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Elevated Uncertainty As We Ring In A New Year

Fixed income markets ended the year on a weaker note. Yields rose in December by 20-40 bps. This is understandable; uncertainty remains elevated as the calendar turns to a new year.

The first "layer" of that uncertainty stems from the cyclical nature of inflation and questions around whether the Fed's hiking campaign – which has now pivoted to a patient holding/easing regimen – has exerted sufficient economic restraint to return inflation to the Fed's 2% target. With CPI still reading 3.3% (unchanged since mid-year) and PCE at 2.8% (up from 2.6% at mid-year), the argument could be made that there is still some work to be done on the inflation front. Yet the Fed seems confident that rates remain sufficiently restrictive and will pull inflation down over the next several quarters.

The second layer of uncertainty revolves around the policies of the incoming administration – and whether those will be inflationary (tariffs), neutral, or deflationary (increased productivity and less regulatory burden).

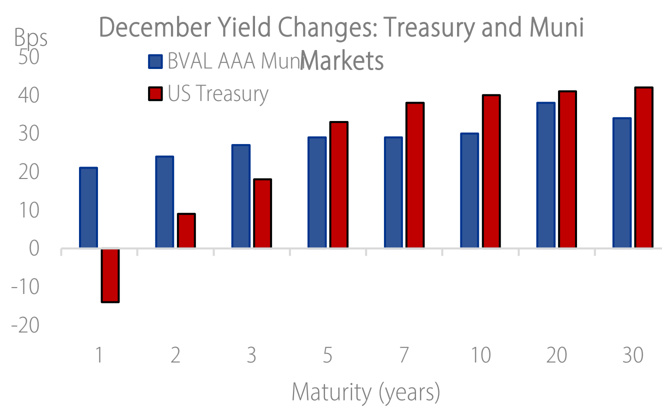
The final layer of uncertainty is specific to the municipal market. Many municipal market analysts are raising concerns that the shifting composition of the federal government at both the executive and congressional levels increases the potential for a threat to the tax exemption of municipal bond issuance. As the incoming administration looks for revenue sources to fund their preferred programs and extension of some provisions of the Tax Cuts and Jobs Act, eliminating the tax exemption of municipal debt has surfaced as one possible revenue source.

All of these taken together create a great deal more uncertainty than we have had in the recent past. Six months ago, for example, the template for Fed policy (continue to raise rates, then pause when they are sufficiently restrictive, and inflation seems to be coming down) was straightforward. The path and the narrative were understood by the market, even if the precise turning points were not. Now, the narrative and the path are highly uncertain, and the factors that will impact those hinge largely on political considerations that are unknowable at this juncture.

Amidst this uncertainty, we urge investors to think long term, rather than getting overly fixated on daily and weekly developments. Within fixed income, this means focusing on the attractive yields available within the asset class and how that can help clients achieve the income needs to bolster their financial objectives. There still exists great opportunity within fixed income and we urge investors to consider those opportunities rather than become paralyzed by concerns about policy outcomes.

Market Activity

Treasury yields rose in all but the shortest maturities. The largest moves were in longer maturities as 10-30 year bonds leapt higher by 40 bps. The portions of the curve more influenced by short-term fed funds movements had more muted moves. One year yields fell by about 15 bps, and 2-3 year treasuries rose only 10-20 bps.



Source: Bloomberg and HTSPM

Municipal yields were a bit more uniform, rising between 20 and 40 bps during the month. However, like Treasuries, the larger moves were in longer maturities, and the front end saw smaller upward movements in rates.

Supply and Demand

December was another strong issuance month in the municipal market. New issue volume was $31.6 billion according to the Bond Buyer – a 15% increase from December 2023.

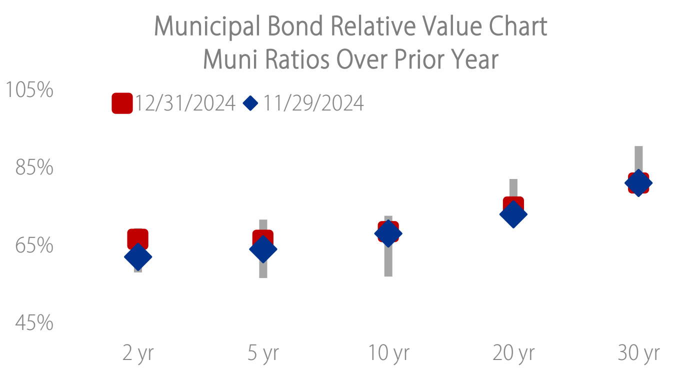
This lifted full year issuance to $507.6 billion – 32% higher than last year's figure and more than $20 billion higher than the previous full-year issuance record in 2020.

Issuers in California sold the most debt of any state - $71.6 billion. That was a 31% increase from last year. Texas came in second with $68 billion (+15%). The rest of the top five were New York ($58.7 billion, + 39%), Florida ($27.5 billion, +103%) and Illinois ($17.4 billion, +21%).

Demand was weaker in December, likely reflecting the uncertainty on the part of investors noted earlier. Three of the four reporting weeks were negative, and overall fund flows for the month were -$852 million according to Lipper. Despite poor December flows, 2024 was a turnaround year for mutual fund inflows. In 2023, Lipper's recording of fund flows was -$15.7 billion. 2024 saw a reversal of that with positive inflows of $21.7 billion.

Municipal Bond Relative Value

Muni relative value was little changed during the month. The shortest maturities saw a modest rise (2 year ratios went from 62% to 66%) while the rest of the curve saw almost no change. The longest maturities (20-30 years) are near the richest levels of the past year, possibly the result of investors trying to lock in tax-exempt yields in the event tax reform does occur.



Source: Bloomberg and HTSPM

Total Return Data

Fixed income returns were sharply negative in all sectors except Leveraged Loans (which are structured to perform well when rates rise) – according to the Bloomberg family of indices.

The US Aggregate Index lost 1.6% in December, resulting in a +1.3% YTD return. Treasuries fared slightly better (-1.5%) while the longer duration sectors of Corporate IG (-1.9%) and Taxable Munis (-2.5%) were hardest hit. YTD, all taxable sectors remained positive. Corporate HY, in particular, turned in a stellar year with an 8.2% return.

The overall municipal bond market had a similar result, posting a -1.5% return during December. Longer maturity bonds were hit the hardest (22+ year bonds had a -2.5% return). Lower-rated bonds struggled the most, with a -1.9% return being posted by BBB/Baa-rated bonds and Muni High Yield flashing -1.7%.

Year to date results were more mixed. Shorter mandates fared better, while intermediate bonds had slight negative returns. Full Curve mandates generally provided slightly positive returns for the year.

Index Returns (through December 31, 2024) *

	Dec	YTD	Yield
Municipal Market Indices			
Municipal Bond	-1.46%	1.05%	3.74%
Managed Money	-1.74%	-0.05%	3.53%
+ Managed Money Short	-0.47%	1.40%	2.93%
+ Managed Money Short-Intermediate	-0.97%	-0.17%	3.01%
+ Managed Money Intermediate	-1.32%	-0.32%	3.21%
Managed Money California	-1.55%	0.08%	3.27%
+ Managed Money CA Short	-0.46%	1.52%	2.75%
+ Managed Money CA Short-Intermediate	-0.93%	0.06%	2.78%
+ Managed Money CA Intermediate	-1.22%	-0.13%	2.96%
Bloomberg Muni High Yield	-1.66%	6.32%	5.52%
Taxable Market Indices			
US Aggregate	-1.64%	1.25%	4.91%
US Gov/Credit	-1.67%	1.18%	4.78%
US Treasury	-1.54%	0.58%	4.45%
US Corporate	-1.94%	2.13%	5.33%
Taxable Muni	-2.46%	1.57%	5.21%
US Corporate High Yield	-0.43%	8.19%	7.49%
LSTA Leveraged Loan Index	0.11%	1.14%	7.96%

Source: Bloomberg

Hilltop Securities
Investment Banking Solutions

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.