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Third quarter 2024 outlook

Municipal bonds: poised for growth in a favorable market

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The second strongest June performance in 20 years brought municipal performance back to -0.02% for the quarter, after negative returns in April and May. The power of income has offset weaker months, and the combination of price appreciation and income has resulted in strong relative performance in this supportive market environment. We believe demand for municipals could strengthen as investors consider shifting to longer duration ahead of anticipated U.S. Federal Reserve rate cuts.

KEY TAKEAWAYS

- The power of higher income generation helped muni bonds absorb a 35% increase in issuance during the quarter.
- Investors are looking to high yield municipals to drive additional yield and total return due to strong fundamentals and after-tax yields.
- The muni bond market is supported by above-average yields, strong fundamentals and an improving technical backdrop.

OUTLOOK: TECHNICAL TAILWINDS SHOULD BEGIN TO SHIFT

The municipal bond market is well positioned to begin the third quarter.

Supply increased meaningfully during the second quarter. Issuers brought deals that had been long delayed due to execution uncertainty and sought to get ahead of volatility that may accompany the U.S. election. Despite the lumpier issuance calendar, meaningful coupon payments and bond maturities provided a natural buyer for the elevated supply.

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We anticipate favorable technical conditions for municipals later this year, as continued reinvestment income combines with slower issuance. And a U.S. Federal Reserve rate cut in the fourth quarter would likely drive inflows as investors seek to lock in yields.

Yields are historically elevated, at more than 100 basis points (bps) above the trailing 10-year average. Investors may enjoy attractive total returns from income alone, a dynamic that has been absent for nearly a decade. And municipal bonds offer an attractive taxable-equivalent yield opportunity, as higher yields amplify their tax-exempt nature.

The yield curve should steepen with Fed action expected later this year. Such an environment should be positive for longer-duration bonds. Investors receive the higher income typically associated with longer-dated bonds while earning additional total return through a combination of declining rates and rolling down the yield curve.

Municipal credit is in a strong position to weather potential economic uncertainty. Statutory reserves remain high, despite excess reserves being drawn down. Though the economy remains on strong footing, we expect munis to perform well even if markets move to a risk-off tone due to their resilience during past economic downturns. Municipal bonds should be well placed to capitalize on these solid fundamentals, and we expect spread compression to continue.

ECONOMIC CRACKS ARE EMERGING

The U.S. economy continues to expand at a healthy pace, but we anticipate growth will start to decelerate over the balance of the year. After several quarters of upside surprises, key indicators are softening. Job creation sharply decelerated in April and resurged in May. Other labor market data — including job openings, quits rate and surveys of business sentiment — have shown weakness.

First quarter U.S. GDP showed an unwelcome mix of weak growth and high inflation. However, we think both halves of the stagflation concern are overblown. We're penciling in a slowdown to around 2% by year end, which is still a decent level of growth.

Regarding inflation, we anticipate modest easing in key areas like housing and services, but movement will likely be slow and uneven. PCE inflation data met expectations for May, showing significant deceleration after a surprisingly quick increase in the first quarter. Overall, core inflation is approaching 'normal.' Goods inflation is fully normalized around zero, housing has decelerated to a cyclical low (though it remains elevated on an annualized basis) and non-housing core services has dropped to around 3% annualized.

Fed funds futures are pricing in two rate cuts this year, with the first one projected to come the day after the U.S. election. While election uncertainty will increase volatility, removing uncertainty should eventually calm markets and possibly inject a modicum of risk-on sentiment.

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MUNI BONDS REMAIN FIRM DESPITE INCREASED ISSUANCE

Municipal-to-Treasury yield ratios moved slightly cheaper during the quarter amid the increase in issuance. The 5-, 10- and 30-year AAA ratios remain lower than historical averages, at 67%, 65% and 83%, respectively. Investment grade municipal credit spreads tightened across AA, A and BBB rated categories. The Bloomberg Municipal Bond Index returned -0.02% in the second quarter versus the Bloomberg U.S. Treasury Bond Index at 0.09%, after outperforming in April into mid-May when issuance picked up.

High yield municipal credit spreads tightened 15 bps to end the quarter at 199 bps, bolstered

by economic momentum, positive flows and less relative issuance. Spread tightening combined with coupon cash flow provided a cushion against broader interest rate volatility. The Bloomberg High Yield Municipal Bond Index returned 2.59% for the quarter.

Investors also recognize that lengthening duration may benefit portfolios in the short-term should yields decline. Choosing to get invested before the Fed begins to cut may offer a cushion against volatility that may emerge from inconsistent economic data and concerns surrounding the election. While income is expected to be a meaningful driver of total return for the rest of 2024, we note that price appreciation could be equally helpful if the economy shows signs of weakness and the Fed becomes more accommodative.

THE TECHNICAL ENVIRONMENT SHOULD IMPROVE

Supply

Total issuance for the second quarter was $139 billion, 35% higher than in the same period last year. Year-to-date issuance is 32% higher, putting pressure on the municipal market. Issuers brought deals that had been long delayed due to execution uncertainty and sought to get ahead of volatility that may accompany the U.S. election later this year. The market absorbed the much-needed supply after two consecutive years of lower overall volume.

New money issuance was up 25%, to $163 billion, while refunding issuance increased 73% versus the same period last year. Much of this refunding volume was due to current refunding deals and refinancing through tender offers, making the activity beneficial from a present value savings perspective. Some current refunding deals were placed to refinance outstanding Build America Bonds in the taxable municipal market.

We expect higher rates of issuance to continue as issuers bring deals ahead of the election, but the pace should cool in the fall. Such an environment should present a buying opportunity during the third and fourth quarters.

Demand

After first quarter inflows totaled $11.7 billion, second quarter flows were just $3.7 billion (as of 19 June). Overall flows were moderate, with only two weeks seeing more than a billion dollars in absolute flow volume. Investors have slowly come back to funds to generate income and total return opportunities.

Demand for individual bonds remains a bright spot. Higher yields continue to fuel strong demand from separately managed account programs and direct purchases, causing short-term ratios to remain historically low. We see opportunity in a barbell approach to enhance income while maintaining duration.

Nevertheless, municipals provided relative stability due to significant coupon payments and bond maturities being put back to work from outsized issuance in lower interest rate environments. The nearly $600 billion expected this year should provide a net negative supply backdrop for the remainder of the year. July and August are expected to see more than $80 billion in proceeds returned to the market. This amount should easily outpace issuance, even if it remains elevated.

Looking forward, we expect net inflows to gain momentum as the Fed gets closer to cutting rates, causing cash to become more expensive for investors. This trend, combined with the net negative supply dynamic, should provide investors with an improved technical backdrop in the third quarter.

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Defaults

First-time municipal bond defaults totaled $294 million in par during the second quarter, 31% lower than in the same period last year. Additionally, newly distressed debt was down 22% compared to the second quarter of last year. There have been no Chapter 9 bankruptcy petitions filed in 404 days — the second longest period since July 1987.

Widespread issues are not expected in 2024, as record balance sheets should provide ample protection from economic uncertainty for most issuers. We expect municipal bond defaults to remain low, rare and idiosyncratic, reflecting the resiliency of the asset class even in economic downturns.

The credit backdrop overall has been robust. While upgrades have outpaced downgrades by a 4:1 ratio for three years in a row, this trend has slowed recently with upgrades being more in line with downgrades. Going forward, we do not expect downgrades to outpace upgrades in the near future.

As fund flows pick up, high yield technicals should improve further. This would be a catalyst for further spread tightening.

Credit spreads

High yield municipal credit spreads narrowed during the second quarter from 214 bps to 199 bps over the equivalent-maturity AAA bond. This spread tightening, combined with high embedded yields, allowed high yield municipal bonds to offer strong positive total returns.

Under the surface, the dispersion of spreads between high yield issuers narrowed. Price discovery allowed smaller issuers and more esoteric credits to experience spread tightening relative to higher beta names. This continues to drive strong positive performance for active managers, and we believe this will be important going forward.

High yield municipal spreads remain near historical averages, spending longer periods below averages separated by short bursts wider. High yield munis remain attractive, considering their fundamental strength and taxable-equivalent yields. In addition, while the outflow cycle of 2022 and 2023 has reversed, it has not meaningfully recaptured the assets leaving the space during that time. Investors have waited for a catalyst such as approaching rate cuts to return to long-duration fixed income, and the growing confidence has slowly brought investors back.

As fund flows pick up, high yield technicals should improve further. This would be a catalyst for further spread tightening, particularly in more alpha driven exposure where credit selection and research drive price appreciation. The ability to source these deals compared to more beta driven exposure in the larger areas of the high yield market provides meaningful credit spread compression opportunity even as the broader high yield market has moved closer to fair value.

MUNICIPAL CREDIT REMAINS RESILIENT

Puerto Rico bankruptcy decision is overturned

PREPA, Puerto Rico's electric system, has been in bankruptcy since 2017 with approximately $8.3 billion in debt outstanding. Last year, the Puerto Rico Oversight Board submitted a Plan of Adjustment that gave bondholders a recovery of less than 20 cents on the dollar. A group of bondholders has challenged the plan as well as various decisions of the bankruptcy court, including the ruling by Judge Laura Swain that bonds were not secured by a lien on net revenue.

On 12 June, the First District appellate court overturned Judge Swain's lien decision, ruling that the bonds in fact have a security interest in PREPA's net revenue, both current and future. The court also affirmed the market's general

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understanding of special revenue bonds, that is, that the lien on revenue continues even after an issuer files for bankruptcy protection. The appellate decision was positive for the municipal market, with implications for special revenue bonds in general. The decision also calls into question the viability of the PREPA Plan of Adjustment and will doubtless prolong the PREPA bankruptcy to the end of the year and likely beyond.

Brightline recapitalizes successfully

During April 2024, Brightline successfully completed a large recapitalization consisting of new tax-exempt bonds, taxable notes and preferred equity. The $2.7 billion of outstanding Series 2019 tax-exempt bonds were retired at premiums ranging from $101 to $107, generating outsized total return. In particular, 7.375% coupon bonds recently taken out at $107 were trading as low as 88 cents on the dollar in early 2023 before rallying hard throughout last year.

The new tax-exempt bonds issued during the second quarter were well over-subscribed. Brightline took advantage of greater market acceptance of their credit story emerging over the past 24 months in addition to anemic high yield supply that provided an opportunity to execute such a large deal.

From a fundamental credit perspective, the recent opening to Orlando continues to gain momentum. During May, long-distance ridership of more than 135,000 passengers set a new monthly record. During the first quarter, one out of every three trains was nearly sold out, and repeat bookings from its long-distance database were increasing by approximately 10,000 riders per month.

At this juncture, Brightline has been deliberately reducing short-distance capacity to better accommodate surging demand to Orlando. This ongoing capacity issue is expected to be resolved in the very near future, as 30 additional train cars ordered back in 2022 are scheduled to be delivered in 3 separate installments over the next 12 months.

Congestion pricing is suspended in New York City

On 05 June, New York Governor Kathy Hochul announced her intention to indefinitely suspend the implementation of the Metropolitan Transit Authority's (MTA) Central Business District Tolling Program (CBDTP), the first congestion pricing program in the United States. The affected region stretches from 60th Street in Manhattan to the southern tip of the Financial District.

The program was anticipated to be implemented on 30 June and forecasted to generate $1.0 billion annually, while also securing up to $15.0 billion in new bonds for the MTA system's 2020–2024 Capital Program. Given the pause on the rollout of the CBDTP, the MTA will be deferring $16.5 billion in less-urgent capital projects while prioritizing state-of-good-repair works. The MTA expects to release an updated financial plan for 2024–2028 in late July that reflects the financial impact of the suspended CBDTP.

Congestion pricing has been a highly politicized and sensitive issue. Numerous lawsuits were filed in federal courts, with plaintiffs including the Trucking Association of New York and Governor Murphy of New Jersey, aiming to halt the implementation of the CBDTP. Governor Hochul had favored the program prior to her abrupt reversal in early June, when she expressed concern that the program would create another obstacle for New York's post-pandemic economic recovery. She worried that it would burden working-class and middle-class families.

Pundits quickly pointed out that the program is largely unpopular in suburban areas, and political motivations may have informed the governor's decision.

According to Governor Hochul, the state intends to find an alternate revenue source for the MTA to compensate for the loss of revenue that the CBDTP would have generated. However, the program could eventually be implemented if no other funding mechanism is approved. On 26 June, the MTA's board of directors approved a resolution to continue to prepare for the eventual roll out of the CBDTP.

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2024 THEMES

Economic environment

- Inflation has trended lower year-over-year. The Fed projects marginally lower Core PCE inflation by year end. Core services inflation plus shelter remains sticky but is trending down.
- After increasing the fed funds rate 525 bps during this cycle, the Fed has been on hold since July 2023. We expect rate cuts, with the timing dependent on inflation, wages and employment data.
- U.S. growth has been resilient, but the consumer is softening. Influential factors include unemployment data, consumer spending and levels of excess household savings. Capital markets are anticipating less risk of recession, but we continue to monitor developments closely.
- Uncertainty regarding Fed policy will continue to cause rate volatility. Rates could decline if a slowdown or recession develops.

Municipal market environment

- Credit remains strong, with robust levels of rainy day and reserve funds. Governments are adjusting for normalization of revenue collections.
- We expect municipal defaults will remain low, rare and idiosyncratic.
- Supply has picked up relative to 2023 levels and could be more predominant before the U.S. election. However, we continue to predict more coupons, calls and maturities than new issues.
- Demand favors owning duration, is driven by higher-for-longer yields. Investors don't want to miss out.
- Municipals have displayed strong relative performance this year.
- High yield credit spreads have tightened below historical averages due to inflows
- Despite tight ratios, municipals should generate attractive returns based on elevated income.

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Endnotes

Sources

Gross Domestic Product: U.S. Department of Commerce. Treasury Yields and Ratios: Bloomberg (subscription required). Municipal Bond Yields: Municipal Market Data. Open-end fund flows: Investment Company Institute. Municipal Issuance: Siebert Research. Defaults: Municipals Weekly, Bank of America/Merrill Lynch Research. State Revenues: The Nelson A. Rockefeller Institute of Government, State Revenue Report. State Budget Reserves: Pew Charitable Trust. Global Growth: International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD). Standard & Poor's and Investortools: http://www.invtools.com/. Flow of Funds, The Federal Reserve Board: https://www.federalreserve.gov/releases/z1/default.htm. Payroll Data: Bureau of Labor Statistics. Bond Ratings: Standard & Poor's, Moody's, Fitch. New Money Project Financing: The Bond Buyer. State revenues: U.S. Census Bureau.

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