September 21, 2022

Municipal Market Comments

Value Opportunities Loom For The Patient And Resilient Long-Term Muni Investor Who Recognizes That The Asset Class Is Not In Kansas Anymore

Not long ago, we posited that unless we saw outsized inflation prints, the Fed should hold its next tightening move to a 50 basis point increase. Although August CPI came in above consensus, the overall data reflected a retrenchment from peak inflation and, in our view, did not justify the attendant market reaction from both bonds and equities. ***This week's FOMC meeting, like most so far this year, is being billed as consequential and the futures contracts are decisively telegraphing a third consecutive 75 basis point hike in the fed funds rate.*** We expect this week's commentary to be in the hands of our readership prior to the conclusion of the two-day policy session and so any thoughts on post-meeting market reaction will be discussed in our next ***Basis Points*** publication.

In our current environment, it is quite common for bond market volatility to remain engaged ahead of a scheduled Fed meeting with UST yields poised to move higher. As this week opened up, rate concerns sent the 10-year benchmark above 3.5% for the first time since 2011 with 3.6% showing up intraday on Tuesday. Given the inversions on the short end, we are seeing a hard-to-believe 4% yield on the 2-year benchmark. ***Such levels, in our opinion, represent psychological significance given that we had previously viewed a 3.5% yield on the 10-year as the upper range telegraphing the most consequential concerns over inflation.***

Against this backdrop, we can reasonably expect to see an easing of rate pressure post-FOMC as the recession narrative likely returns to the investment thesis and with the next policy meeting not scheduled until November, allowing more data to enter the conversation. Year-to-date, it has been quite common to witness a fixed-income market sell-off leading up to a scheduled policy meeting as there is no way to adequately determine just how much tightening is needed to place inflation on the right course toward the Fed's 2% target.

Although market participants may be spot on with the exact move in the funds rate for this meeting, they are

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eager to dissect every word uttered by Chair Powell during his post-meeting press conference in search of any nuanced guidance that has yet to be scripted or communicated. Of course, ***we do not rule out the possibility that Mr. Powell could assume an even more hawkish posture that could potentially extend the sell-off.*** As we have been saying for some time now, ***the market has been doing much of the heavy lifting for the Fed, and this week has been extremely illustrative of this observation.***

There are those hold outs calling for a full percentage point raise in the funds rate, yet we assign a low probability to what we believe would be an unjustified and likely damaging move of such magnitude that was last applied during the 1980s. ***Given where we are in a tightening cycle that still has legs to run, with accelerating roll-off of the Central Bank's balance sheet, tied in with economic data points and evidence of cooling inflationary expectations, a 50 basis point bump would be our choice***. Nevertheless, the Fed has done a good job signaling its intent and the markets were prepared for the prior two 75 basis point rate increases, but there is no credible guidance posturing a 1% spike in the funds rate.

Should Chair Powell remain true to his word by considering the "totality" of the data, we do not consider the August CPI print, which admittedly offers a lagging view of price performance, as supportive of the 100 basis point argument. The Fed neither wants to convey panic nor does it want to exacerbate financial market volatility, but as we can observe, such behavior tends to take on a life of its own. While eliminating the inflationary grip is job number one, Central Bankers are mindful of the financial burdens created by rising interest rates with clear implications for the housing and rental markets. Looking at the overall inflation data, ***upward wage pressure is elevating concerns over a wage-price spiral and will likely help keep the Fed on its tightening course through the first quarter of 2023 and perhaps beyond if the data takes us there.***

Fed speak has been keenly absent given the onset of the pre-meeting "blackout period" two Saturdays ago, but not before a unified policy voice telegraphed a commitment to bring 40-year high inflation down even at the expense of compromising a favorable growth trajectory. ***While efforts to slash inflation are being met with outsized resistance, there are reasonable expectations that the Fed's tightening sequence will continue to relieve pricing pressure, with core inflation cooling from stubbornly hot levels. Nevertheless, we remain concerned over persistently high rents and other service costs as well as indications that many food items are crowding out allocations of household resources.***

The visible decline in gas prices at the pumps is providing relief to the headline number, yet geopolitical factors could return oil to higher ground. We anticipate further easing across commodities, particularly as supply chain dislocations demonstrate further resolution. ***Closely watched negotiations between U.S. railroads and labor unions gave way to a deal that would avert a rail strike of crisis proportion and prevent an even greater hardship for global supply chains.***

Easing energy costs contributed to more temperate wholesale prices for August, but again let's not get too comfortable as renewed upward price pressure could derail much of the containment progress made to date. ***We suspect that policymakers will need to see clear and consistent evidence of easing core inflation before they soften their hawkish narrative and move away from their journey into more restrictive territory.***

A shift in consumer sentiment has contributed to a decline in inflation expectations to the lowest level in more than a year, yet we are questioning the resiliency of this course given our outlook for ongoing volatility in consumer behavior with what may be a delivery of conflicting price data. While August retail sales surprisingly advanced following declines in the previous month, activity visibly moderated month-over-month. Eight out of thirteen retail sales categories expanded last month with a noted surge in auto sales, while sales across furniture, health and personal care and non-store retailers declined.

Gas station sales receipts dropped last month given cheaper fuel prices as grocery store sales rose in August due to rising food prices with the cost of food at home surging year-over-year. Sales at restaurants and bars showed the strongest performance since April following a dip in July. While the retail sales data generally focuses on goods, consumer preferences have been displaying pre-pandemic spending patterns with greater allocation of resources toward services such as travel and entertainment.

Away from the headline increase in the funds rate, we will be looking at the accompanying policy statement, which can be expected to identify continued elevated inflation. More importantly, ***we will be paying close attention to Chair Powell's post-meeting press conference for any hints on what necessary conditions have to materialize before the aggressive policy stance can take a break.***

In our view***, it would be a mistake for Mr. Powell to break away from his hawkish bias, but there can be acknowledgement that existing policy tightening needs time to work through the system. While a pause beyond the September meeting would not necessarily be a bad thing in our view, assuming the incoming data shows support, perhaps a more conventional rate hike, such as 50 or 25 basis points, would make sense at the November and later meetings.***

As much as we prefer not to overly obsess over the futures contracts, it has become increasingly difficult to ignore the projections given that our Central Bank rightfully hardened against runaway inflation. At the conclusion of this week's FOMC meeting, the new target range for the funds rate will likely be between 3% and 3.25%. By year-end, it is quite conceivable to have a 4% rate, with higher targets thereafter, before reaching a possible peak by the end of Q1 of next year, which is now forecasted at 4.5% (subject to change). ***At least through the first quarter of 2023, the funds rate will continue to follow a restrictive path as further accommodation is removed from the system.***

With the release of a revised summary of economic projections coming this week, we anticipate forecasts for slower economic growth and higher unemployment. Inflation expectations are likely to reflect declines over the next few years, with the Fed's 2% target showing up in 2025. Of course, we will wait until we can appropriately assess the Fed's "dot plot" before we offer up more substantive assumptions***, but restrictive levels may linger for a bit. Over the near term, we would not be surprised to see a degree of renewed divergence among policymakers as they recast their economic outlook based upon fresh data.***

We entered 2022 with expectations of heavy volatility, yet perhaps we are seeing more than we bargained for as the volatility has escorted bond pricing to much lower valuations. The Treasury yield curve remains decisively inverted throughout, indicative of outsized concerns over rate policy and recessionary expectations. The 2s/30s part of the curve has recently posted the steepest inversion in almost 22 years. Since the beginning of the year, the 10 and 30-year UST benchmark yields have advanced by 194 and 158 basis points respectively, while like maturity muni benchmarks have increased by 196 and 219 basis points respectively.

Admittedly, ***all of this volatility does give rise to higher levels of market liquidity concerns, yet we are not anticipating any significant dislocations over the coming months and likely even longer term.*** Let's recall that it took the onset of a pandemic in 2020 to bring about a liquidity freeze, and even then, unprecedented circumstances were met with multiple rounds of both monetary and fiscal stimulus. ***Perhaps one could ascribe the source of liquidity pressure to the Fed, particularly as it ramps up its QT campaign, yet we must recognize that liquidity pressure is being felt on a global scale and it will likely take a stabilizing rate trajectory without all of the violent shifts to create relief.***

Having said this, ***consistent resiliency has provided the underpinnings for a functioning U.S. bond market. Although it is becoming harder and harder to deny the end of a secular bull market for global bonds given the losses revealed by the Bloomberg Global Aggregate Performance Index, we are not likely to return to an era of zero and below-zero interest rates with ultra-accommodative monetary policy and seemingly endless amounts of cheap money any time soon.***

There was a time not all that long ago when it was quite challenging to cultivate interest in the bond market given the low levels of nominal interest rates and the competitive disadvantage offered by the tighter income streams available on fixed income securities. ***Given the current rate-centric environment, the bond market now provides both attractive yields and cash flow relative to risk assets, and can represent a safe haven for risk-off investors seeking to expand portfolio diversification. We expect this dynamic to persist for some time, particularly as inflation and a tight labor market have been resistant to higher interest rates.***

As we consider the value opportunities now offered through fixed income investment given the historic repricing, the muni asset class is poised to deliver defensive attributes as the financial markets navigate their way around onerous inflation and uncertain growth performance. Now is the time to lock in tax-efficiency, strong credit quality in support of capital preservation, and compelling income streams thanks to higher interest rate conditions. Those credits and structures that offer less defensive attributes are more likely to see widening spreads leading into a recession. As Treasury yields have made their way to new historic highs this week, munis have worked hard to outperform the sell-off, particularly on the short-end.

It probably helped that the new-issue calendar was light ahead of the FOMC meeting given that many issuers remain vexed over the outlook for interest rates. Although we do expect to see issuance pick up this month as monetary policy anxiety dissipates somewhat, the scheduled FOMC meetings for November and December will likely influence Q4 supply to the downside.

The long-end of the muni curve would need to rally significantly in the final quarter for issuance to demonstrate significant growth and any meaningful advances in refunding activity would require a material curve flattening bias. While we are still having a difficult time getting our arms around the double-digit losses for YTD muni returns, the asset class is still less "red" than the negative total returns on both UST and corporate bonds.

We often discuss the diversification attributes attached to municipal bond investment as being part of a disciplined and defensive investment strategy and we remind our readership of the near-zero long-term correlated risk to equities and largely uncorrelated risk to other fixed income asset classes.

Diversification has the ability to smooth portfolio returns over time, especially throughout Fed tightening cycles. Diversification in munis, like diversification in corporate bonds, comes in multiple forms. With munis, there are general obligation (G.O.) and revenue bonds. G.O.s are typically backed by an obligor's full faith credit and taxing power with such pledge being either of an unlimited or limited taxing nature.

Revenue bonds are generally backed by a lien on a specific revenue source and are typically structured with secure legal provisions such as a rate covenant, additional bonds test (although we are seeing less of this), and a debt service reserve fund. Technical defaults, such as a rate covenant violation, may require a consultant call-in and the financing documents generally detail the terms of a cure period.

Revenue bonds can help to insulate the portfolio from the vagaries of a state/local government's budgetary process and political trappings. Sector diversification can also help to create different types of revenue streams that are dissociated from one another and that tend to perform at different levels during an economic downturn.

Muni outflows, which are running at about $85 billion YTD, continue given the existing liquidity needs from mutual fund complexes, albeit at a reduced pace compared to the heavier withdrawals earlier in the year. Much of this money seems to be moving into cash alternatives. In our view, ***once muni yields appear to reach their peak, we can expect to see a meaningful repricing of the asset class with a significant easing in bid-wanted activity and a return to an inflow bias as institutional investors put much of this sidelined cash to work.***

For now, relative value is on display on the long-end of the muni curve with the 30-year benchmark ratio standing at 103% according to Refinitiv. At these levels, we watch for signs of greater crossover buyer interest, and this could come from traditional corporate bond investors.

While it is extremely difficult to call the top of an interest rate cycle, we do feel confident that munis are getting close to their peak and from a yield and income perspective, it makes little sense to ignore the opportunities available from municipal bond investment. Being able to clip larger coupons and book more generous yield is a long time coming and ***portfolio asset allocations should consider a 30%-40% commitment to fixed income as opposed to what was a 20% investment for a protracted period of time. Should the muni tax-exemption offer accretive benefits, it would be reasonable to place most of the fixed income allocation into municipal bonds. Of course, such guidance is predicated upon the longevity of current market dynamics.***

In addition to the yield and income opportunities, keep in mind that there is appreciation potential should interest rates drop as the value of bonds issued at higher/peak rates tends to be greater. This dynamic offers investors the potential to realize capital gains should they sell their positions. Alternatively, older, lower coupon bonds offer value given that they can be purchased at discount prices as compensation for acquiring below-market cash flows.

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