Parametric

Municipal Bond Market Insight | October 2024

Municipal Bonds: The Cuts, Votes and Value

Key takeaways

» Municipal issuance is on track to break records, with September supply coming in approximately 40% above average. This marks nine consecutive months of above-average supply.

» The Fed made a 50 bps reduction in September, bringing the overnight federal funds rate to a range of 4.75% to 5%. Chair Jerome Powell implied the cut was intended to keep the Fed from falling behind.

» If the TCJA tax rates is extended, we don't expect a large impact to muni pricing in light of the prevailing constrained supply/demand dynamic.

» The payroll situation report is one of the month's most-watched releases, but its readings routinely defy market pundits. This was the case in September, when the data was unequivocally strong and eclipsed street consensus estimates.

Parametric
800 Fifth Avenue
Suite 2800
Seattle, WA 98104
T 206 694 5575
F 206 694 5581
www.parametricportfolio.com

General market update

September's data was friendly to bonds, with August nonfarm payrolls coming in below expectations and August Consumer Price Index (CPI) meeting expectations. This gave the Fed sufficient cushion to begin cutting rates, doing so with a 50 basis points (bps) cut at the September 18 meeting. Chair Jerome Powell seemed like he intended to temper market expectations regarding the size and pace of future rate cuts. The 10-year Treasury began the month at a 3.90% and rallied heading into the Federal Open Market Committee (FOMC) meeting, putting in a low closing yield of 3.619% on September 16. It sold off to finish September at 3.78%.

The major bond indexes continued their recent run. The Bloomberg US Aggregate Index returned 1.34% in September, the Bloomberg US Corporate Index returned 1.77% and the Bloomberg Muni Index was up 0.99%. The Bloomberg Muni Index is up 2.30% year to date (YTD). Stocks rose and the S&P 500® reached new highs, with a 2.14% return on the month. Oil was down, but copper and gold performed well.

Supply

Municipal issuance is on track to break records. September supply came in just under $45 billion, a bit shy of the $49 billion we saw in August but approximately 40% above average. We've now experienced nine consecutive months of above-average supply. YTD supply now totals $380 billion, which is up about 35% on a year-over-year (YOY) basis. The predominant new-issue coupon structure was 5% throughout the yield curve.

Market opportunity

Last month we discussed the expectation that a new rate-cutting cycle from the Fed would commence at the September FOMC meeting. That meeting resulted in a 50 bps reduction, bringing the overnight federal funds rate to 4.75% to 5%. While the majority of bond market pundits expected a 25 bps cut, Powell's explanation for the larger move was it was intended to keep the Fed from falling behind. The US Treasury market unexpectedly shrugged off the double cut, and yields rose minimally in subsequent trading sessions. Nudging yields higher still was a surprisingly robust September payroll situation report, after which the 10-year US Treasury note rose approximately a full point to reach 3.97% by day's end.

The obvious takeaway is that the bond market is indeed a humbling mechanism. This unexpected turn of events has kept yields elevated and circles us back to a topic we discussed last month: the remaining value proposition in tax-exempt municipal bonds. This theme has a stronger emphasis now with the fast-approaching presidential election.

Benchmark AAA-rated muni yields remain higher than the start of the year as of October 4, up by 32 bps at the 10-year maturity. This stands in sharp contrast to a 10-bps-lower 10-year Treasury yield. The yield pickup from the two-year maturity to the 10-year maturity in Treasurys is seven bps and 26 bps for munis. It pays to extend duration in tax-exempt municipal bonds. From a relative value standpoint, according to Bloomberg, 10-year muni yields stand at 67% corresponding Treasurys versus the year-to-date average of 62%.

But why the stronger emphasis now? The 30-day visible supply for upcoming new-issue municipal bonds just dipped to its lowest reading in the last 60 days, down to $8.4 billion from a high of more than $20 billion a month ago. This sharp deceleration suggest that supply is likely to dwindle heading into November, and munis may outperform Treasurys toward year end. Ten-year muni relative value versus 10-year Treasurys was 71% when we last published this note, and it's 67% now, so that outperformance appears underway.

Another reason for the added emphasis is that the US presidential election is less than 30 days away and squarely in focus. The results of the election may hold direct and binary implications for tax-exempt municipal bonds. Whoever wins, the impact for munis ranges between status quo and a material positive.

Tax Cuts and Jobs Act (TCJA)
The 2018 TCJA brought the top marginal tax rate down to 37% from 39.6%. Since the muni market has grown very minimally over the last decade versus both US Treasurys and US corporate bonds, the lower tax rate didn't have a detrimental impact on pricing. A return to the higher tax rate would likely boost investor demand.

Given the need to keep the act budget-neutral over 10 years, advance refunding (refinancing) using tax-free bonds was disallowed. Only federally taxable muni bonds could be issued. Savings for issuers were less than those from using tax-exempt munis, but refundings continued using taxable bonds, which impaired the available supply of tax-free bonds.

If the TCJA tax rates aren't extended by year-end 2025, we expect that reversion to the prior higher tax rates will be a tailwind for muni demand, even if advance refunding using tax-exempt munis returns. We expect little impact to muni pricing if it's extended in light of the prevailing constrained supply/demand dynamic.

Alternative Minimum Tax (AMT)
The AMT wasn't indexed for inflation, and it captured more taxpayers each year prior to TCJA enactment. The number of affected taxpayers plummeted under the TCJA. Most munis whose income was subject to the AMT now had a much larger audience, bringing yield spreads tighter versus non-AMT munis. A return of the prior AMT formula could capture even more filers than pre-TCJA, and related AMT bond spreads could widen 20 to 40 bps.

State & Local Tax Deduction (SALT)
State and local tax deductions from federal tax returns are commonly referred to as the SALT deduction. Previously allowed without limitation, the $10,000 TCJA cap made municipal bond investors favor in-state bonds when they reside in states that don't tax the income of their own muni bonds. The admittedly demand-positive impact of the SALT cap was underwhelming, and we suspect the removal of that cap in a TCJA sunset scenario would be similarly underwhelming.

The "outside chance"
Although the federal government has never removed the tax exemption of municipal bonds, it can. The Obama administration considered it a budget item for years. That prospective change would likely have severely damaged muni demand and drove tax-exempt munis to trade at higher yields than US Treasurys. We believed it was a unique opportunity to get the federal tax exemption "for free," and we would likely view a discussion and related market dislocation similarly should it reoccur.

Economic outlook

The September FOMC meeting came and went, and the Fed's monetary policy is solidly in easing mode. The next FOMC meeting is scheduled for November 6 and 7, and the is Fed halfway through the 100 bps of the 2024 policy ease that the latest dot plot suggests. The market turns its attention to economic data for guidance regarding the pace of expected rate cuts both this year and next.

Key among economic data is the payroll situation report. Although it's one of the month's most-watched and heavily forecasted releases, its readings routinely defy market pundits. This was exactly the case for September's report. Released on October 4, the data was unequivocally strong and eclipsed street consensus estimates. The headline nonfarm payroll increase of 254,000 handily beat expectations for just 150,000 and brought with it a mild upward revision of the prior month's release.

The driver of the outsized increase was in private payrolls, which grew by 223,000 versus expectations of a 125,000 gain. Manufacturing payrolls lowered mildly and largely in line with consensus estimates, coming in at a loss of 7,000 jobs versus an expected 8,000 job loss. Average hourly earnings growth registered 0.4% for the month versus 0.3% expected, bringing the YOY average to 4% versus 3.8% expected. Average weekly hours came in a touch weaker at 34.2 versus 34.3 expected, unchanged from the prior month. The labor force participation rate held steady at 62.7%, which was in line with expectations and unchanged from the prior month, while the unemployment rate declined to 4.1% versus 4.2% expected, lower than the prior reading of 4.2%.

The strength of this labor market reading, combined with the Fed's recent 50 bps rate cut, invites bond market volatility. It also heightens the market's sensitivity to subsequent economic data releases, most notably the CPI and Producer Price Index, which the Fed monitors for progress on inflation. The Fed will have the benefit of one more payroll situation report to digest before its November meeting, which wasn't the case back in July. According to Powell, the lack of data contributed to the catch-up 50 bps cut enacted in September. With the bond market routinely having its expectations dashed, not to mention the presidential election, it promises to be an interesting fall.

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

	MTD return	YTD return
Bloomberg Municipal Index	0.99%	2.30%
Bloomberg US Treasury Index	1.20%	3.84%
Bloomberg US Aggregate Index	1.34%	4.45%
Bloomberg US Corporate Index	1.77%	5.32%

Source: Bloomberg, 9/30/2024. 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 September 30, 2024

Year	Current	MTD change	YTD change
2-year	2.30%	-15 bps	-22 bps
5-year	2.31%	-11 bps	3 bps
10-year	2.60%	-11 bps	32 bps
30-year	3.52%	-8 bps	10 bps

Source: Thomson Reuters Municipal Market Data, 9/30/2024. For illustrative purposes only. Not a recommendation to buy or sell any security.
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Figure 3: US Treasury yields as of September 30, 2024

Year	Current	MTD change	YTD change
2-year	3.92%	-28 bps	-61 bps
5-year	3.70%	-14 bps	-29 bps
10-year	3.90%	-12 bps	-10 bps
30-year	4.20%	-8 bps	9 bps

Source: Bloomberg, 9/30/2024. For illustrative purposes only.
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Parametric is headquartered at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.

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