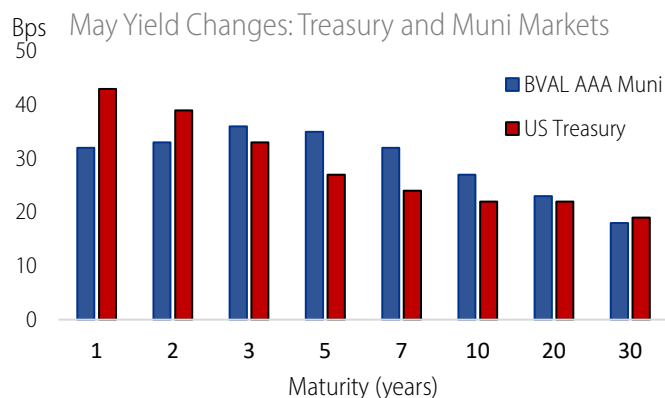


June 7, 2023

May 2023 Muni Minute: Don't Fight the Fed!

Yields moved higher across both taxable and tax-exempt markets as fixed income investors reassessed the prospects of additional tightening by the Federal Reserve. At the end of April, fed funds futures were forecasting one additional rate hike by the Fed at its early-May meeting, then a pivot towards rate *cuts* later this year. This market view was in sharp contrast to comments by Fed speakers that 1) there may be more hikes to fed funds in the future and 2) they intend to keep rates at higher levels for some period of time once hiking has been completed.

Economic data releases this month revealed continued strong employment, and core inflation that remains both elevated and “sticky” – both factors that caused more pointed Fed comments about possible additional rate hikes as the month progressed. The market took note, swinging its assessment of year-end fed funds higher by 37 bps. It is noteworthy that even this higher year-end forecast still incorporates rate cuts later in the year, as the implied rate – at just under 5% - is slightly below the middle of the current fed funds range (5-5.25%). However, the reassessment pushed bond yields higher by 20-40 bps across most of the curve in both the taxable and municipal markets.



Source: Bloomberg

Supply and Demand

Low supply of new-issue munis was met, on the demand side, with continued outflows – plus the additional pressure brought on by the FDIC's liquidations of muni positions seized from failed banks.

Municipal bond issuance for May was \$28 billion, down \$2.5 billion from last month and 23% below last May's level of \$36.6 billion. As was the case last month, and in many of the months since rates have moved higher, May 2023's lower new-issue volume versus May 2022 is due to both lower tax-exempt volume (issuance fell \$2.0 billion or 7%) and lower refunding activity (taxable muni issuance fell by a whopping 82% from \$6.5 billion to \$1.2 billion). This slowdown in refunding activity is common in elevated rate environments and is forecast to continue for the next several months, at least.

Texas' white-hot pace of population growth continued to fuel strong new issue volume, powering it to the top of the issuer chart during May (\$4.6 billion) despite not having a deal over \$500 million. Texas remains the largest issuer of municipal bonds this year. In second place for the month was New York (\$4.4 billion), headlined by three deals over \$700 million each. California (\$4.3 billion) nabbed the third spot for the month and remains the second largest issuer year-to-date.

According to Lipper/Refinitiv, municipal bond mutual funds experienced outflows each of the five reporting weeks in May. Outflows totaled \$3.3 billion, matching April's figure.

Another factor influencing the supply and demand equilibrium in the market is the liquidation of bonds held by the FDIC as part of the takeover of several large regional banks. According to street estimates, another \$800 million of munis were sold in the last week of May. This brings total sales to approximately \$1.7 billion, about 25% of the \$6.8 billion in total seized bonds that the FDIC needs to sell. Most of the remaining bonds fall in the 10-17 year range of the curve.

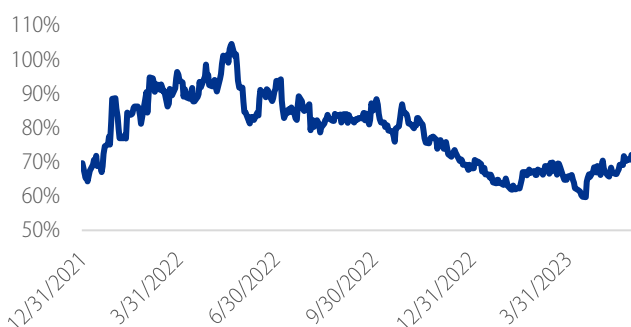
Municipal Bond Ratios

In light of the supply-demand headwinds noted above, it should come as no surprise that municipal ratios - the metric by which investors evaluate supply-demand equilibrium in the muni market – rose during the month. The 10-year ratio (10-year AAA muni yield / 10-year treasury yield) moved up to its highest level of the year. The “rest of the story”, though, is the current level of 72% still leaves it on the expensive end of the spectrum (note that higher muni ratios indicate higher value in the muni market

relative to the larger, more-efficient treasury market). The analysis holds across virtually the entire municipal curve.

In addition, this reprieve from the exceedingly high muni valuations present for much of the year is widely expected to reverse over the next several months. The reason for that belief lies in the number of expected calls and maturities during the June-August period – a regular annual occurrence in the muni

10 Year AAA Muni Yield / 10-Year Treasury Yield



Source: Bloomberg

market. In short, the expected supply of munis is less than the amount of bond calls and maturities over that period – referred to in the market as “net negative supply.” Bloomberg estimates the net negative supply for June is -\$23.5 billion – and that July and August are expected to be even larger. All of this points to conditions likely to result in demand for munis far outstripping expected supply over the summer, which should push muni ratios back down from current levels.

Total Return Data

Returns were negative across all fixed income sectors and asset classes. The Bloomberg Municipal Bond Index (-.87%) fared better than the broadest measure of the taxable market, the Bloomberg US Aggregate Index (-1.09%).

Lower quality munis performed slightly better than higher quality bonds. AAA munis were down -.9% for the month versus single-A (-.8%) and BBB (-.7%). High yield munis also held in slightly better (-.7%).

From a maturity standpoint, the worst-performing sector was 5-10 year bonds – (down 1.0-1.1%), while shorter maturities in the

1-2 year range (-0.1%) spared investors from the worst of the month's price deterioration.

There are two silver linings to May's market decline. First, year to date returns are still positive. The overall muni market return is 1.65% for the year. Once again, lower-quality bonds have performed better (both lower-tiers within the investment grade category as well as Muni HY). For the year, longer duration has generally been beneficial, with returns on the longest bucket of bonds (22+ years) still exceeding 3% despite May's negative results.

Index Returns (through May 31, 2023) *

	May	YTD	Yield
Municipal Market Indices			
Municipal Bond	-0.87%	1.65%	3.64%
Managed Money	-1.18%	1.64%	3.44%
+ Managed Money Short	-0.73%	0.11%	3.08%
+ Managed Money Short-Intermediate	-1.21%	0.38%	2.92%
+ Managed Money Intermediate	-1.26%	1.01%	3.10%
Managed Money California	-1.06%	1.69%	3.32%
+ Managed Money CA Short	-0.64%	0.13%	2.99%
+ Managed Money CA Short-Intermediate	-1.07%	0.51%	2.80%
+ Managed Money CA Intermediate	-1.08%	0.97%	2.93%
Bloomberg Muni High Yield	-0.69%	2.61%	5.82%
Taxable Market Indices			
US Aggregate	-1.09%	2.46%	4.59%
US Gov/Credit	-1.24%	2.53%	4.56%
US Treasury	-1.16%	2.35%	4.07%
US Corporate	-1.45%	2.78%	5.37%
Taxable Muni	-1.44%	4.97%	4.92%
US Corporate High Yield	-0.92%	3.64%	8.81%
LSTA Leveraged Loan Index	-0.82%	0.49%	9.99%

Source: Bloomberg

In the taxable space, corporate bonds and taxable munis were hit particularly hard – mostly due to their generally longer duration profile. The two high yield sectors – Corp HY and Leveraged Loans – continue to perform well versus other taxable alternatives.

The second silver lining is the high level of yields for investors looking to put cash to work. Higher-quality profiles in both the municipal and taxable spaces offer yields that have rarely been available over the last 15 years. While the outlook for further rate movements remains complicated, investors can take solace in the notion that these higher yields help cushion the potential price volatility if yields do move higher.

Glossary / Index Descriptions*

Bloomberg Municipal Bond Index consists of fixed-coupon, investment-grade tax exempt municipal bonds with maturities greater than 1 year, with a par value of at least \$7 million and issued as part of a transaction of at least \$75 million. Securities must be rated at least Baa3/BBB-/BBB- by Moody's, S&P and Fitch (based on middle rating if rated by three agencies, lower rating if rated by two agencies, sole rating if rated by only one agency).

Bloomberg Managed Money Index consists of fixed-coupon, tax exempt municipal bonds issued within the past five years with maturities greater than 1 year, with a par value of at least \$7 million and issued as part of a transaction of at least \$75 million. Securities must be rated in the highest two rating categories by Moody's, S&P and Fitch (based on middle rating if rated by three agencies, lower rating if rated by two agencies, sole rating if rated by only one agency). Bonds whose purpose is for health care or housing are excluded.

Bloomberg Managed Money Short Index consists of fixed-coupon, tax exempt municipal bonds issued within the past five years with maturities greater than 1 year and remaining effective maturity no more than five years, with a par value of at least \$7 million and issued as part of a transaction of at least \$75 million. Securities must be rated in the highest two rating categories by Moody's, S&P and Fitch (based on middle rating if rated by three agencies, lower rating if rated by two agencies, sole rating if rated by only one agency). Bonds whose purpose is for health care or housing are excluded.

Bloomberg Managed Money Short-Intermediate Index consists of fixed-coupon, tax exempt municipal bonds issued within the past five years with maturities greater than 1 year and remaining effective maturity no more than ten years, with a par value of at least \$7 million and issued as part of a transaction of at least \$75 million. Securities must be rated in the highest two rating categories by Moody's, S&P and Fitch (based on middle rating if rated by three agencies, lower rating if rated by two agencies, sole rating if rated by only one agency). Bonds whose purpose is for health care or housing are excluded.

Bloomberg Managed Money Intermediate Index consists of fixed-coupon, tax exempt municipal bonds issued within the past five years with maturities greater than 1 year and remaining effective maturity no more than seventeen years, with a par value of at least \$7 million and issued as part of a transaction of at least \$75 million. Securities must be rated in the highest two rating categories by Moody's, S&P and Fitch (based on middle rating if rated by three agencies, lower rating if rated by two agencies, sole rating if rated by only one agency). Bonds whose purpose is for health care or housing are excluded.

Bloomberg Managed Money California Index consists of fixed-coupon, tax exempt municipal bonds issued within the past five years by issuers domiciled in the state of California with maturities greater than 1 year, with a par value of at least \$7 million and issued as part of a transaction of at least \$75 million. Securities must be rated in the highest two rating categories by Moody's, S&P and Fitch (based on middle rating if rated by three agencies, lower rating if rated by two agencies, sole rating if rated by only one agency). Bonds whose purpose is for health care or housing are excluded.

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Bloomberg US Aggregate Index consists of investment grade, USD-denominated, fixed-rate taxable bonds, including treasuries, government-related and corporate securities, agency MBS, ABS, and CMBS with at least one year to maturity, subject to issue-size restrictions.



Bloomberg US Government/Credit Index is a component of the Bloomberg US Aggregate Index (above) that excludes securitized debt and includes only treasury, government-related and corporate securities.

Bloomberg US Treasury Index consists of securities issued by the US Treasury with at least one year to maturity.

Bloomberg US Corporate Index is a component of the Bloomberg US Aggregate Index (above) that includes only securities issued by industrial, utility, and financial issuers. Securities must be rated at least Baa3/BBB-/BBB- by Moody's, S&P and Fitch (based on middle rating if rated by three agencies, lower rating if rated by two agencies, sole rating if rated by only one agency).

Bloomberg Taxable Municipal Index consists of fixed-rate, taxable municipal securities with at least one year to maturity, with a par value of at least \$7 million and issued as part of a transaction of at least \$75 million. Securities must be rated at least Baa3/BBB-/BBB- by Moody's, S&P and Fitch (based on middle rating if rated by three agencies, lower rating if rated by two agencies, sole rating if rated by only one agency).

Bloomberg US Corporate High Yield Index consists of bonds issued by Corporate (industrial, financial institutions, utilities) issuers. Securities must be rated at least Baa3/BBB-/BBB- by Moody's, S&P and Fitch (based on middle rating if rated by three agencies, lower rating if rated by two agencies, sole rating if rated by only one agency).

LSTA Leveraged Loan Index is a capitalization-weighted index of US-domiciled, USD-denominated syndicated loans that are held within top-tier institutional investor loan portfolios. Loans are senior/secured, with an initial term of at least one year and minimum issue size of \$50 million.

*Indexes are unmanaged, do not incur management fees, costs, and expenses, and cannot be invested in directly. Past performance is not a guarantee of future results.

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