Municipal Market Insights

Federated Hermes CW Henderson
A division of Federated Investment Counseling

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Municipals held their own in the third quarter despite elevated supply and the highest new issue volume in more than a decade. As the quarter progressed, municipals offered better value as supply outstripped seasonal demand, resulting in higher ratios and underperformance versus Treasuries. With the asset class being this attractive against taxables, crossover buyers (banks/insurance companies), returned to the market, further supporting municipals. The 10-year AAA Municipal Market Data (MMD) yield began the quarter at 2.84% and finished at 2.60%, while 10-year Treasuries started at 4.34%, and finished at 3.79%. The Federal Reserve took center stage as they commenced easing monetary policy and signaled a total of 100 basis points in rate cuts by year-end.

Ten-year prime municipal/Treasury ratios opened at 65% and finished at 69%, as supply forced ratios higher throughout the quarter. Two-year MMD yields began at 3.11% and fell to 2.30%, as short-term munis performed better than longer maturities.

Both the municipal and Treasury yield curves bull steepened for the quarter. Two-year municipal yields fell 81 basis points, and the 10-year fell by 24 basis points, while 2-year Treasuries fell 106 basis points and 10-year yields fell 55 basis points, respectively.

The all-muni funds category saw inflows for the third straight quarter as LSEG Lipper reported total inflow of $13.7 billion, consisting of open-end funds +$8.4 billion, and ETF's +$5.3 billion. The activity in municipal bond funds marked 13 consecutive weeks of inflows.

Primary market issuance in the third quarter was $135.1 billion (9% taxable), bringing the YTD total to $380.4 billion, the highest amount since 2013. The surge in supply was driven by state and local governments rushing to issuance ahead of the November presidential election to avoid any market volatility that could follow. The trend of large deals coming to market remained elevated, with 12 loans greater than $1 billion, similar to the amount of the first two quarters. Secondary market selling fell 22% from the previous quarter at $940 million daily as investors were flush with cash from large maturity redemptions in the interim.

Activity at Federated Hermes CW Henderson was quite brisk in the third quarter, as opportunity presented itself with supply and subsequent ratios on the rise. With ratios and spreads pushing the highest levels of the year, we were able to access high-quality issuers in the primary market at attractive levels. In the secondary market, we continued to augment the barbell with shorter callable structure as much as 25 basis-points wider than non-callable bullets. The duration target remained unchanged from the second quarter at the 4.00-4.20 years range.

On September 18, the Fed lowered interest rates for the first time since an unscheduled ease in March 2020 due to the Covid-19 pandemic, decreasing the target range to 4.75%-5%. The 50-basis point cut was an aggressive start to a policy shift. It appeared to be aimed at bolstering the U.S. labor market, with policymakers indicating 50 more basis points in cuts this year and another 100 in 2025. The Fed's statement indicated that they see the risks to employment and inflation as "roughly balanced." Projections for 2024 now show a 4.40% median for the federal funds rate, down from 5.10%, 3.40% for 2025, down from 4.10%, and 2.90% for 2026, down from 3.10%. The unemployment rate for 2024 is now estimated at 4.40%, up from 4.00%, 4.40% in 2025, up from 4.20%, and 4.30% in 2026, up from 4.10%. The median core PCE Index is now expected to be 2.60% in 2024, down from 2.80%, 2.20% in 2025, down from 2.30%, and 2.00% in 2026, unchanged from the previous estimate in June. Median projections for gross domestic product are 2.00% in 2024, down from 2.10%, and 2.00% in 2025 and 2026, unchanged from the last Fed meeting. It will continue to let its monthly holdings of Treasury securities fall by up to $25 billion, and mortgage-backed securities by $35 billion, respectively, mirroring July's statement.

Looking ahead, the municipal market seems well positioned to finish the year strong with a combination of Fed easing, stronger technicals and lower visible supply after the November elections. Credit spreads that were driven wider to get deals done should revert closer to the mean from earlier in the year, especially Texas Permanent School Fund issues that flooded the market mid-quarter. Net positive supply should flip to

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net negative, as the supply should shrink post-election amid stronger reinvestment demands in November and December.

Market Yields

	9/30/2024	6/30/2024	3/31/2024	12/31/2023
1 yr. AAA Muni	2.55	3.15	3.24	2.67
5 yr. AAA Muni	2.31	2.89	2.54	2.28
10 yr. AAA Muni	2.60	2.84	2.51	2.28
30 yr. AAA Muni	3.52	3.72	3.68	3.42
10 yr. U.S. Treasury	3.79	4.34	4.19	3.86
10 yr. Muni/UST Ratio	69%	65%	60%	59%

Sources: Bloomberg and The Bond Buyer

Key Market Points & Commentary

- Supply was $135.1 billion in the third quarter.
- Mutual fund net inflows totaled $13.7 billion.
- The municipal yield curve “bull steepened,” with 2-year yields falling 81 basis points and 10-year yields falling 24 basis points.
- As always, Federated Hermes CW Henderson’s focus remains on high-quality, liquid and thoroughly researched credits with good management teams. Credits owned are monitored on a regular basis.
- Intermediate product portfolio durations are targeted at 4.00 - 4.20 years.
- Ultra Short product portfolio durations are targeted at about 0.65 years.

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Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

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