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Municipal Market Comments

The Search Is On!

Every time the bond market attempts to get back in bed, it falls right back out with an even greater thud. The early May FOMC meeting is fast approaching and we have had quite a bit of Fed speak seemingly more hawkish with every turn at bat. ***Finding that elusive neutral rate is no easy task and there are multiple targets that are leaving outsized market volatility well entrenched.*** Early last week, UST yields were jolted higher following clear messaging from Federal Reserve Governor (soon to be confirmed Vice-Chair) Lael Brainard that methodical rate hikes along with an accelerated unwinding to the Fed's balance sheet will be needed to regain control over advancing inflation.

The minutes from the March FOMC meeting left little doubt that a 50 basis point hike in the fed funds rate at one or several subsequent meetings is a likely outcome and signaled one of the more aggressive tightening cycles in some time. There was even a suggestion that if it were not for the war in Eastern Europe, policymakers would have put through a 50 basis point lift last month.

The bond market is a rather interesting phenomenon as expectations are vivid enough to catalyze a sell-off, only to display further price erosion when those expectations turn into reality. It was only a short while ago when the 10-year UST yield was sure to breach the psychological 2% threshold after beginning the year at just over 1.6%, and now 3% is in close sight. Let's recall that it was the release of February CPI showing a near 8% rise YOY that provided conviction for the 2 – handle. ***Ahead of this week's March CPI report, showing a consensus advance of 8.4% YOY, bond prices remained under downward pressure as the Fed's task of controlling inflation reveals mounting challenges.***

The headline CPI print came in just above target at 8.5%, the fastest annual rate since 1981 and providing sufficient runway for the FOMC to bump the funds rate by 50 basis points at the early May meeting, despite some ebbing price pressure reflected in the core number. While the data point was widely anticipated and reflects elevated energy prices amid the war in Eastern Europe as well as higher rental and food costs, ***the thought process seems to have more to do with whether or not inflation has peaked***

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as well as with the identification of possible transitory elements within the inflationary mix. The 11.2% spike in March YOY producer prices was above estimate and reflected a record print.

Any discussion over the recovery must account for consumer sentiment and the level of spending on goods and services, with discretionary spending patterns being part of the bigger picture. We must keep in mind that although consumer balance sheets are in very good shape, sentiment may inhibit active deployment of consumer resources and reveal shifting demand patterns.

Globally, inflation has reached outsized proportion given the rise in energy, food and other commodities prices and so this has become a major concern for Central Bankers around the world. ***The longer the war in Eastern Europe goes on, the greater the potential impact upon the global economy with downward revisions to international growth and demand now taking hold.***

Housing rentals are at rather frothy levels in a number of markets across the country while home prices in many regions have been buoyed by historically low mortgage rates and a COVID – induced outmigration into the suburbs. ***Now that mortgage rates have broken through 5% on the 30-year conventional, certain lower income and first-time homebuyers may be taken out of the search as higher borrowing terms limit affordability.*** We must also consider oil and other commodity costs as rising prices appear to be moderating from their early-March highs and any relief on used car prices requires greater sustainability.

Excluding the more volatile food and energy contributors, core CPI advanced 0.3% MOM and 6.5% YOY (both below consensus) as used car prices dropped at the fastest pace in over 50 years and posted the second consecutive monthly decline. Although new car prices rose modestly, we will be watching for further signs of ebbing goods inflation, with the caveat that car pricing will remain tethered to some extent to demand originating from rental car companies.

Against this backdrop, ***we expect any meaningful unwinding to the inflationary trajectory to pursue a slow and uneven course as supply chain bottlenecks, which have been exacerbated by the Eastern European war and COVID lockdowns in China - which may intensify should COVID lockdowns extend their reach - , take time to abate and consumers shift spending preferences to service needs.*** Furthermore, we will be looking for evidence of slowing employment growth across economic sectors as a signal of tempering wage advances, even though wages are still trailing inflationary growth rates.

As we parsed the minutes of the March FOMC meeting, we remained somewhat fixated on the near unanimity among policymakers signaling that an aggressive tightening cycle needs to be employed to force inflation down to target, which again will take some time. The Fed party line calls for a series of deliberate and methodical rate hikes to attain a desired neutral rate, which according to median estimates among Fed officials now stands at about 2.4%. This target, however, is at variance with a growing number of market predictions, yet we may see some clarity as the funds rate gets closer to 2%.

As we have mentioned in prior commentaries, the Fed's balance sheet grew from $4.17 trillion in February 2020 to its current $8.9 trillion. The tapering of asset purchases concluded last month and now the focus will be on normalizing the balance sheet, which means a significant reduction in both U.S. Treasury and mortgage-backed securities. ***While the wager is on for a 50 basis point hike in the funds rate at the May meeting, it also seems likely that this move will be accompanied by the beginning phase to a much smaller balance sheet.***

The FOMC minutes expressed a monthly cut of $95 billion with a cap of $60 billion for Treasuries and $35 billion for mortgage-backed securities (just over $1 trillion annually). ***We believe that the outsized sell-off in the UST bond market can be partly attributable to expectations for the balance sheet unwinding with the Fed no longer being the buyer of last resort as it reins in unprecedented support levels that have helped to artificially keep UST yields at historically low levels.*** However, a slower, more methodical wind-down to the Treasury's bill portfolio could keep supply at bay and short rates at more repressed levels.

Perhaps the maiden voyage will target lower amounts, but with heavier numbers over the ensuing months to possibly reach target by the summer. With this schedule in mind, Central Bank asset holdings as a percentage of GDP will likely fall back closer to pre-pandemic levels by the end of 2024. The minutes further indicated a higher forecast for PCE inflation (4% vs. 2.6% in January) for this year and a more observable concern for longer-term inflation expectations. A conspicuous absence of any mention of recent UST curve inversions in the minutes speaks for itself in our view.

Last week, we saw the benchmark UST 10-year yield surge at the fastest pace since March 2020 following Lael Brainard's overtly hawkish comments, thus extending the 2022 bond market sell-off, which posted quarterly losses of generational significance. The ever-so-fickle bond market appears, at least as of this writing, to welcome the March CPI data preferring to focus on the more tempered core number as opposed to the broader YOY print. Supportive comments from Fed Governor Brainard emphasizing moderating inflation certainly did not hurt. ***As of Tuesday afternoon and continuing into Wednesday of this week, UST bond benchmarks were flashing green along the curve and futures were signaling less aggressive tightening moves through the balance of the year while holding steady to a 50 basis point hike in May.*** However, concern remains over the anticipated course of service price and wage inflation and so upward yield pressure will likely ensue for a while.

The past week saw muni yields move higher with the 10 and 30-year benchmarks rising 22 basis points since April 5. True-to-form, munis underperformed Tuesday's CPI-induced rally in the Treasury market, with yields rising 2 to 4 basis points out three years and steady performance throughout the balance of the curve. The 3 and 10-year UST benchmark yields tightened by 15 and 7 basis points respectively while the 30-year Treasury yield fell by 2 basis points.

The muni underperformance lifted benchmark 10 and 30-year relative value ratios somewhat to 89% and 98% respectively according to Refinitiv. Having said this, munis moved in sympathy with the Treasury market sell-off prior to the CPI release and even realized periods of outperformance. Still, ***outsized volatility continues to produce large-scale mutual fund outflows and heavy bid-wanted activity, and this volatility is testing the boundaries of liquidity and price discovery and the overall resiliency of the muni asset class.***

At the risk of sounding like a broken record, ***a sustained period of tempered volatility and market conviction is needed to reverse course and produce a renewed cycle of positive muni flows. When this occurs, we suspect that the more idiosyncratic nature of the municipal bond market will re-emerge with demand for product signaling a degree of compromise with respect to structure and credit spreads. For now however, we can expect to see continued outflows, yet we do think that a cyclical change will likely begin with a visibly slowing pace of negative flows.***

As we think about the outlook for the muni asset class, we cannot help but reference that idiomatic expression, “shoot first and ask questions later”. ***A perfect storm had created a very forgettable rate-driven first quarter for munis and adverse credit events and circumstances were conspicuously absent from that perfect storm.*** Various tax receipts are growing stronger, reserves and rainy day funds have been strengthened, debt management practices have become more conservative, and disclosure standards have made significant strides. Although greater provisions can be developed with respect to cyber-security threats and climate change, issuers are taking serious steps to reflect these considerations within their budgetary and operational framework. ***Certainly, the war in Eastern Europe and a growing unpredictability in Russian responses intensify the need to prepare for potential cyber-attacks.***

We further note that rating upgrades are outpacing downgrades and a big part of the muni credit story is tied to the unprecedented amounts of Federal stimulus made available to state and local governments and revenue-generating enterprises. We note that these resources have yet to be fully allocated and additionally, funding under the infrastructure package has a multi-year time horizon for deployment.

Munis fell victim to a broader sell-off in the U.S. Treasury market as a Fed pivot responded to advancing inflationary pressure with a commitment to lift interest rates as needed to achieve price stability. While we can expect to see munis following the lead of UST, disproportionate underperformance seemed counter-intuitive as munis typically outperform a run-up in bond yields. Circling back to “shoot first and ask questions later”, perhaps more than a pound of flesh has been extracted from munis and maybe cheaper valuations and hopefully some UST stability can place munis on course for better quarterly performance.

Our theme of late centers upon the notion that better entry points now exist when compared to the lower rate and richer valuation environment that characterized the 2021 municipal bond market. While spreads may have been somewhat wider earlier in the year, there is still value to be found thanks to an unforgiving first quarter and with the dynamics at play now, cross-asset class evaluation makes sense given cheaper muni levels.

While it is difficult to predict how much additional pain may lie ahead for munis, we believe that the heavy bloodletting is behind us and that observant investors can capture the market accretion when technicals guide us away from the cliff. When we consider ratios from both a UST and a corporate yield perspective, the value proposition can alter the investment calculus for those otherwise traditional investment grade taxable buyers with munis offering better returns and falling in line to provide inflationary ballast.

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