Municipal Bonds

October 2024

What Fed Cuts Mean for the Muni Market

The Federal Reserve is in the early stages of a rate cutting cycle. There is an ongoing debate about the size of the next cut and the terminal rate, however there is consensus that there are more cuts coming. A lower Federal Funds rate will likely affect the municipal market directly and indirectly in a number of ways:

- Yield curve inside of ten years will likely continue to steepen,
- Lower rates for Money Market Funds (MMFs) and Certificates of Deposit (CDs) are likely to increase flows into longer duration municipal bonds,
- Better flows will likely support further spread tightening for lower-rated credit, and
- Lower rates in general should be supportive of the economy which could help avoid a recession in the near-term while being supportive of fundamental municipal credit.

The municipal curve is no longer inverted but remains flat

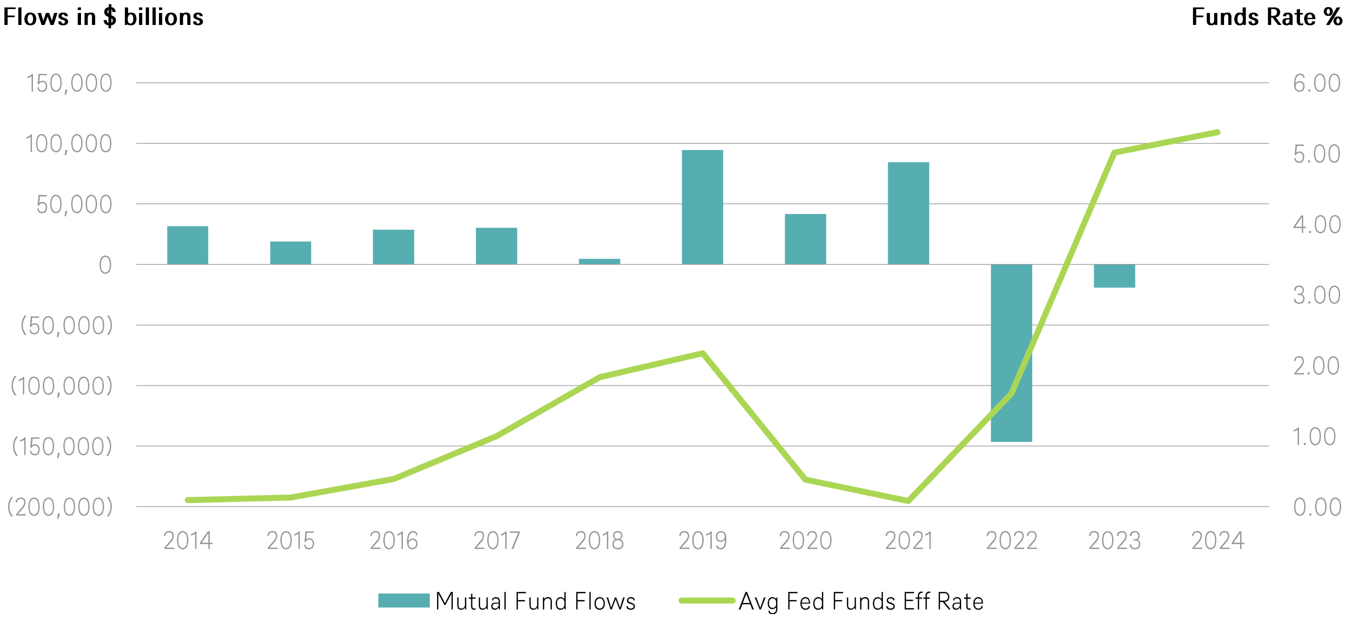
The shorter end (2-to-10-year) of the municipal yield curve is no longer inverted but remains roughly 40 basis points flatter than its 10-year average (based on the Bloomberg Municipal Bond Index). Therefore, investors who would like to lock-in current rates but avoid potential interest rate increases can find value in shorter maturities. Lower short-term rates also indirectly benefit investors that use leverage to finance the purchase of long maturity municipals. The inverted yield curve made the practice of borrowing short to buy long bonds very unattractive and removed a fairly significant source of demand for longer maturity bonds. As the yield curve steepens, we believe leverage should come back into favor and help to support the longer maturity portion of the market.

Lower short rates are likely to push investors into bonds

As the Federal Funds rate is lowered, all short-term rates will fall as well. This will lower the rates on money market funds and CDs. According to the latest Federal Reserve data, households have accumulated an extra $5 trillion in cash and equivalents since the fourth-quarter of 2019. Based on our analysis, facing lower rates on these deposits is likely to encourage some investors to move out the yield curve into bonds or mutual funds. Flows into mutual funds turned positive this year after a cumulative outflow of $132 billion in 2022 and 2023 (based on Morningstar and Bloomberg data); mutual funds thus far have taken in more than $25 billion, and DWS believes that trend is likely to continue as investors move out of cash investments. The positive flows into mutual funds have had the effect of tightening quality spreads that are now below long-run averages.

Within investment-grade credit, we have not reached the lows in spreads experienced in 2021 which was the last year that mutual funds experienced inflows. Therefore, there is the potential for credit spreads to tighten further. Spreads for high-yield municipals, on the other hand, have moved all the way through the lows seen in 2021, resulting in less room for narrowing spreads in this segment. With continued mutual fund inflows, however, it is unlikely the market would see spread widening for high-yield credit in the near future.

Mutual Fund Flows vs. Effective Funds Rate



Source: Morningstar and Bloomberg, August 2024

Lower rates may lower the odds of a recession which should support municipal credit

Lower rates by the Federal Reserve should help the economy continue to expand and increase the probability that a recession can be avoided in 2025. This will be a positive for overall municipal credit as many state and local governments will continue to see year-over-year increases in their tax revenues. Furthermore, this is important for more economically-sensitive portions of the municipal high-yield market such as economic development districts that are dependent on sales or hotel taxes in the local area. This would also include land development districts and senior living facilities which are both dependent on the health of local real estate markets. A growing economy with lower unemployment rates and lower mortgage rates would help in this area.

Bottom Line

Given our expectation of further rate cuts from the Federal Reserve, we are forecasting continued support for the municipal market in the form of mutual fund inflows and economic growth. Lower quality credit should continue to be supported by mutual fund demand as well as stable-to-improving credit given the growing economy. The Municipal Bond Management team also sees support in the short part of the municipal curve as rate cuts move the curve closer to long-run averages, and in the long end of the curve as investors look to lock in rates in longer maturities. This could be enhanced as we see a return to the market of leveraged investors.

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