U.S. Municipal Bond Market

Municipal Bond Investor Playbook for Rest of the First Quarter, 2024

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- This is what we like about municipal bonds in Feb. 2024. We like the better-than-expected macroeconomic backdrop to begin 2024. Municipal yields remain appealing. Credit is normalizing, making an argument for individual credit analysis to distinguish between the stable and improving situations and all the others. This normalizing process is why you may be reading headlines about budget shortfalls and revenues missing expectations.
- The way that we are reading what has occurred in recent weeks is that the FOMC's moves higher are likely complete. The path downward is coming, but the timing of the downward trajectory is less certain.
- Municipal bond yields have dropped from their October 2023 summit, but yields are not only high relative to where they were to end 2021, they are still generationally attractive.
- Investors deposited $1.5 billion for the week ending Wed. Jan. 31st into municipal bond mutual funds per Lipper data. This was the fourth consecutive week of positive flows into municipal mutual funds to begin 2024.

Outlook for Interest Rates & Municipal Bond Yields

Themes that could potentially drive investor behavior such as geo-political chaos, happenings in the halls of Washington D.C., events on the 2024 campaign trail, and technology industry growth have all been trumped by what the U.S. Federal Reserve may or may not do on March 20, May 1, June 12 and July 31. If there is any subject driving

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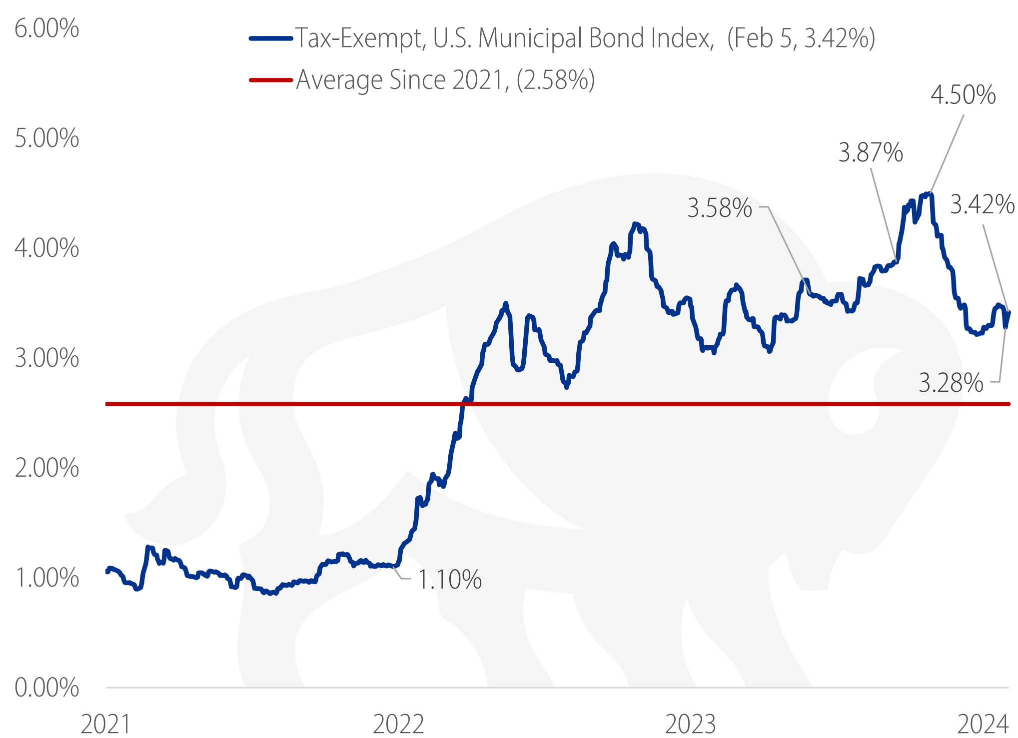
Municipal Yields Dropped, but Remain Generationally Attractive in Feb. 2024



Source: Bloomberg and HilltopSecurities.

how investors are approaching financial markets in 2024 it is still the path of the U.S. Federal Reserve's Federal Open Market Committee (FOMC). On Jan. 31 the FOMC held their target rate steady for a fourth straight meeting at 5.25%-5.50%. Important changes to the FOMC's language symbolized the shift in the FOMC's thinking, even though the target rate remained the same. See more in Fed Holds Rate Steady, Sees Risks Moving into Better Balance (Jan. 31), for more.

The key message from Chair Powell was that a March 20 rate cut was unlikely.

In the beginning of February yields have largely risen. The move higher first occurred after a higher-than-expected Nonfarm payroll report (Feb. 2) and then the ISM Services Index for January rose above its forecast as well (Feb. 5). During an interview on 60 Minutes (Sunday Feb. 4) Fed Chair Jerome Powell mostly reiterated the messages delivered on Jan. 31. The key message from Chair Powell was that a March 20 rate cut was unlikely. During prepared comments on Feb. 6 Fed Reserve Bank of Cleveland President Loretta Mester shared a view similar to Chair Powell when she shared, "If the economy evolves as expected, I think we will gain that confidence later this year, and then we can begin moving rates down." In all, the way that we are reading what has occurred in recent weeks is that the Fed's moves higher are likely complete. The path downward is coming, but timing of the downward trajectory is less certain.

Municipal bond yields have dropped from their October 2023 summit, but yields are not only high relative to where they were to end 2021, they are still generationally attractive. We think it is important investors remained disciplined in the midst of the market and interest rate uncertainty. Timing the market will be difficult with the current level of uncertainty, therefore we continue to expect that it makes sense to allocate investment dollars on a regular, ongoing basis to take advantage of market moves. It is important we acknowledge that traditional measures of relative value are less appealing right now. However, absolute yields and tax-exempt yields here remain highly attractive. Waiting for the market to move further or provide more clarity could work against an investing strategy now, and in coming months.

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Municipal Credit Selection Will Be Increasingly More Important in 2024 and Beyond

There was a temporary upswing in municipal bond market credit quality that began in March of 2021, and now three years later we are seeing that upswing normalize. We lowered our State Government sector outlook to "Stable" from "Positive" in 2023, and this year we lowered our Local Government and School District sector outlooks to "Stable" from "Positive" as well. We are not expecting credit deterioration in those sectors, but the credit normalization process is going to become stronger as entities will need to better balance revenues with expenditure demand. By-and-large we still see more reasons to like public finance credit quality going into 2024 even though credit selection is becoming increasingly important. Please also see The Municipal Market in 2024, Hilltop's Municipal Sector Credit Outlooks (Jan. 22) for more about the HilltopSecurities Municipal Sector Credit Outlooks.

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HilltopSecurities Municipal Sector Credit Outlooks

Sector	HilltopSecurities Sector Outlook	Jan. 2024 HTS Action(s)
State Government	Stable	None
Local Government	Stable	Lowered to Stable
School Districts	Stable	Lowered to Stable
Community Facilities Districts	Stable	None
Airports	Stable	None
Charter Schools	Stable	None
Health Care	Negative	None
Higher Education	Private: Cautious Public: Cautious	Raised Private to Cautious
Housing	Stable	None
Public Power (Elec.)	Stable	None
Senior Living	Cautious	Raised to Cautious
Tobacco	Negative	None
Toll Facilities	Stable	None
Water & Sewer	Stable	None

Source: HilltopSecurities.

This year we expect municipal issuance to rise to a level not seen since 2021 ($483 billion.)

The Municipal Bond Supply and Demand Dynamic, 2024

This year we expect municipal issuance to rise to a level not seen since 2021 ($483 billion.) We revised our 2024 forecast to $420 billion, up from $330 billion on Jan. 26 because of the improving macroeconomic backdrop, please see An Improved Macroeconomic Backdrop Compels Us to Raise Our 2024 Issuance Forecast to $420 billion. Public finance entities sold $30 billion worth of debt in the month of January, just above the 10-year average of $27 billion and also well above last year's $24 billion.

January's $30 billion was absorbed by investors fairly easily, meaning that demand met the above average level of supply brought by issuers. It remains yet to be seen if the month-to-month supply and demand dynamic will prove to evolve this easily for the rest of the year. We are projecting issuance to come in at about $35 billion a month, which is just about the 10-year monthly average of $34 billion of month. If demand remains this level of issuance should continue to be absorbed with minimal problems.

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A Rotation Back Into Fixed Income?

Many investors have decided to park their investment dollars on the sideline, and or in short term investments since the Federal Reserve began raising its target rate. This is a dynamic we are paying very close attention to because investment dollars in money market funds hit over the $6 trillion mark back at the end of 2023. We expect that now the Fed is starting to signal that a lower, and not a higher target rate is likely, that investment dollars could start to pour back into fixed income markets, like the U.S. municipal bond market. This is a dynamic that could upset the current municipal bond supply and demand dynamic. If it is possible that a larger than usual level of investment dollars could be looking for a home in the tax-exempt market all at once, this could be an argument for allocating to municipals before such a larger move occurs.

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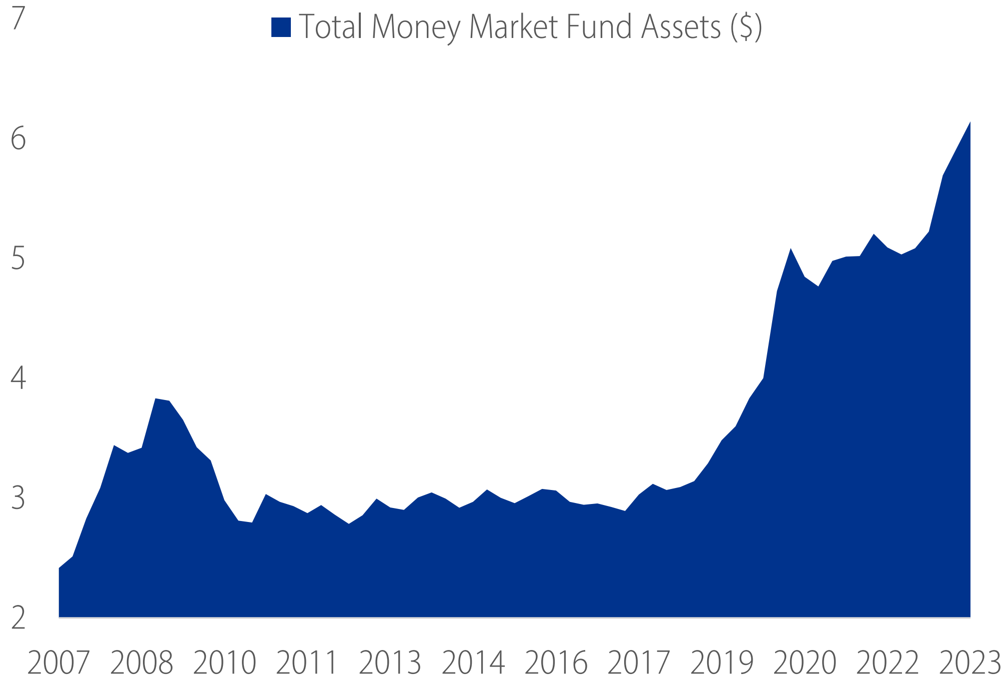
Money Market Investments Topped $6 Trillion

Interest is rising in fixed income and the rotation back into institutional funds is picking up steam.



Source: U.S. Federal Reserve and HilltopSecurities. $ in trillions.

We are Seeing Investment Dollars Flow Into Municipal Mutual Funds

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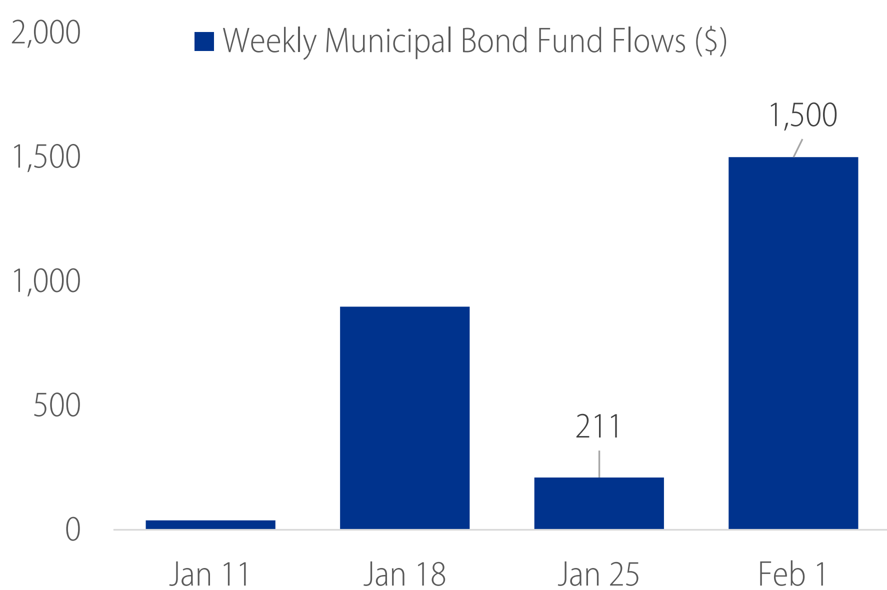
Interest is rising in fixed income and the rotation back into institutional funds is picking up steam. Investors deposited $1.5 billion for the week ending Wednesday, Jan. 31 into municipal bond mutual funds per data released by Lipper on Thursday Feb. 1. This was the fourth consecutive week of positive flows into municipal funds to begin 2024. This action is being fueled by the attractive absolute yields (still generationally attractive as noted above), status of the Fed, and the better than expect economic backdrop to begin the year. We are not quite ready to call this a massive, or great rotation back into municipal bonds yet.

Investment Dollars Have Flowed Into Municipal Bond Funds in 2024



Source: Lipper and HilltopSecurities, $ in millions.

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This very well could be a seasonal trend. We saw similar numbers in January of 2023. However, the likelihood that rates are lower, and not higher in six or twelve months from now helps to make a strong argument for investors to act now and not wait. It makes sense for investors to continue to stay ahead, rather than behind where the Fed's actions and resulting interest rates could end up being at this point in the cycle.

Recent HilltopSecurities Municipal Commentary

- Chinese Cyberthreat to U.S. Infrastructure Highlighted by FBI, CISA, Others Today, Jan. 31, 2024
- An Improved Macroeconomic Backdrop Compels Us to Raise Our 2024 Issuance Forecast to $420 billion, Jan. 26, 2024
- The Municipal Market in 2024, Hilltop's Municipal Sector Credit Outlooks, Jan. 22, 2024
- Fed Shifts Outlook, Municipal Yields Dropping, Yet Still Relatively Attractive, Dec. 14, 2023

Readers may view all of the HilltopSecurities Municipal Commentary here.