



Municipal bond market recap and outlook



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Overview

- Supply-and-demand dynamics supported the municipal bond market in the first quarter despite ongoing US Treasury volatility.
- Demand for municipals increased with fund flows turning positive amid healthy supply trends.
- High yield municipals outperformed investment grade municipals, as credit spreads modestly tightened during the quarter.
- Credit fundamentals remained solid, with ratings upgrades continuing to outpace rating downgrades in the first two months of 2024.

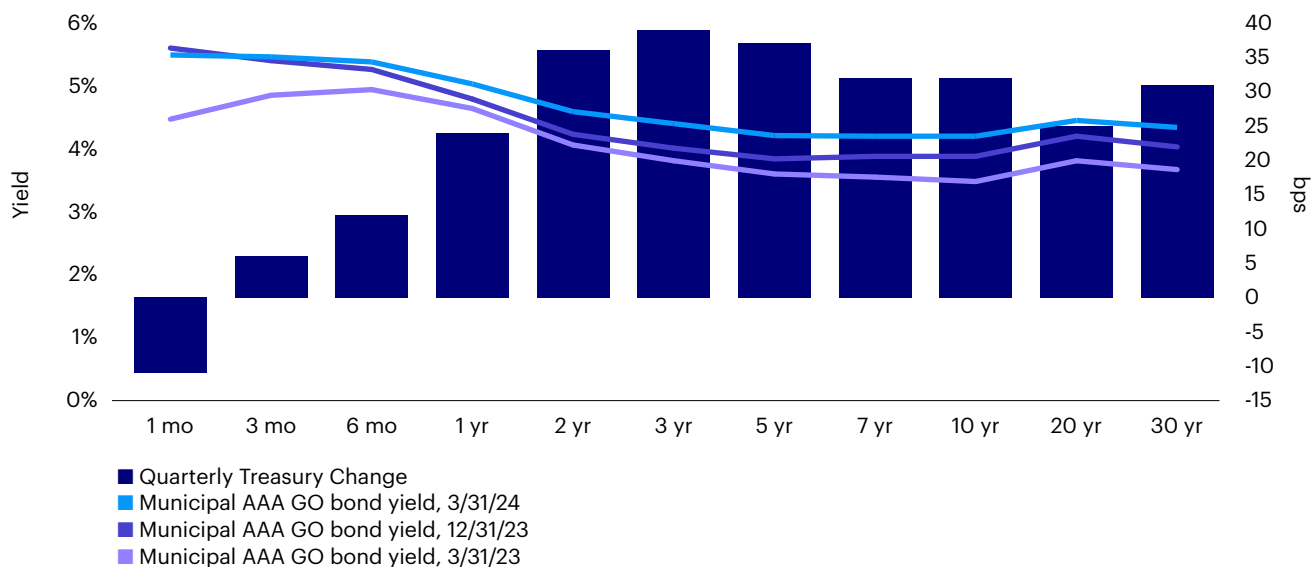
Municipal bonds, which were among the best-performing asset classes of 2023,¹ started 2024 on a strong note, suggesting continued gains. However, the rally ran out of steam in early January and municipal returns were generally flat thereafter. Investment grade municipal bonds returned -0.39% for the first quarter of 2024. High yield municipal bonds posted a gain of 1.51%, benefiting from investors' appetite for yield. Taxable municipal bonds, which tend to follow trends in the US Treasury market, returned 0.10%.² Municipal bonds outperformed many other fixed income assets during the quarter, including US Treasury securities and investment grade corporate bonds.

The municipal market's performance was respectable considering its strong rally going into the new year and the continued volatility in the US Treasury market. US Treasury yields fluctuated in response to shifting market sentiment about Federal Reserve (Fed) monetary policy. At its December 2023 policy meeting, the Fed had adopted a transitory tone, implying that rate cuts might be coming in 2024. However, persistent inflation and strong job numbers suggested the Fed would keep interest rates higher for longer than previously anticipated. Indeed, at both the January and March meetings, policymakers decided to hold the target federal funds rate steady.³

US Treasury yields rose during the first quarter of 2024, as investors pushed out their expectations for the timing of Fed interest rate cuts. The yields of two-, five-, ten-, and thirty-year Treasury bonds rose 36 basis points (bps), 37 bps, 32 bps and 31 bps, respectively. At the end of the quarter, the Treasury yield curve remained inverted between two- and ten-year maturities.

Municipal yields also rose during the first quarter, with the yields of two-, five-, ten-, and thirty-year AAA general obligation bonds climbing 45 bps, 26 bps, 23 bps and 26 bps, respectively (see Exhibit 1). The municipal yield curve steepened ten-years and beyond amid continued uncertainty about the Fed's rate-cutting schedule and as investors focused their buying on short-term instruments.

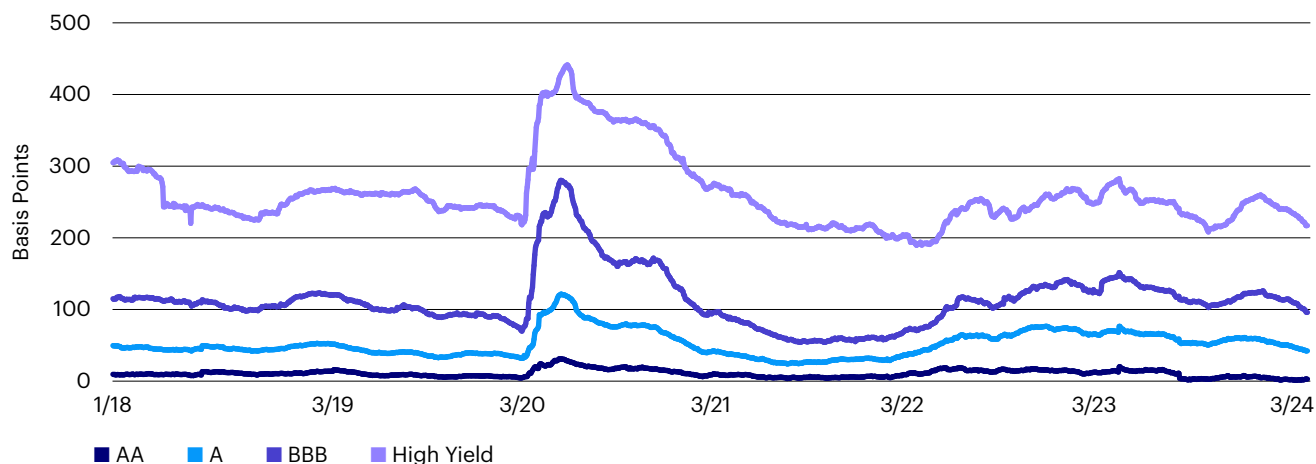
Exhibit 1: Municipal yields rose more than Treasury yields on the short end of the curve but less in maturities of five years and longer



Source: TM3 and US Department of the Treasury, Daily Treasury Yield Curve Rates. Data as of March 31, 2024. A yield curve is a curve showing several yields to maturity or interest rates across different contract lengths for a similar debt contract. The Municipal AAA GO bond yield is represented by the Municipal Market Data proprietary yield curve of AAA-rated state general obligation bonds, based on the institutional block size of \$2million-plus market activity in both the primary and secondary bond market. **Past performance does not predict future returns.**

High yield municipal bonds outperformed investment grade municipal bonds during the first quarter, benefiting from light supply and increased demand. Investors may have been attracted to the yield advantage they offered (see Exhibit 2).

Exhibit 2: High yield municipals offered an attractive yield advantage over investment grade municipals at the end of the first quarter

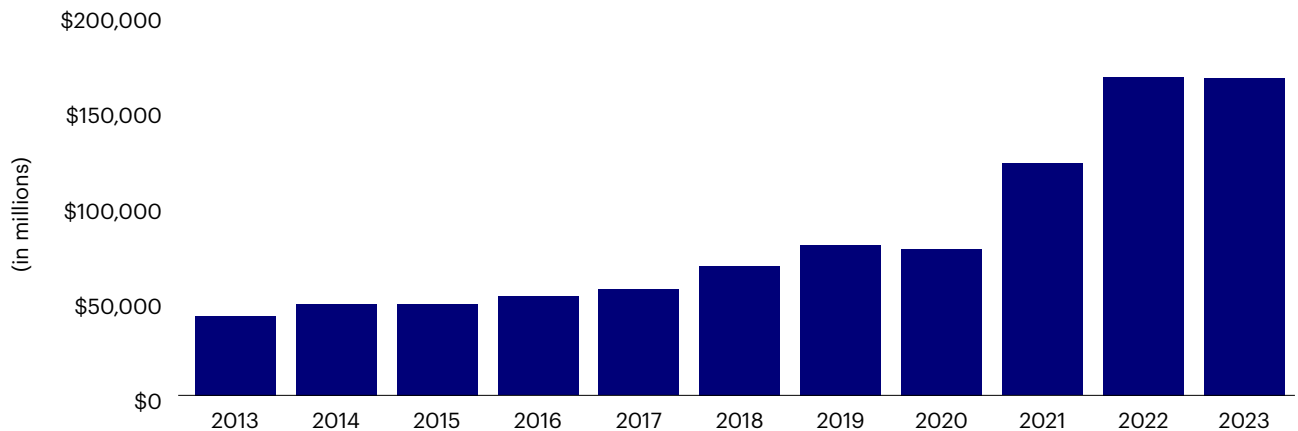


Source: Bloomberg for period between 1/1/2018 and 3/31/2024. **Past performance cannot guarantee comparable future results.** The Bloomberg Municipal AA, A and BBB Indices are subsets of the Bloomberg Municipal Investment Grade Index, an unmanaged index considered representative of investment grade municipal bonds. The Bloomberg Municipal High Yield Index is an unmanaged index consisting of noninvestment-grade, unrated or below Ba1 bonds. An investment cannot be made in an index. A basis point is the movement of interest rates or yields expressed in hundredths of a point.

Solid credit fundamentals continued to bolster the municipal market

Credit quality remained stable during the first quarter, though a number of factors suggested the peak of the credit cycle may have passed. These factors included the ongoing effects of inflation and higher interest rates on state and local government budgets, the impact of wage increases and cost-of-living adjustments in labor contracts, return to office trends, and the impact of commercial real estate on large cities' property taxes;⁴ however, municipal credits continued to benefit from federal pandemic aid and strong tax collections, which has helped maintain healthy reserves. Fiscal restraint may also be helping keep most credits in a resilient position. Furthermore, states continued to add to their rainy day funds, which were at decade-high levels at the end of 2023 (see Exhibit 3). Partly as result, credit ratings upgrades continued to outpace credit rating downgrades in the first two months of 2024. S&P Global Ratings upgraded 86 ratings in January and February 2024 and downgraded only 39 ratings, for an upgrade to downgrade ratio of 2.2 to 1.⁵

Exhibit 3: State rainy day balances were at record highs at the end of 2023



Source: National Association of State Budget Officers (NASBO), Fall Fiscal Survey of States (1989 - 2023), as of December 19, 2023.

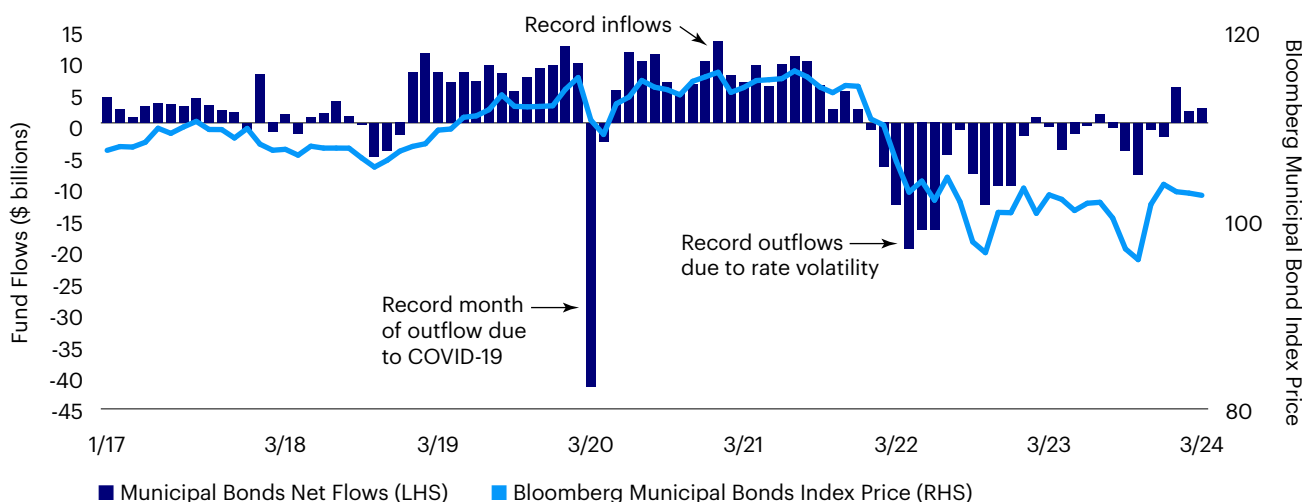
Supply and demand dynamics supported municipal performance

Market technicals improved during the first quarter. Though still low by historical standards, new issue volume grew. The supply was met with strong investor demand.

New issuance came in at about \$100 billion during the first quarter, on par with the fourth quarter of 2023; however, the supply picture was considerably higher than it had been in the first quarter of 2023, when approximately \$76 billion of new supply was brought to market. Tax-exempt supply accounted for approximately \$95 billion of the 2024 first-quarter total, more than the \$90 billion in the fourth quarter of 2023.⁶ Investment grade municipal issuers may have grown more comfortable with coming to market at prevailing interest rates, which remained higher than pre-pandemic levels but lower than their recent peaks. Nevertheless, many issuers — with ample cash on their balance sheets — still seemed reluctant to issue new bonds or to advance refund existing bonds given that increased borrowing costs continued to make the economics of new issuance and refundings less attractive. However, below investment grade and non-rated primary market issuance remains quiet, likely due to the elevated interest rates, causing spreads to tighten in the first quarter. As for taxable new issuance, it declined to about \$5 billion in the first quarter, down from \$10 billion in the fourth quarter of 2023.⁶ In addition, some existing taxable bonds were redeemed, as certain issuers exercised the embedded extraordinary redemption provisions (ERP) in their Build America Bonds. ERPs allow issuers to call all or a portion of outstanding bonds following an extraordinary event affecting the financed project. Market conditions in the first quarter made sense for some issuers to use the ERP and refinance in the tax-exempt market.

As for demand, after many quarters of investment outflows, municipal fund flows turned positive during the first quarter of 2024. Inflows to municipal bond mutual funds rebounded in January and continued through February and March (see Exhibit 4). First quarter inflows totaled \$9.8 billion, compared to outflows of \$1.7 billion in the first quarter of 2023 and outflows of \$11 billion in the fourth quarter of 2023.⁷

Exhibit 4: Demand improved during the first quarter, as investment flows turned positive



Source: Strategic Insight (SI), Bloomberg, as of March 31, 2024. The Bloomberg Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market. An investment cannot be made directly in an index.

The largest group of municipal investors continued to be individuals — through direct ownership, mutual funds and/or exchange traded funds. Individuals seem likely to remain the largest group of municipal investors, especially as tax-exempt income may have become even more appealing in light of President Biden's budget proposals. The proposals include raising the top tax income tax rate for individuals and applying a 25% minimum tax rate on households worth at least \$100 million.⁸ With \$6 trillion sitting in money market funds, mostly in taxable accounts, the municipal market could benefit when this money starts in motion.⁸

Meanwhile, banks and insurers generally remained on the sidelines, having reduced their holdings after the enactment of the 2017 Tax Cuts and Jobs Act (TCJA). TCJA cut the corporate tax rate from 35% to 21%, giving banks and insurance companies less incentive to invest in tax-exempt securities; however, President Biden is seeking to roll back this corporate tax cut, and if he is successful, it could conceivably fuel new demand for municipals from banks and insurance companies.⁸ Whatever happens, banks and insurers are likely to continue investing in taxable municipal bonds. Taxable municipals generally have high credit quality, especially as similarly rated investment grade corporate bonds can be scarce. They can also be useful to investors who want to increase the diversification of their overall portfolio.

Outlook

At the end of the first quarter, we believed high absolute yields, strong fundamentals, and investor migration out of cash would present positive opportunities for municipal bonds. The US economy remained resilient in spite of continued inflationary pressures and the Fed's commitment to higher-for-longer interest rates. In our view, municipal credit quality should remain stable in the near term, with fewer upgrades but probably no material increase in downgrades or defaults.

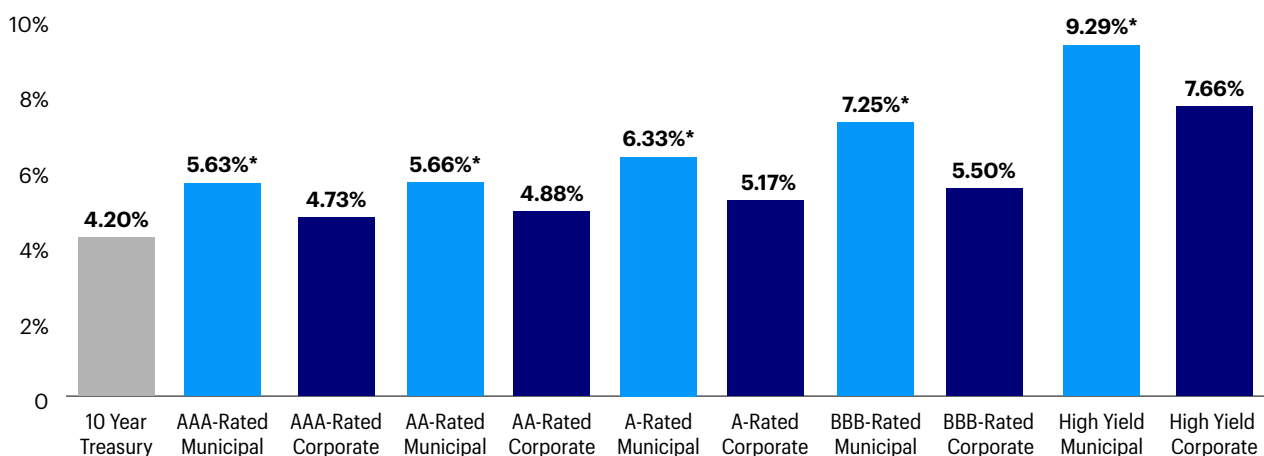
Supply and demand dynamics also seem likely to support municipal bonds in the months ahead. Tax-exempt new issuance for 2024 is estimated to increase, reaching a potential \$350 billion, 8% more than calendar year 2023.⁹ As for taxable new issuance, it could increase to \$50 billion in 2024, up 32% from 2023's \$38 billion, though that would still be 50% lower than the trailing five-year average.⁹ We continue to monitor the impact of ERP calls on the taxable municipal market.

Overall, at the end of the first quarter, we thought seasonal patterns might be reasserting themselves. Historically, the municipal market sees a slight pull-back in March and April during tax season, strength during the late spring and summer months, another pull-back in the fall, and ending the year with positive momentum.¹⁰ If this seasonality reemerges in 2024, investors may find attractive opportunities to add municipals to their portfolios and could then have the potential to be further rewarded if the Fed cuts rates in the second half of the year, as widely anticipated.

Whatever happens on the macro side, the tax-exempt income that municipals can provide is likely to remain appealing to individual investors, especially those in higher tax brackets and living in high-tax states. It may also be of interest to investors who want to prepare for the sunset of a number of the TCJA's tax provisions on December 31, 2025. Many Americans are likely already facing a higher tax bill this year due to higher taxable rates on money-market accounts and CDs and without additional policy changes, those tax liabilities could increase on the horizon.

Furthermore, municipal bonds continued to offer compelling tax equivalent yields at the end of the first quarter, especially compared to US Treasury securities and corporate bonds (see Exhibit 5).

Exhibit 5: Municipals offer compelling tax equivalent yields versus US Treasuries and corporate bonds



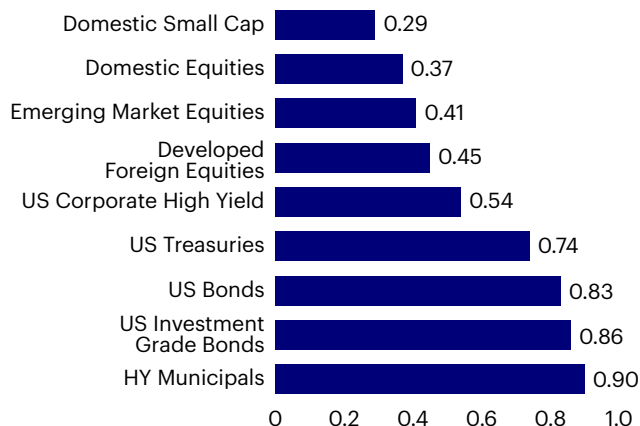
Source: Bloomberg, as of March 31, 2024. AAA-rated municipal is represented by the Bloomberg Municipal Bond AAA Index. AA-rated municipal is represented by the Bloomberg Municipal Bond AA Index. A-rated municipal is represented by the Bloomberg Municipal Bond A Index. BBB-rated municipal is represented by the Bloomberg Municipal Bond BBB Index. High Yield Municipal is represented by the Bloomberg Municipal High Yield Municipal Bond Index. AAA-rated corporate is represented by the Bloomberg US Corporate Bond AAA Index. AA-rated corporate is represented by the Bloomberg US Corporate Bond AA Index, A-rated corporate is represented by the Bloomberg US Corporate Bond A Index. BBB-rated corporate is represented by the Bloomberg US Corporate Bond BBB Index. High yield corporate is represented by the Bloomberg US Corporate High Yield. An investment cannot be made directly into an index. **Past performance does not guarantee future results.**

* $(37\% \text{ Federal Tax Rate} + 3.8\% \text{ NIIT})$ effective as of January 1, 2024. Irs.gov, as of November 9, 2023. Top marginal tax rate for single taxpayers with more than \$578,125 in taxable income or couples with \$693,750 or more. NIIT is the Net Investment Income Tax of 3.8% on investment income for single taxpayers with more than \$200,000 in taxable income or couples with \$250,000 or more.

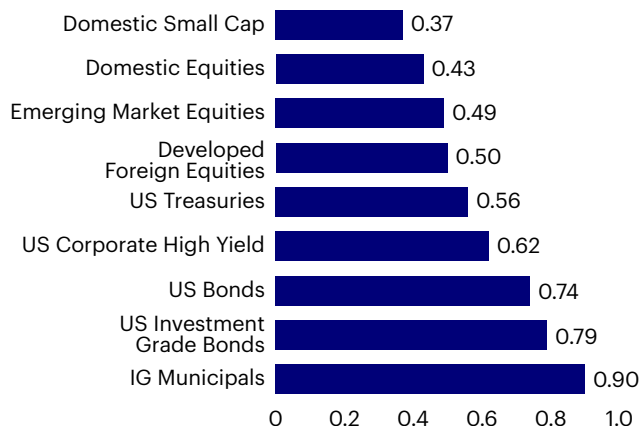
Municipal bonds may also help diversify an investment portfolio, as they historically have a very low correlation to other asset classes, including equities, US Treasuries, and high yield corporate bonds⁶ (see Exhibit 6). Diversification can potentially increase opportunities for growth and help mitigate overall portfolio risk.

Exhibit 6: Municipal bonds may be effective portfolio diversifier

Tax-Exempt Municipal Bonds 10 Year Correlations



Taxable Municipal Bonds 10 Year Correlations



Source: Bloomberg, as of March 31, 2024, based on monthly returns. Asset Classes are represented by the following Index returns: Bloomberg Municipal Bond Index represents IG Municipals, Bloomberg Municipal High Yield Municipal Bond Index represents High Yield Municipals, Bloomberg US Corporate Investment Grade Index represents US Investment Grade Bonds, Bloomberg US Aggregate Bond Index represents US Bonds, Bloomberg US Corporate High Yield Index represents US Corporate High Yield, Bloomberg US Government Index represents US Treasuries, MSCI EAFE Index represents Developed Foreign Equities, MSCI Emerging Markets Index represents Emerging Market Equities, S&P 500 Index represents Domestic Equities, Russell 2000 Index represents Domestic Small Cap. **Past performance cannot guarantee future results.** An investment cannot be made directly in an index.

Going forward, we will continue to rely on our experienced portfolio managers and credit research staff to navigate the marketplace as they look for opportunities that can provide long-term value for investors.

- Source: Barclays, as of January 3, 2024. Calendar year 2023 performance for calendar year is as follows: Bloomberg Municipal High Yield Bond Index, 9.21%; Bloomberg US Corporate High Yield Index, 13.44%; Bloomberg US Asset-Backed Securities Index, 5.54%; Bloomberg US Agency Intermediate Index, 4.90%; Bloomberg Taxable Municipal Index, 8.84%; Bloomberg Municipal Bond Index, 6.40%; Bloomberg US Credit Index, 8.18%; Bloomberg US Aggregate Bond Index, 5.53%; Bloomberg US Government Index, 4.05%; Bloomberg US MBS Index, 5.05%; Bloomberg Global Treasury ex US Index, 4.24%. **Past performance does not guarantee future results.** An investment cannot be made directly into an index.
- Source: Bloomberg, as of March 31, 2024. Investment grade municipal bonds are represented by Bloomberg Municipal Bond Index. High yield municipal bonds are represented by Bloomberg Municipal High Yield Bond Index. Taxable municipal bonds are represented by the Bloomberg Taxable Municipal Index. 1Q24 performance is as follows: Bloomberg Municipal High Yield Bond Index, 1.51%; Bloomberg US Corporate High Yield Index, 1.47%; Bloomberg US Asset-Backed Securities Index, 0.68%; Bloomberg US Agency Intermediate Index, 0.20%; Bloomberg Municipal Taxable Bonds Index, 0.10%; Bloomberg Municipal Bond Index, -0.39%; Bloomberg US Credit Index, -0.41%; Bloomberg US Aggregate Bond Index, -0.78%; Bloomberg US Government Index, -0.96%; Bloomberg US MBS Index, -1.04%; Bloomberg Global Treasury ex US Index, -3.81%. **Past performance does not guarantee future results.** An investment cannot be made directly into an index.
- Source: Federal Reserve, as of April 10, 2024.
- Source: BofA Global Research, as of November 10, 2023.
- Source: BofA Global Research, as of March 31, 2024.
- Source: Bloomberg, as of March 31, 2023.
- Source: Lipper, as of March 31, 2024.
- Source: Bloomberg, as of March 18, 2024.
- Source: JPMorgan, December 31, 2023. 2024 estimates as of November 21, 2023.
- Source: JPMorgan, as of December 31, 2022, based on a 5-year average of net supply from 2017-2022: January: -\$9bn; February: -\$10bn; March: \$0; April: \$1bn; May: -\$2bn; June: -\$5bn; July: -\$17bn; August: -\$14bn; September: \$4bn; October: \$5bn; November: -\$5bn; December: -\$10bn. Market technicals include supply and demand for a security and how it can affect changes in price, volume, and volatility. Net negative supply allows for favorable technicals in the municipal market.

About risk

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

Junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality.

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

All fixed income securities are subject to two types of risk: credit risk and interest rate risk. Credit risk refers to the possibility that the issuer of a security will be unable to make interest payments and/ or repay the principal on its debt. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Municipal bonds are issued by state and local government agencies to finance public projects and services. They pay interest that is typically tax-free in their state of issuance. Because of their tax benefits, municipal bonds usually offer lower pre-tax yields than similar taxable bonds.

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Invesco does not provide tax advice. The tax information contained herein is general and is not exhaustive by nature. It is not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding tax penalties that may be imposed on the taxpayer under US federal tax laws. Federal and state tax laws are complex and constantly changing. Investors should always consult their own legal or tax advisor for information concerning their individual situation.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

Past performance does not guarantee future results.

Diversification does not guarantee a profit or eliminate the risk of loss.

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice.

Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations.

There is no guarantee the outlooks mentioned will come to pass. These opinions may differ from those of other Invesco investment professionals.

A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other debts. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. NR indicates the debtor was not rated and should not be interpreted as indicating low quality. For more information on rating methodologies, please visit the following NRSRO websites: www.standardandpoors.com and select 'Understanding Ratings' under Rating Resources on the homepage; www.moody.com and select 'Rating Methodologies' under Research and Ratings on the homepage; www.fitchratings.com and select 'Ratings Definitions Criteria' under 'Resources' on the homepage. Then select 'Rating Definitions' under 'Resources' on the 'Contents' menu.

Spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another.

Spread tightening is when the difference between yields on differing debt instruments decreases.

A Yield Curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.

An Inverted Yield Curve slopes downward, indicating short-term interest rates exceeding long-term rates.

Market technicals is the price movement and patterns of a security.

A basis point is a unit that is equal to one one-hundredth of a percent.

An investment cannot be made into an index.

Bloomberg Municipal Bond AAA Index is an unmanaged index of the AAA-rated municipal bond market.

Bloomberg Municipal Bond AA Index is an unmanaged index of the AA-rated municipal bond market.

Bloomberg Municipal Bond A Index is an unmanaged index of the A-rated municipal bond market.

Bloomberg Municipal Bond BBB Index is an unmanaged index of the BBB-rated municipal bond market.

Bloomberg US Corporate Bond AAA Index is an unmanaged index considered representative of AAA-rated municipal fixed-rate debt.

Bloomberg US Corporate Bond AA Index is an unmanaged index considered representative of AA-rated municipal fixed-rate debt.

Bloomberg US Corporate Bond A Index is an unmanaged index considered representative of A-rated municipal fixed-rate debt.

Bloomberg US Corporate Bond BBB Index is an unmanaged index considered representative of BBB-rated municipal fixed-rate debt.

Bloomberg Municipal High Yield Bond Index is generally representative of bonds that are non-investment grade, unrated or rated below Ba1.

Bloomberg Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market.

Bloomberg US Asset-Backed Securities Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Bloomberg US Agency Intermediate Index measures the performance of investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, with maturities of 1-10 years.

Bloomberg US Credit Index is an unmanaged index considered representative of publicly issued, SEC-registered U.S. corporate and specified foreign debentures and secured notes.

Bloomberg US MBS Index tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Bloomberg Global Treasury ex US Index measures the performance of fixed-rate, local currency government debt of investment grade countries, including both developed and emerging markets except the United States.

Bloomberg Taxable Municipal Index measures the US municipal taxable investment grade bond market.

Federal Funds Rate is the interest rate that banks charge each other to borrow or lend excess reserves overnight.

Bloomberg US Government Index is an unmanaged index of public obligations of the US Treasury.

Bloomberg US Corporate Investment Grade Index is an unmanaged index considered representative of fixed-rate, investment-grade debt.

Bloomberg US Aggregate Bond Index is an unmanaged index considered representative of the US investment-grade, fixed-rate bond market.

Bloomberg US Corporate High Yield Index is an unmanaged index considered representative of fixed-rate, noninvestment-grade debt.

MSCI EAFE Index is an unmanaged index considered representative of stocks of Europe, Australasia and the Far East. The index is computed using the net return, which withholds applicable taxes for non-resident investors.

MSCI Emerging Markets Index is an unmanaged index considered representative of stocks of developing countries. The index is computed using the net return, which withholds applicable taxes for non-resident investors.

S&P 500 Index is an unmanaged index considered representative of the U.S. stock market.

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