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Municipal Bonds

Ongoing Rally in Munis

Attractive performance but supply is slim.

After a fairly dismal performance for much of 2023, municipal bonds took off during the fourth quarter. High all-in yields, a decline in net par outstanding due to large principal and interest reinvestment, and change in rate expectations all combined to drive buyers back to the market.

The strength in the market left municipals entering the first quarter with municipal/Treasury yield ratios at three-month and 12-month tights, while all-in yields have dropped by nearly 100 basis points since October. Secondary trading volumes are lower year-over-year, and demand exceeds supply. In this environment, market participants are reluctant to transact at current levels in the secondary market, and are instead waiting for a rebound in new issuance to reset valuations.

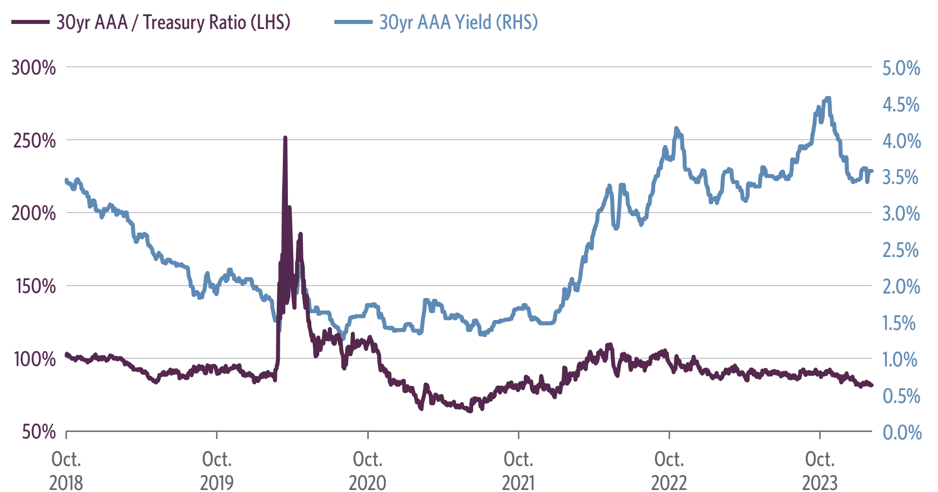
Some 86 percent of the record-setting fourth quarter return came from price appreciation, with the balance from coupon. Given the starting valuations in 2024, we expect coupon to drive the bulk of municipal market performance over the next few months. Muni/Treasury ratios should move incrementally wider on the back of new issuance, but we believe all-in yields are sufficiently attractive to keep retail buyers engaged and prevent a major valuation reset. On the credit front, revenue trends have decelerated and more states are reporting intra-year deficits. Some of the slowdown can be attributed to tax cuts enacted in the last two years. For example, 25 states have cut personal income tax rates since 2021—including 14 states that will see lower rates in 2024—and 19 are holding some version of a sales tax holiday this fiscal year.

Many states are required to balance their budgets, and their elevated rainy day funds will help them operate comfortably through a couple years of flat to slight declines in tax collections. However, we are keeping an eye on how reduced state appropriations affect smaller municipal entities such as local governments, which tend to have less budgetary flexibility. For now, defaults remain manageable. Although the total defaulted par amount rose by 29 percent to $2 billion in 2023, more than half of those came from the historically risky nursing home and hospital sectors. We are cautiously watching market technical conditions develop as we evaluate attractive entry points for higher-quality credits.

By Allen Li and Michael Park

High all-in yields, a decline in net par outstanding due to large principal and interest reinvestment, and change in rate expectations have driven buyers back to the market, and left municipal/Treasury ratios at three- and 12-month tights.

Higher Yields Have Increased Demand for Municipal Bonds



Source: Guggenheim Investments, Municipal Market Monitor. Data as of 2.12.2024. Past performance does not guarantee future returns.

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