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Municipal Bond Market Insight | March 2024

Should Investors Leap Out the Curve?

Key takeaways

» Municipals outperformed Treasury and corporate bonds in February, enriching valuations inside of 10 years.

» With rate cuts likely coming this year, we're finding more attractive ratios at the longer end of the curve.

» Investors unwilling to extend should consider using a crossover strategy that can switch between sectors as relative value shifts.

» Rate cuts are on the way, but strong economic data is keeping the Fed on hold. Markets now expect three cuts this year, in line with Fed statements, rather than the six cuts priced in at the beginning of the year.

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General market update

Fixed income markets continued to experience weakness in February after a disappointing January and in the face of generally robust US economic data. Further upward yield pressure came from Fed chair Jerome Powell uncharacteristically indicating the Fed's unlikeliness to enact a rate cut at the March FOMC meeting. With the bond market recalibrating its expectations toward the Fed's guidance, the resulting upward trend in yields brought the 10-year US Treasury as high as 4.33% before settling at 4.25% by February's month-end. This was 39 basis points (bps) higher than where the month began and a major shift from the 3.88% that opened 2024.

The Bloomberg US Aggregate Index ended February with a year-to-date (YTD) return of -1.68%, and the Bloomberg US Corporate Index returned a similar -1.67% YTD. Municipal bonds fared best of all, with the Bloomberg Muni Index returning just -0.38% YTD by month's end. However, this outperformance also means that municipal yields haven't adjusted higher in lockstep with Treasurys and corporates, making them relatively expensive on a comparative basis. Municipal ratios accordingly remain rich, though they may improve soon as new-issue supply grows and organic reinvestment demand abates in March.

Elsewhere, the equity market continued its solid performance, with the S&P 500® returning 7.7% YTD through March 1 despite ongoing geopolitical tensions and continued violence in the Middle East. Meanwhile, crude oil and gold changed little in February.

Supply

Municipal supply for the month of February came in at $28 billion, lower than the five-year average for the same month. This brings YTD gross issuance to $58 billion. March typically sees higher monthly issuance, which tends to come with less reinvestment capital. Sustained higher issuance in the coming months, along with rich ratios, may lead to some short-term weakness relative to taxables. Larger new-issue deals for February include the City of New York, the Midland School District in Texas, the University of California, and the State of Massachusetts.

Figure 1: Fixed income returns as of February 29, 2024

	MTD return	YTD return
Bloomberg Muni Index	0.13%	-0.38%
Bloomberg US Treasury Index	-1.31%	-1.59%
Bloomberg US Aggregate Index	-1.41%	-1.68%
Bloomberg US Corporate Index	-1.5%	-1.67%

Source: Bloomberg, 2/29/2024. 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 February 29, 2024

Year	Current	MTD change	YTD change
2-year	2.74%	+10 bps	+21 bps
5-year	2.44%	+8 bps	+16 bps
10-year	2.46%	+8 bps	+18 bps
30-year	3.59%	+7 bps	+17 bps

Source: Thomson Reuters Municipal Market Data, 2/29/2024. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Figure 3: US Treasury yields as of February 29, 2024

Year	Current	MTD change	YTD change
2-year	4.53%	+41 bps	+69 bps
5-year	4.16%	+41 bps	+40 bps
10-year	4.18%	+34 bps	+37 bps
30-year	4.17%	+21 bps	+35 bps

Source: Bloomberg, 2/29/2024. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Market opportunity

Recent feature articles around February 29 have us asking when to leap—that is, when to move out of cash and into municipals. The thousand thousand-foot view would say soon. The Fed has telegraphed that rate cuts are coming this year, and historical precedent would suggest that locking in yields today may allow investors to significantly outperform cash equivalents over the next 12 to 24 months.

However, the picture is murkier on the ground. After a strong close to 2023, the municipal market has barely retraced in 2024, with municipals outperforming Treasury and corporate bonds. One consequence that ratios are low and municipals are rich. From one to 10 years, the AAA MMD benchmark is currently yielding less than 59% of comparable-maturity Treasury notes. An investor in almost any bracket looking to maximize after-tax return might find better opportunities in those other markets.

So what's a muni investor to do? The steepest part of the current curve is between 10 and 15 years, and ratios improve as we move out from there. An investor in the 25-year portion of the curve will find ratios around 80%, which is in the range of fair to good relative value. We like locking in today's yields for longer. If our performance thesis holds, the longer the better.

Alternately, using an active strategy that can move between asset classes might be an attractive option for investors who appreciate relative-value trading but would prefer to have a muni portfolio most of the time. Active crossover strategies focus on the best value at the time of investment, rotate out of sectors when they're rich, and rotate back when they become fairly valued. This is more dynamic than a multisector laddered strategy, which uses best value at the time of investment but doesn't rebalance on a relative value shift.

What if an investor is already in municipals and not interested in reallocating? Back to the thousand thousand-foot view: Bonds should perform when rate cuts begin, and longer bonds more so than shorter ones. If municipals are rich today, it's because investors may have already priced in some of that performance. But that need not preclude future gains as overall rates come down. So we recommend staying the course.

Economic outlook

The disinflationary trend in consumer prices is well-established. Core PCE year over year (YoY) has dropped from over 5% to below 3% in the past 24 months. The labor market remains robust, with jobs data in January coming in over 350,000, and unemployment remains low at 3.7%. Preliminary estimates for February signal growth of 200,000 in nonfarm payrolls.

Taken together, these strong economic indicators have allowed the Fed to be patient in signaling changes to the overnight rate. Market expectations have adjusted quite a bit this year in the face of this new data. To start 2024, fed funds futures priced in just over six cuts of 25 bps to the overnight rate, despite the Fed dot plot from December signaling three cuts. As stronger-than-expected data emerged, future expectations have diminished. Today the futures market is pricing in just about three and a half cuts of 25 bps between today and the end of 2024, with the first rate cut expected in June or July.

Heightened market reactions to new economic data are likely to continue, increasing volatility in the Treasury market. As noted above, since the start of the year, the 10-year Treasury went as high as 4.32% and as low as 3.88%, a direct result of investors grappling with changing economic projections. Until economic activity slows, we're likely in a wait-and-see phase from the Fed. Investors—and the Fed—will be closely monitoring the data to try and predict timing.

Key economic data

Change in nonfarm payrolls (Jan.)	353K
Unemployment rate (Jan.)	3.7%
Core CPI–YoY change (Jan.)	3.9%
Core PCE–YoY change (Jan.)	2.8%
Average hourly earnings–YoY change (Jan.)	4.5%
Real GDP annualized (Q4 2023)	3.2%

Source: Bloomberg, 3/4/2024.

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