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A Patient Fed Navigates an Uncertain Economy

In July, the market continued to exhibit uncertainty about the confounding economic policy mix the Trump administration is implementing and the patient approach that the Fed has adopted. The fed funds market was settled on the immediate future for fed funds, consistently forecasting less than a 5% probability that the Fed would cut rates at its July meeting. But future activity, at the September meeting, has been more of a question mark. At the beginning of July, the market was forecasting a 100% probability of a 25 bps rate cut. By mid-month, that had changed to a 50/50 probability. Post-meeting, that probability slipped a bit more to 40%.

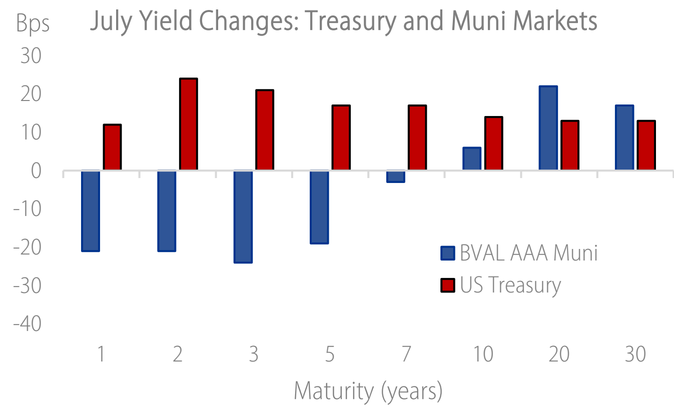
The employment report released the morning of the writing of this piece (August 1st) caused a seismic shift in the markets. That report, in which nonfarm payrolls grew by just 83k (versus an already-weak consensus forecast of 104k), revealed a severely weakening job picture. Even more, the revisions to previous data (prior month revised from 74k to 3k, and a two-month payroll revision of negative 258k) changed market perceptions instantly. The mild concerns about the state of the labor market – concerns the market seemed able to shrug off as interest rates and equity prices both rose during the month of July - have suddenly elevated to become alarm bells. As of this writing, the 2-year treasury yield is down 23 bps from the prior night's close and domestic equity markets are down between 1-2%. The probability of an easing in fed funds at the September meeting have risen to 87%.

The last six months have been turbulent, and sentiment has undergone polar shifts several times. This may be nothing more than another of those shifts, subject to subsequent change(s) in direction – but it certainly feels different. The market's reaction makes this feel more like a confirmation of what investors had feared. After all, it's not just the weakness in employment that is of concern. The first reading of Q2 GDP growth was released during the month. The prevailing opinion of economists who dig through the component numbers is that the 3% reading this quarter overstates the "true" growth in the same way that the -0.5% contraction in Q1 understates the true growth – and that the more reasonable picture emerges by simply averaging those quarters. That approach reveals an economy growing at an anemic 1.25% rate with (most worryingly) a consumer-led slowdown pulling the economy down.

Market Activity

Rates were mostly higher amidst the confusing stew of well-behaved recent readings on inflation, slower growth, the Fed being on hold in the near term, and investor concern over longer term inflation as federal budget deficits are expected to worsen. The treasury curve moved higher by 12-24 bps, with the largest jumps in the 2-7 year ranges.

Municipals followed treasuries higher in 10 year maturities and longer. However, shorter munis found strong demand and yields dropped by 20-25 bps in 5 years and shorter.



Source: Bloomberg and HTSPM

Supply and Demand

July issuance of municipal bonds was $53.4 billion, a 29% increase from July 2024. This represents the fourth consecutive month in which issuance exceeded $50 billion.

This is particularly surprising since July tends to be a month with less issuance – but issuer's needs have been increasing. The much-discussed loss of pandemic aid and policy uncertainty (even after concerns about the municipal tax exemption have passed) have been supplemented by rising costs to complete projects and growing recognition that federal resources are likely to be less available for infrastructure projects for the next several years. All of these have combined to create a strong appetite on the part of issuers to tap into the new issue market.

On a YTD basis, issuance stands at $336.3 billion – 17% higher than last year's figure. California bolstered its standing as the state with the largest issuance – with $51.7 billion in volume, a 21% increase from last year. Texas is second with $43.8 billion

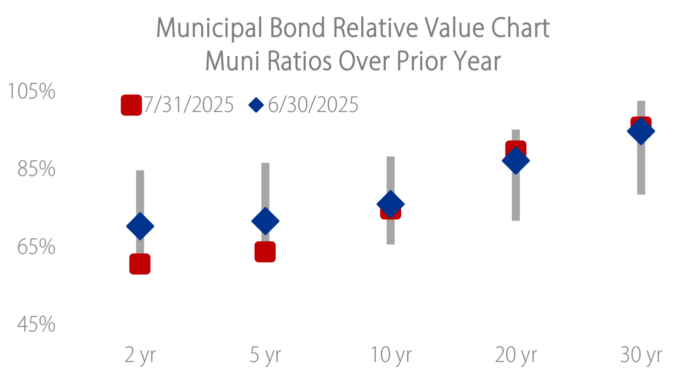
(+10.2%). Rounding out the top five are the states of New York ($37.3 billion, +9.9%), Florida ($12.5 billion, -15.8%) and Wisconsin ($12.3 billion, +73.1%).

According to Lipper, mutual funds experienced the third straight month of inflows in July, including two very strong weeks at the beginning and end of the month. Total inflows were $2.7 billion.

Municipal Bond Relative Value

Relative value increased modestly in longer maturities. In those ranges, 10 years and longer, municipals continue to manifest strong relative value versus taxable alternatives.

The front end of the curve underwent a more significant shift this month. Municipal yields dropped while taxable yields rose, and the result is much richer municipal valuations. Consequently, investors in the front end of the curve should once again be evaluating which market provides the highest after tax returns given their marginal tax bracket.



Source: Bloomberg and HTSPM

Total Return Data

Fixed income returns were mixed this month.

On the taxable side, the Bloomberg Aggregate Index fell -0.3% in July, but still maintained a +3.8% return YTD. Treasuries led the way down this month (-0.4%) while corporate bonds eked out a small positive return (+0.1%). High yield fared better with returns of +0.5% (Corporate HY) and +0.4% (Leveraged Loans).

The overall municipal market return was -0.2% in July, causing the YTD return to slide further negative (-0.5%). Shorter maturities performed better within the municipal market; bonds with maturities out to 10 years had positive returns, and bonds with 15 year maturities and longer experienced negative returns.

Lower quality credits deteriorated a bit more than higher quality bonds. AAA, AA and A-rated bonds had returns within about 10 bps of each other – all clustered around -0.2% returns - but BBB-rated bonds were down -0.7% and the Muni HY index had a difficult month with a -1.5% return.

Index Returns (through July 31, 2025) *

	July	YTD	Yield
Municipal Market Indices			
Municipal Bond	-0.20%	-0.55%	3.98%
Managed Money	-0.26%	-1.26%	3.83%
+ Managed Money Short	0.81%	2.85%	2.47%
+ Managed Money Short-Intermediate	0.60%	2.44%	2.81%
+ Managed Money Intermediate	0.15%	0.76%	3.29%
Managed Money California	-0.16%	-1.62%	3.63%
+ Managed Money CA Short	0.90%	2.64%	2.33%
+ Managed Money CA Short-Intermediate	0.84%	2.12%	2.63%
+ Managed Money CA Intermediate	0.42%	0.74%	3.04%
Bloomberg Muni High Yield	-1.51%	-1.83%	5.91%
Taxable Market Indices			
US Aggregate	-0.26%	3.75%	4.64%
US Gov/Credit	-0.22%	3.72%	4.50%
US Treasury	-0.39%	3.39%	4.19%
US Corporate	0.07%	4.24%	5.07%
Taxable Muni	-0.16%	3.66%	5.08%
US Corporate High Yield	0.45%	5.04%	7.08%
LSTA Leveraged Loan Index	0.35%	0.08%	7.62%

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.