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Municipal Basis Points – Weekly

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Municipal Market Comments

Stay Cautious, but Stay Engaged and Nimble

It seems like ***the sentiment pendulum is swinging back to an assertive monetary policy tightening bias with a recalibration of interest rate expectations***, and dare we say, a higher for longer narrative. When the FOMC meets in late March, policymakers are sure to raise the benchmark funds rate, but the die-hard hawks are circling overhead hoping for something stronger than a 25-basis point hike. ***Our view remains in support of 25 basis points against a backdrop of recent data signaling economic resiliency and an underwhelming disinflationary trajectory.***

Starting with the out-sized employment report for January, fresh CPI, retail sales, PPI, and manufacturing prints combined to push Treasury yields higher and alter the investment calculus surrounding inflation, interest rates, liquidity, and future growth performance. ***The question to ask is, will the February bond market sell-off have staying power? This will prove to be a difficult question to answer given all of the moving pieces involved and the fact that no one knows for sure what the proper dose of restrictive policy needs to be in order to accelerate the disinflation process.***

As we were formulating our thought process last Friday, UST securities were catching a bid along most of the curve. We suspect that the quick ascent to higher bond yields, bringing about a return to more tempting entry points, was behind the renewed interest. ***As we have been telegraphing for some time now, greater divergence among the chorus of Fed officials was likely to emerge in 2023, and we are now seeing this dynamic play out.*** Following acknowledgement from two non-voting, yet influential, FOMC participants (Cleveland Fed President Loretta Mester/St. Louis Fed President James Bullard) of their bias toward a 50-basis point hike, another non-voting participant (Richmond Fed President Thomas Barkin), voiced his desire to stay on the 25-basis point track.

At this point, talk of a 50-basis point splurge is largely theatre and there is no need to secure front-row seating. ***While the economy is exhibiting signs of broad-based strength, largely driven by consumer participation, we must be mindful that there are pockets of weakness and bulge bracket corporations***

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continue to announce scheduled layoffs. We are certainly on board with a modest rate increase for next month, and we are not opposed to similar hikes for May and June if circumstances warrant further tightening.

As we returned from the extended holiday weekend, Treasury yields were reverting higher with the 2s/10s inversion modestly wider relative to the beginning of the month and the 10-year benchmark moving to take back 4% while the futures contracts were pointing to a higher terminal rate at the conclusion of the July meeting. ***The simple reality of the present situation is that pinpointing the number of remaining rate hikes and the peak funds target during the current tightening cycle will remain elusive for both the Fed and for the financial markets. For now, it is purely a matter of interpreting the data points along with a host of Fed-speak.*** What we can say with certainty is that we are witnessing an aggressive tightening sequence of historic proportion designed to bring down the highest inflation in forty years that originated form very unique events and circumstances.

The bond market is poised to react to a number of scheduled releases this week, led by the minutes of the last FOMC meeting (1/31-2/1) with follow-up prints on Q4 GDP, and January consumer activity, PCE and new home sales. The PCE deflator brings about particular anxiety as the Fed's preferred inflation barometer is expected to show headline and core inflation accelerating on both a M/M and Y/Y basis. ***The consumer represents the heaviest gauge of economic standing as this most consequential component of GDP can be expected to exhibit more selective and discerning participation, yet we do posit that a resilient consumer will keep a deep and extended recession at bay.***

Given the upsized February data points for January, the FOMC minutes offered a rear-view mirror look into the policy thought process, yet we are interested in the prospects for more insight into the support for higher rate increases and fresh targets for the funds rate. ***The convergence of expectations between the Fed and the bond market is evolving with greater pronouncement and we point out that aside from some elevated Fed-speak to the hawkish side, policymakers are essentially telegraphing the same message while the 10 and 30-year benchmark yields have advanced by 43 and 33 basis points respectively since the beginning of February.***

Contracts are anticipating a terminal rate of 5.34% with the July meeting, versus 4.9% at the beginning of the month. This estimate is subject to adjustments up or down depending upon the data, and such data may give rise to justification for a higher anticipated terminal range of 5.25%-5.5%, visibly higher than the 5.1% median forecast in the Fed's December Summary of Economic Projections. ***The presence of stronger economic prints and protracted inflationary pressure would, in our view, give the Fed cover to extend its tightening cycle and solidify a disinflationary trajectory with a pause not likely prior to the September meeting.***

At the March FOMC meeting, fresh employment, CPI, PPI, and retail sales data for February will be entered into the policy calculus. ***Should there be a repeat of upside surprises, underscored by tighter labor conditions, market expectations may call for a 50-basis point hike in the funds rate, yet we would remain supportive of a smaller move.*** Let's recall that ***over a relatively short 11-month period, the Fed has lifted the benchmark short-term rate from near-zero to its current target range of 4.5%-4.75% (admittedly much of the front-end moves were normalizing policy as opposed to hitting restrictive levels), and that disinflation has yet to be fully exposed to lagging economic characteristics.***

Against this backdrop, ***we acknowledge an eroding political climate in the U.S., particularly given intensifying brinksmanship over the debt ceiling and a fast-approaching Presidential campaign cycle, as well as advancing geopolitical concerns which could have implications for our economy, inflation, and market performance.***

We also have to be mindful that while current economic conditions are yielding limited deference to the Fed's tightening efforts, the appropriate restrictive policy, as elusive as it seems, may occur with a swift and decisive impact. Although disinflationary forces can be characterized as being in their infancy, the data points could shift with little or no warning just as we are presently seeing how sticky inflationary pressure can be.

Furthermore, while we recognize price stability as one of two Fed mandates and believe it to be sacrosanct, we are growing uneasy, realistically, with the 2% target and we have to wonder if in their private policy sessions (outside of FOMC minutes) there is any discussion of having a degree of comfort with a somewhat higher rate, while still credibly preserving the 2% inflation goal. ***From a pure economic health perspective, we believe, and do not mean to pontificate, that an accelerated trajectory down to 2% would likely be accompanied by adverse consequences and so the Fed would be well-advised to pursue a measured pathway while unofficially and non-publicly accepting something higher along the way.***

Given the performance in the Treasury market, municipal bond yields finally moved higher in sympathy and begrudgingly joined the bond market sell-off, catalyzed by an unexpected (somewhat) return to higher interest rate anxiety as the Fed professes to more assertively bring down the inflationary growth rate. ***We are seeing new highs being set year-to-date across Treasury bond yields, led by short tenors, and we are beginning to question our assertion that the 10-year is not likely to breach new highs during the current tightening sequence. We may still be correct, but we have to be nimble and realistic enough to shift expectations as we are presented with fresh data and new realities.***

As mentioned, the UST curve inversion is now modestly wider versus the beginning of February, yet we have been at wider levels throughout the month and we can certainly expect even wider levels over the near-term. The front-end of the muni curve remains inverted, a rare phenomenon for the asset class that seems to have staying power thanks to the Fed's tightening gift that keeps on giving. ***Since the beginning of February, AAA benchmark 10 and 30-year yields have increased by 36 basis points, while the 1 through 5-year tenors saw upward adjustments of between 78 and 54 basis points, taking the brunt of the sell-off to under-perform much of the curve.***

Although munis behaved as expected by out-performing a UST sell-off for much of the MTD, had it not been for constructive technicals and positive flows into muni mutual funds (conditions that brought relative value ratios to very expensive levels), the out-performance gap would have likely been thinner. Given the events of the past week, munis are now reacting more rationally, under-performing in response to the movements made along the Treasury yield curve. ***What the performance Gods giveth in January to Munis, has been taketh away so far in February, and while our call for modest single-digit returns at year-end has not necessarily been derailed, the early-in-the-year deficit (February) was not expected.***

Although Munis are posting a 2.17% loss MTD and earning 64 basis points YTD, they are out-performing UST MTD and YTD losses of 2.58% and 14 basis points respectively. The back-up in rates has pushed relative value ratios modestly higher with the 10 and 30-year benchmarks standing at 65% and 90% respectively per Refinitiv, versus 60% and 87% about one week ago. ***Richer valuations have been evident for shorter tenors, and despite the yield back-up with short ratios moving disproportionately higher, they remain the most expensive. As we alluded to, unique muni technicals could, at times, have distortive effects upon performance and relative value, with muni responsiveness to certain market conditions being less than intuitive.***

We contend that a normalized supply-build could move ratios to more attractive levels, with the 10-year ratio moving closer to fair value and with the 30-year approaching full value. While ratios may be off their lows, they remain expensive relative to historical averages. Ratios can, in part, be viewed as state specific, depending upon unique issuance and overall supply characteristics across the states. We believe that there will be those issuers who are likely to remain tentative, for now, given the Fed/interest rate anxiety, and issuance can be expected to be light during the days leading up to the March FOMC meeting.

As of this writing, limited primary supply is setting the stage for a stronger bid, with the larger deals receiving the most aggressive interest with good pre-sale. Adjustments made in the 1-10-year range have sparked renewed institutional support as munis are now over 60% of Treasuries. Against this backdrop, supply should still build, with sufficient interest, particularly if ratios hold steady or move higher.

Retail interest seems to respond to available flexibility with being able to have greater choice. Lighter reinvestment needs in February coupled with earlier bumps along the curve, likely kept retail on the sidelines awaiting cheaper opportunities. ***More recent cuts along the curve and improved relative value have created a more attractive backdrop, yet there is evidence suggesting that even cheaper entry points are desired.***

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