Muni Summer Set-up: Seasonal Tailwinds and Easing Interest Rates

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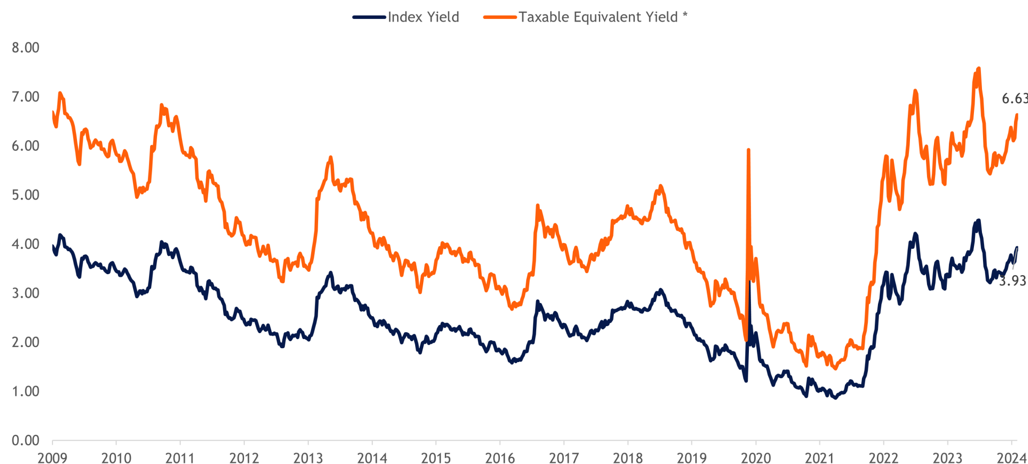
After a solid 2023 in which the Bloomberg Municipal Index was up over 6% (including a positive 8% in November and December), it's been a slow start to the year in 2024. Changing Federal Reserve (Fed) rate cut expectations and already rich relative value ratios (versus Treasury yields) have, so far, offset still high tax-equivalent yields and solid fundamentals for the asset class. But with the unofficial kick-off to summer behind us, the muni market, we think, is set up for a number of potential tailwinds that could help push the index back into positive territory by yearend.

- Summer redemption season is about to start. While the new issuance calendar will likely remain robust over the next month or so, muni investors will be receiving $42 billion of principal and $13 billion of interest in June (up from $22 billion of principal and $11 billion of interest in May). An additional $34 billion in principal is slated to be paid out in July and $43 billion in August. Redemption amounts, if reinvested (as they usually are), will help provide price stability to the market.
- As illustrated in the chart below, despite strong performance in 2023, the index yield-to-worst (YTW) at 3.93%, or 6.63% on a taxable-equivalent basis, remains above its longer-term average. The elevated nominal yields and income

opportunities offered by the muni market remain above the levels over much of the past decade.

Starting Yields are Still Attractive

Bloomberg Municipal Bond Index Yield and TEY are Above Long-term Averages



* Assumes tax rate of 40.8%
Source: LPL Research, Bloomberg 05/31/24
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- Fundamentals for the asset class are healthy as well, as many municipalities continue to sit on ample rainy days and reserve funds. And though tax revenue collections are likely past peak levels, they remain healthy and above pre-pandemic trends. Even in a scenario in which the economy slows meaningfully, ample cash reserves on hand make defaults unlikely. Historically, the default rate for municipalities is extremely low and with positive fundamentals, downgrades and defaults will be limited, in our perspective.
- The wild card, in the near term, is the broader macro environment and the potential for Fed rate cuts. While economic data has shown signs of softening, inflationary pressures are still too high to warrant an aggressive rate-cutting cycle, at least right now. However, if the inflation story continues to improve, the Fed may be able to start to slowly reduce the fed funds rate, which would provide a tailwind to muni prices.

While the slow start to the year may be frustrating to some muni investors, we think the outlook remains positive. With the positive summer technicals upon us, coupled with still attractive starting yields and solid fundamentals, the second half of 2024 could be a positive one for muni investors (no guarantees of course). But even if interest rates don't fall from current levels, the income opportunities within the muni universe are as attractive as they've been in decades.

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