U.S. Municipal Bond Market

President Signs Stopgap Funding Bill, Municipals are a Fitting Option Considering a Wide Range of Economic Outcomes

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- President Joe Biden signed a stopgap funding bill keeping the federal government open until January 19 and February 2, 2024.
- Potential for a shutdown next year is low, actions are setting the stage for a potentially impactful 2024 election season on the financial markets and public finance.
- Urgency to invest in municipals is growing because institutional interest and activity is currently strong.
- Tax-exempt municipal yields remain generationally attractive even though they have retreated.
- While the odds of a recession are dropping, we still believe state and local governments have never been this fiscally prepared for an economic contraction if one should appear.

Federal Government Funding Extended Into Jan. & Feb., 2024

President Joe Biden signed a stopgap funding bill that will keep the federal government open until January 19 and February 2, 2024, yesterday. Polling results are sending lawmakers a clear message on this issue. There is no upside for lawmakers to shut down the government. This is especially true in an election year. Most Americans, or three out of four, "say it is not acceptable for members of Congress to threaten a government shutdown during budget negotiations to achieve their goals," according to a Marist National Poll. 49% of those surveyed would have blamed Congressional Republicans for a shutdown and 43% would have blamed President Biden and Congressional Democrats, according to the same poll.

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The real political story here is House Democrats again were the catalyst that moved the funding legislation forward. Just like they did in September. Tuesday's vote in the House was 336-95. But, more Democrats voted in favor of the continuing resolution than Republicans. The House vote looked like this:

Republicans (in the House)
Yes: 127, No: 93
Democrats (in the House)
Yes: 209, No: 2

This was an informative result and a telling process that could factor into how Congress continues to operate in the new year. Almost everything that happens going forward in D.C. is setting the stage for the 2024 elections, which could very well have the most profound impact on public finance since the Democrats won the Georgia run-off elections in 2021. In some scenarios the impact could be even more profound. The macro-economic impact of a federal shutdown would have been rather minimal, but

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prospects for a shutdown to emerge next year are now very low. Actions by Congress in recent months show that bipartisan cooperation is possible, even if it is not necessarily a strategic collaboration.

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Wider Range of Economic Outcomes Possible

Economic data this week was very "soft-landing" friendly. Tuesday's Consumer Price Index result argued that inflation was not reaccelerating. Producer Price Index and retail sales results were mixed on Wednesday. Several other economic releases on Thursday argued for a softer finish for the year, one that has reinforced the idea that the Federal Reserve has likely concluded its rate hikes. Fixed income and municipal yields continued to fall this week.

The 10-year tax-exempt municipal benchmark (MMD) fell 15 basis points to 3.05% on Thursday compared to Monday. And 30-year tax-exempt municipal benchmark (MMD) fell 13 basis points to 4.09% on Thursday also compared to Monday. The tax-exempt Bloomberg U.S. Municipal Bond Index has plummeted 55 basis points to 3.95% since its 2023 peak on October 30th of 4.50%. This week it slid 16 basis points to the above mentioned 3.95% from a 4.11%.

The data results we are seeing point to a wider variety of potential macro-economic scenarios. There is a reduced likelihood of more Fed rate hikes in the near term now, and some believe the Fed may begin to cut rates starting as early as the beginning to middle of 2024. In some cases strategists are forecasting substantial rate decreases to materialize in 2024. Our base case, as we noted in our issuance forecast analysis, is the Moody's Analytics "Slower Growth Scenario" where economic growth slows and interest rates only slightly tick lower in 2024.

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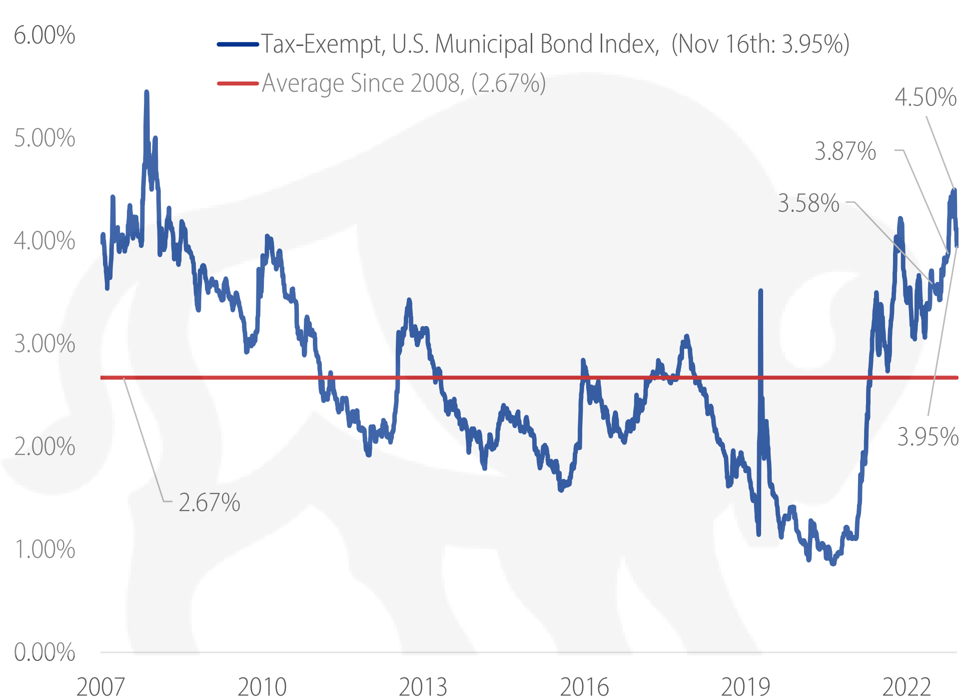
Municipal Yields are Falling, Yet Still Attractive



Source: Bloomberg and HilltopSecurities.

We are not ready to call an interest rate peak, nor do we need to because our approach to fixed income generally and municipal bonds specifically has not changed despite the volatility. We continue to think these generationally attractive tax-exempt municipal yields are very good options for investors.

Although municipal fund flows have been negative for the last 11 straight weeks, we believe investor sentiment could begin to improve now that more observers and strategists believe the Fed could be content. If that is the case then we should reiterate that our expectation for primary market supply in 2024 dropped year-over-year, and attractive tax-exemption municipal bonds could be more scarce in the coming year than in 2023. We are already seeing an increased level of institutional interest in municipal bond compared to the beginning and the end of the summer. If investors wait too long they could be waiting in the cold, wishing they would have acted sooner. We do not want that to happen to our readers, we know that many investors have already felt duped by the fixed-income market going back to the beginning of 2022.

In summary, we believe tax-exempt municipal yields remain generationally attractive even though they have retreated. While the odds of a recession are dropping, we still believe that state and local governments have never been this fiscally prepared for an economic contraction if one should appear.

Recent HilltopSecurities Municipal Commentary

- We Predict $330 Billion of Municipal Bond Issuance for 2024, the Lowest Since 2018, Nov. 8, 2023
- State and Local Credit is Incredibly Resilient, and We Expect Only a Very Limited Credit Impact from Commercial Real Estate Weakness, Nov. 2, 2023
- U.S. State Fiscal Health: State Reserves Remain Near Record Levels, State and Local Employment Still Rising, Oct. 19, 2023
- Municipal Yields Remain Generationally Enticing Amongst the Latest Flight to Quality, Future Attractive Investment Opportunities May Occur But Will Be Less Frequent, Oct. 11, 2023

Readers may view all of the HilltopSecurities Municipal Commentary here.