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Municipal Ratios Improve While the Fed Sees Slow Progress on Inflation

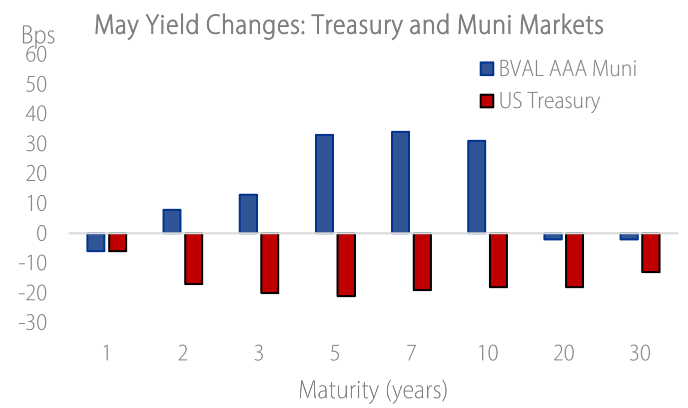
Between June 2022 and June 2023, US CPI fell more than 6 percentage points – from 9.1% to 3.0%. In the 9 months since, CPI has bounced around between 3.2% and 3.7%. The dramatic and much-needed fall in inflation came as a great relief to US consumers and policymakers – but it has now given way to a stubborn channel in which inflation remains uncomfortably above the Federal Reserve's 2% target.

The Fed continues to believe that the fed funds rate – the overnight rate that the Fed controls directly – is still restrictive. In other words, the Fed believes that rates are still high enough to exert a slowing effect on the US economy. The question that they are (transparently, to their credit) working through now is: how restrictive is it? How hard is the pressure on the brake pedal of the US economy? As Dallas Fed President Lorie Logan said in late May: "It also may be that policy is just not as restrictive as we think it might have been relative to the level of interest rates before the pandemic." To summarize: the Fed is trying to understand and navigate a puzzlingly strong economy, and traditional thoughts about fed funds policy seem to be less applicable in today's US economy. The delicate balancing act of trying to slow the economy without overdoing it and throwing the US into a recession is a bit like trying to brake in the snow; applying too little pressure and applying too much pressure each create their own problems.

Market Activity

The uncertain macroeconomic picture continues to provide an ebb and flow to conflicting narratives about Fed policy – resulting in shifting outlooks for the direction of interest rates. The treasury market this month seemed to focus on the Fed's statements about keeping the fed funds rate high for a significant period until inflation shows a clear cooling trend. Consequently, traders seemed to judge that the Fed is not likely to allow inflation to reignite and that they will slowly, eventually, bring inflation back into line. The result of that narrative was a drop in yields centering around the 15-20 bps range.

Municipals reacted to a different set of market influences – notably an exceptionally strong new issue calendar. That robust issuance overwhelmed investor demand, causing yields to lurch higher. The largest jump was in the 5-10 year range, where yields surged by more than 30 bps during May.



Source: Bloomberg and HilltopSecurities

Supply and Demand

Each of the first four months of the year saw supply exceed the same-month figures from 2023. In May, the market kicked that up a notch. According to The Bond Buyer, issuance in May was $44.0 billion, a whopping 47% increase from May of 2023. The average May issuance volume over the last ten years is about $36 billion. Total YTD issuance for 2024 is $191.3 billion – an impressive 34% jump from last year. Projections for full-year issuance have climbed to the $450 billion range.

The market struggled to absorb all of this supply, leading to lower demand on new issue pricings, balances in dealer inventories, and weaker bids on secondary trades. There are likely many factors that contributed to the surge in supply, but chief among them are: pent-up borrowing needs as issuers have stayed on the sidelines in recent months hoping for yields to fall, the new-found belief on issuers' parts that rates may remain elevated and that better issuance conditions may not present themselves in the next several months, the need for funds as pandemic-related funding runs out, and strong economic growth that creates the need for additional infrastructure.

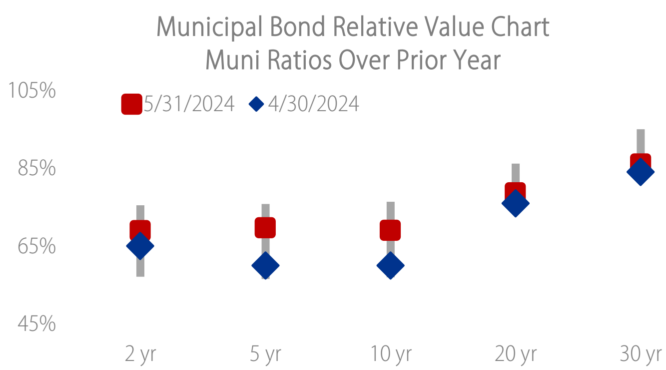
Changing demographic patterns may also help explain some of the increased issuance. Several states, notably Texas and Florida, have seen population surges over the last several years – which creates the need for new schools, wider highways and bridges and other infrastructure to help support increased population densities.

According to The Bond Buyer, California once again accounted for the highest level of issuance, with $30.0 billion in May. Texas was the second largest issuer with $25.2 billion. The list of top five issuance states was rounded out by New York ($23.2 billion), Florida ($11.3 billion) and Massachusetts ($6.5 billion).

Lipper reported outflows for three of the five reporting weeks in May, but the inflow weeks were significantly larger – resulting in net inflows of $760 million during the month.

Municipal Bond Relative Value

The dramatic surge in new issue volume created a supply-demand imbalance that manifested itself in changing ratios in the municipal market. Ratios shifted upwards across the entire curve. The largest changes occurred in the 5-10 year range, which moved higher by about 10% - moving from 60% to around 70%. For investors with cash to invest, this represents an opportunity to buy municipals at better valuations versus treasury (and other taxable) fixed income alternatives.



Source: Bloomberg and HilltopSecurities

June marks the time of year when important seasonal shifts tend to influence the market. Issuance patterns exist within the municipal market such that there are typically a large number of bond calls and maturities during June and July. The proceeds of those events show up in investor accounts as cash and are typically reinvested in the market – creating a wave of demand. For this reason, the municipal market often outperforms treasuries during the early part of the summer – pushing ratios down.

As it stands now, municipals look better on a relative value basis and, as we have pointed out in prior months, on an absolute basis from an historical standpoint. We continue to see strong value in municipals, with very little in the way of credit concerns in the investment grade space.

Total Return Data

Taxable bonds rebounded nicely from last month's selloff. The US Aggregate Index returned 1.7%. Investment grade corporate bonds had slightly better performance (1.9%), while treasuries lagged slightly at 1.5%. Corporate high yield also lagged with a 1.1% return for May.

Municipals, on the other hand, experienced another down month. The Municipal Bond Index returned -0.3%. The Municipal high yield market fared much better, returning .8%.

On a year to date basis, only the high yield sectors (Muni high yield, Corporate high yield, and Leveraged Loans) are showing positive total returns. The investment grade sectors are all negative.

Index Returns (through May 31, 2024) *

	May	YTD	Yield
Municipal Market Indices			
Municipal Bond	-0.29%	-1.91%	3.93%
Managed Money	-0.50%	-3.04%	3.70%
+ Managed Money Short	-0.25%	-1.30%	3.38%
+ Managed Money Short-Intermediate	-1.02%	-3.06%	3.33%
+ Managed Money Intermediate	-0.92%	-3.13%	3.44%
Managed Money California	-0.51%	-3.03%	3.51%
+ Managed Money CA Short	-0.20%	-1.19%	3.27%
+ Managed Money CA Short-Intermediate	-1.05%	-3.03%	3.18%
+ Managed Money CA Intermediate	-0.91%	-3.09%	3.26%
Bloomberg Muni High Yield	0.76%	1.65%	5.63%
Taxable Market Indices			
US Aggregate	1.70%	-1.64%	5.10%
US Gov/Credit	1.60%	-1.53%	5.00%
US Treasury	1.46%	-1.85%	4.69%
US Corporate	1.87%	-1.12%	5.52%
Taxable Muni	1.73%	-1.12%	5.27%
US Corporate High Yield	1.10%	1.63%	8.00%
LSTA Leveraged Loan Index	0.30%	0.73%	9.28%

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.

Sources: Bloomberg and Hilltop Securities research.