Parametric

Municipal Bond Market Insight | May 2024

After Taxes

Key takeaways

» Tax-exempt municipal bond yields set new year-to-date (YTD) highs in late April, with the jobs report, durable goods and CPI all coming in stronger than expected.

» Today's unique fixed income environment—punctuated by inverted yield curves that result in shorter maturities often yielding more than longer maturities—warrants a tax-optimized approach.

» Munis are entering the final stretch of a seasonally favorable window for buyers.

» Markets rejoiced at Fed chair Jerome Powell's generally dovish remarks, which suggested the next policy move won't be a hike.

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General market update

April economic data rained on the fixed income market's parade toward lower interest rates. Data released across the month pointed to strong growth and persistent inflation, with the jobs report, durable goods and most importantly CPI all coming in stronger than expected. The 10-year Treasury yield rose from 4.2% at the end of March to 4.68% at the end of April.

The Bloomberg US Aggregate Index returned -2.53% in April. The Bloomberg US Corporate Index moved in concert, down -2.54% for the month. Treasuries were marginally better, with the Bloomberg US Treasury Index down 2.33%. The star performer, if there was one, was municipals, with the Bloomberg Muni Index ending the month off just 1.24%. Ratios remain rich, and while municipals aren't cheap, especially inside of 10 years, the scheduled large June and July reinvestment flows may mean this richness persists.

Supply

Municipal supply for April came in at $39 billion, higher than the five-year average for the same month. YTD issuance on a gross basis is now at $142 billion, about 26% higher than in 2023. Higher supply for the month, along with a combination of elevated fund outflows and rising Treasury rates, contributed to a negative month of total-return performance. As tax-related selling is expected to slow down, redemptions will likely slow going into May. The largest deals for April included the Los Angeles Unified School District, Novant Health, Brightline Passenger Rail and the Houston Combined Utility System.

Market opportunity

We chose our brief, somewhat ambiguous title for this month's insight for two reasons. With the US tax-filing deadline just weeks behind us, it captures the timeliness of the topic, while the filing process itself—and possibly paying as a result—highlights the importance of measuring what you actually keep above what you technically earn. Given that this is a municipal bond update, this insight will remain focused on tax-efficient fixed income investing, but not just with municipal bonds.

Figure 1: Fixed income returns as of April 30, 2024

	MTD return	YTD return
Bloomberg Muni Index	-1.24%	-1.62%
Bloomberg US Treasury Index	-2.33%	-3.26%
Bloomberg US Aggregate Index	-2.53%	-3.28%
Bloomberg US Corporate Index	-2.54%	-2.93%

Source: Bloomberg, 4/30/2024. For illustrative purposes only.
It is not possible to invest directly in an index.

Past performance is no guarantee of future results.

Figure 2: AAA municipal yields as of April 30, 2024

Year	Current	MTD change	YTD change
2-year	3.22%	+25 bps	+70 bps
5-year	2.85%	+31 bps	+57 bps
10-year	2.81%	+30 bps	+53 bps
30-year	3.96%	+28 bps	+54 bps

Source: Thomson Reuters Municipal Market Data, 4/30/2024. For illustrative purposes only. Not a recommendation to buy or sell any security.

Past performance is no guarantee of future results.

Figure 3: US Treasury yields as of April 30, 2024

Year	Current	MTD change	YTD change
2-year	5.04%	+41 bps	+79 bps
5-year	4.57%	+36 bps	+72 bps
10-year	4.68%	+48 bps	+80 bps
30-year	4.79%	+44 bps	+76 bps

Source: Bloomberg, 4/30/2024. For illustrative purposes only.
Not a recommendation to buy or sell any security.

Past performance is no guarantee of future results.

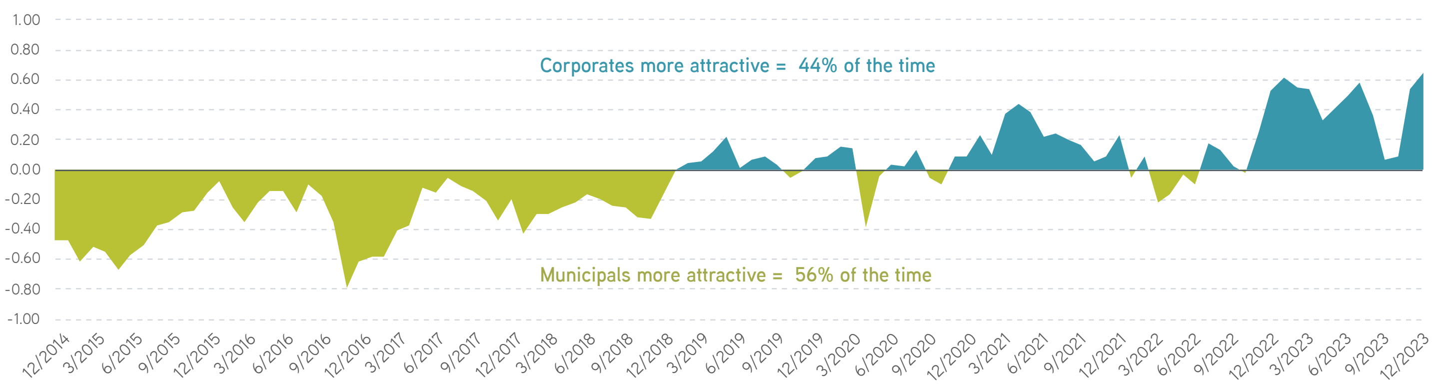
In addition to our experience in both municipal bond ladders and tax-efficient investing, we also offer corporate bond ladders and US Treasury ladders. An investor typically chooses among these products based on their unique tax situation to capture the best after-tax yield. However, today's uncommon fixed income investing environment—punctuated by inverted yield curves that result in shorter maturities often yielding more than longer maturities—demands a finely-tuned approach that accounts for the intricacies that occur along the various yield curves of US Treasuries, US corporates and tax-free municipal bonds.

Enter tax-optimized ladders. Indeed, it's hard to envision a better time for introducing a fixed income ladder that encompasses these three asset classes while evaluating after-tax income on a granular, maturity-by-maturity basis. Our tax-optimized ladders do exactly that. Custom-tailored for each investor, these bespoke, cost-effective ladders employ the buyer's federal, state and local (if applicable) tax brackets, as well as the Affordable Care Act's 3.8% net investment income tax (where applicable) to construct a truly unique portfolio for each client in a separately managed account (SMA).

In addition to the tax bracket, the investor chooses the credit quality of the bonds (minimum A- or minimum BBB-) for both the municipal and corporate bond components, as well as the length of the ladder, which begins in year one and can extend as far as 10 years. The ability to add year-round tax-loss harvesting and the option to fund the ladder with existing fixed income securities of US Treasurys, US corporates or tax-free municipal bonds (subject to credit approval) further enhance customization.

When does a more tactical approach than the traditional single asset class model make sense? As illustrated below for an investor in the 32% tax bracket, it would have been beneficial almost half the time over the past nine years.

10- year corporate yield (after tax in 32% bracket) minus 10-year municipal yield



Source: Bloomberg, 12/31/2023. Municipal yield is the 10-Year GO BVAL A+/A/A- curve. Corporate yield is the 10-year US Corp A+/A/A- BVAL curve, after tax in the 32% bracket. Difference is computed monthly from December 2014 to December 2023. For illustrative purposes only. Not a recommendation to buy or sell any security. Past performance is no guarantee of future results.

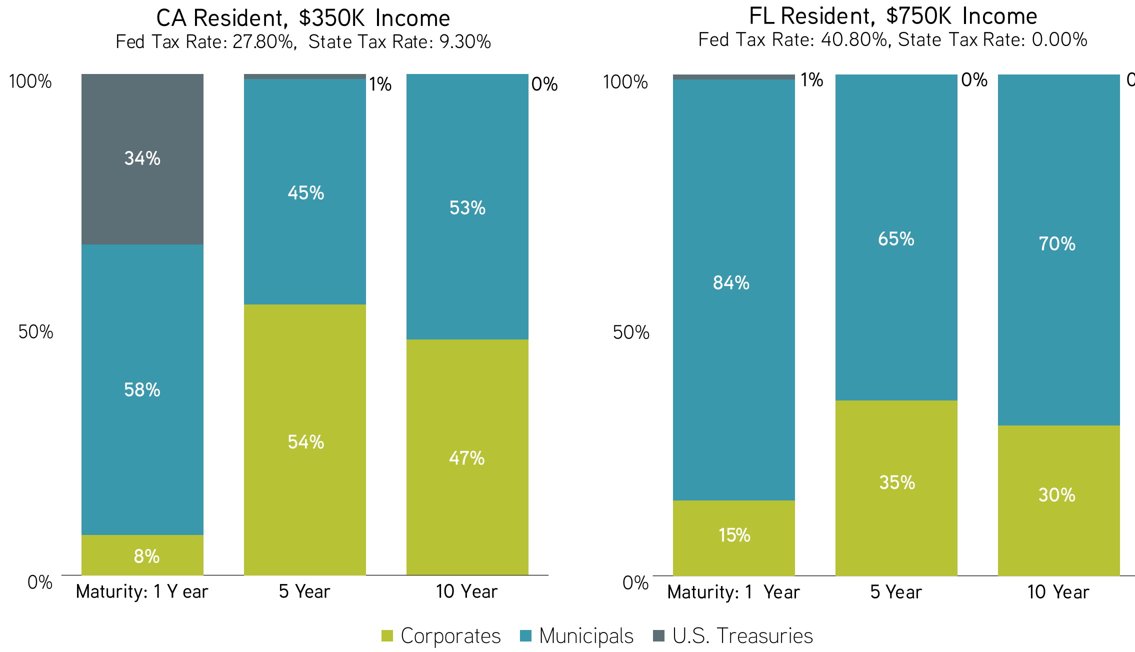
In the accompanying chart, we compared 10-year A+/A/A- rated corporate index yields after tax (adjusted for the marginal tax rate of 32%) with 10-year A+/A/A- rated muni index yields going back to 2014. When the value was positive, corporates provided a higher after-tax yield. When the yield differential fell into negative territory, tax-exempt munis were more attractive. While tax-exempt munis were more attractive in 56% of our observations, corporates after taxes were more attractive 44% of the time, even for an investor in a 32% bracket. In this case, the muni buyer may have benefited from optimizing the allocation of tax-exempt munis and taxable corporates based on relative value.

For clients in the highest tax bracket, tax-exempt municipal bonds have the potential to provide the highest level of after-tax return most of the time, but not all the time. Reviewing lower tax brackets, we find that selectively allocating to taxable sectors may become more beneficial. A client can potentially enhance their fixed income allocation to maximize after-tax income by carefully considering their tax rate and relative value between asset classes.

That said, investors often wonder which fixed income asset class offers the most income after taxes. It's a good question, and the answer will change over time. In the exhibit below we examine two different investors, subject to different tax rates. For example, a California resident with $350,000 in annual income would have been best served in US. Treasuries 34% of the time in the one-year maturity over the last five years.

After-tax yield potential of corporates, municipals and US Treasuries

% of time over the last five years when each asset class offered the highest after-tax yield



Source: Bloomberg, 12/31/2023. Corporate yields based on Bloomberg US Corporate A+/A/A- BVAL Yield Curve. US Treasury yield based on US Treasury Bills and Bonds BVAL Curve. Tax-rate assumptions include tax filing status of married, filing jointly. For illustrative purposes only. Not meant to be tax advice. Not a recommendation to buy or sell any security. Past performance is no guarantee of future results.

With the Fed having been on hold all year and market expectations dwindling to just one or two rate cuts toward the end of 2024, these uncommon inverted yield curves may endure for longer. It's high time to make the most of them. After all, what really matters is what investors keep after taxes.

Economic outlook

The Fed's progress against inflation appears to have stalled in the short term. Month-over-month declines in Core PCE growth have slowed to 2.8%, above the Fed's target. Labor markets and economic growth experienced a hiccup in April. The first read on Q1 2024 GDP data came in at 1.6%, compared with an estimated 2.5% and a decline from 3.4% in Q4 2023. Nonfarm payrolls in April added 175,000 jobs, compared with an estimated 240,000. These economic surprises added volatility to rates markets.

The Fed met at the end of the month. During the May 1 press conference, the Federal Open Market Committee left the overnight lending rate unchanged. Chair Jerome Powell explicitly cleared the air regarding potentially more rate hikes, stating, "It's unlikely that the next policy rate move will be a hike." Markets rejoiced at this direct messaging and generally dovish remarks, despite a Core PCE reading that remains elevated relative to the Fed's long-term 2% targets.

The market has adjusted its views on future cuts. Before weaker April jobs numbers came out on May 3, the fed funds futures market priced in only one cut of 25 basis points (bps) from the Fed by year end. Today that has increased to roughly two cuts of 25 bps each by year end, with the first rate cut projected in September.

Heightened market reaction to emerging economic data is likely to continue in the interim, increasing volatility across fixed income markets. US Treasury yields ended the month at new highs for the year as investors grapple with changing economic projections. Growth rates and jobs data appeared to take a step backwards in April, but it may be too early to predict the beginning of a new trend.

Key economic data

Change in nonfarm payrolls (Apr.)	175K
Unemployment rate (Apr.)	3.9%
Core CPI–YoY change (Mar.)	3.8%
Core PCE–YoY change (Mar.)	2.8%
Average hourly earnings–YoY change (Apr.)	3.9%
Real GDP annualized (Q1 2024)	1.6%

Source: Bloomberg, 5/6/2024.

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27547 | 4.30.2024 | RO 3577012