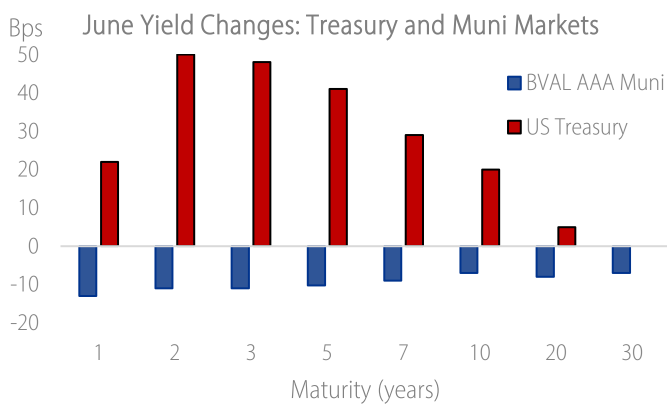
Chris Nicholl
HilltopSecurities Asset Management
Managing Director, Sr Portfolio Manager
214.953.4133 chris.nicholl@hilltopsecurities.com

July 7, 2023

Strong Demand for Municipals Cuts Through Treasury Headwinds

Treasury yields marched higher during June as Federal Reserve comments about expected hiking activity for the balance of 2023 continue to cause investors to reassess their interest rate outlooks. The Fed's June mid-month meeting included the release of its latest Summary of Economic Projections (SEP). That SEP surprised the market by showing that the majority of FOMC members expect an additional 50 bps of hikes during the year. For the second month in a row, this hawkishness by the Fed caught the market flatfooted and resulted in upward adjustments to Treasury bond yields. Worth noting, this all took place against the backdrop of the Fed *not* raising rates at this meeting – although they have strongly hinted that a hike at next month's meeting is likely. The biggest yield moves were on the front end of the curve in 2-5 years.



Source: Bloomberg and HilltopSecurities Asset Management

By contrast, yields on municipal bonds moved lower on the month, thanks to strong demand and continued low supply.

Supply and Demand

New issue municipal volume was $34.4 billion in June. This is the largest issuance month of the year and, in fact, the largest since August 2022. Despite that, it was 9% lower than June issuance a year ago, highlighting the low level of municipal issuance in 2023. First half volume was $174.8 billion, down 20% from last year. Tax-exempt volume during that time was down 13% while taxable volume sank 43% in the first half. With the Fed poised to keep rates elevated and a US economy showing resilience – but certainly not booming growth – there is no reason to believe that issuance will pick up in any meaningful manner for the rest of 2023. See Tom Kozlik's issuance commentary.

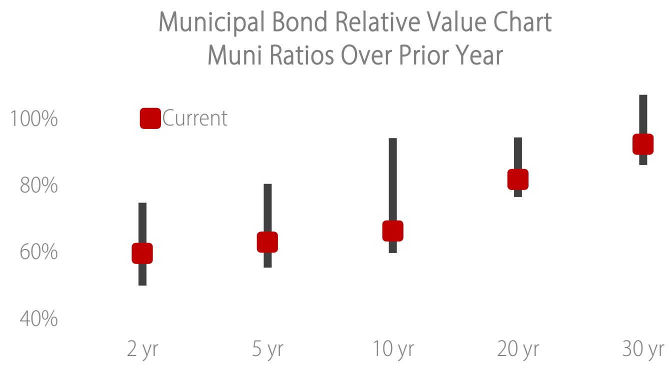
One "wall of worry" in the municipal market the past couple of months has been knowledge that the FDIC would need to liquidate its holdings of municipal bonds owned due to the bailout of SVB and Signature banks. That process concluded in June – all bonds have now been sold - and this additional supply was absorbed by the market without any challenges.

On the demand side, mutual fund flows stabilized in June, with about $850 million in inflows coming in an alternating inflow/outflow weekly pattern. While only a lukewarm month of inflows, it is a sharp reversal of the prior 16 weeks of consistent outflows totaling $10.6 billion. The largest contributor to demand, however, was the large number of calls and maturities seeking reinvestment, thereby creating additional demand.

Municipal Bond Relative Value

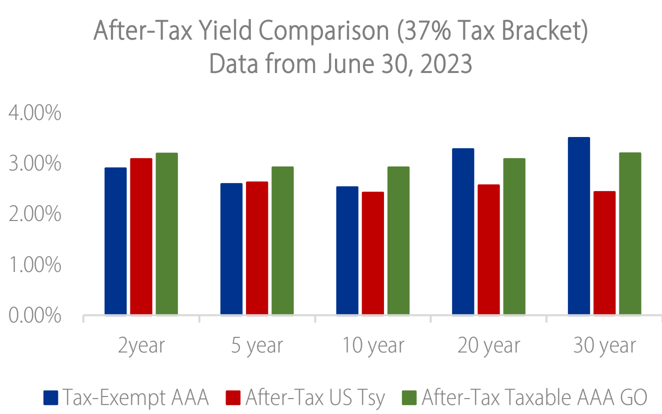
Municipal bond yields are quite high today. Surprisingly entrenched inflation has pushed yields sharply higher over the last 18 months. The result is that investors can earn higher yields than have been available in many years. There have only been a handful of opportunities over the last 15 years to buy municipal bonds at today's yields. The reason, of course, is that inflation eats away at some of that yield. However, if one is convinced that the Fed will succeed in returning inflation to more normal levels around 2%, then today's elevated yields can be viewed as an opportunity to buy bonds at temporarily elevated yields.

Municipal bond relative value is a more nuanced topic. The surging demand and meager supply have combined to push muni valuations to very high levels. The metric by which relative value is measured, municipal bond ratios, highlights how expensive municipals have become relative to taxable alternatives.



Source: Bloomberg and HilltopSecurities Asset Management

That's good news for holders of munis but should give prospective investors reason to pause and consider. In many cases, even the highest-bracket (37%) investors can benefit by buying something other than tax-exempt municipal bonds. The chart below provides a comparison of tax-exempt yields with the after tax yield on treasuries and taxable municipals. In the shortest maturities, both treasuries and taxable munis provide higher after-tax yields. In 5-10 years, treasuries are not as attractive, but taxable munis still provide more after-tax yield than tax-exempt munis. Beyond 20 years, traditional tax-exempt munis provide superior after-tax returns. The point of this exercise is that investors should not automatically assume that tax-exempt munis provide the most after-tax yield. In some market environments where supply and demand get out of sync, tax-exempt muni valuations can become so high that investors are compensated to look at other corners of the high-quality fixed income space.



Source: Bloomberg and Hilltop Securities Asset Management

Total Return Data

Returns on high quality taxable bonds were negative, including treasuries, agencies (not shown) and taxable munis. Credit spreads narrowed during the month in the investment grade and high yield sectors, propelling both Corp IG and Corp HY to positive monthly returns.

The supply and demand imbalances in the municipal bond market noted earlier created more favorable conditions for municipal returns – where all sectors produced positive returns. Similar to the risk-on sentiment prevailing in the taxable market, investors were rewarded for accepting more credit risk in munis. BBB and A-rated bonds outperformed AA and AAA-rated securities, and Muni HY was the best performer of the month.

Turning to YTD returns, the divergence in performance between taxable and tax-exempt markets seen in June has allowed the Bloomberg Muni Bond Index's YTD return to overtake the US Aggregate Index. Lower quality bonds have been the best performers at the halfway mark of the year – BBB-rated bonds in the investment grade arena and the two high yield sectors (Corp HY, and Muni HY). Other notable strong performers are taxable munis and Corp IG.

Index Returns (through June 30, 2023) *

	June	YTD	Yield
Municipal Market Indices			
Municipal Bond	1.00%	2.67%	3.52%
Managed Money	1.13%	2.79%	3.32%
+ Managed Money Short	0.63%	0.74%	2.92%
+ Managed Money Short-Intermediate	0.74%	1.12%	2.80%
+ Managed Money Intermediate	0.85%	1.87%	2.98%
Managed Money California	1.13%	2.84%	3.19%
+ Managed Money CA Short	0.65%	0.78%	2.82%
+ Managed Money CA Short-Intermediate	0.71%	1.22%	2.66%
+ Managed Money CA Intermediate	0.85%	1.82%	2.80%
Bloomberg Muni High Yield	1.77%	4.43%	5.71%
Taxable Market Indices			
US Aggregate	-0.36%	2.09%	4.81%
US Gov/Credit	-0.32%	2.21%	4.80%
US Treasury	-0.75%	1.59%	4.37%
US Corporate	0.41%	3.21%	5.48%
Taxable Muni	-0.21%	4.75%	5.06%
US Corporate High Yield	1.67%	5.38%	8.50%
LSTA Leveraged Loan Index	1.45%	1.95%	9.56%

Source: Bloomberg

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.

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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.

Bloomberg Managed Money Short 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 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.

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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.