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Municipal Market Comments

Feeling The Muni Heat

We are now well into the summer months and many parts of the country are experiencing uncomfortably high temperatures. Market participants are juggling their summer vacations while managing their financial asset exposures during these uncertain times. Believe it or not, another FOMC meeting is concluding and this one will likely be one of the more impactful for the year. Futures contracts are placing the easy money on a second 75 basis point hike in the fed funds rate, bringing it to a new range of 2.25% - 2.5%. Of course, ***the accompanying statement language may provide some useful guidance, but the real direction should derive from Chair Powell's post-meeting press conference*** and we will be sure to listen attentively as this meeting will not come with a summary of economic projections.

Consistent with our ongoing narrative, the Chair's messaging must be carefully scripted with almost every word considered for market reaction. ***While the Fed strongly desires to avert recession, it will nevertheless deploy all policy tools necessary to bring inflation under control in order to fulfill its prime directive of price stability. We have made no secret of our overall support of Fed policy actions conducted to date and we are much appreciative of the Central Bank's commitment to a routine of transparent communication. Whether one believes that the Fed was slow to deter runaway inflation, there is now widespread concurrence that Chair Powell and team have fashioned a sufficiently aggressive tightening sequence that is already constraining, albeit unevenly, demand and tempering inflationary pressure.***

Certainly, there has been no shortage of recession speak with the discourse resonating loudly in the absence of any Central Banker commentary during the present blackout period. Our readership recognizes that we have distanced ourselves from the popular recession mantra, yet we do have an appreciation for the complexities involved in the identification of a recession. Conventionally, the accepted textbook "technical" definition of recession is two consecutive quarters of negative GDP, but as we discussed in a recent edition of our ***Basis Points, the official pronouncement must be rendered by the National Bureau of Economic Research (NBER).***

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Let's recall that the third and final print for Q1GDP showed a 1.6% contraction in the annualized rate. Following this week's FOMC meeting, the preliminary release for Q2 GDP is expected to show 0.4% annualized growth as the economy is evidencing a reduction in consumption and spending activity. A formal declaration of recession from the NBER, comprised of an eight-person panel of esteemed academics, typically comes when the nation is already entrenched in a down cycle. ***While we do not expect such action from the NBER anytime soon, the textbook or "technical" guidance could reflect a recession should we receive enough of a downside miss in the GDP forecast this week.*** The last recession occurred between February and April 2020 as COVID-19 effectively shut down our economy and we have repeatedly expressed the unprecedented circumstances involved.

The emergence from one of the shortest recessions on record (possibly the shortest) has also been chaperoned by extremely unprecedented circumstances as both monetary and fiscal policies quickly infused heavy doses of liquidity and stimulus into the economy with multiple backstops in support of financial assets. The point here is that we are dealing with unique events and so it is challenging to advance recessionary projections based upon historical framework.

Although our base case does not forecast recession between now and at least through the first half of 2023, we must be prepared to acknowledge the arrival of the textbook definition for recession***. From our perch, we are reluctant to place disproportionate reliance upon the two consecutive quarterly contractions scenario, as we prefer to consider a broader basket of economic data points and activity.***

We believe that our expertise in municipal credit analysis affords us with a unique and insightful perspective on the economy and we can incorporate a cross-section of sectors and regional trends into our calculus. Consumer and corporate balance sheets remain in good shape and while consumer goods spending is slowing, service related activity shows consistently strong demand. We continue to exhibit a robust labor market with low unemployment, there is no looming financial institution crisis, personal income levels remain favorable, and from our view, we do not foresee any sector-wide bubbles that could undermine our economic integrity. Thus, ***while we could see a negative GDP for Q2, we would argue that many areas of the economy continue to expand. If it doesn't look like a recession, smell like a recession, and act like a recession, then it probably isn't a recession.***

We must also recognize that declines in car sales and for other purchases may reflect outsized price advances driven more by supply chain disruptions and less by substantive drops in consumer spending preferences. ***As pricing hopefully normalizes with abating inflationary pressure, we would expect to see more typical demand patterns and with the strong demand for services, we are not convinced that spending would decline to levels more consistent with recessionary indications.*** It was not that long ago when the markets were obsessing over inflationary expectations, and now they are fixated on the Fed's tightening cycle and its impact on economic growth. ***The shape of the Treasury yield curve continues to portend recession with demand for longer-tenor securities becoming less conflicted given ebbing inflationary forces and advancing concern over economic growth.***

During his post-meeting press conference, we expect Chair Powell to acknowledge a softening in certain key data points, yet he can still cite the overall strength of our national economy. One area that

he should address is the state of the housing sector given some recent evidence of cooling activity attributable to a doubling of mortgage rates and 20% year-over-year escalations in home prices. Overall, ***our support for a second 75 basis point hike in the funds rate this week, as opposed to a 100 basis point lift, should align with a less hawkish tone throughout Mr. Powell's press conference.*** Perhaps he will address the Central Bank's outlook regarding corporate hiring activity and expectations for unemployment insurance claims with the latter migrating upward, and of course the outsized June CPI print cannot be ignored, which is sufficient justification for a 75 basis point boost in the funds rate.

Against this backdrop, we are by no means suggesting that the end of the Fed's tightening sequence is upon us. In fact, ***there is plenty of work to do in order for monetary policy to curb excess demand in the system, although we believe that much of the heavy lifting is behind us with the bond market providing assistance to the Fed. Although recession is not a desired outcome for the Fed, failing to gain control over runaway inflation could have greater adverse consequences for the economy.***

Of course, we must recognize that the Fed yields no control over the inflationary elements brought about from COVID and geopolitical driven supply chain dislocations and this is a worrisome reality. Yet we would mention that ***a cooling housing sector with softening demand could provide some degree of supply chain relief, thus curbing some cost inflation in the housing market and returning the sector closer to equilibrium.***

Looking at the futures contracts before going to press, a 50 basis point boost in the funds rate is anticipated at the September meeting with smaller jumps expected at the final two meetings of the year, bringing the implied rate to 3.405% (at the moment) at year-end. A policy reversal is currently being priced in beginning in February 2023 as the Fed is expected to ease policy in order to ignite economic growth with an implied funds rate of 2.86% (at the moment) by the end of next year.

While Treasury market volatility was more pronounced ahead of the FOMC meeting, munis managed to firm up with 3 to 5 basis point bumps along much of the curve on Tuesday. It was only late last week when munis underperformed a UST rally. ***Muni participants are not without worries over the Fed's tightening campaign, but cyclical forces and strong fundamentals have catalyzed positive returns for July, with the asset class doubling the returns shown for UST securities month-to-date.***

With the outperformance booked by munis, relative value ratios have become more expensive with shorter maturities still the richest. The 10 and 30-year benchmarks presently stand at 84% and 98% respectively and while munis have moved further away from fair value, relative value remains far more compelling today compared with the more expensive ratios that existed throughout 2021. ***Given the looming FOMC meeting this week, it was not a surprise to have a very light calendar, in fact the smallest of the year so far, as issuers often display caution ahead of a rate decision.***

Demand for muni product has been strong this summer and we expect market technicals to remain supportive through August with a likely continuation of positive performance. We suspect that as recessionary concerns intensify, a sustainable flight-to-quality trade should emerge with munis well positioned to offer investors a predictable revenue stream of tax-exempt income. A repositioning of deployable cash into longer dated maturities may offer strategic value with more attractive total return should rates revert to lower ground, and so we suggest that curve extensions may be appropriate for those investors relatively unhindered by duration risk.

As we think about spread activity, there has been some noted thinning among the weaker investment grade and high yield cohorts. We note that month-to-date, muni high-yield is outperforming the broader index with respective returns of 2.87% and 2.0% respectively. ***We posit that high-yield spreads could continue to narrow with potentially stronger performance through year-end.***

Although fund flows returned to negative during the last reported period, we continue to believe that stronger market conviction and less inflationary stress will temper the pace of outflows and likely produce a cycle of intermittent inflows or perhaps even a sustained period of positive flows. While there may still be somewhat active bid wanted activity, we expect institutional selling pressure to subside with the availability of better relative value along the long end of the curve.

Although long dated muni yields have come down from their YTD highs, the 30-year AAA benchmark is still about 150 basis points higher than where it was at the beginning of the year. We expect short ratios, which have become extremely rich, to cheapen up later this year or during the first quarter of 2023 as inflationary concerns ease and the higher rate bias subsides and possibly shifts course, thus potentially underperforming the overall market. Should this scenario come to fruition, we would expect to see some curve flattening as front-end strength steepened the muni slope.

In our view, there is a compelling list of muni tail winds that provide fertile ground to extend the July performance momentum. Entry points are now attractive with munis poised to recover even more of their year-to-date losses, although it would be a reach to end the year in positive territory. Greater comfort with Fed policy actions can make fixed income investment more compelling for those anxious investors starving for directional guidance and can pave the way for heavier allocations of capital into the muni asset class.

While one could argue that muni credit has peaked, the asset class enters a possible recession with strong fundamental attributes, which can be relied upon to augment portfolio performance and resiliency. Of course, we must be mindful that volatility and declining valuations within the equity markets may pressure pension funding requirements for certain issuers, and tax collections will likely reveal mixed performance as national and regional growth metrics weaken.

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