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Moments of Rate Backup Stall Long-Awaited Rate Decline

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As a portfolio manager who has been around the block a few times, I always feel a bit uneasy whenever a strong, one-way consensus takes hold among market participants. At the start of this year, given clear Federal Reserve pronouncements, there was general agreement in the bond market that 2024 was likely to include falling interest rates. That remains a fair general assessment. The question was always just how soon that process was going to start.

In my last commentary, I thought it necessary to honor my uneasy feeling about the strong, one-way market consensus with the following observation: "*While the bond market consensus is for falling interest rates in 2024, there will likely be market miscalculations and disappointments regarding how quickly the highly expected rate cutting will begin, creating moments of rate backup.*" The reality of market miscalculations and disappointments away from a strongly held positive consensus is a fair shorthand explanation for bond market activity in the first quarter. It is also a fair description of what will be on the mind of bond market participants for the next six to nine months.

Intermediate Treasury bond yields generally rose throughout the first quarter with ten-year yields reaching 4.20% by the end of March, a meaningful increase from the 3.88% level of early January. April so far has been more of the same with ten-year Treasury bond yields moving up to 4.42%, matching the Treasury yields of late November 2023. Municipal bond yields followed; though true to form, it took them some time to get there. Strong muni fundamentals were the culprit. While the average 30-day supply of expected new issues in the first quarter was 16% higher than last year's first quarter, this reasonably sized increase in supply did not overwhelm the muni market. The robust demand for municipal bonds as measured by net flows into muni bond ETFs and bond funds was a countervailing factor (80% higher this year than a similar period in 2023).

The market miscalculations and disappointments of the first quarter were internalized bit by bit, gradually pushing rates upward. Concerns about that tough last mile of getting inflation completely down to the Fed's 2% target caused the bond market to re-think just how quickly lower rates might materialize. The idea that Fed rate cuts would start in March gradually lost steam until it disappeared altogether. There is now reasonable doubt among bond market participants if

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rate cuts will come at the Fed's June meeting. The labor market and the economy generally, while not booming, are showing resilience. A slight uptick in the rate of inflation in the first quarter also fueled the uncertainty.

In early April, municipal bond yields in the intermediate maturity range continued their rise with yields equaling the levels seen in late November and early December of last year. While not as high as the unusual period of August through November of last year, current municipal bond yields offer a reasonably attractive entry point, particularly when compared to the lower yields of 2019 through early 2022. Currently, single A-rated municipal bonds in the attractive 11 to 15-year range offer yields of 3.75% to 4.20% tax-free, or a 6.2% to 6.9% taxable equivalent yield for top tax bracket investors.

The bond market is still working on the idea that the Fed will cut rates at some point this year. The actual starting point of that process will continue to be debated among bond market participants. Volatility in Treasury and municipal bond yields will reflect that back-and-forth debate. Since we do not see major changes in recently positive municipal bond market fundamentals, we expect municipal bond yield movements to be more muted, particularly on the upside. We will continue to employ careful judgment on the pace at which we invest cash. As always, we will continue our dogged and judicious search for value in the investment grade, intermediate maturity space of the municipal bond market.

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