The Muni Market: What's in Store for 2024?

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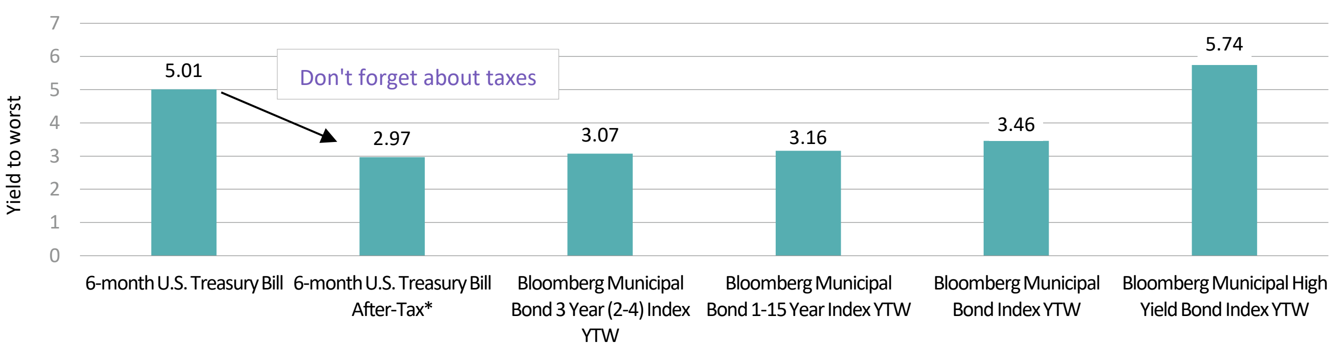
Market volatility is likely to continue until the Federal Reserve's (Fed) first cut to the Fed Funds rate. The futures market currently says we may not have to wait that long with the first cut fully priced in before mid-year 2024. However, the futures market has been too quick to price in lower rates ever since the Fed started hiking rates in 2022. While we don't believe a significant recession or economic downturn is a prerequisite for lower rates, the Fed will likely be more focused on getting inflation back to its 2% target. All this means volatility is likely with us for the foreseeable future.

So, what does this mean for the municipal bond market? There are several dynamics in the market that we think will play prominently in 2024. Now that we are unlikely to see further Federal Reserve rate hikes, investors may start to consider moving out of cash, especially when they can potentially lock in higher after-tax yields with tax-exempt bonds. Although credit spreads aren't necessarily wide from a historical standpoint, high yield may still be the place to be in 2024 given the extra yield and potential upside from a return of positive fund flows. Another area we think will be key in 2024 is curve placement as the Fed shifts from hiking to cutting rates.

Cash Likely to be Dethroned as King

Investors can't be blamed for parking cash in high interest savings accounts, money market funds, or U.S. Treasury Bills. What is not to like about yields north of 4% or even 5% with no interest rate risk? Although these short rates may persist for a little longer, especially if market expectations for the first Fed rate cut by mid-2024 are too optimistic, they will eventually move lower as the Fed starts cutting the Fed Funds rate. The market typically anticipates Fed action and longer maturity rates tend to move lower before short rates do. Therefore, waiting until short rates decline to invest in longer bonds may miss the opportunity to lock in higher rates now and can potentially enjoy much more significant price appreciation than the above average yields currently being realized in savings or money market accounts. For those individuals in higher income tax brackets, longer dated municipal bonds already offer more attractive yields on an after-tax basis.

After-tax Yield Comparison



YTW = Yield to Worst
Source: Bloomberg as of 12/31/2023
*Assumes top income tax rate plus Medicare tax for total 40.8% rate

High Yield Likely to Repeat as Champ in 2024

When looking across the credit spectrum, we think lower quality still has the potential to outperform in 2024. There are several reasons that we believe high yield will deliver the best return in 2024 despite also taking the top spot in 2023.

— The strong performance posted by Bloomberg Municipal High Yield Index in 2023 occurred in the last three months of the year and was almost completely due to the longer relative duration of lower quality bonds.

— Credit spreads, as measured by the yield to worst of the Bloomberg Municipal High Yield Index versus the yield to worst of the AAA subset of the Bloomberg Municipal Bond Index, widened in the fourth quarter. Because we aren't expecting a major recession and municipal credit quality tends to lag the broader economy, we don't believe any potential spread widening will be driven by fundamentals. Spreads do remain tighter than historical levels, but supply is likely to remain tepid and any return of positive flows into high yield mutual funds could push spreads even tighter. Since the beginning of 2018, the high yield municipal yield to worst versus the AAA subset of the Bloomberg Municipal Bond Index has ranged from 1.92% to 4.36% with an average of 2.62%. The current spread is around 2.50%.

— Below investment grade has a built-in yield advantage that provides more cushion against price declines when compared with higher quality municipal bonds. The Bloomberg Municipal High Yield Index began the year with a yield to worst of 5.57% -- 2.35% higher than the Bloomberg Municipal Bond Index

— Even with the strong performance in the 4th quarter of 2023, the Bloomberg Municipal High Yield Index remains just over 5% below where it was to begin 2022. Combining the above average yield now available with potential further price upside could result in another strong year for high yield.

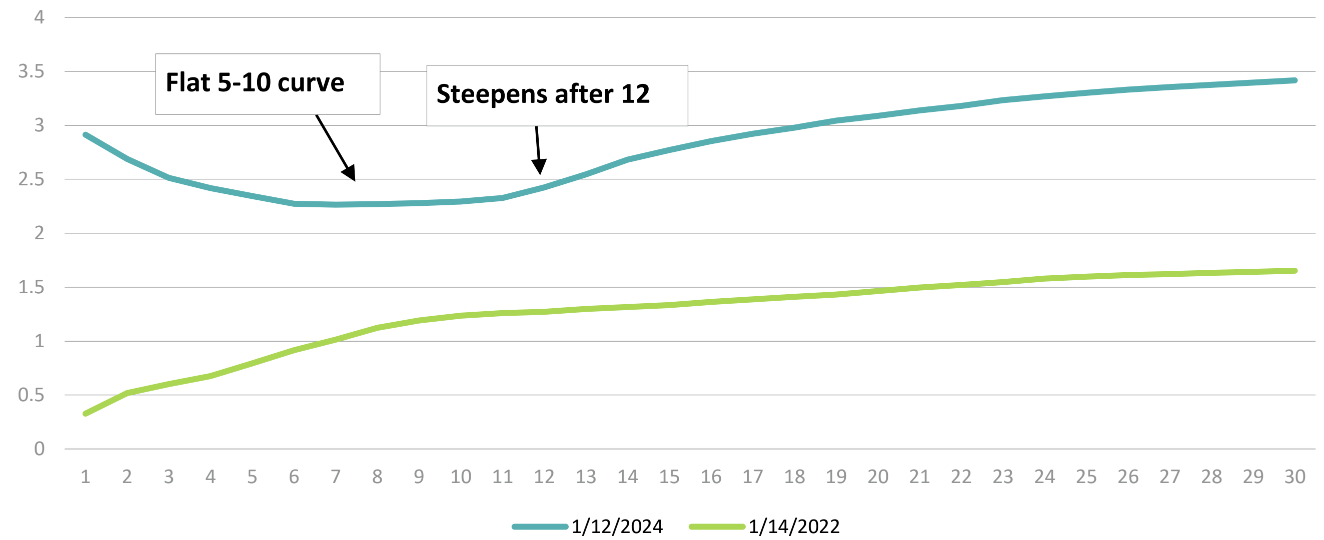
HY Muni Spread

Source: Bloomberg as of 1/15/2024

Intermediate Curve Play as Fed Pivots

Although yields may not return to the historic lows we saw in 2021, yields may still have room to move lower than they are today if the Fed starts to lower the Fed Funds rate. In this scenario, fixed income of any maturity should benefit, but we think certain parts of the municipal curve have the potential to outperform. The municipal curve is currently inverted from 2 to 13 years but mostly flat from 5 to 10 years. Beyond 10 years, the curve steepens significantly out to 25 years. Fed actions tend to have more immediate effect on the short end of the curve. Therefore, we think 5-year yields should decline more than 10-year yields, resulting in outperformance. Going out to 15 years might allow an investor to pick-up more than 80% of the entire 1-30 muni yield curve. There is the potential for the 15-year part of the curve to outperform as the curve moves back to average which is likely if we see a return to mutual fund inflows. We anticipate that intermediate strategies that focus more heavily on the 5- and 15-year maturities should do well as the curve shifts.

Municipal AAA Yield Curve



Source: Bloomberg as of 1/12/2024

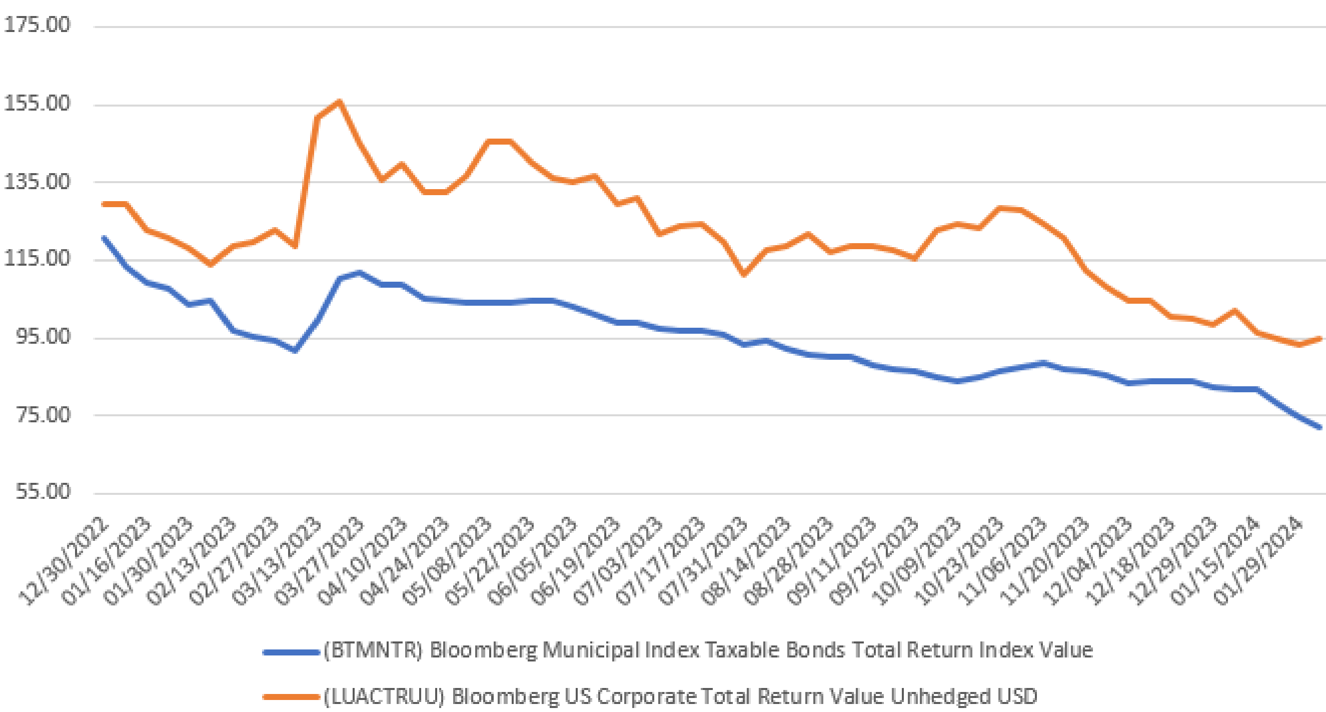
Since we may be approaching the highly anticipated Fed pivot, sitting in cash is likely no longer the best approach. Therefore, considering locking in today's higher yields for longer may be a prudent approach, especially for those in higher tax brackets where after-tax muni yields are more attractive than cash. Utilizing active management to seek the best opportunities in high yield and along the yield curve could potentially add to returns as investors look to navigate 2024.

Some Thoughts on the Taxable Portion of the Market

Taxable municipal bond supply was approximately $37 billion in 2023, down from 2022, but we are forecasting a modest increase for the current year. Our assessment is that demand for the securities remains steady, given their spread to comparable U.S. Treasuries and risk of default when compared with other Credit types. Even with DWS' outlook for a mild economic recession, we expect overall municipal credit to remain stable.

Taxable municipal bonds also demonstrated resiliency during the year. The below chart highlights that spreads for taxable munis were much less volatile than corporate debt, especially as those bonds saw increased volatility during the bank crisis in March as well as the equity volatility in October.

OAS – Taxable Munis and Corporates



Source: Bloomberg as of 1/12/2024

Glossary

Credit quality measures a bond issuer's ability to repay interest and principal in a timely manner. Rating agencies assign letter designations such as AAA, AA and so forth. The lower the rating, the higher the probability of default. Credit quality does not remove market risk and is subject to change.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

Fed Funds rate refers to the target interest rate range set by the Federal Open Market Committee (FOMC). This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

Municipal bonds (Munis) are debt securities issued by a state, municipality or country.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.
A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

A yield-curve inversion is when the yields on bonds with shorter duration are higher than the yields on bonds that have a longer duration.

Yield to worst is computed by using the lower of either the yield to maturity or the yield to call on every possible call date for a bond.

OAS, or option-adjusted spread, is a yield spread that measures the fixed income security rate and the risk-free rate of return while adjusting for embedded options. A yield spread is the difference between returns on investments from debt instruments that carry different risks, credit ratings, or maturity dates.

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