2Q 2023

MUNICIPAL FIXED INCOME TEAM

# *Municipal Basis Points*

## *Safety First*

Municipal bonds delivered strong performance in the first quarter, amid softening interest rate expectations and a flight to quality tied to the banking crisis. Looking ahead, we note the strong fiscal condition of many issuers, as well as potential for favorable technical tailwinds given reduced funding needs and appetite for tax-exempt yields that remain far above levels from a year ago.

PRIVATE WEALTH

*"History never repeats itself; man always does."*

— VOLTAIRE

**JAMES L. ISELIN**
HEAD OF MUNICIPAL
FIXED INCOME

# Safety First

*Amid market volatility, the quality of municipal bonds has been fueling a comeback.*

Building on solid performance in the last two months of 2022, municipals bonds delivered a strong first-quarter 2023 from a total return standpoint. In our last *Municipal Basis Points,* we pointed out that we expected volatility to remain elevated this year as markets and the Federal Reserve became more data-dependent. Despite strong results in the first quarter, the ride did prove to be a bit bumpy. In January, the muni market rallied as a lack of supply and optimism that Fed tightening could be coming to an end pushed municipal bond prices higher. February was marked by a reversal in sentiment as sticky and stubbornly high inflation readings caused investors to sharply increase their expectations for the Fed's terminal rate; Treasury yields moved up and municipal yields followed suit. Then, in March, strains emerged in the banking sector and the market quickly dialed back its expectations for future rate increases. A strong flight-to-quality trade ensued in the Treasury market, and munis again served as an asset class that investors turn to in times of uncertainty. For the quarter, the full investment grade muni market,

as measured by the Bloomberg Municipal Bond Index, returned 2.78%. From November through March, the index returned 7.89%. Investors are clearly taking a close look at fixed income and municipal bonds.

Moving forward, all eyes will continue to be on the Fed. While its job is a tough one and its members are an easy target when things don't work out, we believe the Fed's performance over the past couple of years does warrant some criticism. In 2021, when the economy was growing at over 5% and inflation was rearing its ugly head just about everywhere, the central bank confidently told the market that rapidly rising prices would be "transitory." The Fed had the perfect backdrop in 2021 to slowly start taking the gas off the pedal, but missed out due to a false belief that inflation would come down on its own. Instead, the Fed chose to continue its zero-rate policy and quantitative easing. Then, in the middle of 2022, it shifted into overdrive and started raising rates at 75-basis-point clips in order to play catch-up. When you drive your car at 100 mph, more accidents happen because you give yourself and others around you less time to react. The Fed has started "breaking things" and, as a result, a potential soft landing is less likely. The pressure on the banking system will only further complicate the battle against inflation as the Fed now has to consider the impact of tighter credit conditions on the broader economy.

Despite these challenges and the probability of further volatility, we believe the outlook for fixed income and munis, in particular, remains compelling. The Fed is probably in the last innings of the tightening cycle. Munis are a "safe haven" asset class, and yields remain more than double where they were at the start of 2022. The "income" is clearly back in "fixed income." In addition, the fund outflows cycle, which weighed heavily on the market in 2022, appears to have stabilized. Finally, municipal supply has been modest and, in our view, should be met with ample demand as investors are attracted by higher rates and the tax-efficiency of the muni asset class.

TRADING NOTES

**RANDY L. GROSS**
SENIOR PORTFOLIO MANAGER
MUNICIPAL FIXED INCOME

*"After I hit a home run, I had a habit of running the bases with my head down. I figured the pitcher already felt bad enough without me showing him up rounding the bases."*

—MICKEY MANTLE

# Munis Reaffirm 'Safe Haven' Status

*Strong technicals and a looming Fed pause should support municipal bonds.*

Investors sought the safety of U.S. Treasuries and municipal bonds during the collapse of three U.S. regional banks in early March. High-quality municipals tend to follow U.S. Treasuries directionally in times of panic and volatility; recent market events proved no different.[1]

During this period of in heightened uncertainty, demand for municipal bonds was robust and liquidity remained strong. Municipals benefitted with strong positive performance as rates moved lower due to the volatility in the banking sector.

### A Fed Pause Should Benefit Munis

The Federal Reserve hiked rates by 25 basis points on March 22 as inflation remains persistently high. Fed futures contracts, which have been changing rapidly, are currently pricing a greater than 50% chance of a May rate hike, with the potential for easier policy toward the end of the year.

[1] Note that municipal bonds, while typically high in quality, are not backed by the full faith and credit of the U.S. government as are U.S. Treasury securities.

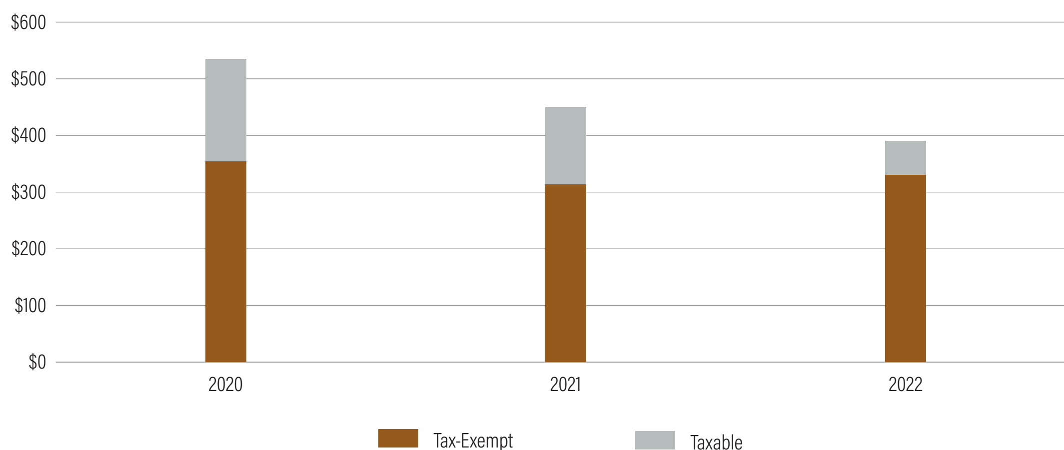
When the Fed eventually pauses, we believe municipal performance could see greater potential for price appreciation as the economy struggles with bouts of slower growth, and there is renewed talk of Fed rate cuts.

**New Issue Supply Is Down**

New issue supply has been anemic thus far in 2023 due to a volatile rate market and the ongoing Fed hiking cycle. Additionally, pandemic-fueled federal stimulus funds given to state and local governments have helped blunt some borrowing needs. In our view, this ongoing scarcity of bonds has led to overvalued ratios when compared to U.S. Treasuries, which are magnified in securities with maturities that are 10 years or shorter.

**SHRINKING MUNICIPAL NEW-ISSUE SUPPLY**

$ Billions




Source: Barclays, JPMorgan.

**And Lastly...Seasonal Market Technicals**

Muni performance in the spring has usually skewed negative due to the dual headwinds of tax-time outflows and increased new issue supply. Thus far, munis have bucked these historically negative performance trends. We would view any meaningful underperformance versus U.S. Treasuries in the coming weeks as a buying opportunity.

Looking past springtime, the dual themes of peak reinvestment season and reduced new issue supply should bolster support for municipal performance during the summer months. Scarcity of bonds, coupled with a likely conclusion of the Fed's hiking cycle, should help increase the potential for positive performance for municipals.

FUNDAMENTAL FOCUS

**STEPHEN COWIE**
DIRECTOR OF MUNICIPAL RESEARCH

*"The shortest period of time lies between the minute you put some money away for a rainy day and the unexpected arrival of rain."*

**—JANE BRYANT QUINN**

# *State Finances Hold Their Own*

*Healthy revenues and stimulus are keeping many states in the black.*

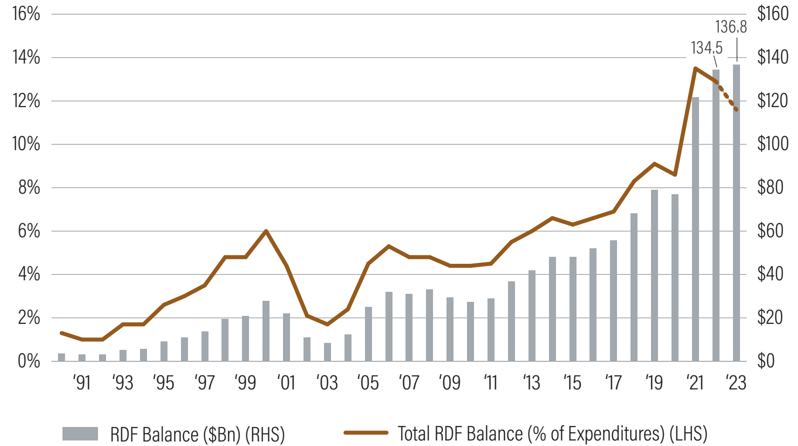
We are entering the busy season of state budget proposals and negotiations, with increased projections for slower economic growth in the near term. Despite these forecasts, state finances are generally in a favorable position due to revenue growth achieved during the pandemic. Impressive for state finances, this growth occurred amid all of the economic uncertainty during the pandemic.

Contributing to the improved fiscal position of many states are tax receipts during the pandemic that exceeded expectations and federal aid via $195 billion from the American Rescue Plan. These two factors significantly contributed to enhanced state reserve levels and have provided additional financial flexibility. As per the National Association of State Budget Officers, 30 states have reserves greater than 10% of their general fund expenditures; and it's now estimated that states will hold an estimated $136.8 billion in rainy-day funds this fiscal year, which will help preserve their credit metrics.

## *Upgrades for Illinois*

After several years of significant credit pressures and rating downgrades into near-junk territory, the State of Illinois was upgraded by both Moody's and Standard & Poor's during the first quarter. The upgrades to A3 and A-, respectively, mark significant progress achieved by the state with regard to several of its largest credit challenges, including pension funding and vendor payables, as well as its proactive fiscal practices that improved financial performance. In particular, the state has experienced favorable tax revenue growth in recent years and its reserve-level position is the strongest it has been in over a decade.

**RAINY DAY FUNDS ARE OVERFLOWING**




Source: NASBO.org.

While some states face unique tax regimes and specific economic issues, strong finances built up in recent years will help in the near term. For example, the State of California is projecting a $22.5 billion deficit for fiscal 2024, but positive financial operations in recent years and significant reserves will help mitigate the situation. In response to its projected revenue slowdown, Governor Gavin Newsom has proposed a 2024 general fund budget decrease of 6.9%.

We believe that current budget discussions are more focused on moderate growth projections that better reflect the economic realities of each state and that, relative to last year, will reflect expectations for a slowing economy. Our stable outlook for states is based upon strong finances generated in recent years that will not only help in the near term, but also provide an additional financial tool during budget negotiations.

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