

U.S. Municipal Bond Market

The Golden Age of Municipal Bonds is Not Over

- The Golden Age of municipal bonds or public finance is still not complete. However, yields will not always be this appealing and credit will not always be this robust.
- It is important investors take advantage of the still generationally attractive yields and strong credit quality we see in the tax-exempt municipal market now.
- Moody’s Public Finance upgrades came in at an almost record number in 2023. This illustrates how strong public finance credit quality is right now, still.
- There are sectors to monitor. Digging into the data we see that downgrades outpaced upgrades in the healthcare and higher education sectors.
- Municipal supply continues to come in heavier than in 2023 and flows into municipal mutual funds have been more positive than last year so far.
- Lawmakers avoided a partial federal government shutdown after passing a spending package that fully funds the federal government through September 2024.

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Credit Quality Remains Very Strong and Tax-Exempt Yields Appealing

We began writing about the Golden Age of Public Finance back in March of 2021 when D.C. fiscal policy supercharged municipal credit quality. Since then, interest rates soared to levels we could not have guessed would appear so quickly, and still now municipal bond credit quality is largely among the strongest it has ever been. Investors should expect the interest rate trajectory to trend lower, not higher, by the end of the year- and perhaps into 2025. Therefore, it is important investors take advantage of the still generationally attractive yields and strong credit quality we see in the tax-exempt municipal market now.

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Navigate Market Influences

If you are not overwhelmed with potential market influences right now then you are not paying attention. If it seems like there is an overload of factors investors are required to navigate, that is because there is a lot going on.

2024 FOMC Meeting Calendar

| Meeting Dates | Results | Hilltop Economic Analysis |
|---------------|-----------------------------|---|
| Jan 30-31 | Unchanged 5.25% to 5.50% | <u>Fed Holds Rate Steady, Sees Risks Moving into Better Balance</u> |
| Mar 19-20 | Unchanged 5.25% to 5.50% | <u>Markets Rally on Fed Confidence</u> |
| Apr/May 30-1 | To come | To come |
| June 11-12 | To come | To come |
| July 30-31 | To come | To come |
| Sept 17-18 | To come | To come |
| Nov 6-7 | To come | To come |
| Dec 17-18 | To come | To come |

Source: U.S. Federal Reserve and HilltopSecurities.

Please see disclosure starting on page 4.

Concern about the potential for investment bubbles is growing across different industries and investment sectors. There are major regional wars going on in Eastern Europe and the Middle East. Immigration policy is starting to cost major American cities in the North and Midwest important revenue, and local leaders are requesting federal help. Costs of adjusting climate related expenses are growing and are likely to climb in coming years. The Report Card for U.S. Infrastructure remains challenged with only an overall "C-" grade. Commercial real estate weakness throughout the U.S. is likely to continue. Foreign entities have targeted and are likely to continue to target U.S. infrastructure assets with havoc-based cyber-attacks. Artificial intelligence specifically and technology generally continues to advance at a break-neck pace. And one of the more important U.S. elections of not only the last century, but perhaps since 1860 is only about eight months away.

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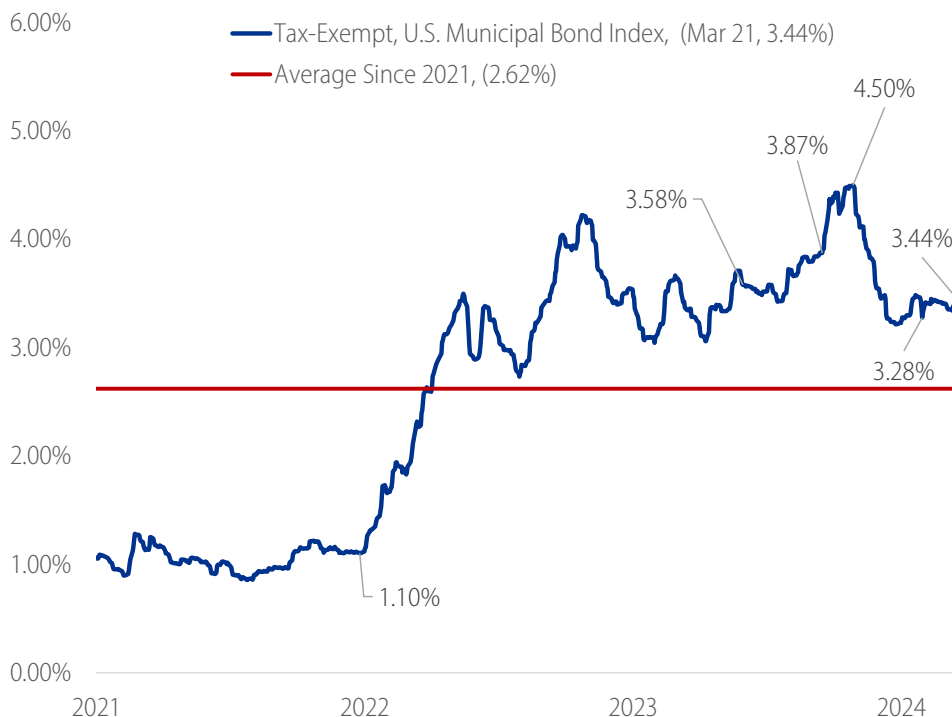
FOMC Policy Remains Most Important to Investors

But still, the number one issue for many investors since the beginning of 2022 has been and continues to be monetary policy. Specifically at issue has been the potential action, or inaction of the U.S. Federal Open Market Committee (FOMC). The FOMC announced Wednesday (March 20) their target rate would remain unchanged at 5.25% to 5.50%. this was the fifth meeting in a row the overnight funds target remained unchanged. For more on the FOMC please see [Markets Rally on Fed Confidence](#) (March 20, 2024) by Hilltop's Scott McIntyre and Greg Warner.

Tax-exempt municipal yields remain in a similar interest rate environment now, compared to what we have seen since the beginning of 2024. The Bloomberg Municipal Bond Index was 3.44% as of Thursday March 21. This is still also very close to the 3.58% (June 2, 2023), we observed back at the beginning of the summer of 2023 when we

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Appealing Absolute Municipal Yields Continue to Impress



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first began to indicate yields were generationally attractive. Yields have come down since November of 2023, but they are still appealing. We still believe investors should be regularly dollar cost averaging at these levels. We do not think it is advisable to wait for additional interest rate certainty, nor should investors wait for more attractive ratios.

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The Current Municipal Bond Supply and Demand Dynamic

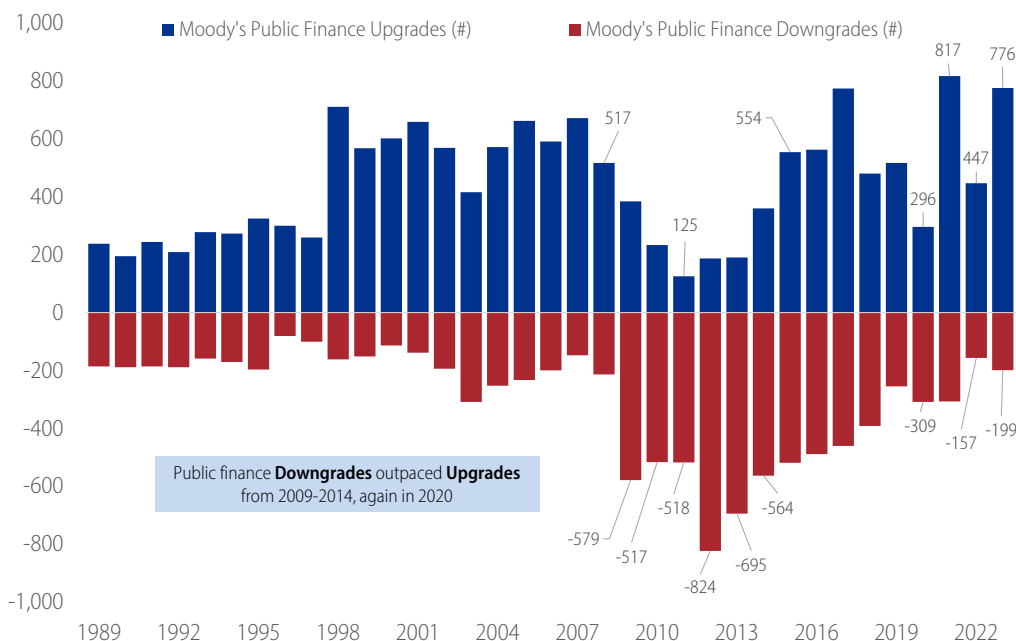
For municipal investors, a key market dynamic to pay attention to, and perhaps get out in front of, is the fact that individual and institutional investment dollars remain on the sideline but could quickly return. Many asset allocators are waiting for more certainty or a stronger signal from the FOMC, and other investors. Problem is that after more certainty arrives investment dollars will very quickly flow into municipal funds, crowding out investors who are late to the trend. Investment dollars already are starting to flow into municipal mutual funds per Lipper data reported since the end of February. Municipal investor sentiment seems to be slowly but steadily improving. We saw \$1.3 billion flow into municipal funds in total during the periods ending Feb. 29, March 7, March 14, and March 21. Again, keep in mind this \$1.3 billion was the total over those four weeks. The positive direction of fund flows is an argument for investors to consider municipal bonds, and the fact that flows are still just barely positive is a sign that investors have not missed the opportunity.

Almost Record Upgrades Reinforces Public Finance Credit Quality & The Golden Age

U.S. municipal bond market credit quality remains very strong. We illustrate this strength by the fact that Moody's public finance upgrades vastly outpaced downgrades in all of 2023. There were 776 rating upgrades and 199 downgrades last year. The only other year we observed more upgrades was in 2021, which is the same year the 2021 Rescue Plan Act was passed.

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The Second Highest Number of Public Finance Upgrades Ever, in 2023



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Source: Moody's and HilltopSecurities.

We continue to expect to see the credit normalization process plays out over coming budget cycles, as we wrote about in our [2024 municipal credit sector outlook report](#). In addition, it is also important to consider our individual sector outlooks and the themes driving those individual sectors. Digging deeper into the Moody's public finance upgrade and downgrade data by sector for example we see that downgrades outpaced upgrades in the healthcare and higher education sectors in 2023. Certain weaknesses in these sectors are key reasons why we still have a "Negative" municipal credit sector outlook on the health-care sector and a "Cautious" outlook on Higher Education.

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D.C. Lawmakers Avoid Partial Federal Shutdown

A partial federal government shutdown was avoided over the weekend as [lawmakers passed legislation that completes their fiscal year spending plan](#). The measure required support from most Democrats and passed the House by a vote of 286-134. More than half of Republican did not vote in favor of the agreement. Representative Marjorie Taylor Green filed a motion to oust Speaker Mike Johnson.

Recent HilltopSecurities Municipal Commentary

- [Municipal Bond Investor Playbook for Rest of the First Quarter, 2024](#), Feb. 8, 2024
- [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

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Readers may view all of the HilltopSecurities Municipal Commentary [here](#).

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