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The Narrative Shifts To When, Not If

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People love a good story and financial market participants are no exception. For investors, it's the stories explaining current and near-term market movements that are most interesting. Competing narratives develop, sides are drawn, and debates ensue. Our commentaries of the past year have reflected the tug-of-war between competing market narratives and how those narratives have shifted. When bond market history is written, the second quarter of 2024 will likely be viewed as the time when the lower-rates-are-coming narrative clearly won the day. Federal Reserve messaging tilted more clearly toward that viewpoint while data confirmed slower growth in inflation and weakness in economic activity and the labor market. The debate now among bond market participants (and there is always some sort of debate) is just when those rate cuts will start.

The first quarter trend of rising 10-year Treasury bond yields peaked at 4.70% in late April before falling in a saw-tooth pattern to 4.28% by early July. As is often the case, municipal bond yields took a bit longer to match Treasury bond movements. According to Bloomberg, 10-year high grade municipal bond yields peaked this year in late May at 3.10% before falling to 2.82% by early July. The municipal bond market often reacts to Treasuries with a lag as muni market participants take some time to discern whether a particular move in the Treasury bond market has staying power. Contributing to that late May peak in muni bond yields was a sizable two-week-in-a-row bulge in new issue supply. While new-issue municipal bond supply has been 30% higher this year compared to last, generally strong demand for municipal bonds has absorbed that additional supply without incident. The two-week period in late May was a brief exception to the standard 2024 environment of steady demand meeting and absorbing plentiful supply.

One possible explanation for the increase in 2024 bond deals coming to market could be the desire of muni bond issuers to finance their cash needs before a potentially volatile bond market in late Summer and Fall of an election year. If that explanation is correct, the next four months in the muni bond market could be one of steady demand looking for relatively scarce supply. Another factor affecting the municipal bond market in the near term is the prospect of changing Federal income tax rates in 2025 and beyond. The municipal bond market is not focusing on this currently, but it could be something to keep an eye on as we progress through Summer and early Fall. A Republican party win in the executive and legislative branches of the Federal government could mean lower tax rates and somewhat lower demand for munis.

A Democratic party win could mean existing or higher tax rates and somewhat higher demand for munis. It is important to keep in mind that election outcomes may be more muddled than a clean sweep by one party or the other. Even a clean sweep outcome may result in more modest changes to tax rates and a muted municipal bond market reaction. A hyper focus on these possible tax rate changes may produce market overreactions and possible value opportunities. Of course, the election results this Fall are unknown and adjusting municipal bond allocations now based on difficult to predict political outcomes should be viewed as a speculative exercise. It is an issue to be aware of and to watch but placing large bets on a particular outcome should be recognized as one fraught with uncertainty.

By early July, municipal bond yields in the intermediate maturity range were available at levels seen in late November of last year. Currently, single A-rated municipal bonds in the attractive 11 to 15-year range offer yields of 3.80% to 4.20% tax-free, or a 6.03% to 6.67% taxable equivalent yield for top tax bracket investors. Currently, we are finding opportunities for capturing value in the municipal bond market in 11 to 15-year maturities with reasonable call protection as well as selective bonds in the 2 to 4-year space. We continue, as always, to use careful judgment on the pace at which we invest cash. We remain committed to our dogged and judicious search for value in the investment grade, intermediate maturity space of the municipal bond market.

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