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MUNICIPAL STRATEGY AND RESEARCH

Municipal Basis Points – Weekly

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Municipal Market Comments

Wake Me Up When September Begins

The Fed's aggressive tightening policy is not being conducted in isolation as various Central Banks across the globe are combatting an upward price spiral that has made inflation a national pariah in their respective countries. The Bank of Canada, the ECB, and the Bank of England have all recently put through outsized rate increases. Now that the Fed has voted through two consecutive rate hikes of 75 basis points with a current target range of 2.25% - 2.5%, the market has the September 20 – 21 FOMC meeting in its sights and the question to ask is whether the Fed's "go big or go home" posture will be appropriate for a third time.

While Chair Powell left the door open for another outsized rate hike during his last post-meeting press conference, he did stress that subsequent policy decisions would be data dependent for consideration at future FOMC meetings and that he would avoid "clear guidance" ahead of those meetings. Although he did suggest that the pace of rate increases would need to be tempered at some point, we do not envision a pause anytime soon. ***Since the initially dovish market interpretation of Chair Powell's post-meeting press conference, it now appears less apparent that the Central Bank is poised to bring about an accelerated conclusion to the Fed's tightening cycle.***

With the return of policymaker commentary during one of the longer inter-meeting periods as the FOMC will not meet again until late September, ***the recession narrative will be pitted against a Fed committed to gaining control over runaway inflation***. ***While many officials recognize evidence of weakening data points, there is much about the economy and the financial landscape to suggest ample distance from the next down cycle. This week, we will receive retail and wholesale price data for July, and another outsized CPI print may likely give the hawks greater ammunition for a third 75 basis point rate increase next month.***

Slowing economic conditions, with a noted pullback in spending and production, declines in food consumption, and lower business investment, can be expected to continue through the balance of the year, yet the effects

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should better align supply dislocations with already moderating demand patterns. ***Chair Powell believes, and rightfully so, that it is not the Fed's job to make the recession call, but nevertheless views recession as a broad-based decline, which is presently not evident.***

So perhaps the market's initial reaction to the rate hike was without merit, but then again, we have grown accustomed to shifting sentiment and the recession debate is not expected to go away quietly, especially if one does take hold of our economy. This thought process segues nicely to the first print of Q2 GDP released a day after the FOMC meeting showing a 0.9% annualized decline. Given that first quarter growth contracted by 1.6%, we now have two consecutive quarters of negative GDP and if one subscribes to the textbook "technical" definition, we are in a recession. However, ***we devoted a fair amount of real estate in the July 27 edition of Municipal Basis Points discussing the National Bureau of Economic Research and its role in advancing a formal declaration of recession as well as our own views surrounding currently sound economic underpinnings and our unwillingness at this time to call recession.***

The decision to raise the funds rate by 75 basis points last month was unanimous and there is similar unified conviction surrounding the national labor market, which appears to be the most visible economic anchor. Last Friday's release of July's employment data revealed stronger-than-expected job formation as nonfarm payrolls surged 528,000, taking the national unemployment rate down to a 1969 low of 3.5%. Consensus forecast called for a 250,000 payrolls gain with unemployment holding steady at 3.6%. Parsing the data, payroll additions were broad-based with noted growth across service industries such as food services, health care, leisure and hospitality, and professional and business services. Wages remain elevated, with average hourly earnings rising 0.5% month-over-month and 5.2% year-over-year, exhibiting broad advances across multiple sectors and industries.

Chair Powell has communicated his belief that the Fed's tightening cycle is "broadly on track" and that the policy rate needs to reach the optimal level necessary to get inflation back down to 2%. He has posited that the balance sheet reduction campaign is working as advertised and that new balance sheet equilibrium could take 2-21/2 years and acknowledged that broader financial conditions have tightened a lot while the nation's banking system remains well capitalized. So as we think about both the economic and financial backdrop, we must wonder what's in store by way of Fed policy through the remainder of the year. Of course, ***the robust payrolls print may argue for more aggressive tightening, especially should CPI convey persistently high inflationary pressure.***

Messaging from various Fed officials since the adjournment of the July meeting would seem to dispel any notion of a Fed pivot, particularly given that the labor market does not appear to be moderating as anticipated, despite rising unemployment insurance claims. The more the employment picture tightens, the greater the likelihood that a wage-price spiral could emerge. In our view, the tide may turn and unemployment could trend higher should we see a material shift in labor demand, and we expect to see this occurring by year-end.

Prior to the next FOMC meeting, the markets will receive one more employment report and two cycles of CPI data, all of which will help shape the policy decisions in late September. Heading into July CPI, the headline month-over-month print is expected to reveal the slowest increase since early 2021, rising 0.2% as gas prices have been steadily declining. However, the core number, which excludes food and energy, is forecasted to increase 0.5%. The headline year-over-year gain is wagered to slow to 8.7% from 9.1%.

Just prior to going to press, we took a fresh look at the fed funds futures contracts, which admittedly could shift bias very quickly, and we see that a 75 basis point rate hike is currently priced in, with much smaller increases being telegraphed for the final two meetings of the year. Several policymakers, with St. Louis Fed President James Bullard leading the charge, favor a more substantial move to a restrictive monetary policy. ***While it is difficult to cry recession when the labor market is creating an outsized number of jobs, we can envision a scenario where the Fed hikes 50 basis points should the data signal progress on controlling inflation.*** We continue to believe that we are nearing peak inflation even though we recognize that the Central Bank has more wood to chop. Presently, futures show the implied funds rate by the end of the year approaching 3.6%, peaking in March of 2023 at 3.68%, and declining to 3.15% by the end of next year.

Clearly, ***Treasury bond yields move in sync with whatever the recession or inflation flavor of the day is. They tend to move lower if the inflation-inspired rate hikes are dialed back, and advance higher on more aggressive tightening sentiment.*** In any event, the Treasury curve has been inverted for some time now and we do not expect it to alter shape anytime soon. ***While the economy will continue to slow in the months ahead, it would be a mistake to underestimate the Fed's resolve to fight inflation at the expense of contributing to the overall weakness.***

July was a good month for bonds, with both UST and Munis booking solid performance. Strong summer technicals combined with a "flight-to-quality" bias rallied tax-exempts to outperform Treasuries, 2.64% versus 1.59% respectively, as long-dated muni yields dropped by 22 basis points throughout last month. ***So far, muni performance has been consistent with our favorable outlook for the second half of 2022 and we expect the bias to remain largely intact as we finish out the year with intensifying recession concerns. The July performance helped to recover some of the year-to-date losses earned in the muni space, yet nothing short of a miracle would be needed to finish the year in the black.***

As we know, muni fund flows are a key barometer of investor sentiment and while we are starting to see intermittent in-flows, we are not ready yet to call a cyclical change, although the period of outsized out-flows has abated. August is shaping up to be somewhat more challenging than July as summer reinvestment needs start to recede, but not before $20 billion (according to Bloomberg) in maturing securities and scheduled redemptions over the next 30 days are expected to be available for potential reinvestment.

Viewing these numbers against approximately $8.56 billion in anticipated supply over the same time period gives the muni market net supply of about (-) 11.44 billion. ***We suspect that if the bond market can view Fed policy through a more realistic lens, without having overly emotional expectations for a policy pivot, there could be less volatility and more favorable guidance for muni performance.***

With the improved market tone and promising outperformance for munis, ratios remain expensive with value opportunities still uneven throughout the curve. Although ratios have cheapened modestly along the short end of the curve, that area remains the most expensive. ***In order to capture fairer value, investors must look at longer tenors. Retail flows have slowed given current ratios, but selective transactions are being booked***. ***Institutional bids remain committed to front-end paper. As technicals revert to their post-summer seasonal patterns, there is an opportunity to capture better relative value moving forward and so we would find it difficult to argue against a temporary pause in buying activity.***

Unsurprisingly, ***July issuance declined over 30% year-over-year as issuers took to the sidelines ahead of the July FOMC meeting as a sign of caution prior to a rate decision. While refunding volume was down almost 77%, new-money issuance dropped over 13%. July's issuance patterns most likely contributed to the supportive technicals that framed much of last month's march to richer valuations.***

We will continue to monitor the recessionary narrative and shape subsequent strategic guidance accordingly with an eye on security selection and a preference for those credits and structures offering defensive attributes. Portfolio reviews are highly recommended and where appropriate, a reallocation to these security types and generally higher quality bonds may be in order. We emphasize our previous guidance to allocate deployable cash into longer dated maturities as a way to capture strategic value with more attractive total return potential should rates revert to lower ground and so curve extensions may be appropriate for those investors unhindered by duration risk.

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