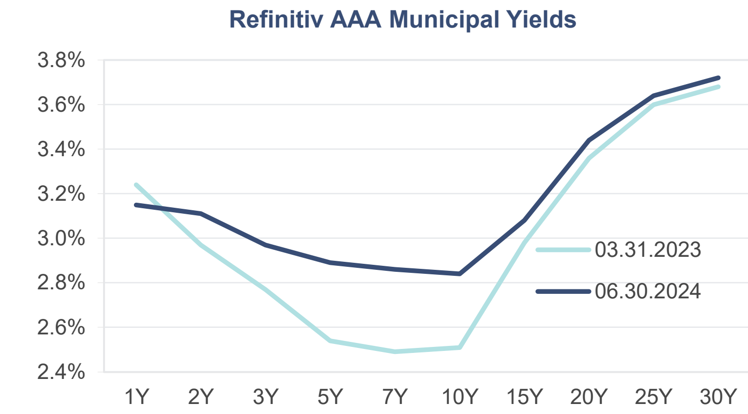
Municipal Fixed Income Commentary

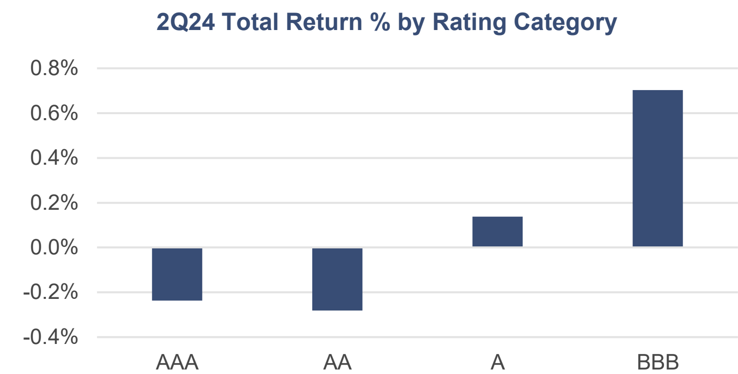
2nd Quarter 2024

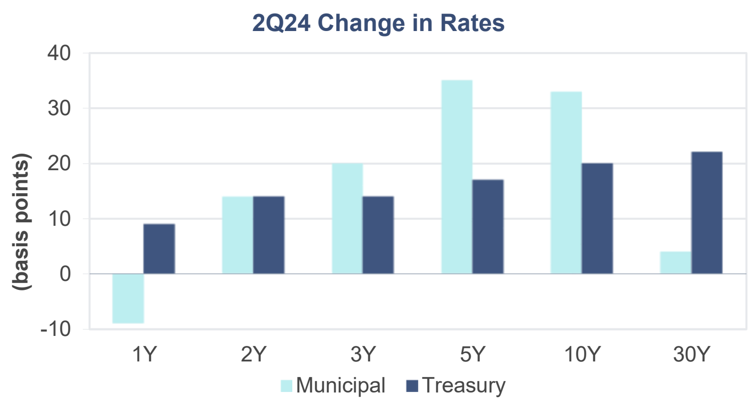
In the second quarter, the municipal market was upended by volatility in U.S. Treasury yields as well as a torrent of new supply that together drove municipal rates higher and cheapened valuations. The ICE BofA 1-10 Year U.S. Municipal Securities Index delivered -0.13% in total return; taken together with the negative total return result from the prior quarter, it was only the fifth time since index inception in 1997 that cumulative first-half returns were negative, highlighting the intensity of the negative price movement. In many ways, the consequences of the colossal bond rally in the fourth quarter of 2023 continued to reverberate and weigh on performance, as exuberantly dovish expectations for monetary policy that had underpinned market pricing to begin the year continued to unwind in the face of above-target inflation and above-trend growth, which in turn catalyzed higher long-dated yields and a normalizing curve shape.

While fixed income markets wrestled with sturdy economic data in April suggesting wide-ranging inflationary pressures and a resilient labor market, the index tracked the returns of duration-matched U.S. Treasuries returns closely. In May, the dynamic reversed sharply with the index generating -1.36% in excess return, as U.S. Treasury yields declined due to signs of the economy marginally slowing while outsized supply steered municipal yields higher. This combination spiked municipal-to-treasury ratios to their peak levels of the quarter of 71% for the 5-year and 70% for the 10-year. Following the sell-off, June brought with it a reminder of investor demand for elevated all-in yields, supercharged by an improving municipal technical environment with heavy summer bond redemptions. Index excess returns improved marginally to -0.98% to end the quarter and ratios richened to 67% and 65%, respectively.

Rate volatility sustained throughout the quarter was most significant for longer-dated bonds. Refinitiv's AAA municipal benchmark declined by 9 basis points (bps) at the 1 year while increasing by more than 30 bps for each tenor across the 5 year to the 10 year, with the former ending the quarter at 2.89% and the latter at 2.84%. Historically resilient to inversion, the municipal market reduced its negative slope and sidled back towards its preferred habitat, ending the quarter with a 10-year and 1-year spread differential of -31 bps after entering the period with a record-low differential of negative 73 bps. Demonstrated investor preference for higher-yielding over higher-quality exposures enhanced the benchmark's upward move, with a much stronger bid for bonds offering additional compensation for risk-taking.







Data is as of 06.30.2024. 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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Surging primary market issuance was a sizable headwind on quarterly performance and major driver of the technical backdrop. Total supply of $138B increased by nearly 40% over the second quarter of the prior year, upsizing the year-to-date total to $237B, also a significant 37% year-over-year increase over the equivalent period. A confluence of factors explained the outburst of activity: having adjusted to the reality of entrenched higher rates and materially drawn down federal stimulus funds, municipal issuers flocked to capital markets to fund their spending needs at a lower cost of capital than the peak levels of late 2023. In addition, Build America Bonds (BAB) refunding activity continued to percolate following the University of California's decision to refund approximately $1B of bonds in March based on an interpretation of their extraordinary redemption provisions, opening the potential for billions more in related issuance throughout 2024.

Natural gas and electric pre-paid bonds featured prominently both in issuance and performance during the quarter. Pre-paid supply for the quarter totaled nearly $4B, a retreat from the $6B issued in the first quarter, but total returns continued to post outsized performance. Index bonds generated 0.89% and 0.73% in total returns for gas and electric bonds, respectively. Red-hot demand for the sector resulted in oversubscribed deals and fueled spread compression throughout the quarter with option-adjusted spreads (OAS) tightening by 24 bps for prepaid gas and 28 bps for prepaid electric. Lower quality sectors such as public power and corporate obligors in the industrial development revenue (IDR) also outperformed for a second straight quarter, delivering 0.28% and 0.45% in total return, respectively, while state and local general obligation bonds, water and sewer utilities, and various tax revenue bonds continued to underperform. Index returns by quality also signaled enhanced investor appetite for risk, as A-rated and BBB-rated securities returned 0.14% and 0.70%, respectively, while AAA-rated and AA-rated securities returned -0.24% and -0.28%.

While municipal credit quality likely peaked in recent years at the zenith of unspent federal stimulus balances, negative pressures remained imperceptible in most sectors and gradual in others. Moody's Rating Revisions quarterly report showed that upgrades exceeded downgrades by more than 2-to-1 in the first quarter. The National Association of State Budget Officers Spring 2024 Fiscal Survey of States indicated that the majority of states projected larger rainy-day balances in fiscal 2024 than in the prior year, adding to already robust reserve levels at 15-year highs, though total fund balances were set to decline as stimulus funds are expended. Ever the bellwether for the tone of the market, the State of Illinois received a positive outlook from Moody's in April, citing a probable surplus in fiscal 2024, and the potential for continued reserve gains going forward. Ongoing stress in pockets of higher education and healthcare credits persisted, with both sectors underperforming the index in the first half of the year. According to MarketWatch, 15 nonprofit colleges have closed, merged, or been acquired since the start of the year relative to 20 in all of 2023, while hospital systems continued to confront cost pressures and lowered reimbursement rates, squeezing margins.

Our View

We view the economy as deaccelerating, though from a broadly robust position, with economic indicators pointing to a weakening of both the consumer and labor market from historic levels of strength. At the same time, Transportation Security Administration (TSA) throughput data reported approximately 236 millions passengers passed through security checkpoints during the quarter, a 15% increase quarter-over-quarter and a 7% increase year-over-year. In the context of this ongoing gradual slowdown with a consumer still willing to spend, we remain sanguine on the outlook for risk in the municipal market over the balance of the year. We also expect the municipal curve will continue to steepen as we approach the first Federal Reserve interest rate cut likely in the second half of the year.

During the quarter, we continued to add to our prepaid energy position as well as various revenue bond sectors. As we opportunistically boost portfolio yields, we will maintain our bulleted curve position to benefit from ongoing normalization of the yield curve. We also anticipate managing a slightly long relative duration position to take advantage of improved ratios and all-in yields available with any further increases activating latent demand. U.S. nominal household net worth has more than doubled in the last ten years while the municipal bond market is approximately the same size, highlighting the potential for structurally growing municipal demand particularly when rate volatility provides the investor base with an opportunity to lock in attractive tax-exempt yields.

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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.

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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