

## U.S. Municipal Bond Market

# Fed Shifts Outlook, Municipal Yields Dropping, Yet Still Relatively Attractive

- The big picture here is that the Fed is shifting its outlook and messaging toward lower rates.
- The market dynamic was ahead of the Fed, but municipal yields are still relatively attractive.
- Investor sentiment has not turned positive yet, but when it does fund flows are likely to steadily build and make it even more difficult to find bonds.

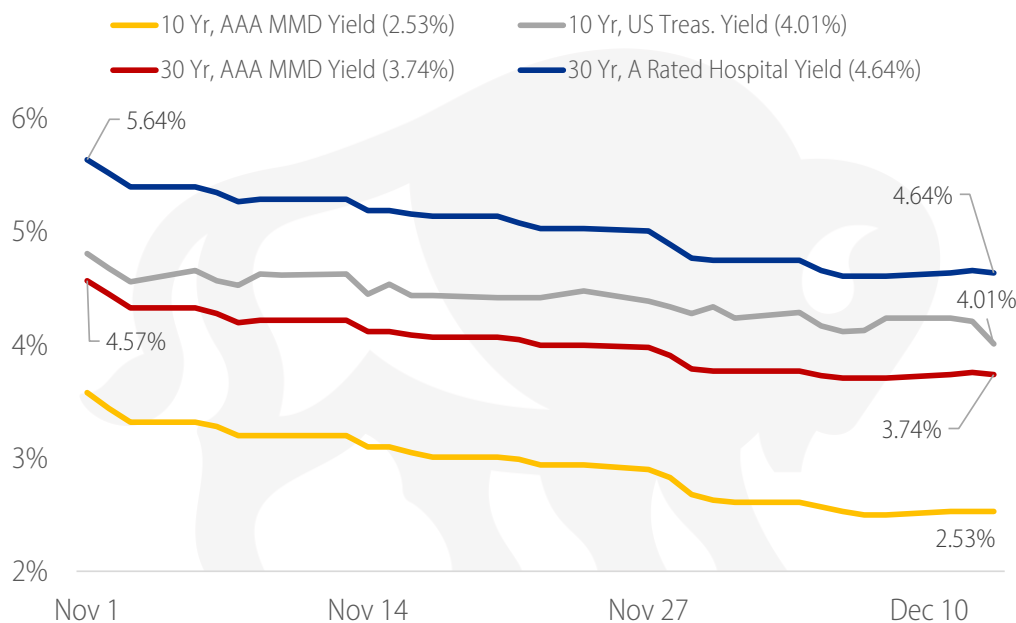
Tom Kozlik  
Head of Public Policy and  
Municipal Strategy  
214.859.9439  
tom.kozlik@hilltopsecurities.com

## The Market Dynamic Was Ahead of the Fed, Reinforced by Yesterday's Shift

The U.S. Federal Reserve kept its benchmark target rate steady in a range of 5.25% to 5.50% for a third straight time yesterday. Agreeable [inflation indicators](#) are encouraging the U.S. Fed to potentially end its aggressive interest rate hiking campaign, however. The Fed did not rule out future rate hikes, but yesterday's dot plot foresees cuts in 2024. Please see Scott McIntyre and Greg Warner's review of the market reaction to yesterday's Fed announcement and The Fed Chair's press conference in [Markets Roar as the Fed Teases Rate Cuts](#) (Dec. 13) and today's analysis [Bond Rally Continues, Despite Resilient Economic Data](#) (Dec. 14). The 10-year U.S. Treasury yield fell 20 basis points yesterday and while AAA municipal yields did not react similarly as of the close of Wednesday municipal benchmark yields are often slower to adjust to market news. The big picture here is that the Fed is shifting its outlook and messaging toward lower rates. The market is probably a month and a half ahead of the Fed as you can see in the line chart, but the implication is that the official pivot lower is likely to begin in 2024.

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## Market Yields Began Falling in November, Fed Confirms 2024 Outlook



Source: Refinitiv and HilltopSecurities.

Please see disclosure starting on page 3.

## The Municipal Market Opportunity Overview Remains, Window Could Be Closing

We have regularly searched for ways to describe the attractive status of municipal yields especially since the beginning of the summer. Examples we have communicated to investors include:

- Historically attractive (June 8, 2023)
- Appealing, most attractive levels of the year (Sept. 19, 2023)
- Remain generationally enticing (Oct. 11, 2023)

The Fed is seemingly shifting its outlook. Taxable and tax-exempt yields have dropped since the beginning of November and municipal yields are less appealing compared to where they began the third quarter, but they are still relatively attractive. And, if November is in fact the peak for yields of this cycle, then investors should take notice. Future attractive investment opportunities may be less frequent as we highlighted in October.

## Investor Sentiment Overview

Another \$144 million flowed out of municipal mutual funds per a Dec. 7 Lipper release. This was the second straight week of municipal outflows. Investor sentiment has not officially turned positive yet as we have seen outflows in 13 of the last 14 weeks. However, the magnitude of available bonds in the secondary market has been less robust than in the first ten months of the year. This, and the fact that the Fed is beginning to shift its outlook could mean more investors will try to get ahead of the officially Fed pivot.

Once the rush for bonds starts, we expect that investment dollars will quickly flow back into municipal mutual funds. Investor sentiment has been very negative in 2022 and 2023, but we foresee a dynamic in 2024 where demand could return to the positive more levels we saw in 2019, 2020 and 2021. In those years it was more difficult to find bonds, and overall primary issuance is not likely going to help satisfy an increase in investor demand when it in fact increases.

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