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MUNICIPAL STRATEGY AND RESEARCH
Municipal Basis Points – Weekly

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Municipal Market Comments

The UST – Muni Hustle

Volatility, uncertainty and wide swings in financial asset valuations remain in full sight and, for now, there seems to be very little in the way of catalysts that could bring about much desired change. The FOMC just concluded its policy meeting and, as anticipated, the benchmark fed funds rate was lifted 50 basis points to a new target range of 0.75 – 1%. The Central Bank also met expectations by announcing the start of the balance sheet reduction campaign with a June 1 commencement date and a mission to normalize the Fed's bloated $9 trillion asset portfolio. Over a three-month period, up to $60 billion of U.S. Treasury and $35 billion of mortgage-backed securities are scheduled to roll off the balance sheet each month as they mature. ***While balance sheet management is certainly part of the policy mix necessary to combat what is proving to be more persistent and broad-based inflation, tightening of the funds rate remains the primary monetary tool of choice.***

From our perspective, we were comforted by both the policy statement as well as by the comments provided by Chair Powell at his post-meeting press conference. As we have been indicating, Central Bank messaging is of critical importance for the markets and ***there was sufficient guidance that a 75 basis point hike is not under active consideration.*** Nevertheless, ***subsequent 50 basis point raises are very much on the table should anticipated inflationary and growth data materialize.*** At the earlier stages of the tightening conversation, the data points largely supported the application of 25 basis point installments, but with a number of decisively outsized inflation prints, 50 entered the narrative and never left.

Overall, we did not see/hear an unexpectedly hawkish tone at the conclusion of the two-day policy session, and seemingly, neither did the markets. While risk assets rallied Wednesday afternoon, bond prices made a concerted effort to find comfort in the Fed's hawkish-lite tone. For a fleeting moment, we were hopeful that the Central Bank's messaging would have some staying power, out of either eternal optimism or simple naiveté. Here's where the old adage, "fool me once, shame on you; fool me twice, shame on me" comes into play.

We are hard-pressed to find fault with the Fed's messaging this week and we continue to have faith in

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its ability to orchestrate something that resembles a soft landing. We committed ourselves to the full Powell press conference and ***we found the Chair to be straightforward*** (many of us recall prior Fed Chairs who were famous for speaking in multiple tongues) ***and transparent.*** Again, ***we found his comments consistent with what he conveyed during his March press conference and with his statements and tone just prior to the onset of the traditional "blackout period."***

Thursday was a day better left forgotten as inflationary fears, perhaps more specifically, stagflationary fears, gripped the equity markets and caused a reversal in fortunes. The scourge of inflation and the open-ended uncertainty of higher interest rates sent 10-year Treasury yields to well above 3% and long-dated tenors to about 3.2%, the highest level since December 2018. Short dated yields also advanced, but with less magnitude, signaling a drive toward a steeper curve.

Perhaps there were second thoughts surrounding Chair Powell's diminishment of a 75 basis point rate hike with the notion that the Central Bank may fall short of successfully containing inflationary growth and bringing price stability back into vogue. Market participants also quickly shifted attention to the release of April employment data, expected to show a 380,000 nonfarm payrolls print and a 5.5% advance in year-over-year wages. ***Given an already tight labor market, with strong demand and muted supply, and wage growth running at the highest levels in decades, April's wage component ahead of the release was viewed as the data point to focus on.***

Friday morning's headline print revealed the creation of 428,000 nonfarm payrolls, led by gains in the leisure and hospitality as well as in the manufacturing, transportation, and warehousing sectors. With another strong monthly advance, the unemployment rate remained steady at 3.6% versus a consensus decline to 3.5%. Average hourly wages increased 0.3% M/M and rose 5.5% Y/Y. ***While the annual rise met expectations, the monthly gain was slightly below estimate, signaling perhaps an easing in upward wage pressure. However, a 0.2% decline in the labor force participation rate last month, the first monthly decline since March 2021, may exacerbate upward wage pressure. At the very least, labor demand remains robust and employment competition demonstrates continued resiliency. Going forward, we will be looking for signs of receding upward wage pressure, which could be constructive for future Fed policy moves.***

We find ourselves in general agreement with the Fed's economic mindset in that favorable, albeit tempered, GDP performance and resilient labor market strength should help to tolerate higher interest rates. Slower economic growth will be catalyzed by geopolitical events, easing fiscal stimulus and higher interest rates. The Central Bank's policy course is expected to bring labor supply and demand back into balance with a resultant easing in wage gains. Again, recession is not part of our base case for the next 12 - month period, yet we do anticipate moderating job formation given the already strong monthly advances and the current point within the domestic recovery cycle.

While COVID lockdowns in China and the war in Eastern Europe can be expected to exacerbate existing supply chain disruptions, near to medium-term projections call for some flattening in core PCE inflation growth. ***We believe that monetary policy will keep inflationary expectations anchored and that higher rates are essential to pushing target inflation back down towards 2% and to achieving stable prices.*** Throughout his entire press conference, Chair Powell reiterated the Fed's firm commitment to get inflation under control. "Inflation is much too high, and we understand the hardship that it is causing," stated Chair Powell. ***While higher rates are broadly elevating consumer and corporate borrowing costs, the risks of extending***

Central Bank accommodation and allowing rampant inflation would far outweigh these higher expenses.

Both business and consumer balance sheets stand in good position and should be able to absorb the shocks of higher interest rates. Of course, we are mindful that a 200 basis point rise in the average conventional 30-year mortgage rate since December 2021 has created economic headwinds for many younger and/or first-time homebuyers, potentially locking part of this segment out of the housing market. ***Coupled with skyrocketing prices and waning inventory, the more expensive financing terms create a deeper divide in wealth disparity and this disparity is further widened by higher rates tied to installment credit cards. Refinancing activity done at sub 3% mortgage rates during 2020 and 2021 has benefitted a large segment of the population by reducing monthly expenses and adding cash to already-flush consumer balance sheets.***

As we have previously indicated, inflationary pressure may start to ebb later this year and into Q1 of 2023 as supply chain bottlenecks untangle and the overall supply/demand balance begins to normalize. While this may be more observable for certain goods such as furniture, automobiles and appliances, rents are likely to stay high for an extended period given their conventional longer-dated terms. The Fed recognizes that current policy remains accommodative, and thus inflationary, and by the Chair's own admission, policy remains "a long way from neutral". ***Inflation-adjusted interest rates are well within negative territory and so this realization does give the Fed ample runway in our opinion to chart a systematic course to a neutral rate, but care must be taken to not allow inflation to overcome the Central Bank's handy work.***

As the title of this week's ***Basis Points*** suggests, Treasuries and munis are performing a well - choreographed dance, but with UST leading the hustle. Even after the wage data for April may have given the bond market cause for hope, market participants, despite a brief respite, were having none of that as UST yields continued their march toward higher ground as of this writing. ***One month of wage data does not establish a trend and so the trajectory to normalize rates will proceed, organically, through Fed intervention or a combination of the two. While UST yields test new cyclical highs in search of a ceiling, or at the very least, a stabilized trading range, munis cannot help but move in sympathy.***

Benchmark 10 and 30-year MMD yields have risen by 178 basis points and 165 basis points respectively since the beginning of the year. Similar maturity relative value ratios now stand at 91% and 99% respectively according to Refinitiv. Let's recall that ratios were significantly more expensive throughout much of 2021, and now fairer value is available. More recent muni outperformance has pressed ratios down from higher levels, yet munis can certainly display intermittent underperformance going forward. Interestingly, almost 90% of the curve can be captured by staying within the 10-year tenor.

With the outsized market volatility, it is very difficult to put forth prognostications at any given point in time. Refinitiv-Lipper reports that municipal bond mutual fund outflows have totaled a YTD record of $41 billion, posting 11 consecutive weeks of cash withdrawals and the longest negative cycle since 2018. ***We continue to foresee a shift in muni market technicals on the horizon, and if fund flows exhibit a change in trajectory, such change would likely be escorted by a slowing pace of outflows as demand is beginning to advance and evidence was on display this week that outflows are somewhat ebbing. In***

this regard, patience is very much being tested and if volatility persists, positive flows may very well be of an intermittent nature.

At the risk of sounding like a broken record, greater market conviction on the course of policy tightening and a return to stability for UST yields would be needed to improve the muni tone and catalyze a reversal in negative muni fund flows. ***Admittedly, it would take a perfect alignment of the muni stars to end the year with net positive flows, but there is a pathway to that scenario, albeit a very thinning one. In our view, the Fed has provided the bond markets with a degree of clarity and guidance and now it is up to investors to decide how to proceed.***

If the belief is that the Central Bank has lost its grip on inflation, volatility and sentiment will likely hold course. Against this backdrop, there is ample cash awaiting directional guidance and at currently cheaper (i.e. attractive) ratios and absolute yield levels, muni interest should take hold and make for a very different muni market during the second half of 2022 with the opportunity to capture value and to add inflationary insulation to portfolios.

We think that the Fed's messaging was appropriately crafted, yet we are but one single voice. This is not a dislocation originating from credit weakness, yet one propelled by rates and inflationary fears. While an allocation to cash makes sense given the level of uncertainty, we must be mindful of the potential inflationary affects upon cash investments and so it is advisable to make muni purchases at these higher yields and cheaper ratios, but to do so selectively with an eye on quality and long-term resiliency.

Retail has been putting in more than just a toe into the market, both for secondary as well as primary business given the compelling opportunities. Daily street bids remain active, and although competitive deals are getting done, syndicate bidding remains cautious. Negotiated transactions continue to be priced at cheaper levels in order to be comfortably placed. Although munis caught a bid post-FOMC, overall fund flows were once again reported negative by Refinitiv Lipper. While muni ETFs saw inflows, high-yield flows remained negative. By Friday afternoon, the MMD was cut 0-4 basis points along much of the curve, while UST securities largely sold off with the solid payroll advances signaling the potential for steady-as-she goes tightening policy.

Bond market performance continues to post negative returns with munis losing 2.77% in April to outperform the loss of 3.1% for UST. YTD, the broad muni index and Treasuries are down 9.3% and 9.2% respectively as a sign of solidarity. Last month, 10-year and in maturities outperformed the broader muni index given softer demand for longer dated tenors and concerns over monetary policy. G.O.s outperformed (-2.67%) the broader muni market and outperformed the returns shown for revenue bonds (-2.96%) last month. Muni high-yield underperformed (-3.55%) the broader muni returns in April, and year-to-date, the speculative space is down 10.57%, in sharp contrast to the meaningful outperformance booked in 2021.

The spreads that are taking hold in IG space seem to be amplified within high-yield. We continue to follow the trading performance of the new Puerto Rico securities now that the Central Government debt exchange has been completed. We do expect some improved liquidity within high-yield to result and we may possibly identify accretive benefits for this area of the market, but for now, Puerto Rico is largely tracking the broader high-yield sector.

There is still outsized volatility and liquidity challenges that lie ahead, but maybe more extended relief is not too far off. Muni yield movements are closely following the volatility very much on display in the

Treasury market and it would likely take a tempering of such volatility and/or a more compelling technical muni backdrop to catalyze enduring market conviction with sustained outperformance.

Although muni bond prices may have some further room to move lower, we believe that yields are moving closer to a range-bound trade, albeit not necessarily permanent, as better technicals loom on the horizon. Now that the Fed has concluded its policy meeting, we still may not see a meaningful withdrawal of Treasury market volatility for some time to come and if that turns out to be the case, we would not expect to see a return to consistent muni inflows until then.

Weaker, albeit improving, demand for product is going hand in hand with declining new issuance. Refunding and taxable volume (which are often one in the same) is down year over year for April given the rise in rates and general market volatility. ***Many issuers are waiting to see what the Fed will do over the coming policy sessions. For now, there is less ambiguity surrounding additional 50 basis point rate hikes at the next meeting or two. The war in Eastern Europe and domestic growth concerns have furthered issuer pause.*** Interestingly, taxable issuance has moved lower month over month. Part of the recent decline in taxable sales can be attributed to several large universities issuing long-dated taxable debt in March to lock in current rates and stockpile capital that does not need to be specifically earmarked like tax-exempt bond proceeds would need to be.

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