Municipal Fixed Income Commentary

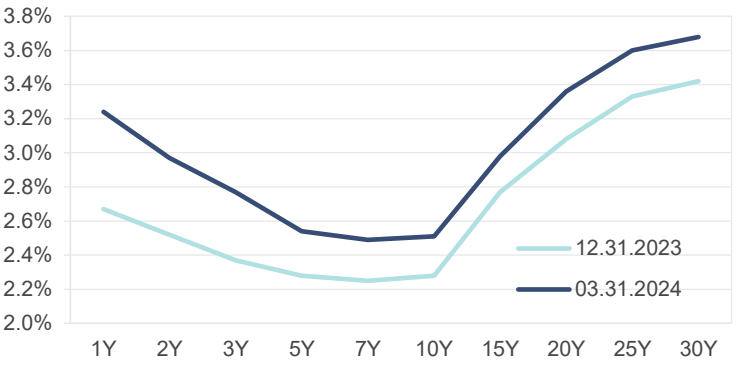
1st Quarter 2024

In the first quarter, the municipal bond market came under pressure as above consensus inflation data and a resilient U.S. economy dampened widespread expectations for less restrictive monetary policy later in the year. The ICE BofA 1-10 Year U.S. Municipal Securities Index delivered total returns of -0.21% during the quarter, with negative index-level price performance in each month throughout the period as persistently rising U.S. Treasury yields relentlessly galvanized higher municipal yields. In the context of relatively stretched valuations to begin the quarter after the furious rally that ended 2023, -0.47%.

As a result of the yield adjustment through the quarter, municipal-to-treasury ratios ended at 61% for the 5-year and 60% for the 10-year, finishing at marginally more attractive levels. While still rich on a longer-term historical basis, a straightforward comparison with the 10-year historical averages of 76% for the 5-year and 86% for the 10-year remained fraught given the steady rise in customized portfolio management vehicles that have buttressed demand in volatile markets, coupled with structurally reduced municipal supply stemming from the 2017 Tax Cuts and Jobs Act (TCJA). Ratios over the past three years have averaged 63% and 72%, respectively, suggesting somewhat better relative value for current market valuations. The municipal curve shape became further inverted during the quarter, ending with a spread differential between Refinitiv's AAA-municipal benchmark 10-year and 1-year yields of negative 73 basis points (bps), materially in-line with the market's record inversion achieved in mid-2023.

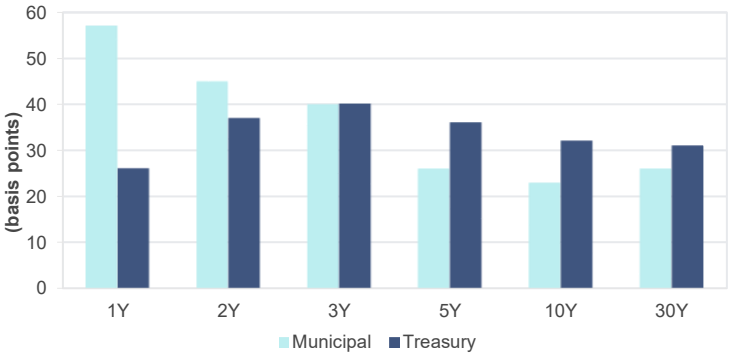
Primary market issuance equaled $99B during the first quarter, approximately keeping pace with the rate of issuance throughout the second half of 2023, though more than 30% higher year-over-year, as factors that depressed supply in 2022 and into 2023 continued to fade such as balance sheets overflowing from federal stimulus and the extraordinary macroeconomic and pandemic-related uncertainties that complicated long-term planning. Taxable issuance remained sluggish, down by 60% versus the prior quarter and 51% versus the prior year, as higher rate levels reduced the economic rationale for refunding tax-exempt bonds. Bid wanted activity returned to a more normal average of 1.0 billion par value per day after peaking in the prior quarter when investors employed tax loss harvesting strategies during the market pullback. Fund flows into municipal bond funds pointed to a markedly different tone than in the prior year, with funds receiving net flows in nine of the 13 reporting weeks of the quarter; the total inflow of positive 3.5 billion was in stark contrast to the -1.3 billion in net outflows experienced in the first quarter of 2023.

Refinitiv AAA Municipal Yields



1Q24 Total Return % by Rating Category

1Q24 Change in Rates



Data is as of 03.31.2024. 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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While total return was overwhelmed and forced into negative territory by the sustained blitz of strong macroeconomic data, lower credit quality was also a major contributor of index return during the quarter. A-rated and BBB-rated bonds produced positive total return of 0.18% and 0.71%, respectively, with each rating cohort far outpacing the -0.46% and -0.39% generated by the AAA-rated and AA-rated categories, respectively. Corporate obligors within the municipal market such as the prepaid gas and industrial development revenue (IDR) sectors led the way amongst lower-rated exposures, each returning 0.74% and 0.65% during the quarter. Notably, as prepaid energy bond issuance increased materially in 2023 and into 2024, the collective prepaid gas and electric subsector weighting of index market value grew from 7% to 10% year-over-year, increasing its heft on index performance. Higher-quality sectors such as state and local general obligation bonds, water & sewer utilities, and various tax revenue bonds underperformed the index-level quarterly result. Higher-beta names such as the State of Illinois and New York Metropolitan Transportation Authority (MTA) experienced steady option-adjusted spread (OAS) tightening during the quarter, reflecting the risk-on dynamic in the market.

Credit fundamentals remained strong with few exceptions. Moody's and S&P reported that upgrades outpaced downgrades in full-year 2023 by a margin of more than 3-to-1 at both agencies, though Moody's indicated that the healthcare and higher education sectors each exhibited net negative rating movement during the year. Based on a reporting sample of the largest cities and counties that received American Rescue Plan Act (ARPA) funds through September 2023, the Brookings Institute indicated that over 60% of the funds were legally dedicated for specific purposes, indicating significant remaining stimulus and a fairly long runway upon which to expend, given the statutory deadline in 2026. Notable upgrades during the quarter such as the State of Louisiana's to AA by S&P continue to portray a broad cyclical upswing in credit quality, though momentum is slowing. The Urban Institute reported that state government tax revenue collections declined 1.2% in the 3Q23 versus the same period a year prior. At the same time, airport passenger volumes for the quarter continued to exceed 2019 levels, averaging 2.3 million passengers a day, indicative of steady consumer spending in our view.

Our View

We believe that economic conditions will remain solid in 2024 with forecasts of real gross domestic product (GDP) growth of 2.0% and unemployment of 4.0% to end the year. While complicated by recent inflation surprises to the upside, monetary policy is likely to ease in the second half of the year as the Federal Reserve looks to lower rates towards a more neutral level. This environment should be constructive for risk as the economy continues to perform and monetary policy loosens incrementally over time, though with tail risk of a dovish policy error that we continue to monitor closely.

Throughout the quarter, we padded credit exposures in prepaid energy bonds as well as various revenue bond sectors, reducing the general obligation sector weighting in portfolios. We continue to look for opportunities to boost book yields in stable-to-improving credits that provide adequate compensation for risk, rather than a wholesale rotation into lower-rated credits given broadly tight spreads. While we expect some mean reversion in valuation, we view this environment as being conducive for persistently more expensive ratios than longer-term averages. We remain bulleted and expect the curve to steepen over the balance of this year as the municipal yield curve adjusts to continuing steady growth in tandem with supportive monetary policy.

Disclosures

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Economic charts are provided for illustrative purposes only. The information provided herein is subject to market conditions and is therefore expected to fluctuate.

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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.

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