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MUNICIPAL STRATEGY AND RESEARCH

Municipal Basis Points – Weekly

November 2, 2022

Municipal Market Comments

Here's a Story of a Bond Named Muni

With the arrival of November, comes the holiday season with all of the traditional shopping distractions. For the average person, this is a time of family gatherings, experimenting with new recipes, and giving unto others. But for market participants, the focus is on consumer buying preferences, year-end corporate window-dressing, portfolio realignment, tax planning, and general activity surrounding the closing out of another year. We also have the first of two final FOMC meetings as well as the release of October employment data scheduled for this week. ***When it comes to monetary policy, 2022 will likely go down in the books as one of the most historically relevant years with almost every one of the eight sessions commanding global attention.***

At this point, the FOMC is less about the actual rate hike, and more about Chair Powell's post-meeting press conference as each and every word will be parsed for meaning, nuance, and credibility. A record fourth consecutive 75 basis point bump in the benchmark fed funds rate is decisively anticipated at the conclusion of this week's meeting. ***At his press conference, we suspect that Mr. Powell will open the door, as opposed to just looking through the peep hole, to a potential pause at a subsequent policy gathering sometime next year.***

Admittedly, outsized inflation has proven to be a stubborn adversary and we are seeing that the effects of the Fed's aggressive tightening cycle have yet to produce consequential results with achieving price stability. The Fed Chair will need to orchestrate one of his best performances so as to not raise the white flag and signal retreat from the Central Bank's mission of taking inflation down or close to target.

While consensus has built around the magnitude of this week's rate increase, there appears to be diverging views surrounding the Central Bank's messaging going forward. ***While we understand that today's enduring inflation has been catalyzed by a number of unprecedented factors, we do believe that patience must be applied throughout the tightening cycle as the higher rate backdrop is poised to break the inflationary fever over the foreseeable future. We further posit that Chair Powell must find comfort with***

Jeffrey Lipton
Managing Director, Head of Municipal Research
Fixed Income Research
(212) 667-5365
jeffrey.lipton@opco.com

Oppenheimer & Co. Inc. 85 Broad Street New York, NY 10004 Tel: 800-221-5588 Fax: 212-667-5925

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allowing the pause narrative to take shape and provide widely sought-after market guidance. The Fed-speak leading up to the "blackout period" largely kept to a hawkish bias, but we did see cracks in the tightening armor starting to emerge. Perhaps the time to bring the "frontloading" of tightening policy to an end is upon us.

The ever-shifting futures contracts are currently signaling a rate hike for December somewhere between 50 and 75 basis points. ***We would prefer to see a 50-basis point raise next month as we are concerned over a potential build-up of financial instability, followed up with a policy assessment as the Central Bank maps out inflationary expectations for 2023. If the financial markets receive the less hawkish message while still evidencing a commitment to a restrictive path at the conclusion of the FOMC meeting that is now being anticipated, we can expect higher price valuations across the spectrum of asset classes, at least over the near-term.***

In our view, the Fed can achieve its desired target on its funds rate, but the road to get to its restrictive policy objective does not have to be carved in stone. 2023 is quickly approaching and we continue to believe that we are at or approaching the peak in bond rates. In our view, current UST trading ranges seem to be in the right zip code to account for the most likely restrictive scenario.

Admittedly, there are visible signs that some of the inflation barometers are receding and that the reliable and resilient consumer is becoming more discerning against a backdrop of generationally high prices. As we have pointed out in previous ***Basis Points*** publications, ***wage advances are not keeping up with the pace of inflation and so discretionary income is under downward pressure for a growing number of households.*** Inflation-adjusted goods spending has already experienced a decline given a shift towards service consumption preferences now that the economy has reopened from a COVID-induced shutdown. Nevertheless, ***spending on big-ticket items such as automobiles and various household appliances has abated and we expect to see similar buying habits through year-end.***

Despite being among the first sectors to recover, the restaurant industry is now meeting resistance given the elevated costs of dining out. A combination of rising home prices, albeit with some noted deceleration, and a 7%-range on a 30-year fixed rate mortgage has significantly impaired housing demand across various regions of the country. Following two consecutive quarters of negative GDP growth, the initial print for Q3 showed an annualized 2.6% increase given resilient participation from businesses and consumers. Personal consumption, representing 70% of the U.S. economy, rose at a 1.4% pace – above forecast but slower than the previous quarter. Subject to revisions and more complete data inputs, the second estimate for last quarter's growth is scheduled for release later this month.

Contributing to the quarterly rise in real GDP, which may keep the recession hawks at bay for now, include increases in both goods and services exports, consumer spending, nonresidential fixed investment, as well as higher spending at the Federal, state and local levels. ***We suspect that further erosion in residential fixed investment may place downward pressure on Q3 revisions as the housing market, highlighted by double-digit declines in residential investment, will continue to be a drag on GDP. We expect full-year GDP to show expansion, but the rate of growth is likely to be modest.***

We will also keep a close eye on future labor market strength and individual savings as guidance for consumer spending activity. Policymakers are likely to consider their preferred inflationary measure, but may be

challenged to derive strong convictions. The PCE price index grew at an annualized 4.2% pace during the third quarter, the slowest rate since the end of 2020. While meeting consensus, headline PCE for September rose 0.3% month-over-month and 6.2% year-over-year, revealing still appreciable pricing pressure.

The economic backdrop is telling us that monetary policy is having its intended impact of slowing growth and curtailing demand, yet the data continues to support a robust labor market with low unemployment and advancing wages. ***While prospects for recession in 2023 have increased, we are betting on a number of resiliency factors to deter a deep and protracted contraction.***

Leading into this week's FOMC meeting, the markets were making an effort to show strength ahead of the anticipated 75-basis point rate hike, until of course fresh economic data appeared to have removed some of the Fed's dovish (oh, can we say this word?) cover and conflicting messaging out of China concerning that government's stance on its zero-COVID policy softened the risk-on bias.

Bond prices were mixed along the Treasury yield curve with the 10-year benchmark yield modestly over the 4% threshold. ***While the global tightening cycle may have taken on a synchronized performance as historic levels of policy stimulus needed to be removed from the system, the pathway to pause, pivot, and pursue an easing posture will likely occur at different times and speeds.***

After spending much of last week flexing its independence muscle with tax-exempt yields backing up despite more favorable technical considerations and rallying U.S. Treasuries, munis have thus far held steady this week in front of the FOMC meeting. ***Even with the muni underperformance during the last week of October, the asset class outperformed UST for the entire month, with respective losses of 83 basis points and 1.39%. The Fed's pathway to arrest uncontrolled inflation by pursuing a restrictive interest rate policy has created a sea of red throughout fixed income, yet munis are outperforming UST and corporate securities YTD, with negative returns of 12.86%, 14.3%, and 19.56% respectively.***

The longest dated maturities, 20 years and out, significantly underperformed the broader muni market last month as that part of the curve played catch-up to the UST sell-off at certain points during the month and saw active bid lists with attendant heavy withdrawals from municipal bond mutual funds. The 30-year AAA benchmark yield advanced by 28 basis points throughout the month and Refinitiv reported 12 consecutive weeks of outflows by month-end.

During last month, revenue bond losses doubled those incurred by G.O. bonds, (-)1.03% versus (-).51% respectively, as investors focused on still-favorable tax receipts and comfortable fund balances associated with full faith credit issuers, and found themselves more cautious given challenged outlooks over certain revenue bond sectors. Within the revenue bond space is where we have seen disproportionate bid-wanted activity and we note specific underperformance relative to the broader revenue bond index across the hospital, housing, and transportation sectors.

Certain cohorts within the hospital sector are experiencing above average margin compression given inflationary conditions, heavier spending needs and staffing deficiencies; housing stress is being felt more for local/conduit issuers experiencing competitive forces and weak management than with state housing agencies demonstrating greater asset diversification, stronger collateralization levels, skilled management oversight, and ample program reserves; the transportation sector remains under operational pressure as a number of systems struggle to regain pre-pandemic utilization.

High-yield munis underperformed the broader muni index last month to post a year-to-date loss of 17.75%. The heaviest losses for October were tied to 15-year and out tenors and were seen in the hospital, housing, education, and high-yield Puerto Rico areas. ***The high-cost of a traditional college education taken within the context of a COVID-induced lockdown has placed heavier scrutiny on college and university financial operations as the cost/benefit analysis has taken center stage.***

The higher education sector will likely become even more competitive and those institutions that have not differentiated themselves within a field of active liberal arts schools are most at risk of future enrollment declines and margin erosion. In our view, whatever performance that could have been attained on Puerto Rico debt had likely already been unlocked, especially prior to restructuring.

In our view, the muni high-yield space will likely remain exposed to both credit and market volatility and it is imperative that careful security selection be applied when considering high-yield investment opportunities. Existing holdings should be actively surveilled for shifting credit characteristics and positions should be scaled back or fully liquidated should in-depth research point to potential covenant violations, if they haven't already occurred, or perhaps to an actual default of interest and/or principal.

It comes as no surprise that October issuance fell 40.3% according to Refinitiv data, bucking otherwise historically strong October supply trends. Higher borrowing terms catalyzed a 78.2% drop in refunding volume which aligned with a 76% drop in taxable issuance given that refundings of outstanding tax-exempt debt can only be accomplished on a taxable basis.

On a more general level, the market volatility brought on by aggressive Fed tightening policy has kept a number of issuers sidelined, particularly as each and every FOMC meeting is billed as consequential. This dynamic certainly impacts pricing, placement and performance and makes for a very uncertain market. Having said this, market behavior has been efficient with deals receiving favorable reception. When needed, re-pricings have been done in order to minimize dealer balances.

As we indicated in our last ***Basis Points*** publication, ***next week's mid-term election will be pivotal as the balance of power in Washington D.C. may be shifted should the Republicans take control of the House and/or Senate.*** As of this writing, while there is a greater likelihood of a GOP-controlled House of Representatives, certain key races for the U.S. Senate have tightened in, thus weakening the chances for Democrats to retain control of the Upper Chamber of Congress. Republicans need only one victory to capture the Senate. With a Republican majority in at least the House, any agenda for tax increases and new regulatory oversight for businesses from the Biden administration would likely be DOA, and there could be renewed tensions surrounding the U.S. debt ceiling.

Away from the Federal contests, there will be 36 gubernatorial races and a vast majority of state legislative seats will be decided. Voting outcomes at the state and local levels can be quite significant as future policy decisions can affect tax initiatives, spending priorities, business climate, and local infrastructure projects – all of which could ultimately have implications for municipal credit.

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