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Municipal Basis Points – Weekly

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# Municipal Market Comments

## The Plot (DOTS AND OTHERWISE) Thickens

The FOMC concluded its two-day policy session last week as pre-game market volatility reflected wide-ranging speculation and unknowns. Going into the meeting, futures were pricing in a 25 basis point hike in the benchmark Fed Funds rate and that is exactly what policymakers delivered with the first increase since 2018 to a new target range of 0.25% to 0.5%. As we posited in our last ***Basis Points***, a 50 basis point bump was off the table, or at the very least teetering on the edge. In our view, the outcome was less about one singular rate increase and more about the velocity and duration of the tightening sequence.

Although we were anticipating what we view as an appropriate hawkish bias, we were somewhat surprised by the "dot plot" messaging which suggested 25 basis point rate increases at the remaining six meetings. ***Clearly, the Fed has made containment of inflationary pressure its number one priority, yet threading the needle becomes more problematic given the simultaneous challenges of keeping the economy from tipping into recession and preventing more systemic runaway inflation. The choreography must lead inflation lower to target while sustaining the economic expansion and a strong, viable labor market.***

***While we continue to forecast moderating inflationary pressure during the second half of the year, we are not convinced that we have seen a peak in the inflation levels, particularly as advancing agricultural and other commodity prices play out.*** Parsing through the summary of economic projections, we are drawn to the median forecasts for PCE inflation and cannot dismiss the idea that perhaps actual prints may be moderately higher. In his post-meeting press conference, ***Chair Powell made every effort to portray a strong and resilient economy while providing comfort that the Central Bank would use all of its monetary tools as necessary to contain the upward inflationary spiral.*** Now that the mandate of full employment has largely been met, Chair Powell is calling for all hands on deck to return to the Fed's other mandate of price stability.

The "dot plot" places the median projection for the Fed Funds rate at 1.9% by the end of 2022, with a rise to 2.8% in 2023 and held at this level in 2024. Of course, between now and then, much could happen that has the

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potential to alter these forecasts. ***While a protracted war in Eastern Europe could defy inflationary expectations and escalate pricing pressure with more expansive and extended supply chain disruptions, the Fed can be expected to demonstrate sensitivities to growth implications.*** The FOMC's accompanying statement acknowledged that, "the invasion of Ukraine by Russia is causing tremendous human and economic hardship" and that, "the implications for the U.S. economy are highly uncertain, but in the near term the invasion and related events are likely to create additional upward pressure on inflation and weigh on economic activity."

Furthermore, ***we will be watching for any unforeseen supply chain distortions and affects upon global growth brought on by elevated COVID transmissions and fresh lockdowns in China. Engineering a soft landing here in the U.S. is no easy feat and we think that the unknowns of the Russian/Ukrainian crisis and tentative market sentiment should promote a more cautious approach.***

Initiating reductions to the Fed's balance sheet is part of the tightening process designed to reign in the Central Bank's unprecedented monetary stimulus. ***The Committee's messaging revealed that its balance sheet runoff would commence at a "coming meeting". Our best guesstimate places this at the May or June gathering.*** As we know, the tapering of the Fed's Treasury and mortgage-backed security purchases concluded this month and so the natural progression to remove the COVID – driven support is to normalize the Central Bank's balance sheet. ***For now, we do not have a close sense of how much reduction to the balance sheet will be made, but we do believe that there is ample runway given that the asset base stood at $4.17 trillion as of February 19, 2020 and now stands at $8.9 trillion.***

Now that the Fed has concluded its second meeting of the year and there is some time before the onset of the next blackout period ahead of the early May policy meeting, we can expect to hear from a number of policymakers offering their own individual thoughts and expectations. We have recently heard from Federal Reserve Board Governor Christopher Waller who embraces the idea of a more "front-loaded" policy trajectory with consideration of a 50 basis point rate hike at one or more meetings so as to aggressively contain inflation. We have seen wages move higher at a rather aggressive pace that has simply been at variance with the Fed's 2% target, and so meaningful progress made with respect to advancing labor supply would have a positive impact upon pricing pressure, yet unemployment will not likely experience a quick ascent. Here, ***the Fed must consider the potential ramifications that an overcorrection could have upon the labor market.***

***We are even witnessing a degree of capitulation from a few officials who are now suggesting they underestimated the inflationary bite. While it is quite rational to maintain an open mind when it comes to monetary policy, we continue to view a 50 basis point bump as a measure better left reserved for a no-holds barred response to inflation. As we move closer to the next policy meetings, we expect to see a building narrative in favor of a more aggressive tightening sequence, particularly as real interest rates will continue to forecast negative. The signaling in this regard will be revealed by the trajectory of Fed Fund futures.*** Let's point out that St. Louis Fed President James Bullard was the lone dissent at the FOMC meeting as he favored a 50 basis point hike in the funds rate.

It was only three month ago when the Fed's consensus seemed to be signaling three 25 basis point rate hikes during 2022, a position taken prior to multiple outsized inflation prints showing the highest levels in 40 years and a swelling concern that inflation will remain significantly above goal for a protracted period. ***Given that we are experiencing elevated levels of uncertainty, not the least of which are geopolitical in nature, there***

***needs to be a degree of sensitivity as global Central Bankers pursue policies that are more restrictive. Recessionary risks, in our view, appear to be well contained, yet we are mindful of evolving conditions.***

***As the Fed now concedes, inflation has proven to trend beyond transitory with supply disruptions longer and more expansive than anticipated, and so perhaps there can be a buy-in to the notion of a Central Bank playing catch-up with efforts to ensure that high inflation does not become entrenched.*** Whereas there may have been a more defining line between transitory and persistent, that line has seemingly become indistinguishable. ***Evidence of a mild and brief slowdown upon growth from the Omicron variant supports the argument that a highly accommodative bias is no longer necessary and should offer the Fed with a degree of tightening cover.***

The Treasury market volatility that has intensified throughout Q1 stayed true to form both before and after the policy meeting with UST curve inversions becoming more pronounced, and ***while not there yet, there is growing concern that the 2s/10s curve could invert over the near term, or at the very least, there is further runway to flatten. Before we went to press, The Treasury market selloff soared to higher altitudes following decidedly hawkish comments from Chair Powell signaling his willingness to support one or more 50 basis point rate hikes in coming meetings with openness to extend beyond a neutral rate to one that may be more restrictive.***

***In our view, we really did not see much of a differentiation in tone between Mr. Powell's post-meeting press conference and his commentary at the start of this week, but again, if the bond market is looking for reasons to sell-off, there are certainly no shortages. Although we believe that inflation has tested our collective patience, we maintain that there is likely to be an organic receding of transitory price pressure given that an element of inflation had been brought on through unconventional means.***

The two-year benchmark yield was propelled above 2% for the first time since May 2019 and is now posting its worst quarterly loss in about 40 years, the three year tenor saw one of the largest daily advances since March 2020, and the 10-year is now in the 2.4% zip code. ***While there is no denying the recessionary signs, we are still inclined to support a continued growth outlook as the Fed tackles stubbornly high inflation. Very strong consumer and corporate balance sheets as well as exceptionally high levels of investible cash underscore the fundamental environment. This backdrop makes for a very different recessionary calculus and so we must be on the lookout for any false alarms brought about by curve inversions.***

While tax-exempt munis weakened leading into the FOMC, we did begin to see some sunshine emerge from behind the storm clouds during the post-meeting trading sessions as the asset class managed some outperformance over UST. ***Let's not get ahead of ourselves and think that it's smooth sailing for munis now that the Fed has engaged with its rate tightening sequence. There is still outsized volatility and liquidity challenges that lie ahead, but maybe more extended relief is not too far off. Muni yield movements are closely following the volatility very much on display in the Treasury market and it would likely take a tempering of such volatility and/or a more compelling technical muni backdrop to catalyze enduring market conviction with sustained outperformance.***

Municipal Mutual fund flows remained negative through the last reported period according to Refinitiv Lipper data. However, ***we do see a return to a period of inflows on the horizon, albeit UST market volatility, geopolitical developments and overall investor sentiment against a hawkish wall of monetary policy***

***will determine its duration. Since the beginning of the year, we have remained steadfast in our assessment of the muni asset class in terms of its continued ability to deliver predictable tax-exempt cash flow amid a backdrop of resilient credit quality. We have made a point of identifying value investment opportunities given advancing muni rates and cheaper relative value ratios.***

Of course, the narrative is challenging when engaging with our clients, retail Financial Professionals and our issuer/advisory community. Let's be clear, ***the Fed made its first move to tighten its benchmark rate and we are still at a low level of interest rates. When the Central Bank completes this tightening sequence, we will still be at a low level of interest rates. The futures market is currently pricing in an end to the rate hike cycle for next year and a renewed easing cycle in 2024. All of this is telling us that we are not embarking on a protracted course of significantly higher interest rates.***

As the compliance adage goes, past performance is no guarantee of future results. Thus, ***past Fed tightening cycles should not be a determinant of municipal yield behavior during the current Fed rate hike sequence. However, past muni yield trajectory during periods of rising interest rates may help to rationalize expectations for many market participants.*** As we have mentioned in prior ***Basis Points***, Fed tightening campaigns have historically been tied to the onset of recession, but this is not the case 100% of the time. ***Fed cycles are engineered for different reasons and are not all created equal.***

This one will be accompanied by a shrinking of the Fed's balance sheet and is designed to remove unprecedented levels of stimulus that were needed to bolster economic conditions as a global pandemic took hold. ***While the Fed could tighten rates beyond what the futures traders are pricing in (there is precedent here), we suspect that such scenario would be tied to the persistence and depth of inflationary conditions and to the extent of transitory runoff that occurs throughout the cycle.***

As we consider the past four tightening cycles, the most recent one that occurred between December 2015 and December 2018 was followed by a "soft landing" and did not bring about recession. ***Although a higher Fed Funds rate will generally have a greater influence upon shorter-tenor munis, creating a flattening curve bias, actual muni yield behavior during past tightening cycles would seem less impacted by a higher funds rate than perhaps what market fears would suggest.*** The following data is derived from the Federal Reserve and Bloomberg and reflects changes in muni yields during the past four Fed tightening sequences:

| Sequence | BP Funds Rate Delta | 3-YR YTW BP Delta | 5-YR YTW BP Delta | 10-YR YTW BP Delta | 30-YR YTW BP Delta |
|---|---|---|---|---|---|
| 2/94 – 2/95 | 275 | 175 | 152 | 142 | 128 |
| 6/99 – 5/00 | 150 | 89 | 79 | 62 | 84 |
| 6/04 – 6/06 | 400 | 134 | 80 | 34 | -44 |
| 12/15 – 12/18 | 200 | 83 | 68 | 49 | 48 |

Generally, overall advances in yields were significantly lower than the aggregate increase in the funds rate throughout the tightening sequence. ***From an investor's point of view, higher rates would produce higher coupons on new issuances offering higher tax-exempt cash flow, which could offset price erosion on lower coupon bonds. We would also point out that muni performance is not necessarily poor during Fed tightening campaigns, and in fact, returns can be positive.***

***Given that the current 30-year muni benchmark yield is trading within a range of the anticipated Fed Funds rate at the conclusion of the tightening cycle, there is historical evidence to support the notion that total muni returns could be higher than what otherwise would be expected, particularly if the Fed increases rates to a level below market expectations.***

Of course, various factors impact performance, including duration, investment objectives, bond structure, curve positioning and absolute yield positioning at the beginning of the tightening sequence. ***We would also suggest that a well-telegraphed and carefully orchestrated tightening sequence without abrupt and/or surprise moves could be accretive to muni performance throughout, and upon conclusion of, the Fed rate hikes. Clearly, the environment today is very different from the environment surrounding the taper tantrum of 2013. A favorable credit backdrop without outsized default activity can also be supportive of performance during this time.***

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