Parametric

Municipal Bond Market Insight | July 2024

Opportunity in Volatility

Key takeaways

- Issuance for the first half of 2024 now sits at $238.7 billion, up more than 30% from the first half of 2023.
- The Federal Open Markets Committee (FOMC) left rates unchanged in June, and uncertainty regarding the timing of rate cuts is causing an uptick in bond market volatility.
- Increased volatility is making year-round tax-loss harvesting (TLH) in the municipal market even more compelling.
- US Treasurys are well above January levels but also more than 25 basis points (bps) below the high yields from April. Heightened market reaction to emerging economic data is likely to continue in the interim, increasing volatility across fixed income markets.

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General market update

Spring can be distracting, and investors could be forgiven for enjoying the good weather. Those not paying attention might assume that little happened. The 10-year Treasury ended May at a 4.5% and began July at 4.46%. In between however, there was a bit of a ride as June's low closing yield was 4.22% on June 14, giving the yield chart something of a smile-like U shape.

The bond markets shrugged off a stronger-than-expected employment report at the beginning of the month and were buoyed by a May Consumer Price Index (CPI) coming in unchanged and a soft retail sales report. Yields started to rise toward the end of the month as durable-goods orders came in above expectations and the Personal Consumption Expenditures (PCE) deflator held steady.

The Bloomberg US Aggregate Index returned 0.95% in April. The Bloomberg US Corporate Index was up 0.64% for the month. Treasuries led the way among taxable bonds, with the Bloomberg US Treasury Index returning 1.01%, but municipals once again were the star performer. The Bloomberg Muni Index was up 1.53% for the month. Strong demand from reinvestment flows offset increased issuance to keep municipals well bid.

Supply

Municipal new-issue supply for June came in at $44.7 billion. Issuance for the first half of 2024 now sits at $238.7 billion, up more than 30% from the first half of 2023. As discussed in last month's insight, where we shared our mid-year municipal outlook, we attribute this increase mainly to the November presidential election pull-ahead effect, which we'll continue to follow closely. Any issuers who might have delayed their deals in hopes of lower borrowing costs may now have reason to come to market, given that the Federal funds rate remained unchanged at the June meeting. Notable deals included JFK International New Terminal One Project, Massachusetts Bay Transportation Authority and Metropolitan Washington Airports Authority.

Figure 1: Fixed income returns as of June 28, 2024

	MTD return	YTD return
Bloomberg Muni Index	1.53%	-0.40%
Bloomberg US Treasury Index	1.01%	-0.86%
Bloomberg US Aggregate Index	0.95%	-0.71%
Bloomberg US Corporate Index	0.64%	-0.49%

Source: Bloomberg, 6/28/2024. 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 June 28, 2024

Year	Current	MTD change	YTD change
2-year	3.11%	-24 bps	+59 bps
5-year	2.89%	-25 bps	+61 bps
10-year	2.84%	-27 bps	+56 bps
30-year	3.72%	-24 bps	+30 bps

Source: Thomson Reuters Municipal Market Data, 6/28/2024. For illustrative purposes only. It is not possible to invest directly in an index. Not a recommendation to buy or sell any security.

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Figure 3: US Treasury yields as of June 28, 2024

Year	Current	MTD change	YTD change
2-year	4.76%	-12 bps	+51 bps
5-year	4.38%	-13 bps	+53 bps
10-year	4.4%	-10 bps	+52 bps
30-year	4.56%	-9 bps	+53 bps

Source: Bloomberg, 6/28/2024. For illustrative purposes only.
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Market opportunity

In April we focused on the benefits of tax optimization between asset classes. This month, we're focused on the confluence of the inevitable and the uncertain and how to take advantage of it. In 1789 Ben Franklin wrote "In this world, nothing is certain but death and taxes." Our focus is on taxes, which at least tend to have an air of inevitability about them.

The uncertainty we're concerned with is the movement of bond prices. Overall bond volatility has increased this decade. Even with a Fed-endorsed consensus that the next move will be toward lower rates, we're still experiencing meaningful volatility over the timetable for those rate cuts. This volatility can be seen in the roughly one-quarter percent move down, then back up in the benchmark 10-year note's yield in the past month.

Volatility in the municipal market creates opportunities to realize tax alpha. Tax alpha is the potential value created by effective tax management of investments and can be generated by strategies like TLH. Whereas TLH with taxable securities is more a tax-deferral strategy, because the income from municipal bonds is tax-exempt, TLH with municipals is more like tax avoidance.

For example, if an investor owns a 4% bond due in 10 years that was purchased at par but is now priced at $97, and they sell that bond to replace it with a similar 4% bond due in 10 years bought at $97, their cash flow is unchanged, but they've booked a three-point tax loss while increasing their book yield. Tax losses can offset realized gain today or in the future and don't expire. However, if this is a taxable bond, the higher book yield results in a higher future tax liability. With a municipal bond, however, the higher book yield doesn't, as long as it is tax exempt. (Note: Understanding the market discount rule is important for maximizing TLH success.)

Ideally, TLH should be a year-round undertaking, because a volatile market can create multiple opportunities over the course of the year. Our experience bears this out. YTD*, we've executed more than $2.3B in TLH trades. Among accounts we manage that are fully invested and eligible for TLH, each has seen at least one TLH sale trade this year. And YTD, the average tax alpha added to managed muni and laddered accounts is 15 bps. The opportunity to use the uncertainty of market volatility to help reduce the inevitability of taxes is out there. We think investors would be wise to avail themselves of it.

*YTD is 6/14/24.

Economic outlook

The June 12 meeting of the FOMC helped confirm that the early-year exuberance the bond markets experienced was premature. The FOMC left the overnight lending rate unchanged, as expected. More significant was a revision to the closely-watched dot projections, where the median rate for 2024 implied only one cut this year.

Chairman Powell's statement reinforced the Fed's cautious, data-focused approach: "We've stated that we do not expect it will be appropriate to reduce the target range for the federal funds rate until we've gained greater confidence that inflation is moving sustainably toward 2 percent. So far this year, the data have not given us that greater confidence."

US Treasurys are well above January levels but also more than 25 bps below the high yields from April. Heightened market reaction to emerging economic data is likely to continue in the interim, increasing volatility across fixed income markets. In addition, as we come closer to Election Day, a tight race is likely to interject further uncertainty into the direction of fiscal and trade policy. This has fostered an emerging narrative suggesting a steepening yield curve. That may or may not occur, but headline risk is certain to add to the volatility.

Key economic data

Change in nonfarm payrolls (May)	272K
Unemployment rate (May)	4%
Core CPI–YoY change (May)	3.3%
Core PCE–YoY change (May)	3.4%
Average hourly earnings–YoY change (May)	4.1%
Real GDP annualized (Q1 2024)	1.4%

Source: Bloomberg, 6/28/2024.

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