OPPENHEIMER
MUNICIPAL STRATEGY AND RESEARCH
Municipal Basis Points – Weekly

August 2, 2023

Municipal Market Comments

Fixated on Fixed-Income

The FOMC arrived on the spot last week and with no surprises hiked the Fed funds rate by 25-basis points to a ***new target range of 5.25% - 5.5%, a 22-year high and totaling 525-basis points of tightening since March 2022.*** With a near 100% probability of an increase on display by the futures contracts just ahead of decision time, market stakeholders solidified their focus on Chair Powell's post-meeting press conference with all eyes turning to the September gathering. In typical Powell fashion, the Chair's opening remarks and Q&A session were delivered with all the right "C's" - confidence, conciseness, clarity, and composure. Much of the narrative was excerpted from prior speaking engagements with Mr. Powell unwavering in his commitment to the Central Bank's dual mandate of full employment and price stability.

Chair Powell reiterated multiple times that ongoing data will guide the policy course in terms of additional firming while pivoting away from forward guidance, and that no decisions have been made about future rate actions, meaning that, for now, subsequent meetings should be considered live and in the current moment. He also emphasized that monetary policy is well-within restrictive territory with the need to keep it there being of great importance. ***We believe that the Fed can conduct monetary policy from a good place right now given that the Central Bank is beyond its heaviest pressure to combat unacceptably high inflation through a series of aggressive rate hikes and has the flexibility to pause at an individual meeting should the data offer support.***

During the press conference, we saw clear acknowledgement from Chair Powell of the downside risks that may accompany an overly restrictive policy campaign, perhaps elevating the Central Bank's desire to engineer a soft landing as the risks seem evenly weighted on both sides of the tightening argument. Credit conditions are already tight, and are likely to become tighter, yet the overall effects remain uncertain, and even elements of a resilient labor market are showing retrenchment such as a decline in the number of hours worked and reduced job vacancies.

The Fed's commitment to its 2% inflation target remains firm as policymakers (not all) sound a "higher-

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for-longer" message to further temper ever-resilient price pressure, not the least of which is elevated core inflation. Further easing of supply constraints as well as more balanced supply/demand labor market conditions should contribute to a well-anchored disinflationary backdrop. Vehicle inflation is decelerating, home sales are slowing, and growth in consumer spending is receding, yet the totality of the data could portend additional rate hikes. Although the impact of the current tightening cycle has yielded meaningful results, we continue to look for lagging effects that are likely to add further progress. Chair Powell further indicated that the Fed could theoretically cut rates while continuing on course with quantitative tightening.

As part of Mr. Powell's narrative, prospects for recession have been fairly remote with the idea that ***tight monetary policy does not necessarily have to lead to economic contraction, yet a broad cooling in labor market conditions with wage growth moving in line with 2% inflation would be acceptable.*** Overall growth could be moderate with expectations for a period of below trend expansion and labor weakness. With the conclusion of the July meeting, the Fed's staff, which may offer different views than FOMC participants and members – and even the Fed Chair, no longer forecasts recession.

While June CPI came in below consensus, more consistent improvement in retail inflation is needed to gauge the effectiveness of current monetary policy. ***Between now and the September FOMC meeting, market stakeholders will receive 2 more jobs reports and two more CPI prints and while that meeting is certainly live, the new rounds of data points could give rise to another pause and may even be part of the calculus that completes the tightening sequence.***

With the July meeting in the rear-view mirror, and low, yet sensitive, prospects for a September rate increase, bond yields initially seemed poised to trade within a somewhat tight range. Last Thursday came and upended this notion as a more hawkish view of monetary policy engaged with favorable economic releases, and combined with also hawkish news out of the Bank of Japan, pushed the 10-year UST benchmark yield back above 4% - again. Evidence of cooling inflation on Friday reversed the tone and sent the 10-year south of the 4% border – again. We indicated in a recent ***Municipal Basis Points*** that ***while the Treasury yield curve remains heavily inverted, the 10-year yield has demonstrated resistance of late to spending much time with a 4-handle, and we continue to make that observation.***

Given that much of the economic discussion surrounds prospects for growth, let's begin the data conversation with the latest report on Q2 GDP, one of several post-FOMC releases that validated the Fed's decision to pursue renewed policy tightening. Growth expanded by an above-consensus annualized 2.4% (inflation-adjusted) with a noted presence of active consumer spending and a heavy return of business capital expenditures, which we expect to be primary drivers throughout the third quarter. ***Although available cash flow has supported both consumer and business participation, we continue to posit that such available liquidity may recede at some point in 2024 as the impact of higher interest rates and tighter lending practices deepens.***

The end-of-week release (last week) of June's personal income and spending revealed stronger performance by the end of the second quarter relative to more tepid consumer support towards the end of Q1. Fresh data on wages indicated abating inflationary pressure in Q2, with year-over-year advances in employment costs easing to 4.5% from 4.9% in the first quarter, and wage growth rising by 1%, the smallest advance in two years. ***Further slowing in wage growth, which is targeting most sectors and which is illustrative of***

wage disinflation, can be expected through the balance of 2023 and into next year given our outlook for softening economic performance and a general easing of inflationary conditions.

Separately, the PCE price index increased by 3% in June year-over-year to meet expectations, yet registered the smallest advance in over two years. Both initial and continuing claims (lowest level since January) for unemployment insurance benefits dropped below forecast during the last reported period, reflecting the protracted resiliency of the labor market. While June durable goods orders rose by 4.7% (versus +2% consensus), albeit with a disproportionate bias towards the transportation segment, new-home sales for that month declined and came in below projections while pending home sales showed minimal changes. Higher mortgage rates have reduced the affordability pool of eligible buyers and are keeping supply at depressed levels given that there are significant numbers of existing home owners holding mortgages with rates of about 400-basis points lower than prevailing conventional rates.

All-in-all, the post-FOMC economic data points reflect an economy that appears to be distancing itself from any near-term recessionary drag and that would tend to bolster the hawkish argument among those Fed policymakers calling for additional tightening measures. The consumer, while slowing down somewhat, has been at the heart of keeping recession at bay, and although we can envision additional consumer displacement, acknowledging that payments on student loans are scheduled to resume in October, recession is not imminent. Against this backdrop, ***525-basis points of tightening have already made significant progress in moving inflation towards the Central Bank's 2% target and we anticipate further price relief over the coming months.***

While the FOMC will not be meeting in August, the annual Kansas City Fed-sponsored economic symposium held in Jackson Hole, Wyoming will provide global Central Bankers with an opportunity to elaborate on monetary policy and to provide market stakeholders with a broader perspective on economic conditions. Following the July FOMC meeting, the accompanying policy statement held its view on inflation as "elevated" and upgraded its economic growth outlook to "moderate" from "modest".

Although policymakers characterized the banking sector as "sound and resilient", they did concede that credit tightening will likely create economic headwinds and we do believe that tighter capital requirements may add to the challenges. While there is still divergence among the Fed ranks, the vote to lift the funds rate was unanimous. ***With the next FOMC set for September, participants will be looking for evidence that the supply/demand labor market imbalances have improved during the inter-meeting period.*** Falling commodity prices, assisted by unwinding supply chain disruptions, have helped to place disinflation on solid ground, with even a stronger foothold expected. Recently, the International Monetary Fund elevated its outlook for the world economy citing easing economic and inflationary risks.

Just ahead of the FOMC, Treasury yields drifted higher, and followed with a modest decline in response to a widely anticipated rate hike and Chair Powell's willingness to entertain prospects for a possible pause in September as policy will pursue a "meeting by meeting" pathway. Global bond yields, however, were quickly escorted somewhat higher on the news that the Bank of Japan is opening the door to removing long-standing caps on the country's bond yields by pulling away from yield curve control in a sign of hawkish solidarity. We also heard from the ECB, which lifted its benchmark rate (for the ninth consecutive increase) by 25-basis points and retained policy flexibility for subsequent meetings.

Market-friendly inflation news released last Friday set the stage for a positive tone, but the mood quickly changed given a sell-off in UST early this week that returned the 10-year benchmark yield back above 4% on the opening day of August. This weakness came in response to elevated issuance of longer-dated securities to address a growing budget deficit, effectively overshadowing what normally would have been well-received prints on ISM Manufacturing Index and JOLTs (lowest level since 2021), both arriving below consensus and visibly indicative of tempered demand for products and workers. ***The early-in-the-week sell-off caught many market participants off guard, but we do anticipate a firmer tone to emerge with the 10-year recapturing its place below 4% as the heavier Treasury supply narrative loosens its grip amid the more nuanced and impactful interest rate plotline.***

Fitch's downgrade on U.S. sovereign debt from "AAA" to "AA+" comes 12 years after S&P took similar action and lowered our nation's debt to "AA+" from "AAA". With the downgrade, Fitch cites, "the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to "AA" and "AAA" rated peers over the last two decades that has manifested in repeated debt limit standoffs and last-minute resolutions."

While this surprise action will likely elicit heavy response and criticism, we do not expect meaningful alterations to fixed income investment strategies. Analytically, we must question Fitch's timing as there is no looming crisis, the U.S. economy has emerged from the COVID-driven shutdown with strength and resiliency, and quite frankly, debt ceilings and the threat of a government shutdown have been consistent participants among fiscal and budgetary deliberations for a very long time.

A debt rating is meant to measure statistical probability of default incorporating a set of financial and non-financial inputs, and so it is unclear as to what has altered Fitch's view. ***Admittedly, it is fairly easy to argue that the fiscal and budgetary processes at the Federal level routinely get caught up in political theater, yet the impact upon credit ratings assessment is open to debate.*** We must also recognize the swelling debt burden and the overall debt to GDP standing of the U.S. among global counterparts, which is a primary consideration in any sovereign credit analysis.

Against this backdrop, we do not foresee substantive impact upon municipal credit or municipal market efficiency at this time. However, we cannot rule out methodology shifts from the rating agencies at some point in the future that draw parallels between U.S. and state sovereign debt practices and political behavior. Having said this, with limited exception, states are required to maintain a balanced budget and states typically engage with effective cash management practices and also benefit from statutory safeguards that help to support credit quality.

In our view, 2023 will be the year of fixed income given the extremely compelling yield and income opportunities that have made re-assessments of asset allocation highly appropriate for many portfolio strategies. Municipal bonds in particular, have demonstrated their effectiveness as a defensive investment in a rising interest rate environment designed to derail outsized inflationary pressure.

Thanks to much better paying cashflows, munis have now earned their place beyond a portfolio diversifier on a tax-adjusted, risk-adjusted, and even on a performance-adjusted basis and the more predictable income streams could offset risk-asset volatility for a growing base of natural fixed income buyers.

We think the allure is now more apparent given the improving trajectory of inflation, the nearing conclusion of the Fed's tightening campaign and the loftier Treasury yields. Let's remember that outsized inflation and the Fed's unwavering commitment to price stability through restrictive actions heavily dislocated equity and bond valuations. ***The tax-efficient nature and relatively strong credit attributes, underscored by low-defaults and higher recoveries relative to corporates, of muinis offer unique benefits for conservatively-biased portfolios.***

In its latest U.S. municipal bond defaults and recoveries, 1970-2022, Moody's cites: only one default (Moody's rated) in 2022; the average five-year cumulative default rate has been stable or has fallen for the municipal sector overall and for each subsector over the past five years; municipal ratings and corporate ratings moved in different directions as municipal sector generally continued to see ratings drift up; and municipal credits continue to remain highly rated, with the median rating of municipal issuers at Aa3, compared to Baa3 for global corporates.

The vagaries of monetary policy and the dynamics of economic data points ended July performance mixed across key fixed-income cohorts, with munis taking the lead and finishing in the black thanks to a very supportive technical backdrop. Last month, munis returned 40-basis points, while UST lost 35-basis points and corporates earned 34-basis points. Let's recall that Munis stood out in June, returning 1% versus a loss of 75-basis points for Treasuries and 41-basis points for corporates. ***Historical performance data would tend to suggest that Munis are capable of weathering the effects of a Central Bank tightening cycle with perhaps less sensitivity to higher rates relative to other asset classes while providing a predictable revenue stream for both tax-exempt and taxable investment portfolios.***

While no two cycles are the same, Bloomberg data indicates that muni returns across the curve were largely positive during the past few tightening periods with higher absolute yields offsetting associated price erosion. Perhaps if the Fed had not elevated rates by as much as 525-basis points, the yield allure of munis may be less compelling and performance less prominent. Of course, we are not suggesting that higher muni yields are the only driver of performance as credit and market attributes comprise important components to the mix. We have witnessed some contraction of credit spreads and have seen longer-duration munis generally outperform given the richness on the short end of the muni curve. We have also been dwelling on the supportive technical environment underlying the municipal bond market.

As we have pointed out in previous ***Basis Points*** commentaries, tax-exempts often distance themselves from U.S. Treasury securities, which tend to reveal more front-line reaction to economic developments as well as to fiscal and monetary policies. We have also noted that the flow environment for munis is more encouraging now than at any point throughout the first six months of the year. ***The year-to-date outflows have trailed the historic withdrawals of 2022 (which saw over $140 billion of outflows) and our expectations for more visible inflows through the balance of 2023 should help to support our favorable performance outlook.***

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