market Data, 8/31/2023. For illustrative purposes only. Not a recommendation to buy or sell any security.
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Figure 3: US Treasury yields as of 8/31/2023

Year	Current	MTD change	YTD change
2-year	4.85	-0.02	+0.42
5-year	4.24	+0.07	+0.23
10-year	4.10	+0.14	+0.23
30-year	4.20	+0.20	+0.23

Source: Bloomberg, 8/31/2023. For illustrative purposes only. Not a recommendation to buy or sell any security.
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Market opportunity

With tax-exempt muni yields near the year-to-date peak and now residing at some of the highest sustained levels in well over a decade, bond investors remained keenly focused on the Fed's next move during what appears to be a hiking cycle that's very close to complete. Most market pundits expect the Fed to be on hold for an extended period following the final rate hike. However, with subsequent rate cuts expected in 2024 and 2025, the inverted shape of both the US Treasury yield curve and the benchmark AAA tax-exempt muni yield curve gives investors pause. We're seeing many attempt to reconcile the near-term benefits of capturing attractive yields in the first few maturities, with the potentially longer-lasting rewards of locking in compelling yields further out on the curve.

It's important to note that these two yield curves are very different. The Treasury curve is fully inverted, with the shortest maturities yielding more than the longest. But the muni curve is only inverted out to the midpoint at 13 years and is positively sloped thereafter. Further, the magnitude of the often-quoted "2s/10s" inversion is quite different, with Treasuries registering 73 basis points (bps) and munis a much milder 17 bps—less than one-quarter that of the Treasury inversion. This means the benefit of staying short in munis is more limited and the potential reward for extending out on the muni curve is more apparent.

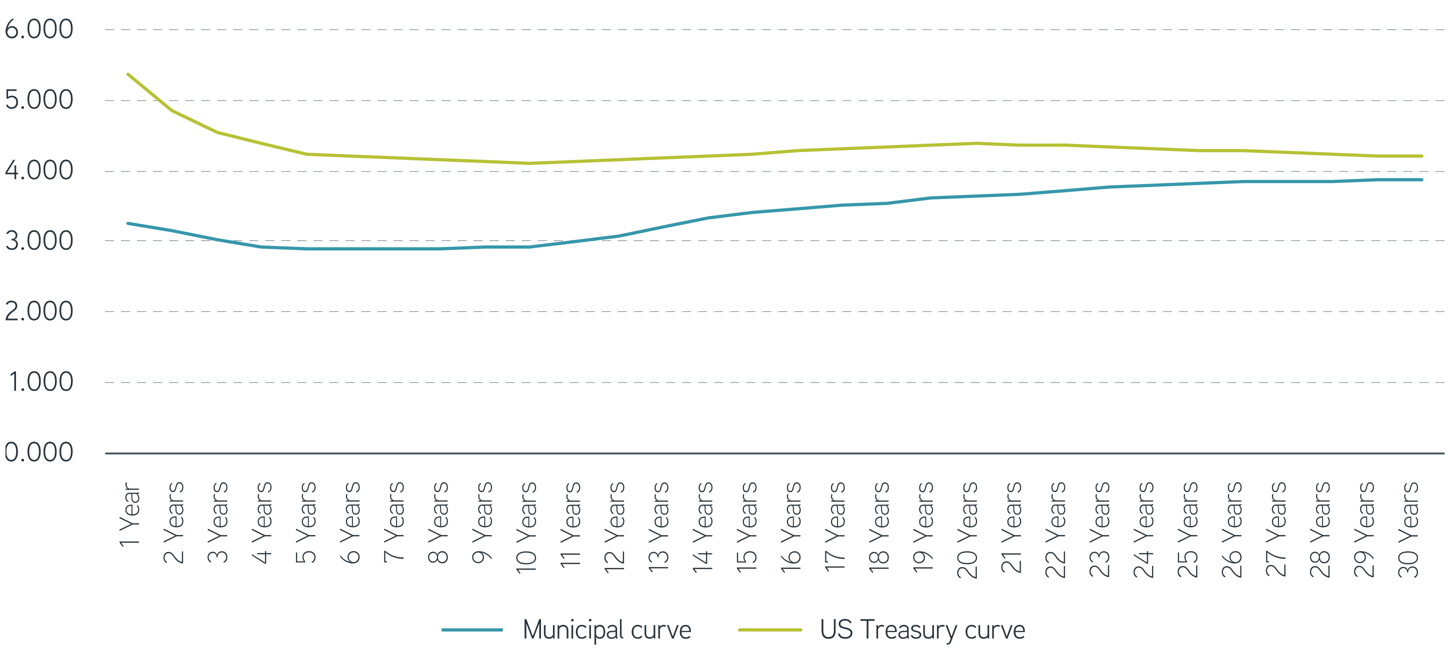
Meanwhile, benchmark AAA tax-exempt muni yields are hovering near the highest levels in over a decade. While it's true that they were higher last October, recall that the Fed's rhetoric was much more hawkish at the time, and incoming inflation data was sharply higher than today's readings.

A little historical context may also be helpful regarding Federal Open Market Committee (FOMC) actions. Reviewing the last five Fed policy tightening cycles and the 12-month period following the final hike, we note that the Bloomberg Municipal Bond Index (six-year duration) has returned 10.19% on average, while the Bloomberg 1–3 Month US Treasury Bill Index has returned 5.7%.

We believe the muni yield curve inversion is largely a distraction for investors with a time horizon of more than two years. Extending out to benchmark 10-year AAA muni yields captures 76% of the curve and attains 2.98%, which is a taxable equivalent yield (TEY) of 5.03% for investors in the highest federal tax bracket as of September 7. Venturing further out, a 20-year tax-exempt muni captures 94% of a 30-year yield and stands at 3.71%, which is a TEY of 6.26% as of the same date.

In terms of market timing, the muni market supply/demand dynamic is highly seasonal. September brings with it the high likelihood of stronger supply and weaker demand, creating an opportune window to acquire high-quality tax-exempt bonds in the intermediate-to-long end of the muni curve.

Treasury yield curve



Source: Refinitiv MMD, 8/31/2023. For illustrative purposes only. Not a recommendation to buy or sell any security.
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Economic outlook

US economic data continues to surprise to the upside. Although the unemployment rate ticked slightly higher to 3.8% in August, it was largely a reflection of new job seekers entering the workforce. Nonfarm payrolls increased 187,000 in August, beating estimates of 170,000. Core CPI continued to move lower from its peak of 6.6% in September 2022.

Markets have been extra sensitive to economic news as investors attempt to stay ahead of Fed policy changes. The next Fed meeting on September 20 is likely to produce no change to the overnight rate. Attention has shifted to the November 1 meeting, when futures markets project a 41% chance of a 25-bps increase as of this month.

Investors believe rate cuts are coming farther out. The overnight rate is currently expected to hit 4.38% by the end of 2024, implying about 95 bps of cutting between now and then. While this measurement can change rapidly, it's a strong indication that lower rates may be in store for 2024.

Key economic data

Change in nonfarm payrolls (Aug)	187k
Unemployment rate (Aug)	3.8%
Core CPI–YOY change (July)	4.7%
Core PCE–YOY change (July)	4.2%
Average hourly earnings–YOY change (Aug)	4.3%
Real GDP Annualized (Q2 2023)	2.1%

Source: Bloomberg, 9/7/2023.

Benchmark AAA tax-exempt muni yield curve

Source: Refinitiv MMD, 8/31/2023. For illustrative purposes only. Not a recommendation to buy or sell any security.
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