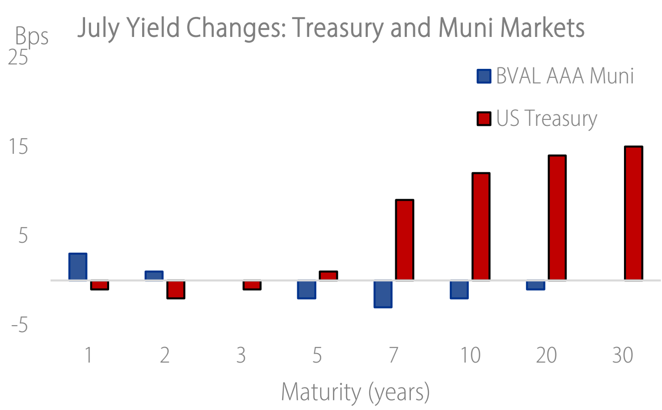
Chris Nicholl
HilltopSecurities Asset Management
Managing Director, Sr Portfolio Manager
214.953.4133 chris.nicholl@hilltopsecurities.com

August 3, 2023

Fixed Income Confronts "Higher for Longer"

For the second consecutive month, yields on treasuries and municipals moved in opposite directions. In the treasury market, investors seem to be confronting the Fed's often-stated-but-rarely-believed resolve to keep rates high for an extended period of time in order to extinguish excess inflation. The Fed raised rates at this month's FOMC meeting, but that was widely expected and caused no real market impact. What does seem to be gradually dawning on the market is that the Fed will not pivot and cut rates this year but will instead keep rates high until core inflation returns to the Fed's 2% target level. As a result, the short end of the treasury curve barely moved, but yields in maturities 7+ years moved higher – reflecting the expectation that fed funds will remain higher for longer than previously anticipated.

Munis, on the other hand, sang the same old tune this month of inadequate supply relative to demand. There was little change in muni yields despite the weak backdrop of rising treasury yields. The largest yield changes in the muni market were in 1 year (up 3 bps) and 7 years (down 3 bps).



Source: Bloomberg and HilltopSecurities Asset Management

Supply and Demand

July's new issue municipal volume was $25.9 billion versus $28.3 billion in July of last year. That 8% decline versus the same month last year is the smallest such decline this year. Year to date, supply is $206.8 billion, 16% below last year's pace. Tax-exempt issuance was down a more modest 4.4%. Taxable issuance, primarily tied to refunding activity and hampered by the higher rate environment, was down 12.8%.

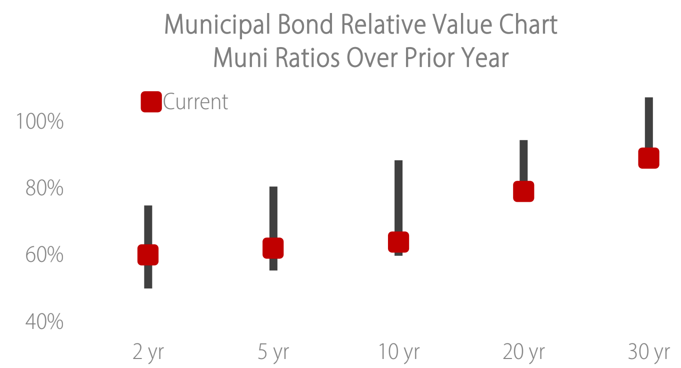
Texas continues to lead the pack in new issue volume. In July, Texas accounted for nearly 1/3 all new issuance, and issued more bonds than the second (California) and third (New York) leading issuers of municipal debt.

Mutual fund flows were variable during July. The first two weeks of the month saw combined outflows of almost $1 billion, which reversed in the final two weeks of July when funds took in over $1.5 billion. This marks the second month of relative stability after 16 consecutive weeks out outflows between mid-February and late May.

Municipal Bond Relative Value

Given the yield changes and supply/demand dynamics noted above, it should come as no surprise that municipal bonds outperformed their taxable counterparts again this month. For investors looking to put money to work in the market, this makes municipals slightly less attractive versus taxable alternatives.

The chart below of municipal bond ratios (muni bond yield divided by similar-maturity treasury bond yield) reveals the overbought conditions present in the muni market today.



Source: Bloomberg and HilltopSecurities Asset Management

From a practical perspective, investors can sometimes benefit by looking outside the tax-exempt market. For example, Texas Tech University came to market mid-month with two deals: one tax-exempt and one taxable. Both deals contained bonds with maturities between 2025 and 2029. Below is a table of yields for each maturity, showing the taxable yield, the after-tax yield assuming a 37% tax bracket, and the tax-exempt deal's yield. Investors could earn an additional 17-29 bps, depending upon maturity, simply by buying the taxable Texas Tech bonds instead of the traditional tax-exempt issue.

	Taxable	After-Tax	Tax-Exempt
2025	5.03%	3.17%	3.00%
2026	4.84%	3.05%	2.81%
2027	4.64%	2.92%	2.71%
2028	4.64%	2.92%	2.65%
2029	4.73%	2.98%	2.69%

Source: Bloomberg and HilltopSecurities Asset Management

We believe this is an underappreciated element in today's market. So many high tax bracket investors are conditioned to believe that the tax-exempt market provides the highest after-tax yields, that they fail to make the necessary comparisons. Of course, there are other reasons for these discrepancies as well. Not all investors are able to cross over to taxable alternatives. Mutual funds, for example, are generally hesitant to surprise their shareholders with taxable income, and therefore stick almost exclusively to tax-exempt securities as per their guidelines. But for investors willing to take the time to make the comparison and buy taxable bonds, there are opportunities for "free extra yield" by adopting this strategy.

It's important to highlight that the efficacy of this trade depends upon the maturity chosen. When this opportunity is present, it's usually isolated to shorter maturities stretching out no more than 5-7 years. For investors looking further out the curve, tax-exempt bonds remain the most effective means of maximizing after-tax yield.

Total Return Data

The overall taxable investment grade market (US Aggregate) delivered a slight negative return of -0.07% in July. Nearly all sectors contributed to negative performance: treasuries (-0.35%), MBS (not shown in table -0.07%) and taxable munis (-0.45%). Corporate bonds (+0.34%) were the sole positive-return taxable investment grade sector. Corporate High Yield turned in another solid month (1.38%) and has an eye-popping 6.8% year to date.

The municipal market fared much better. The overall Muni Bond index returned 0.40% in July, and every sector, maturity, rating bucket breakdown was positive.

From a maturity perspective, the strongest performance came in 10-20 year maturities, returning around 0.5%. The weakest returns were on the front end of the curve inside 4 years, with returns around 0.2%.

By rating, lower quality outperformed higher quality. BBB-rated bonds returned 0.85% this month while AAA-rated munis eked out only a 0.16% return. This dynamic extended to the Muni High Yield index as well, delivering a 0.65% return on the month. Much like the taxable market, high yield has tallied the strongest year to date returns – delivering 5.11% thus far.

Turning to sector, revenue bonds delivered better returns than general obligation debt. This is most likely due to the supply drought, which has particularly hampered the issuance of revenue debt. Year to date general obligation debt issuance is actually up 2%, whereas revenue bond debt is off 26%. This constriction in supply is likely the cause of revenue bond performance exceeding general obligation returns by over 100 bps.

Index Returns (through July 31, 2023) *

	July	YTD	Yield
Municipal Market Indices			
Municipal Bond	0.40%	3.08%	3.50%
Managed Money	0.28%	3.08%	3.32%
+ Managed Money Short	0.21%	0.95%	2.92%
+ Managed Money Short-Intermediate	0.29%	1.41%	2.78%
+ Managed Money Intermediate	0.34%	2.22%	2.97%
Managed Money California	0.39%	3.24%	3.16%
+ Managed Money CA Short	0.24%	1.03%	2.81%
+ Managed Money CA Short-Intermediate	0.36%	1.58%	2.63%
+ Managed Money CA Intermediate	0.43%	2.26%	2.77%
Bloomberg Muni High Yield	0.65%	5.11%	5.70%
Taxable Market Indices			
US Aggregate	-0.07%	2.02%	4.85%
US Gov/Credit	-0.08%	2.13%	4.83%
US Treasury	-0.35%	1.23%	4.43%
US Corporate	0.34%	3.56%	5.45%
Taxable Muni	-0.45%	4.29%	5.14%
US Corporate High Yield	1.38%	6.83%	8.30%
LSTA Leveraged Loan Index	0.63%	2.59%	9.58%

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.

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.

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.

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