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The Muni Bond Market Has A Lot On Its Plate

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The distinguishing characteristic of the municipal bond market in the third quarter of 2024 was its modest volatility, particularly relative to Treasuries. While the 10-year Treasury bond yield had an 87-basis point difference between its third quarter high and low, high grade 10-year municipal bond yields traded in a much tighter range of just 27 basis points. For much of the quarter, municipal bond yields had multiple two-or-three-week periods of relative calm where yields fluctuated little. Munis throughout the summer and early fall seemed content to play a waiting game and to take their time sorting out all that was on the muni bond market plate.

One thing to sort out of course was Federal Reserve monetary policy. Bond market participants understood a cut in the Fed Funds rate was coming, but its exact timing and size was the source of back and forth debate all summer. The anticipation and haven't-seen-this-in-a-while nature of a rate cutting environment sparked spirited debate, including the usual Treasury bond market over-reactions. Yield movements in the muni market often lag those of the Treasury bond market as muni bond market participants tend to wait for the Treasury bond market to consolidate a move before making their own adjustments. This muni market tendency was evident in spades in the third quarter.

Another factor for the muni market to sort out in the third quarter was the sizable new issue supply coming to market. While volume has been about 35% higher than last year's levels, it has been absorbed generally without incident by strong steady demand. Still, the muni bond market, in dealing with this above average supply, has been seemingly afraid to make a major move downward in yield in anticipation of more sizable new issue volume to come. This has also caused muni yields to mark time relative to Treasuries.

Couple these two factors with an election just around the corner and you can appreciate the volume and complexity of what has been on the muni bond market plate. It is unsurprising the muni market seems to be taking its time sorting it all out. The upcoming election – one where the make-up of the federal executive and legislative branches is up for grabs – appears at present to be generally evenly divided and quite close. For the muni bond market, the focus in the coming months and next year will be on possible changes to individual Federal income tax brackets according to who prevails this November. There are also proposed changes to Federal income tax rates for corporations. Changing income tax rates can have an impact on municipal bond demand. Here we offer a gentle reminder about elections: expected changes may be more muddled even with a clean sweep by one party or the other. In addition to the actual make-up of the executive and legislative branches and the size of the majority and its legislative priorities, it is unknowable at the present time what final legislation in the future will look like. The muni bond market, with its usual caution, appears to not be making any particular bets presently. Election results in November should provide some clarity to these issues but I have a seen a hyper focus and speculation on actual tax rate changes produce market overreactions and possible value opportunities in the past. It is an issue to be aware of and to watch but placing large bets presently on a particular outcome should be recognized as one fraught with uncertainty.

The muni bond market has sought fit to not make any major moves in the past three months for a host of reasons listed above. Trading ranges like that of course don't last forever. In the next few months, it appears likely we will be dealing with some version of accommodative Federal Reserve Policy, moderating inflation, modestly slowing economic activity, a likely lessening of muni bond supply, and steady muni bond demand. When you assess the forces at work likely to push muni bond yields downward and those forces working to counteract that, I suggest the road we'll likely be driving on in the next few months is one of somewhat lower yields.

By early October, municipal bond yields in the intermediate maturity range remain, with their relative recent calm, 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 3.75% to 4.10% tax-free, or a 5.95% to 6.51% 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. 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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