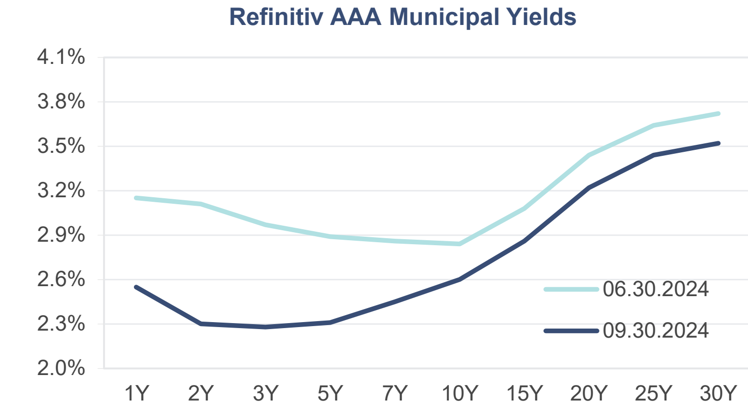
Municipal Fixed Income Commentary

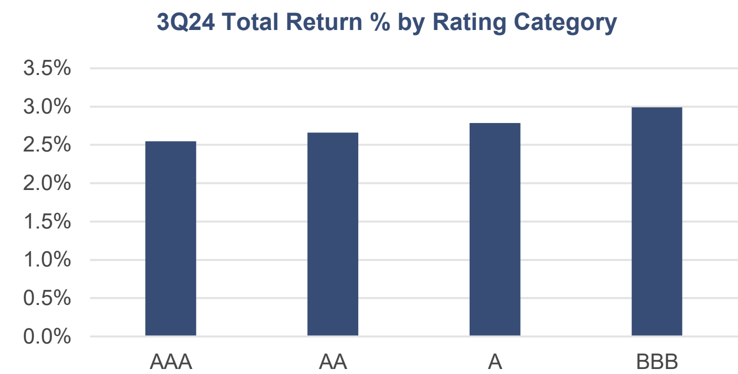
3rd Quarter 2024

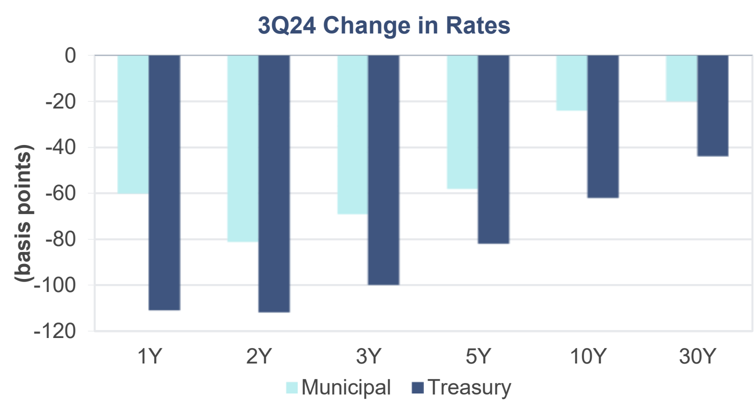
The municipal market rebounded from a sluggish start to the year to produce three consecutive months of positive total returns in the third quarter, as broad fixed income markets persistently reset rates lower due to cooling inflation data and concerns of overly restrictive monetary policy effectuating an economic slowdown. In this context, the ICE BofA 1-10 Year U.S. Municipal Securities Index delivered 2.69% in total return, equaling the largest third quarter performance result for the index since 2009. Excess return of -0.56% reflected underperformance to duration-matched treasuries, a function of the market entering the period at elevated municipal-to-treasury ratios and grappling with abundant new supply throughout.

Coming off peak inversion levels in municipal market history in the prior quarter, municipal curve steepening retained its status as a dominant market theme. Refinitiv's AAA-municipal 1-year and 10-year spread differential turned positive, ending at 5 basis points (bps) after beginning the period at -31 bps, predominantly driven by a decisive 60 bps move lower in 1-year yields corresponding with increasingly dovish expectations for monetary policy. As the curve slope normalized, the 10-year municipal-to-treasury ratio cheapened meaningfully from 64% to 69%, revealing an investor preference for shorter tax-exempt duration exposures relative to U.S. Treasury market alternatives. Otherwise, ratios across the curve took a mercurial path to roughly unchanged during the quarter and ended the period in all tenors within a few percent to their rolling 12-month and 3-year averages.

New supply remained a force to be reckoned with during the quarter in our view. Total supply totaled $135.0 billion in the third quarter, far outpacing the five-year average for the period of $119.7 billion and bringing the year-to-date total to $371.9 billion: a 39% year-over-year increase. In addition to standard inflationary pressures padding nominal project costs, refunding issuance continued to play a large role in the booming supply trend. Bloomberg estimated that refunding activity comprised approximately 20% of all municipal bond sales year-to-date, the highest rate since 2021, as issuers actively capitalized on opportunities to reduce debt service following limited chances throughout the prior multi-year rate hiking cycle period. Fund flows into municipal bond funds were positive in every week of the quarter for the first time year-to-date, summing to over $10 billion, indicative of the improving market sentiment. As the firehose of external supply blasted against a wall of market demand, internal supply via bid wanted activity weakened by 22% over the prior quarter and 19% over the equivalent period in the prior year.







Data is as of 09.30.2024. Sources: Bloomberg L.P.; U.S. Treasury; Refinitiv. Yields are subject to market conditions and are therefore expected to fluctuate. Charts are for illustrative purposes only. The views expressed represent opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. Past performance does not guarantee future results.

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Performance, once again, favored risk-on sectors during the quarter, though risk compensation was constrained by credit spread widening in virtually every lower-rated index category. Total returns for A-rated and BBB-rated securities were 2.79% and 2.99%, respectively, outpacing AAA-rated and AA-rated returns of 2.55% and 2.66%, reflecting the tightest year-to-date AAA-to-BBB total return differential of 44 bps following the first quarter's 117 bps and the second quarter's 94 bps. Lower quality exposures such as corporate obligors in the industrial development revenue (IDR) sector as well as airports and power bonds experienced option-adjusted spread (OAS) widening of 16, 9, and 6 bps respectively. Prepaid gas and electric index subclasses again outpaced the index's total return result despite OAS widening of 13 and 2 bps during the quarter, respectively, demonstrating their potent total return potential.

Credit conditions remained sound, although municipal officials widely acknowledged a slowing operating environment after white-hot pandemic-era revenue growth. The National Association of State Budget Officers (NASBO) indicated that states had largely forecasted revenues in fiscal 2025 to flatten or moderate from fiscal 2024 levels, anticipated less one-time spending, and enacted fewer tax cuts. Even so, Transportation Security Administration (TSA) throughput data in the third quarter exhibited a 4% increase year-over-year, providing a salient reminder of ongoing economic resilience. Furthermore, U.S. States such as Arizona and New Jersey received positive outlooks, from S&P and Moody's respectively, in recognition of their improving fundamentals and budgetary flexibility. Moody's reported upgrades outpaced downgrades in the second quarter of 2024 by a ratio of more than 2-to-1, though the healthcare and higher education sectors sustained more downgrades than upgrades for the second consecutive quarter.

Our View

Amidst the Federal Reserve's tightrope act of choking out inflation without damaging economic growth, we expect real growth to moderate but remain sturdy in 2024 and into 2025, a result of steady consumer spending, softening though still healthy labor markets, and monetary policy closely attuned to providing further accommodation as needed. While the cutting cycle's terminal rate and pace of adjustment remains highly uncertain, the direction of travel is likely set towards a materially lower federal funds rate. Paired with resilient economic data, continued curve steepening and a range-bound spread environment remains our base case.

During the quarter, we continued to opportunistically pad risk exposures in portfolios, rotating from more defensive general obligation (GO) bonds to revenue bonds, and maintained our prepaid energy overweight. We also boosted our bulleted positioning as we consider the market to be in the middle-innings of its curve shape normalization. We remain positioned slightly long duration relative to benchmarks to capitalize on the market's shift from focus on inflation to a softening labor market, though recognize the various tax policy uncertainties ahead of the 2024 presidential election that will influence municipal market valuations. Regardless of the result in November, we consider the value of tax-exempt instruments to be structurally increasing given the outstanding U.S. fiscal debt burden and both parties' willingness to spend, each pointing to a potentially more onerous tax regime over the longer term.

Disclosures

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The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The ICE BofA 1-10 Year Municipal Securities Index is a subset of the ICE BofA U.S. Municipal Securities Index including all securities with a remaining term to final maturity less than 10 years.

Refinitiv Municipal Market Monitor (MMD) AAA benchmark: The Municipal Market Monitor has been delivering the municipal market's MMD AAA benchmark for over 30 years, and is integrated into the most comprehensive source of critical municipal market information.

Bid Wanted: An announcement by an investor who holds a security, commodity, or currency. It indicates that they are looking to sell the product, and are ready to entertain price bids for it. Interested parties may thus respond with bids.

Build America Bonds (BABs) were taxable municipal bonds that featured federal tax credits or subsidies for bondholders or state and local government bond issuers.

General Obligation Bonds (GOs) are municipal bonds which provide a way for state and local governments to raise money for projects that may not generate a revenue stream directly.

Industrial Development Revenue Bonds (qualified small issue bonds or IDRBs) are securities issued by a local government agency for the purpose of acquiring or constructing capital facilities for use by private business and industry.

National Association of State Budget Officers Spring (NASBO) has been in existence for nearly 80 years and is a professional membership organization for budget and finance officers. The survey referenced is a semi-annual report gathered from all 50 state budget offices. Spring survey referenced: https://www.nasbo.org/reports-data/fiscal-survey-of-states

Option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option.

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