OPPENHEIMER
MUNICIPAL STRATEGY AND RESEARCH
Municipal Basis Points – Weekly

May 2, 2023

Municipal Market Comments

Running On Empty

Admittedly, we sometimes give too much thought to our ***Basis Points*** titles, but choosing the right words from the outset can convey an overriding theme or idea that we want to resonate with our readership. This commentary is being released just ahead of this week's FOMC meeting amid ***expectations that the Central Bank will raise the benchmark funds rate by 25 basis points, boosting the aggregate tightening cycle-to-date to 500 basis points through a series of what will be 10 rate hikes over a little more than one year. The new target range will be 5% - 5.25%.*** With still-conflicting economic data points demonstrating sticky inflation against slowing growth, policymakers have no easy task beyond next month's meeting.

Running on Empty was recorded by Jackson Browne in 1977 and set as the title track of the artist's live album released in the same year. Debuting as a single in early 1978, ***Running on Empty*** spent over four months on the ***U.S. Billboard Hot 100 chart.*** In 2010, ***Rolling Stone Magazine*** ranked it at number 496 on its list of ***"The 500 Greatest Songs of All Time".*** While the literal significance of ***Running on Empty*** captures the time when Jackson Browne drove the daily short-distance trip from home to the studio with a near-empty gas tank when making his ***Pretender*** album, the more philosophical interpretation conveys restlessness or perhaps even exhaustion, yet still with a sense of hope for a better tomorrow.

With this in mind, ***we posit that market participants are likely suffering from monetary policy fatigue with a growing chorus signaling a near-conclusion to the Fed's tightening cycle.*** Further evidence of economic retrenchment and elevated concerns over the viability of First Republic Bank and the general health of the overall regional banking system caused the futures contracts to modestly lower their wager for a 25-basis point rate hike through much of last week. The release of Q1 GDP with the accompanying, and more concerning, PCE price index seemed to alter perception with UST returning to sell-off mode, and odds of a 25-basis point bump in the funds rate advanced.

Real GDP (advance estimate) grew at an annualized rate of 1.1%, versus consensus of +1.9%, during the first quarter of 2023, and marked a slowdown from the 2.6% expansion booked in Q4 of last year. Core PCE

Jeffrey Lipton
Managing Director, Head of Municipal Research
Fixed Income Research
(212) 667-5365
jeffrey.lipton@opco.com

Oppenheimer & Co. Inc. 85 Broad Street New York, NY 10004 Tel: 800-221-5588 Fax: 212-667-5925

inflation exceeded consensus and advanced 4.9% during the January – March period, the highest acceleration in a year. This came along with the most active consumer spending in about two years, with the overall increase of 3.7% showing strength across both goods and services. Purchases on motor vehicles were visibly strong, yet inventory drawdowns prevailed, and signs of household and business spending retrenchment were evident during the later stages of the quarter.

Subsequent revisions to Q1 GDP will likely reflect the overall resiliency of the American consumer with views on discretionary spending, but we do maintain that our Nation's growth trajectory is expected to exhibit further tightening, with anticipated contraction a very possible scenario. A separate report for March core PCE showed still-elevated price pressure, rising 0.3% from the prior month and 4.6% year/year. Recent reads on ISM manufacturing PMI and U.S. factory activity demonstrated negative pressure, albeit at a slower rate, yet further retrenchment is more likely than not.

Signals that the domestic housing market may be bottoming out may bode well for our economic outlook, but subsequent housing developments will likely be tied to the level of mortgage rates, the strength of the labor market, supply/demand dynamics (which may have greater impact than where mortgage rates stand), and overall degrees of consumer confidence. Friday's anticipated release of April employment data should provide meaningful guidance. The freshly reported JOLTS report for March revealed that available positions declined month/month, sending Treasury yields lower on softer labor market evidence.

The contracts are now flashing a full 25-basis point increase with the fresh growth and inflation data points as well as with the recently minted deal between the FDIC and JP Morgan Chase for the disposition of First Republic's loans, investment securities, and deposits. Nevertheless, ***the ongoing concerns over future economic growth and the potential for further bank displacements with tightening credit conditions have set market expectations for a Central Bank pause beyond this week's meeting.*** Overall business capital spending and investment will likely show continued pullback, especially if credit and overall financial conditions reveal meaningful erosion.

Although contracts continue to point to a Q3 pivot, Chair Powell's post-meeting comments could alter the bond market's policy calculus. While the actual magnitude of the rate decision may be a foregone conclusion, the tone and guidance communicated by Chair Powell during his post-meeting press conference will likely be more relevant. ***Admittedly, inflation still has a long journey to the Fed's 2% target, yet there needs to be meaningful recognition of slowing growth conditions as well as existing credit developments and the potential for further banking-related stress.***

We expect the Chair to be presented with questions surrounding the debt ceiling and associated Congressional and White House deliberations, as strained as they appear to be, and how such developments factor into Fed thinking. ***The markets can be expected to elevate the debt ceiling issue to heightened levels of concern absent an immediate-term resolution, and failure to act, with an inability to pay debt obligations when due, would certainly have catastrophic domestic and global implications.***

Having said this, Mr. Powell may stick to his previous comments that resolution is in the hands of the legislative and executive branches of government. Treasury Secretary Janet Yellen has just notified House Speaker Kevin McCarthy that her department's use of special accounting measures to operate within the current debt limit is nearing an end, with June 1st as a targeted date whereby Treasury may no longer be able to service all government debt. Secretary Yellen emphasized, “Given the current projections, it is imperative that Congress act as soon as possible to increase or suspend the debt limit in a way that provides longer-term certainty that the government will continue to make its payments.”

Even negative sentiment without actual bank failures can wreak havoc upon confidence and result in a tighter credit environment, and while Washington is expected to favorably act, sentiment can also suffer erosion should the debt ceiling issue remain unresolved through much of May. A crisis in confidence could certainly resonate throughout the global economy and call into question our commitments made to multiple stakeholders.

Should a highly unlikely payment default on U.S. debt occur, severe economic contraction, a devaluation of the dollar, and skyrocketing borrowing costs would ensue. ***The combination of an aggressive monetary policy tightening campaign and SVB et al has pushed lending standards to more restrictive ground, and the Fed must consider the potential for additional lending dislocation.*** We would also suggest that deposit activity may demonstrate un-anticipated distortions in flows moving forward in the event of further banking-related stress.

Against this backdrop, we support a pause beyond May and prefer to re-evaluate the economic trajectory and financial conditions for the June FOMC meeting. We expect the Fed to acknowledge progress made on the inflation front by softening its language, yet we are not sure just how far policymakers will go with capitulating on the arrival of sufficiently restrictive rates at the conclusion of the FOMC meeting.

We take the view, along with others, that the tighter credit conditions brought on by the banking stress equate to at least 25-basis points of additional rate advances. Chair Powell can retain a hawkish tone, particularly surrounding future evidence of persistent inflationary pressure, but we feel strongly that the above acknowledgements should be part of his narrative. ***Whether or not the Fed sees greater risk of recession given the evolving banking events and outcomes, there is little denying the observation that growth will suffer collateral damage.***

Throughout the past week, UST securities have been trading beyond a previously tighter range with greater volatility, bouncing among reaction to a flight-to-quality bias, economic data prints, an approaching FOMC meeting, and Treasury market offerings. Munis, following a heavy sell-off given the unsustainable richness of the tax-exempt curve, with greater corrections on the short-end, have settled into a very tight trading range with relative stability ahead of the FOMC meeting. The frothy price levels on the short-end of the muni curve actually made similar maturity UST securities more compelling on a tax-adjusted basis.

Now that we are in a new month, there is ample runway to discuss muni performance for April. Even though April volume fell by 24% year/year (per Refinitiv data), led by a 69% drop in taxable issuance, munis lost 29 basis points last month, underperforming the 5-basis point loss posted by UST. ***Year-to-date, munis are also underperforming UST and corporate bonds, 2.52%, 2.59%, and 3.06% respectively, although we would add that the performance spread has narrowed in favor of munis over the past few trading sessions. We would posit that April muni performance would have been meaningfully worse had supply taken on a more normal trajectory.***

The reasons for the continued monthly declines in supply range from existing stimulus funds available to many municipal governments and enterprise units to ongoing monetary policy uncertainty, which has taken rates higher and kept refunding opportunities scarce. Refunding volume in April dropped almost 44% year/year.

Aggregate issuance year-to-date stands at $107.63 billion, down over 25% from the same period of 2022. Issuers tend to hold off on accessing the market ahead of policy meetings, but we would note that this week's supply is fairly heavy given the Tuesday/Wednesday gathering. We expect this week's plate of offerings to be priced to sell so as to minimize underwriter balances.

For much of 2023, many issuers have been sidelined for one reason or another, and we do not see a meaningful break from this trend anytime soon. However, Federal stimulus funds will not last in perpetuity, and at the very least, monetary policy is likely close to the end of its tightening sequence, and if the market gets its way, rates may shift downward later this year – a big ask and subject to a range of conditions.

Should rates drop enough, we can expect to see a resurgence of refunding activity. Furthermore, new-money issuance declined by about 38% in April year/year, and issuers would likely elevate new-money debt if there are compelling arguments to lock in lower long-term financing terms.

Parsing the performance data for April, seven-year and in maturities underperformed the broader index given the richer valuations and greater attendant corrections on shorter tenors during the muni sell-off. The month ended with limited impact from tax-liability related selling activity, largely attributable to the presence of lower capital gains.

The out-performance demonstrated by taxable munis (35 basis points) in April reflected expensive prices on exempts relative to the cheaper valuations available on taxable muni alternatives with ratios favoring the latter, particularly on shorter areas of the curve. Year-to-date, taxable munis are returning 5.14%, outperforming the broader muni index as relative value opportunities support taxable performance, and even outperforming the UST and corporate bond indices for the same time period.

In a recent ***Municipal Basis Points*** commentary, we suggested that ***technical conditions should improve with expanding demand amid heavier reinvestment needs, thus setting up the month of May for better performance, with single-digit positive returns a very real possibility. This technical support should continue into June and July, with anticipated positive returns in those months as well. While issuance may advance, we expect the market to manage the supply fairly well amid a more stable rate environment.***

This month may see some type of return to positive fund flows, but we are not signaling a cyclical shift just yet. As we move throughout the month, better value opportunities may be found on longer dated exempts and even on mid-range investment grade cohorts with a focus on certain revenue bond structures.

There is much to talk about now with the First Republic/JP Morgan Chase deal in place. Of the approximately $30 billion in securities to be acquired by JP Morgan from the First Republic investment portfolio, munis comprise about $16.6 billion (Held-to-maturity fair value) according to Federal Reserve data. Although significant, this figure is down from a year ago as many banks liquidated muni holdings in 2022. Assuming that these securities will be acquired at discounted levels, there is probable motivation for JP Morgan to largely hold these muni positions with a degree of attention paid to credit and structure.

Thus, we do not expect any material dislocations to the muni market from the First Republic developments. However, we will be monitoring BlackRock's liquidation of muni bonds previously held by SVB and Signature Bank. The sale of these securities will be made in tranches and will take place over time. We suspect that market pricing has already accounted for what should be an orderly liquidation of muni assets, but we are prepared to experience a degree of market dislocation.

We continue to posit that the muni asset class is well-positioned and should outperform other fixed income investment classes through an anticipated recession with respect to credit, even though muni credit has effectively peaked. Munis will offer defensive attributes to an investment portfolio, and we suspect that institutional buyers will consider munis more closely. For the individual muni investor, the unfolding First Republic events, along with previous banking scenarios, should bring about calm and help to keep financial stability in place and disruptive market forces at bay.

Important Disclosures and Certifications

Analyst Certification –-The author certifies that this research report accurately states his/her personal views about the subject securities, which are reflected in the ratings as well as in the substance of this report. The author certifies that no part of his/her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this research report.

Oppenheimer Credit Rating System:

Rating	Description
Outperform (OP)	The analyst thinks that the security will outperform the average total return of similar securities over the next 6 – 12 months.
Market Perform (MP)	The analyst thinks that the security will match the average total return of similar securities over the next 6 – 12 months.
Underperform (UP)	The analyst thinks that the security will underperform the average total return of similar securities over the next 6 – 12 months.
Not Rated: (NR)	Oppenheimer does not rate the security.

Conflicts of Interest - Oppenheimer & Co. Inc.'s fixed income research analysts are compensated from revenues generated by various Oppenheimer & Co. Inc. businesses including the Oppenheimer & Co. Inc. Investment Banking Department, Taxable Fixed Income Capital Markets Department and Municipal Capital Markets Group. Research analysts do not receive compensation based upon revenues from specific investment banking transactions, specific sales and trading transactions or on revenues derived from investment banking services provided to a specific issuer or industry sector. Oppenheimer & Co. Inc. generally prohibits any research analyst and any member of his or her household from executing trades in the securities of a company (or entity) that such research analyst covers. Additionally, Oppenheimer & Co. Inc. generally prohibits any research analyst from serving as an officer, director or advisory board member of a company (or entity) that such analyst covers.

Oppenheimer & Co. Inc. trades as principal the fixed income securities (or related derivatives) that are the subject of this research report and may at any time have proprietary positions in the securities (or related derivatives) that are the subject of this research report. Oppenheimer & Co. Inc. may have a long or short position or deal as principal in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon.

Oppenheimer & Co. Inc. has or may seek to have an investment banking, underwriting, advisory, lending or other credit relationship with the company (or entity) that is the subject of this report., This may at times give rise to potential conflicts of interest.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of Oppenheimer & Co. Inc. or any particular investor. The securities mentioned in this report may be thinly traded; their prices, value and/or income they produce may be subject to extreme volatility. These debt securities are not suitable for all types of investors. Investors that are not "Qualified Institutional Buyers" or "QIBs" (as defined in SEC 144A) should not purchase or sell any of the securities mentioned herein without contacting a financial adviser in such investor's jurisdiction to discuss the investors particular circumstances.

This report is based on public information. Oppenheimer & Co. Inc. makes every effort to use reliable, comprehensive information, but Oppenheimer & Co. Inc. makes no representation that it is accurate or complete. All estimates, opinions and recommendations expressed herein constitute judgments of the Oppenheimer & Co. Inc.'s research analyst as of the date of this report and are subject to change without notice. Oppenheimer & Co. Inc. has no obligation to update this report. No statement contained in this report should be misinterpreted as a guarantee of the future performance of any recommended securities.

This research contains the views, opinions and recommendations of Oppenheimer & Co. Inc. fixed income research analysts. Research analysts routinely consult with Oppenheimer & Co. Inc. trading desk personnel in formulating views, opinions and recommendations in preparing research. Trading desks may trade or have traded as principal on the basis of research analysts' views and reports. Therefore, this research may not be independent from the proprietary interests of Oppenheimer & Co. Inc. trading desks, which may conflict with an investor's interests. In addition, while research analysts do not receive compensation based on any specific investment banking transactions, specific sales and trading transactions or on revenues derived from investment banking services provided to a specific issuer or industry sector, research analysts do receive compensation based, in part, on the quality and accuracy of their analysis, client feedback, trading desk and firm revenues, and competitive factors..

This report is provided for informational purposes only, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited.

To the extent this report references municipal securities, investors should consult with their tax or accounting advisor(s) regarding the suitability of tax-exempt investments in their portfolio as Oppenheimer & Co. Inc. does not offer tax or accounting advice. Income generated from investments in municipal securities may be subject to state and local taxes as well as the Alternative Minimum Tax. Municipal securities are subject to gains/losses based on the level of interest rates, market conditions and credit quality of the issuer. Non-rated municipal bonds or municipal bonds rated below investment grade are speculative in nature and may not be suitable for all investors.

This research is distributed in the UK and elsewhere throughout Europe, as third party research by Oppenheimer Europe Ltd, which is authorized and regulated by the Financial Conduct Authority (FCA). This research is for information purposes only and is not to be construed as a solicitation or an offer to purchase or sell investments or related financial instruments. This research is for distribution only to persons who are eligible counterparties or professional clients and is exempt from the general restrictions in section 21 of the Financial Services and Markets Act 2000 on the communication of invitations or inducements to engage in investment activity on the grounds that it is being distributed in the UK only to persons of a kind described in Article 19(5) (Investment Professionals) and 49(2) (Financial Promotion) Order 2005 (as amended). It is not intended to be distributed or passed on, directly or indirectly, to any other class of persons. In particular, this material is not for distribution to, and should not be relied upon by, retail clients, as defined under the rules of the FCA. Neither the FCA's protection rules nor compensation scheme may be applied.

Distribution in Hong Kong: This report is prepared for professional investors and is being distributed in Hong Kong by Oppenheimer Investments Asia Limited (OIAL) to persons whose business involves the acquisition, disposal or holding of securities, whether as principal or agent. OIAL, an affiliate of Oppenheimer & Co. Inc., is regulated by the Securities and Futures Commission for the conduct of dealing in securities and advising on securities. For professional investors in Hong Kong, please contact researchasia@opco for all matters and queries relating to this report.

Oppenheimer & Co. Inc. transacts business on all principal exchanges.

Additional Information Available

Please log on to http://www.opco.com or write to Oppenheimer & Co. Inc. 85 Broad Street, New York, NY 10004, Attn: Municipal Research