Investment Highlights

US Municipal Bond

Key Takeaways

- *The municipal bond market posted positive returns during the quarter.*
- *Muni supply and demand both increased during the quarter.*
- *Municipal credit fundamentals remain favorable, underscored by strong tax collections.*

Market Review

The investment-grade municipal market posted positive returns in the third quarter as fixed-income yields moved lower following weaker-than-anticipated labor and inflation data, which ultimately culminated in a 50-basis-points (bp) cut to the fed funds rate. The Bloomberg Municipal Bond Index returned 2.71%, turning year-to-date (YTD) total returns positive at 2.30%. Longer-duration municipals generally outperformed as rates moved lower across the municipal bond yield curve. Quality returns within the investment-grade segment were mixed, but high-yield municipals outperformed, returning 3.21% for the quarter and extending strong YTD performance of 7.48%.

During the third quarter, US Treasury (UST) bond yields drifted lower and the 10-year yield hit its lowest level in over a year. US economic data increasingly showed the balance of risks shifting more convincingly in favor of a Federal Reserve (Fed) rate cut, which culminated in the Fed initiating a long-awaited rate normalization cycle and delivering its first rate cut since March 2020.

US releases reinforced the trend of a softening job market and continued disinflation. Nonfarm payrolls rose by 142,000 in August, which fell short of consensus expectations. Revisions to the prior months' additions pushed the three-month average to its lowest level since mid-2020. The unemployment rate crept higher—rising to 4.3% in July, which triggered debate over the "Sahm Rule" and whether the jobless rate indicated that the economy is already in a recession—before ticking lower to 4.2% in August. Meanwhile, inflation continued to decelerate with core and headline Consumer Price Index (CPI) falling to 3.2% and 2.5% year-over-year (YoY), respectively, from 3.4% and 3.3% at the end of the second quarter, respectively. In its September meeting, the Federal Open Market Committee (FOMC) reduced rates by 50 basis points (bps), bringing the fed funds target rate to a range between 4.75% and 5.0%. The updated Summary of Economic Projections showed that the median FOMC member now calls for an additional 50 bps of rate cuts over the balance of 2024, matching the market's pre-meeting consensus.

Municipal supply conditions remained near record levels as 3Q24 supply increased 45% YoY to $136 billion. Total YTD supply of $378 billion is on pace for a record year and is 40% higher YoY, with tax-exempt supply up 44% YoY to $347 billion and taxable supply up 9% YoY to $30 billion.

Demand strengthened over the quarter with approximately $17 billion of municipal mutual fund inflows, leading YTD inflows to $31 billion according to ICI. While fund inflows turned positive this year, the magnitude of flows remains limited relative to the substantial collective outflows observed in 2022 and 2023.

The Census released 2Q24 state and local tax collection estimates, which coincide with the fiscal year end for many municipalities. Second quarter major state and local government tax collections grew 7.4% from 2Q23 levels. Among the major state revenue sources, individual income taxes increased 11.9%, corporate income tax collections increased 7.2% and sales tax collections increased 2.6% YoY. Property tax collections, the primary source of revenues for local governments, increased 8.1% YoY to $146 billion. The continued growth of tax collections highlights the strength of municipal credit, and we expect a strong labor market and consumer to support tax collections and municipal credit conditions over the medium term.

Data Sources: Thompson Reuters MMD, Bloomberg, Lipper, Barclays and St. Louis Fed.

Performance Scorecard

We thought that …	Therefore, we …	And the results …	
Yields would edge lower over time as growth slowed and inflation would continue to decline.	Maintained a duration overweight to the benchmark.	An overweight to duration contributed to performance as yields fell.	+
Revenue-backed municipal sectors would offer better risk-adjusted value versus general obligation counterparts.	Maintained an overweight to revenue-backed sectors, including transportation, lease-backed and industrial-backed securities.	Revenue-backed securities modestly underperformed during the quarter.	–
Favorable credit conditions would continue to support investment-grade municipal fundamentals.	Maintained an overweight to lower-rated investment-grade and high-yield securities.	An overweight to lower-rated investment-grade and high-yield securities contributed to returns.	+

Investment Outlook

Western Asset believes that the municipal asset class may offer investors attractive tax-exempt income opportunities today, along with the potential for additional price appreciation in a possible lower-rate environment ahead. Municipal credit fundamentals are likely to remain resilient due to strong labor conditions that support tax collections and elevated cash balances. Meanwhile, we anticipate supportive supply and demand technicals, given the potential for supply to decline into the election cycle. Demand may increase due to attractive relative valuations and declining cash yields as the Fed is poised to proceed with a rate-cutting cycle. As such, we are opportunistically extending duration and credit exposures that we anticipate would perform well under such favorable technical conditions.

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The Bloomberg Municipal Bond Index is a flagship measure of the USD-denominated tax exempt bond market over 1 year to maturity. The index includes four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds. Securities must be rated investment grade (Baa3/BBB-/BBB- or higher).

The Bloomberg Municipal Taxable Bonds Index is a flagship measure of the USD-denominated taxable municipal bond market over 1 year to maturity. Securities must be rated investment grade (Baa3/BBB-/BBB- or higher).

The Bloomberg Municipal High Yield Bond Index is a flagship measure of the non-investment-grade and nonrated USD-denominated tax exempt bond market. Included in the index are securities from all 50 US States and four other qualifying regions (Washington DC, Puerto Rico, Guam, and the Virgin Islands). The index includes state and local general obligation bonds and revenue bonds. High-yield (Ba1/BB+/BB+ or below) and non-rated issues are eligible. Defaulted securities are not index eligible.

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