Parametric

Municipal Bond Market Insight | December 2024

Value in Volatility

Key takeaways

- Financial markets responded in various ways to the incoming presidential administration. Treasury yields initially climbed over concerns over a potential lack of fiscal discipline, with the 10-year Treasury yield reaching 4.45% mid-month before bonds rallied and the 10-year Treasury yield closed November at 4.17%.

- The major bond indexes rebounded from the October sell-off. The Bloomberg US Aggregate Index rose 1.06% in November and the Bloomberg US Corporate Index rose 1.34%. The Bloomberg Muni Index rose 1.73%, more than reversing its October weakness and bringing year-to-date (YTD) total return to 2.55%, which eclipsed the YTD Bloomberg US Treasury Index total return of 2.15%.

- Bonds were overshadowed by equity markets, which rallied sharply on the consensus view that the election result would be good for stocks. The S&P 500® returned 5.87% for the month, the best monthly performance of the year.

- The headline November nonfarm payrolls number showed an increase of 227,000 jobs, higher than consensus street estimates of 220,000. The unemployment rate ticked up to 4.2% against estimates of 4.1%.

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

©2024 Parametric Portfolio Associates® LLC

General market update

The election has finally passed after months of anticipation. The results saw control of the White House and the Senate shift to the GOP. Since Republicans also retained a slim majority in the House, we'll have a united government in 2025. Financial markets responded in various ways to this prospect. Treasury yields initially climbed over concerns that the new administration might lack fiscal discipline. The 10-year Treasury yield rose 16 basis points (bps) the Wednesday after the election and reached a 4.45% high by mid-month. But the November 22 announcement of Scott Bessent, a former hedge fund manager, as Treasury secretary seemed to ease those fears, and bonds rallied from there. The 10-year Treasury note finished the month with a solid rally during a holiday-shortened session to close at 4.17%.

The major bond indexes rebounded somewhat from the October sell-off. The Bloomberg US Aggregate Index rose 1.06% in November, while the Bloomberg US Corporate Index was up 1.34%. Munis were the star performer, with the Bloomberg Muni Index rising 1.73%, more than reversing the October weakness and bringing YTD total return to 2.55%, which mildly eclipsed the YTD Bloomberg US Treasury Index total return of 2.15%. Equity markets overshadowed bonds, however, by rallying sharply on the consensus view that the election result would be good for stocks. The S&P 500® returned 5.87% for the month, the best monthly performance of the year.

Supply

Municipal new-issue supply in November clocked in at $24.7 billion. This was a sharp decline on a month-over-month basis, especially since October's mammoth $55 billion supply was the largest of the year. November municipal issuance was approximately 15% below the 10-year average. That's not surprising, since it's in line with the supply declines we experienced during the previous two election cycles. The market digested several mega deals last month, including a $1.1 billion Houston United Airlines Terminal Improvement AMT offering and a $1.7 billion California Community Choice issuance. Primary supply YTD stands at $468 billion, up 35% from 2023.

Figure 1: Fixed income returns as of November 29, 2024

	MTD return	YTD return
Bloomberg Muni Index	1.73%	2.55%
Bloomberg US Treasury Index	0.78%	2.15%
Bloomberg US Aggregate Index	1.06%	2.93%
Bloomberg US Corporate Index	1.34%	4.14%

Source: Bloomberg, 11/29/2024 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 November 29, 2024

Year	Current	MTD change	YTD change
2-year	2.59%	-10 bps	+7 bps
5-year	2.61%	-7 bps	+33 bps
10-year	2.78%	-23 bps	+50 bps
30-year	3.62%	-25 bps	+20 bps

Source: Thomson Reuters Municipal Market Data, 11/29/2024. 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 November 29, 2024

Year	Current	MTD change	YTD change
2-year	4.15%	-2 bps	-10 bps
5-year	4.05%	-11 bps	+20 bps
10-year	4.17%	-11 bps	+29 bps
30-year	4.36%	-12 bps	+33 bps

Source: Bloomberg, 11/29/2024. For illustrative purposes only. Not a recommendation to buy or sell any security.

Past performance is no guarantee of future results.

©2024 Parametric Portfolio Associates® LLC

Market opportunity

Following the lead of US Treasuries (USTs) and reversing much of the upward trend that was set in October, the early-November muni market saw 10-year maturity benchmark yields set a new YTD peak of 3.13% before declining 40 bps over the balance of the month and into early December. While clearly having different drivers, the timing of this late-year volatility was oddly reminiscent of last year's price action, when the 10-year Treasury yield briefly touched 5% during the closing days of October, immediately followed by a massive bond rally that lasted through year-end.

From a relative-value standpoint, the deluge of new-issue supply throughout the year had been suffocating muni performance against Treasurys and had kept muni-to-Treasury ratios, plus yields, elevated since March. November brought with it a return to fair value (circa 65%), with supply generally lower than prior months, stronger interest at higher absolute yields for tax-exempts and consistent inflows into muni mutual funds. The net effect of this potent combination was massive muni outperformance over Treasurys by month-end.

This brings us to the value we see in volatility. The magnitude of price volatility in the bond markets has been immense in recent years because of the pandemic, inflation, an active Fed and the election, among other reasons. How investors respond to these swings is often a key determinant of account performance in both the near and long term. That said, the peak weakness in early November offered many municipal bondholders the opportunity to tax-loss-harvest their positions while replacing them with higher-yielding securities that have similar attributes, such as credit quality, coupon income, final maturities and even call features.

Investors with ready cash or money-market range holdings got the opportunity to purchase bonds at the highest muni yields of the year, at levels in striking distance of the decade's highs. As previously mentioned, the timing of the sell-off and subsequent rally was similar to last year, which also means this is the second consecutive year that it paid to embrace year-round tax-loss harvesting. Once again, those who followed the more traditional pattern of conducting tax-loss trades in November likely saw their valuable losses rapidly vanish. Volatility can erupt at any time of the year, resulting in mark-to-market losses on existing bond positions. We believe there's value in having a plan in place to harvest losses as they occur, using a manager with the necessary acumen, tools, resources and market access.

In a broader sense, the outsized volatility also makes the case for active portfolio management. A longer-term market perspective and depth of experience can inform decisions that may capture additional yield while others simply step back. Further, the volatility may not abate in the near term. As we covered last month, the incoming presidential administration is expected to make changes to the tax code. This also brings fresh concerns for the tax-exempt municipal bond market, namely the longevity of the municipal bond tax exemption itself. Those concerns didn't come to fruition during the first Trump administration as it crafted the Tax Cuts and Jobs Act of 2017. But each time the US tax code is under construction, there's a risk of loss or mitigation of the muni exemption, because the federal government often seeks offsetting revenue. We've been here before: The Obama administration years saw "capping" the value of the muni exemption considered as a revenue item in the budget. While that consideration went nowhere, the mere existence of the threat drove 10-year muni-to-Treasury relative value ratios to well above 100% of Treasurys, compared with 66% today. This extracted an additional heavy toll from US taxpayers well beyond the typical cost of financing infrastructure and other municipal needs in the primary market, and it could happen again. We anticipate writing further on this timely topic in the coming months, but for now it certainly warrants mentioning.

Key economic data

Change in nonfarm payrolls (Nov.)	227,000
Unemployment rate (Nov.)	4.2%
Core CPI–YoY change (Nov.)	2.6%
Core PCE–YoY change (Nov.)	2.8%
Average hourly earnings–YoY change (Nov.)	4%
Real GDP annualized (Q3 2024)	2.8%

Source: Bloomberg, 12/10/2024.

©2024 Parametric Portfolio Associates® LLC

Economic outlook

With its sights set on the next FOMC meeting December 17–18, the bond market's consensus expectation is yet another 25-bps cut that would fulfill the Fed's prevailing dot plot's indication of 100 bps of policy ease during calendar 2024. This would bring the fed funds range to between 4.25% and 4.5%. That said, one highlight of the December FOMC press conference will likely be questions regarding the new Summary of Economic Projections ("dot plot"), scheduled for release with the rate decision.

Before that mid-month convocation, the bond market will likely focus on US economic data, starting with the high-profile November Payroll Situation Report released the morning of December 6. As we mentioned last month, the November report carried more weight with market pundits than the October report, which showed only a 12,000 gain (later revised to 36,000) but was of little value because of two major hurricanes and a sizable labor strike. The headline November nonfarm payrolls number showed an increase of 227,000 jobs, only slightly above street consensus estimates of a 220,000-job gain. The unemployment rate ticked up to 4.2% against estimates of 4.1%. The initial bond market reaction was muted and mildly positive, with the 10-year Treasury yield immediately dipping two bps and holding at less than five bps lower hours after the release. This indicated that the fresh data did little to change market expectations of a 25-bps cut at the upcoming FOMC meeting.

Beyond the payroll data, another high-profile data series that may capture market attention is the following week's Consumer Price Index (CPI) and Producer Price Index (PPI) for November, which are scheduled for release on December 11 and 12, respectively. Later in the month, quarterly GDP growth, personal income and spending, gross domestic product, home sales, durable goods orders and the US GDP Personal Consumption Core Price Index—the PCE Deflator, widely regarded as one of the Fed's preferred economic indicators—will likely hold the market's attention through year-end.

We've long anticipated an interesting fall, and it's exceeded our expectations. Outside the US, rising geopolitical tensions, foreign government upheavals and otherwise negative developments on multiple fronts have the capacity to unexpectedly affect the markets at any time.

©2024 Parametric Portfolio Associates® LLC

About

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, fixed income, alternative, and options strategies. Parametric also offers implementation services, including customized equity, traditional overlay, and centralized portfolio management. Parametric is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley, and offers these capabilities through offices located in Seattle, Boston, Minneapolis, New York, and Westport, Connecticut.

Disclosures

This material may not be reproduced, in whole or in part, without the written consent of Parametric. Parametric and its affiliates are not responsible for its use by other parties.

This information is intended solely to report on investment strategies and opportunities identified by Parametric. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Past performance is not indicative of future results. The views and strategies described may not be suitable for all investors. Investing entails risks, and there can be no assurance that Parametric will achieve profits or avoid incurring losses. Parametric and Morgan Stanley do not provide legal, tax, or accounting advice or services. Clients should consult with their own tax or legal advisor prior to entering into any transaction or strategy described herein.

Charts, graphs, and other visual presentations and text information were derived from internal, proprietary, or service vendor technology sources or may have been extracted from other firm databases. As a result, the tabulation of certain reports may not precisely match other published data. Data may have originated from various sources, including, but not limited to, Bloomberg, MSCI/Barra, FactSet, or other systems and programs. Parametric makes no representation or endorsement concerning the accuracy or propriety of information received from any third party.

The views expressed in this report are those of the authors and are current only through the date stated at the top of this page. These views are subject to change at any time based on market or other conditions, and Parametric disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions are based on many factors, may not be relied on as an indication of trading intent on behalf of any Parametric strategy. This commentary may contain statements that are not historical facts, referred to as "forward-looking statements." The strategy's actual future results may differ significantly from those stated in any forward-looking statement, depending on factors such as changes in securities or financial markets or general economic conditions.

The index data referenced herein is the property of ICE Data Indices, LLC ("ICE"), its affiliates, and its third-party suppliers. ICE, its affiliates, and its third-party suppliers accept no liability in connection with its use.

An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads, and a lack of price transparency in the market. As interest rates rise, the value of certain income investments is likely to decline. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. While certain US government–sponsored agencies may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the US Treasury. Mortgage- and asset-backed securities are subject to credit, interest rate, prepayment, and extension risk. Derivative instruments can be used to take both long and short positions, be highly volatile, result in economic leverage (which can magnify losses), and involve risks in addition to the risks of the underlying instrument on which the derivative is based, such as counterparty, correlation, and liquidity risk. Diversification does not guarantee profit or eliminate the risk of loss.

All contents ©2024 Parametric Portfolio Associates® LLC. All rights reserved. Parametric Portfolio Associates® and Parametric® are trademarks registered with the US Patent and Trademark Office and certain foreign jurisdictions.

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.

27547 | 11.30.2024 | RO 4091731