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Muni MOment

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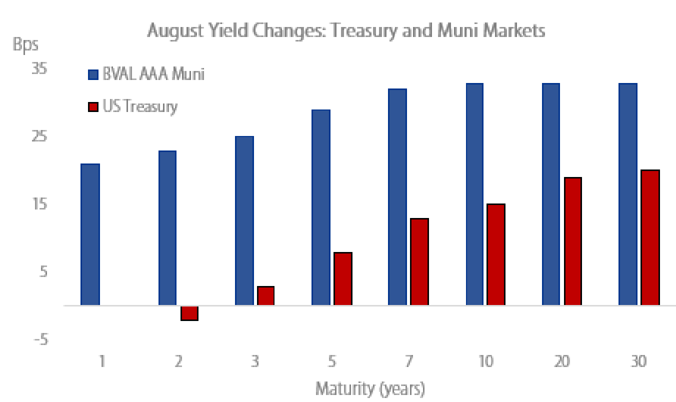
A Steepening Yield Curve Across Fixed Income Markets

Treasuries experienced another curve-steepening in August similar to what took place in July. Yields on longer-dated bonds moved up 15-20 bps, while yields on shorter-maturity bonds were little changed. This makes some sense, as it's widely anticipated that the Fed will hold rates steady at their upcoming September meeting. In fact, as inflation continues to improve (albeit very slowly) and economic releases show evidence of a cooling labor market (one even hears the phrase "rapidly cooling labor market" more frequently now), fixed income investors are now wrestling with the question of whether we've reached the terminal fed funds rate. The fed funds futures market is currently forecasting that the Fed is done (technically, it is showing a 39% probability of one more hike) and that the Fed will begin cutting rates in the spring of 2024. On the other hand, it was not too long ago that the same fed funds futures market was forecasting rate cuts *this* year. As Warren Buffett says: "Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future."

The municipal market experienced a very different type of month. The muni curve also steepened but – in contrast to treasuries – the entire yield curve shifted upwards. Short yields moved higher by 20-25 bps and the long end saw yields jump by 30-35 bps.

There are a few reasons for this, including a bounce back from the high valuations of munis over the last several months, mutual fund outflows, and a shift in so-called net supply as we move out of the summer into the fall.



Source: Bloomberg and HilltopSecurities Asset Management

Supply and Demand

Supply during August totaled $36.5 billion, a decrease of 13% from August of 2022. Viewed through a different lens, however, August's supply represents an increase of more than $10 billion from last month's $25.9 billion.

As has been the case all year, the issuance of taxable municipals has been hardest hit as refunding activity has slowed to a trickle – consequently, taxable issuance fell by 66% from last August. The picture is a bit brighter on the tax-exempt side, however, where issuance for the month increased 8% from last year. This increased issuance has helped alleviate the structural imbalance between supply and demand.

Once again, the booming population shift into Texas helped propel issuance within the state. According to the Bond Buyer, Texas has been the largest issuer of bonds year to date. This has been a fairly dramatic shift. Historically, California and New York (in that order) have been the dominant issuers of municipal debt, with Texas coming in third. But migration to the Lone Star State has opened up a need for infrastructure that has created a boom in issuance.

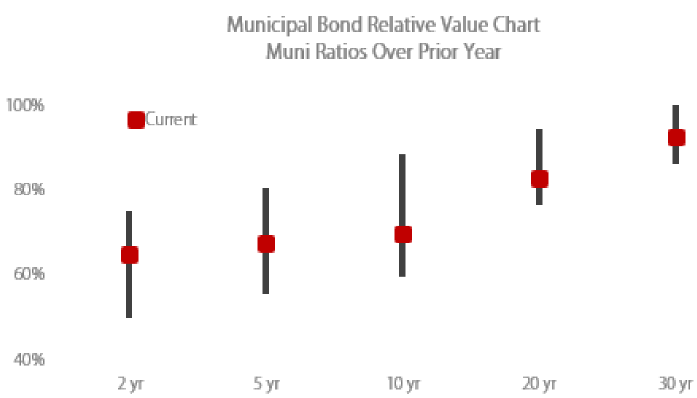
Mutual funds experienced about $1.1 billion of outflows during the month, according to Lipper. This marks a subtle shift from the last couple of months where net flows were mixed but more muted.

Municipal Bond Relative Value

The combination of mutual fund outflows and higher issuance of tax-exempt debt have helped alleviate the extreme disequilibrium in the supply and demand dynamic. There's one additional element - a more forward-looking metric – that impacts market valuations as well: net supply. Net supply is defined as expected issuance minus maturities, with the view that maturities of munis will naturally gravitate towards reinvestment within the market and thereby create increased demand.

During the summer, net supply was consistently negative; that is, there were more maturity proceeds (presumably looking to reinvest) than issuance – creating an overbought dynamic to the market. As we move into fall, that dynamic is changing. According to JP Morgan, net supply for September and October is expected to be $12 billion, marking a strong reversal and a return to more normal conditions.

All of these factors have impacted municipal bonds' relative value, as shown on the chart below. The current level (red box) has increased within each maturity bucket. Readers of this piece from last month might recall that most of those red boxes were at or near the bottom of the range at the end of July. This translates to a muni market that looks more attractive to investors who have money to put to work. In past months, we have looked to the taxable market rather than tax-exempts in order to boost after-tax yield. While this is still true in some cases, the change in relative valuation has made tax-exempt munis more attractive, in our opinion. Treasuries no longer provide higher after-tax yields than tax-exempt munis, although taxable munis – where they can be found – often still do. Investors, even those in the maximum tax bracket. should consider their options in both the taxable and tax-exempt markets.



Source: Bloomberg and HilltopSecurities Asset Management

Total Return Data

The broadest measure of the domestic taxable investment grade market – the US Aggregate Index – posted a -0.64% return for the month. All components of that index – treasuries, corporates, mortgaged backed and asset backed securities, and taxable municipals – were negative in August. The only taxable sectors that delivered positive results were the high yield sectors of corporate high yield and leveraged loans.

Corporate bond spreads – an interesting barometer even for muni-focused investors to follow – continue to reveal an investor base that seems unconcerned about recession risk in the near future. Year to date, high yield spreads are down 89 bps (to 3.70%) and corporate investment grade spreads have declined 14 bps (to 1.17%).

Municipal bonds were harder hit in August than their taxable counterparts. The overall municipal bond index posted a -1.44% return. Longer maturity munis fared the worst, a natural consequence of the steepening yield curve discussed earlier. The longest traches (17-22 years and 22+ years) posted returns that were down more than 2%. Shorter munis held in considerably better, with 2-4 year bonds down only -0.27%.

There seemed to be little distinction across credit quality buckets. BBB-rated bonds fared the worst (-1.79%) but everything else from AAA all the way down to high yield munis fell in a reasonably tight range.

One of the interesting elements of Texas' transition to the market's leading issuance state is the impact on returns. California and New York, with their high state tax rates, have a built-in natural appetite for their bonds. Texas does not, since state residents can buy bonds from any state without impacting their after-tax returns. As a result, the increase in Texas issuance has caused Texas bonds to lag some of the high-tax states. The YTD return on Texas bonds is 0.81% versus California's 1.67%, New York's 2.00% and New Jersey's 2.83%. On a more forward-looking basis, what this means is that the yield on Texas bonds has not fallen as quickly as the yield on high-tax states' bonds – which means Texas bonds represent better relative value at the moment.

Index Returns (through August 31, 2023) *

	August	YTD	Yield
Municipal Market Indices			
Municipal Bond	-1.44%	1.59%	3.79%
Managed Money	-1.95%	1.06%	3.62%
+ Managed Money Short	-0.35%	0.60%	3.12%
+ Managed Money Short-Intermediate	-1.06%	0.34%	3.06%
+ Managed Money Intermediate	-1.48%	0.70%	3.28%
Managed Money California	-1.59%	1.60%	3.41%
+ Managed Money CA Short	-0.24%	0.78%	2.96%
+ Managed Money CA Short-Intermediate	-0.91%	0.66%	2.86%
+ Managed Money CA Intermediate	-1.20%	1.03%	3.03%
Bloomberg Muni High Yield	-1.52%	3.52%	5.87%
Taxable Market Indices			
US Aggregate	-0.64%	1.37%	4.97%
US Gov/Credit	-0.59%	1.53%	4.93%
US Treasury	-0.52%	0.70%	4.51%
US Corporate	-0.78%	2.76%	5.61%
Taxable Muni	-0.40%	3.87%	5.23%
US Corporate High Yield	0.28%	7.13%	8.41%
LSTA Leveraged Loan Index	0.56%	3.16%	9.53%

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.