Parametric

Municipal Bond Market Insight | November 2023

Forecasting the End of Rate Hikes

Key takeaways

» Rhetoric suggesting that the market has been doing some of the Fed's work inspired a narrative shift toward the expectation that the Fed might be finished hiking its overnight funds rate.

» Despite an uptick in October, year-to-date (YTD) municipal issuance is still down approximately 5% from 2023.

» Realizing tax losses in the muni market can add meaningful value when rates rise. However, if this is done carelessly, investors may find that they receive much less benefit than they had expected, potentially none at all.

» The overnight rate is currently expected to hit 4.35% by the end of 2024, implying about 99 bps of cutting between now and then. While many read this as meaning rates will be "higher for longer," we believe it's more accurate to say they'll be "higher for as long as possible."

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General market update

Fixed income yields rose again in October at a similar pace to September, but they steadied during the final week of the month ahead of the November 1 Federal Open Market Committee (FOMC) meeting. A narrative shift toward the expectation that the Fed might be finished hiking its overnight funds rate—inspired by rhetoric that suggested that the market has been doing some of the Fed's work—drove the calm. During the month's final trading sessions, the 10-year US Treasury note momentarily reached 5% and then quickly backed away. The Bloomberg Municipal Bond Index returned -0.85% for October, outperforming the Bloomberg US Treasury Index, which registered -1.21%. The Bloomberg US Aggregate Index ended the month with a return of -1.58%, and the S&P 500® returned -2.2% for October. Although the Fed's Summary of Economic Projections (the dot plot) suggests one more hike during calendar year 2023 is possible, market sentiment toward the close of October cast doubt on a final hike transpiring at the December 13 meeting.

Market sentiment seems to be shifting from "higher for longer" to "here for how long?" Market participants may soon find themselves closely monitoring upcoming economic data releases for clues regarding the potential path of monetary policy on the other side of the peak in rates. In the interim, prospective municipal bond buyers can lock in tax-exempt yields near 14-year highs. Further, these elevated yields have prevailed during a season of adequate muni bond supply, tepid reinvestment demand, and persistent mutual fund outflows. We don't expect this favorable buyer-friendly window to endure, since December likely ushers in a reversal of these technical factors. Finally, both munis and corporate indexes outperformed T-bills in four of the last five hiking cycles when looking back 12 and 24 months after the last rate hike. We believe this supports adding to high-quality intermediate- and longer-duration municipal bond holdings now.

Supply

Municipal bond issuance for the month of October came in over $37 billion for the month, bringing only the third month of year-over-year (YOY) supply growth this year, up 29.3% from October 2022's issuance. This surge follows many months of issuers remaining on the sidelines amid rate volatility and a growing market consensus regarding the Fed's higher-for-longer rhetoric. Despite the uptick in October, YTD municipal issuance is still down approximately 5% from 2022. The largest deals that came to market last month include the Triborough Bridge and Tunnel Authority, the New York City Transitional Finance Authority, and the State of Connecticut.

Figure 1: Fixed income returns as of 10/31/2023

	MTD return	YTD return
Bloomberg Muni Index	-0.85%	-2.22%
Bloomberg US Treasury Index	-0.15%	-2.71%
Bloomberg US Aggregate Index	-1.58%	-2.77%
Bloomberg US Corporate Index	-1.87%	-1.86%

Source: Bloomberg, 10/31/2023. 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 10/31/2023

Year	Current	MTD change	YTD change
2-year	3.67	+0.01	+1.07
5-year	3.51	+0.1	+0.99
10-year	3.61	+0.15	+0.98
30-year	4.57	+0.23	+0.99

Source: Thomson Reuters Municipal Market Data, 10/31/2023. For illustrative purposes only. Not a recommendation to buy or sell any security.

Past performance is no guarantee of future results.

Figure 3: US Treasury yields as of 10/31/2023

Year	Current	MTD change	YTD change
2-year	5.05	+0.04	+0.66
5-year	4.61	+0.24	+0.85
10-year	4.58	+0.36	+1.06
30-year	4.70	+0.39	+1.13

Source: Bloomberg, 10/31/2023. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Market opportunity

As we enter the fourth quarter with the Bloomberg Municipal Bond Index negative on the year, we thought it would be appropriate to do a deeper dive into our subject from last month: tax-loss harvesting. Last month we discussed the advantages of using a year-round systematic approach. This month we'll discuss some challenges investors may encounter.

We think a systematic approach is best if it operates year-round. This approach, if well designed, sells one bond and simultaneously buys a ready replacement while avoiding a wash sale. This method offers the advantage of potentially eliminating cash drag and minimizing friction costs. The one drawback is that the absence of a ready replacement may mean that some losses don't get realized. Investors in need of realizing more losses usually have the option of a directed sale, which we offer at Parametric with a few caveats. The directed sale approach has the drawbacks of potentially resulting in cash drag—particularly in state-specific or state-preferred portfolios—and significantly higher friction costs.

We believe the best practice when considering a directed sale is to determine the value of the tax asset created. For example, consider a $1,000 loss in the portfolio of a top-bracket federal taxpayer. The value of the loss should be related to the value of taxes saved. If the investor uses that loss to offset a $1,000 gain, we consider the value to be $408 for a short-term gain or $200 for a long-term gain. Let's say this is a short-term gain, which makes the value of the tax asset $408. Before realizing that loss, the investor must consider the cost of doing so. The position size and cost of liquidity are important components of this consideration. Timing the reinvestment is a third variable, and one that's difficult to quantify.

Realizing a loss involves selling the bonds, which generally entails hitting a bid. If the bid-ask spread is one point (or 1% of par), the cost of selling is $100 per 10m in par. If that $1,000 loss is on 10m bonds, the net value of the tax asset is $308. If it's on 50m bonds, the net value of the tax asset is -$92 ($408 minus $500). The percentage loss per bond matters.

In sloppy markets that are selling off, the bid-ask spread often widens out. In our experience, it can easily reach 3% of par or more during stressful moments. If we're trying to realize our $1,000 loss on $10m, but the cost of liquidity is $300, that brings the net value of the tax asset down to just $108. Add in the income forgone by being in cash and the risk of having to invest at lower yields (should the market bounce before the investor can reinvest), and suddenly realizing that loss becomes much less compelling. Investors are right to want to realize losses in the municipal market when they have them, and we'd encourage them to employ a systematic, year-round approach. However, trying to force the issue through directed sales can be a little more nuanced, and investors should exercise careful judgment.

Key economic data

Change in nonfarm payrolls (Oct)	150k
Unemployment rate (Oct)	3.9%
Core CPI–YOY change (Sep)	4.1%
Core PCE–YOY change (Sep)	3.7%
Average hourly earnings–YOY change (Oct)	4.1%
Real GDP annualized (Q3 2023)	4.9%

Source: Bloomberg, 11/5/2023.

Economic outlook

US economic data slipped in October, with nonfarm payrolls coming in at 150,000 compared with an expected 180,000. The unemployment rate ticked higher to 3.9% from last month's level of 3.8%. YOY Core Consumer Price Index data continued to grind lower, with September's reading coming in at 4.1%, compared with August's level of 4.3%. That's still significantly higher than the target rate, but we've seen progress since the 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 Fed meeting on November 1 produced no change to the overnight rate, but Fed governors left the door open to continue hiking if economic conditions warrant. This meeting marks three in a row since July that the Fed has left rates unchanged.

Investors believe rate cuts are coming. The overnight rate is currently expected to hit 4.35% by the end of 2024, implying about 99 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. The official narrative is "higher for longer," but we'll more likely see "higher for as long as possible" before economic conditions deteriorate.

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27547 | 11.13.2023 | RO 3229114

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