THE RATE AND CREDIT VIEW

2024 Municipal Market Outlook

A Publication of LPL Research

January 17, 2024

Lawrence Gillum, CFA,
Chief Fixed Income Strategist

EXECUTIVE SUMMARY

- Following the worst calendar year return in 40 years in 2022, the Bloomberg Municipal Bond Index returned an above-average 6.40% in 2023.
- But despite the above-average returns generated in 2023, we think the muni market still offers value for tax-exempt investors.
- With nominal yields above levels seen over of the past decade, still-strong fundamentals, and perhaps an improving supply/demand dynamic, we think munis could be poised for another solid year in 2024.

WHAT COULD BE IN STORE FOR MUNI INVESTORS IN ’24?

Municipal bond (muni) investors experienced the same roller coaster ride of returns in 2023 that many taxable investors experienced. What started out as one of the best January’s in recent memory for the Bloomberg Municipal Bond Index (index), quickly turned into one of the worst February’s on record. And monthly returns were mixed throughout the year until the index finally found its footing to end the year with positive returns. So, following the worst calendar year return in 40 years in 2022, the muni index returned an above-average 6.40% in 2023. The majority of the year’s positive performance arrived during the final two months of the year, as the index returned 8.82% in November and December. The positive returns were a direct result of the perceived Federal Reserve (Fed) pivot from more rate hikes to the potential for rate cuts in 2024. But despite the above-average returns generated in 2023, we think the muni market still offers value for tax-exempt investors.

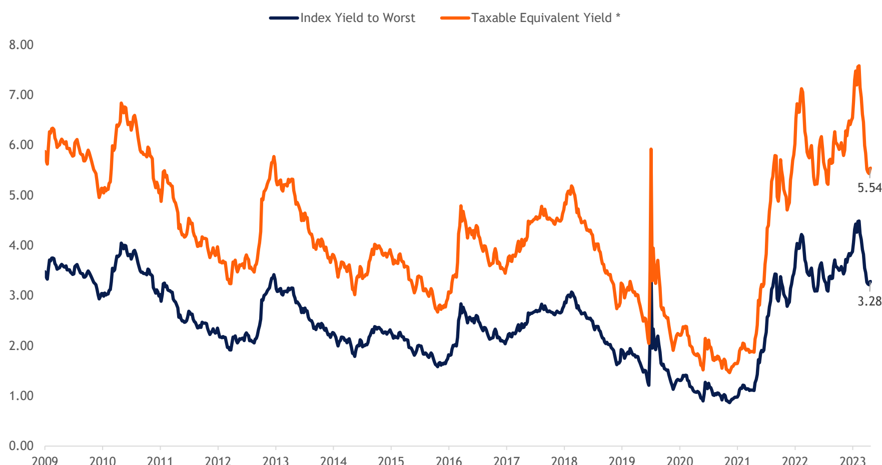
DESPITE THE RECENT RALLY, VALUATIONS REMAIN ATTRACTIVE

Starting yields matter for most fixed income markets but particularly for the muni market. Low credit risk and very low default rates (more on this later) allow investors a certainty that you don’t get from many other financial instruments. And because starting yields take into consideration the underlying price of the bond as well as the required coupon payments, starting yields are the best predictor of future returns. So, despite the rally to end 2023, index starting yields are still very attractive (relative to history). As illustrated in **Figure 1**, despite strong performance during the year, the index yield-to-worst (YTW) was down just 0.33% to 3.28%, or 5.54% on a taxable-equivalent basis, and remains above its longer-term average. The elevated nominal yields and income opportunity offered by the muni market remains above the levels seen over much of the past decade.

__LPL Research__ is your financial professional’s trusted partner. Our mission is simple: Provide independent and objective investment research to support you and your financial professional as you work toward your investment goals.

1 Despite the Recent Rally, Starting Yields Are Still Attractive

Despite strong performance last year, the index yield-to-worst (YTW) was down just 0.33% to 3.28%, or 5.54% on a taxable-equivalent basis, and remains above its longer-term average.



Source: LPL Research, Bloomberg, 01/15/24
Past performance is no guarantee of future results.
Indexes are unmanaged statistical composites and cannot be invested into directly.

That said, and to be fair, the muni market isn't universally "cheap". Retail ownership (66%) remains the largest ownership block of holders, with banks (15%) and insurance companies (11%) also large holders. While total yields for muni securities have increased and may be attractive to retail investors, the relative value proposition of munis still isn't very compelling for banks and/or insurance companies, so the market is unlikely to get additional crossover support from those investors.

Comparing muni yields to either Treasury yields or high grade corporate yields, paints a slightly different picture. Muni ratios (the relative difference in yields) are still below longer-term averages. As outlined in **Figure 2**, munis versus Treasury yields, particularly at shorter tenors, likely don't provide the necessary incentive for some investors to eschew taxable alternatives for munis. Nonetheless, and despite likely paltry interest from banks and/or insurance companies, retail demand should pick up in 2024 to take advantage of these still-high yields.

2 Munis Remain Expensive Relative to Treasuries/Corporates

That said, the muni market isn't universally "cheap" relative to U.S. Treasuries and/or AA-rated corporates.

AAA Muni Yields vs U.S. Treasury Yields

	2Yr Muni/UST Ratio	5Yr Muni/UST Ratio	7Yr Muni/UST Ratio	10Yr Muni/UST Ratio	30Yr Muni/UST Ratio
Last	64.1	60.3	58.4	59.5	83.6
Avg 1 Yr	63.0	64.7	64.4	66.7	90.5
Avg 3 Yr	64.9	64.0	66.0	72.8	89.1
Avg 5 Yr	86.6	79.1	76.6	84.3	96.2
Avg 10 Yr	85.2	79.6	80.1	88.3	99.2
Avg 20 Yr	101.0	87.4	86.4	91.9	102.4

AA Revenue Bonds vs AA Corporates

	2Yr AA Muni/AA Corp	5Yr AA Muni/AA Corp	7Yr AA Muni/AA Corp	10Yr AA Muni/AA Corp	30Yr AA Muni/AA Corp
Last	62.7	57.8	55.3	54.1	77.5
Avg 1 Yr	62.3	60.9	60.2	60.4	79.9
Avg 3 Yr	61.0	59.7	60.4	62.5	74.4
Avg 5 Yr	66.3	62.5	62.3	64.6	74.9
Avg 7 Yr	66.0	63.5	64.2	67.0	77.6

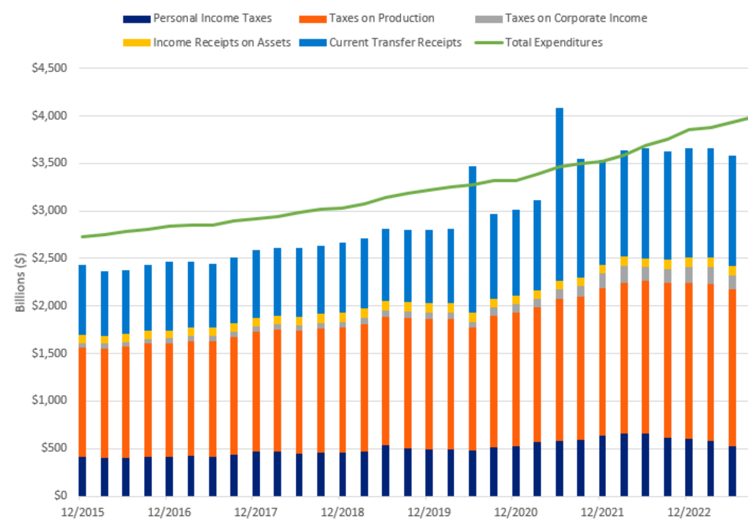
Source: LPL Research, Bloomberg, 01/15/24
Past performance is no guarantee of future results.

PAST PEAK BUT FUNDAMENTALS REMAIN SOLID

Although tax revenue collections are likely past peak levels, they remain healthy and above pre-pandemic trends.

In addition to valuations, muni fundamentals are also an important part of the (likely) interest in munis. And fundamentals for the asset class remain healthy as well, as many municipalities continue to sit on ample rainy day and reserve funds. And though tax revenue collections are likely past peak levels, they remain healthy and above pre-pandemic trends. Twelve-month trailing state and local revenues as of September (**Figure 3**) were unchanged from the prior year, just shy of record levels. While slowing tax collections are expected to contribute to headline deficits in 2024, strong labor and real estate markets should continue to support historically high state and local revenues, elevated cash balances, and favorable budgetary flexibility.

3 **12-Month Trailing State and Local Revenue Collections Vs. Expenditures**



Source: LPL Research, Bureau of Economic Analysis, 01/15/24
Past performance is no guarantee of future results.

Munis have, by far, better default characteristics than corporate issuers.

That said, despite record revenues over the past several years, profligate spending states and cities remain. As just one example, California Governor Gavin Newsom proposed deep spending cuts during the next fiscal year to deal with a $37.9 billion deficit left by inflation and a plunge in tax revenue from wealthy earners, a gap that is much smaller than had been projected by the state's fiscal analyst. The $208.7 billion proposal would shrink the state's general-fund budget by more than 7% from the current fiscal year. As such, investors need to be cognizant of and careful within individual credit selection.

The good news though is that munis tend to be more resilient than corporate issuers. Rating agency Moody's recently updated its historical default rate analysis between munis and corporates. Munis have, by far, better default characteristics. So, while investment grade munis underperformed highly rated U.S. corporates last year (not tax-adjusted), munis tend to outperform corporate debt during economic slowdowns. Moreover, the default rate for munis is significantly better than corporate borrowers. The cumulative muni default rate for investment grade issuers (between 2013 and 2022) was just above 0 versus 1.9 for taxable corporate bonds. Additionally, the high yield muni credit default rate was around 4.0%, cumulative, versus 32.5% for high yield corporates. Munis represent a more defensive asset class for investors concerned about an economic slowdown.

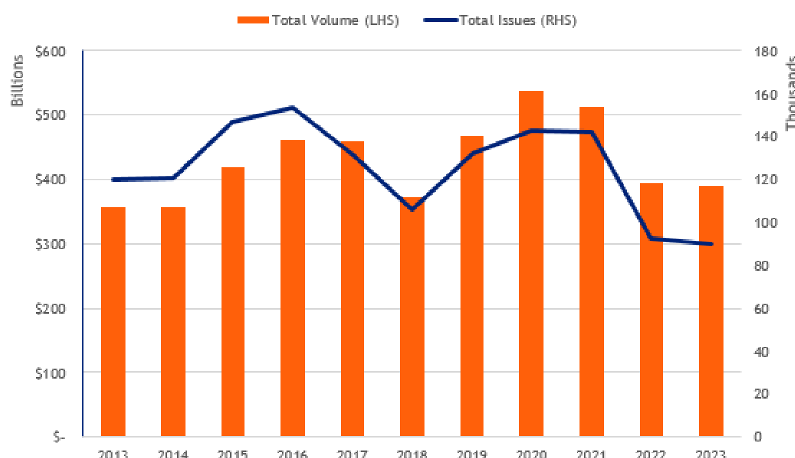
SUPPLY/DEMAND DYNAMICS HOLD THE KEY

For 2024, issuance is expected to stay around 2022 and 2023 levels, which should help support muni prices.

The muni market tends to be relatively illiquid. Unlike say the equity markets that trade on an exchange, muni bonds still trade over-the-counter. Moreover, despite all the disparate issuers (there are over 56,000 issuers) the market in general is still relatively small. At $1.6 trillion, the muni market pails in comparison to the $6.6 trillion U.S. investment grade corporate bond market. As such, supply/demand imbalances can unduly influence market prices much more than most other markets (except perhaps the high yield muni market, which is significantly less liquid).

From a supply perspective, total (taxable and non-taxable) muni issuance of $367 billion in 2023 was down 2% from 2022 levels (**Figure 4**). Tax-exempt muni supply reached $328 billion in 2023, 5% higher than the prior year's level, but still nearly 17% below pre-2018 levels when the Tax Cuts and Jobs Act limited tax-exempt refinancing activity. For 2024, issuance is expected to stay around 2022 and 2023 levels, although if interest rates fall as much as markets expect in 2024 (markets currently expect the Fed to cut interest rates by approximately 1.5%), then the motivation to increase issuance increases as well.

4 Issuance Trends Remain Below Historical Averages



Source: LPL Research, Bloomberg, 01/15/24
Past performance is no guarantee of future results.

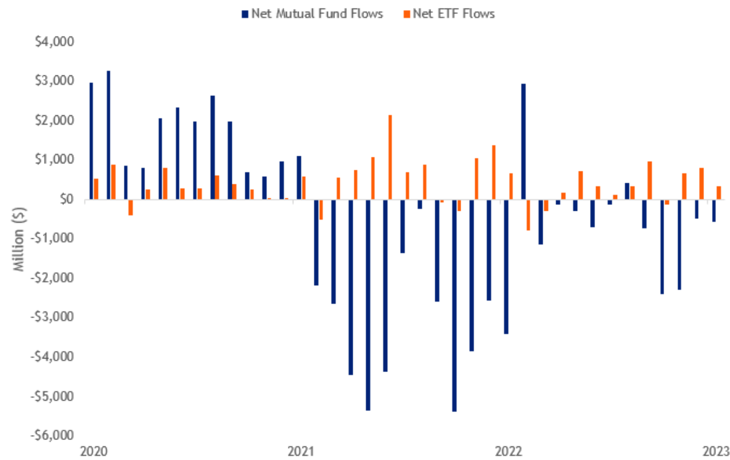
With the Fed expected to cut interest rates in 2024, if history at least rhymes, we could see investor inflows into the market before yields move lower this year.

Any concerns regarding the election? According to Morgan Stanley, over the nine election cycles they analyzed back to 1986, they found that 50% of bonds came to market through the second quarter during election years versus 49% during non-election years. November and December supply were notably lower during election years but by just $5 billion on average per month, or a 1% delta versus average historical issuance during the month. As such, just because it's an election year, the supply picture shouldn't meaningfully change.

From a demand perspective, following the record $116 billion municipal mutual fund outflow cycle observed in 2022, muni mutual funds recorded an additional $6 billion of outflows in 2023 (**Figure 5**). However, lost in the headline number for fund outflows was that 2023 saw investment moving out of short-term funds, and towards longer dated investments, which could likely continue in 2024. With the Fed expected to cut interest rates in 2024, if history at least rhymes, we could see investor inflows into the market before yields move lower this year (which is what we expect).

Assets under management of municipal ETFs has increased to 14% of total funds outstanding and the expectation is that number will continue to increase.

5 **Technical Pressures Remain With Outflows Outpacing Inflows**



Source: LPL Research, Bloomberg, 01/15/24
Past performance is no guarantee of future results.

The other notable trend recently has been the resilience of muni ETFs. Assets under management of muni ETFs has increased to 14% of total funds outstanding, and the expectation is that number will continue to increase. One factor that has increased the flow of capital into ETFs has been tax loss harvesting. The ease of moving capital in and out of ETFs makes them attractive vehicles to move investments over short periods for tax purposes. However, investors interested in ETFs should certainly do their due diligence, as ETFs can vary meaningfully from each other as well as the national index. As mentioned earlier, the muni market tends to be illiquid and fragmented, so when the vehicle is more liquid than the underlying market it is supposed to replicate, full replication can be challenging. LPL advisors, make sure you check out the Resource Center for a recommended list of ETFs and mutual funds.

WHAT DOES THIS MEAN FOR INVESTORS?

Fundamentals for the muni asset class are generally healthy, and many municipalities continue to sit on ample rainy day and reserve funds. And though tax revenue collections are likely past peak levels, they remain healthy and above pre-pandemic trends. The wildcard in the short-term remains the supply and demand dynamics for the asset class. While 2024 issuance could continue the trend of lower net issuance, demand could accelerate as investors seek to take advantage of still-attractive yields by moving out of cash and other shorter-maturity investment strategies before the Fed starts to cut rates, which we think could happen this summer (if not earlier). With nominal yields above levels seen over the past decade, still strong fundamentals, and perhaps an improving supply/demand dynamic, we think munis could be poised for another solid year in 2024.

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

References to markets, asset classes, and sectors are generally regarding the corresponding market index. Indexes are unmanaged statistical composites and cannot be invested into directly. Index performance is not indicative of the performance of any investment and do not reflect fees, expenses, or sales charges. All performance referenced is historical and is no guarantee of future results.

Any company names noted herein are for educational purposes only and not an indication of trading intent or a solicitation of their products or services. LPL Financial doesn't provide research on individual equities.

All information is believed to be from reliable sources; however, LPL Financial makes no representation as to its completeness or accuracy.

US Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage, or more commonly a collection ("pool") of sometimes hundreds of mortgages. The mortgages are sold to a financial institution (a government agency or investment bank) that "securitizes", or packages, the loans together into a security that can be sold to investors. The structure of the MBS may be known as "pass-through", where the interest and principal payments from the borrower or homebuyer pass through it to the MBS holder, or it may be more complex, made up of a pool of other MBSs.

Floating rate bank loans are loans issues by below investment grade companies for short term funding purposes with higher yield than short term debt and involve risk.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Floating rate bank loans are loans issues by below investment grade companies for short term funding purposes with higher yield than short term debt and involve risk.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply.

This research material has been prepared by LPL Financial LLC.

Securities and advisory services offered through LPL Financial (LPL), a registered investment advisor and broker-dealer (member FINRA/SIPC). Insurance products are offered through LPL or its licensed affiliates. To the extent you are receiving investment advice from a separately registered independent investment advisor that is not an LPL affiliate, please note LPL makes no representation with respect to such entity.

Not Insured by FDIC/NCUA or Any Other Government Agency | Not Bank/Credit Union Guaranteed | Not Bank/Credit Union Deposits or Obligations | May Lose Value

For Public Use | Tracking # 528594 (Exp. 01/25)