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2024 Outlook: Municipal Bonds

By: Craig R. Brandon, CFA | & Cynthia J. Clemson | December 6, 2023

High Stakes Tug-of-War in 2024

KEY POINTS

1. Elevated yields, low issuance and solid credit fundamentals could underpin a reversal of fund flows into municipals.
2. Positioning for a rally in high quality, longer duration bonds may be timely given where we are in this interest rate cycle.
3. The expectation for a significant decrease in yields across the curve is contingent on softer inflationary data and a more restrained Federal Reserve (Fed).

What We Are Seeing

In recent weeks, the market has focused closely on the Fed's ability to balance a tug-of-war between economic fundamentals and the U.S. Treasury issuance needed to fund a continually mounting deficit.

Yields across the curve are at decade-plus highs and valuations look attractive. This combination could be the catalyst to drive net positive flows to the asset class in 2024. And, unless issuance increases materially in Q1 2024, a turn of flows from negative to positive could quickly push up municipal valuations early in the year.

The unique shape of the muni curve allows for a yield pickup over the front end by extending duration, something that cannot be said about the U.S. Treasury market.

We consider munis attractive relative to other asset classes on an after-tax basis, with the Bloomberg Municipal Bond Index yielding 3.73% as of November 28.¹ Assuming a top federal tax rate of 40.8% (including the tax on net investment income), the muni index yields 6.30% versus the Bloomberg U.S. Corporate Bond Index yield of 5.66%.

What We Are Doing

For high-quality duration, we are maintaining our neutral to overweight positioning going into 2024. Given duration's general underperformance of credit in 2022 and 2023 and the potential for a U.S. economic slowdown in 2024, we are broadly structuring our portfolios for a rally in high quality, longer-duration assets.

Among sectors that present opportunities in such a flight-to-quality environment, high-quality general obligation bonds or dedicated tax-backed and essential service sectors—such as water and sewer systems—may outperform.

Given the municipal curve's elevated front-end yields, inversion in the belly of the curve, and positive upward slope out longer, we believe a barbell approach may be an attractive way to deploy capital into munis.

High quality healthcare and airport bonds are both attractive from a spread basis and provide opportunity for investors. Within the higher education sector, we are weighted towards higher quality issuers. We believe institutions with strong credit fundamentals and brand recognition will be the winners in this sector over the near to intermediate term.

What We Are Watching

Our base case is for yields to be meaningfully lower in one year's time, but this is contingent on a less hawkish Fed and softer inflationary data. However, there is the possibility for more rate hikes if inflation remains sticky and employment continues to be robust.

The biggest challenge is managing unexpected interest rate moves across fixed income. Although we have high conviction that technical factors in the municipal market will be positive in 2024, there is clearly risk given the uncertainty around interest rates driven by Federal Reserve policy.

Geopolitical risk is not insignificant. Between conflicts in Ukraine and in the Middle East posing challenges to the global energy market and droughts affecting shipping via the Panama Canal and other major waterways, there is potential for inflationary pressure to further rear its ugly head.

¹ Source: Bloomberg.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results.

Risk Considerations: An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline. Investments involving higher risk do not necessarily mean higher return potential.



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