2024 Municipal Bond Outlook

The broad municipal bond market should see support from higher yields and strong credit quality, while supply/demand dynamics should continue to improve.

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Key Points

- Positive U.S. economic fundamentals, along with the higher yields available to investors, should be supportive for the municipal bond market in the New Year.
- Improving technical conditions, such as higher flows into muni-bond funds, may represent another tailwind. The strong credit quality of the broad muni market should also be a plus.
- Other factors to watch in 2024 include the pace of state tax collections, the health of the commercial real estate market, and sentiment among retail investors.

As we enter the New Year, inflation pressures are easing, and the U.S. Federal Reserve appears to be near the end of its rate hiking cycle. Although growth will likely slow from strong levels in the third quarter, the U.S. economy is expected to expand this year, and municipal bond credit quality should remain strong. While there may be bouts of rate volatility ahead, we expect the aforementioned factors, along with higher starting yields and the steep municipal bond yield curve, to be supportive for municipal market performance in 2024.

Even after the significant rally at the end of 2023, the yield-to-worst of the Bloomberg Municipal Bond Index, a common bellwether for the muni market, is near levels not seen since the heights of the so-called "taper tantrum" in 2013. (See Figure 1.)

Figure 1. Municipal Bond Yields Remain Near Multi-Year Highs

Yield-to-worst on the Bloomberg Municipal Bond Index, December 31, 2008–December 20, 2023

Source: Bloomberg. Data for the Bloomberg Municipal Bond Index as of indicated dates. Yield-to-worst refers to the lesser of a bond's (a) yield-to-maturity or (b) the lowest yield-to-call calculated on each scheduled call date.

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This greater carry provides cushion for total returns should rate volatility continue. And although municipal bonds generated positive performance in 2023, most of which occurred in the fourth quarter, the market has still not fully recovered from the 2022 repricing, and we believe the current environment should remain an attractive entry point.

As rate volatility declines, we expect a continued recovery in demand and a resumption of steady municipal bond fund inflows. While positive flows into separately managed accounts have shown relative consistency in 2023, mutual fund flows were flat to slightly negative over the last year, primarily due to redemptions in short-term funds. We expect supply to pick up somewhat in 2024, though it likely will remain below average given the higher level of rates and significant reserves of municipal issuers.

We believe the fundamental backdrop of the municipal market will remain resilient. Although year-over-year growth of tax receipts slowed for parts of the country in 2023, tax collections are coming off a historic base in 2022 and moderating from the strong growth and stimulus since the pandemic. Municipal credit-rating upgrades significantly outpaced downgrades overall in 2023, and while we expect the positive momentum to continue into the New Year, we believe this trajectory will slow somewhat going forward. Finally, we expect that municipal defaults will remain very low and isolated to specific sectors of the high yield segment.

Aside from a resurgence in inflation and rate volatility or unexpected market shocks, one of the primary risks to broader market performance may be investor sentiment. Retail investors, who represent a significant proportion of the municipal market, could become more pessimistic about the market amid headlines of slowing growth, even if credit remains strong. We would see such a shift as an opportunity, and we continue to monitor the market for signs of fundamental weakening. We are paying close attention to broader secular trends that began during pandemic, such as the deterioration of fundamentals in sectors of commercial real estate and the resulting effects on tax collections by local governments; hybrid working arrangements and their impact on mass transit passenger volumes; and the broader demographic shifts impacting higher education, among other areas. So far, these risks appear contained and idiosyncratic, leaving broad fundamental strength as the primary driver of performance in 2024.

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The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. There is a risk that a bond issued as tax-exempt may be reclassified by the IRS as taxable, creating taxable rather than tax-exempt income. Municipal bonds may be affected by local, state, and regional factors. These may include, for example, economic or political developments, erosion of the tax base, and the possibility of credit problems.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

Glossary & Index Definitions

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

A basis point is one one-hundredth of a percentage point.

Carry is the difference between the yield on a longer-maturity bond and the cost of borrowing.

The U.S. Federal Reserve (Fed) is the central bank of the United States. The federal funds (fed funds) rate is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight.

Taper tantrum is a term popularly used to describe the 2013 increase in U.S. Treasury yields which resulted from the U.S. Federal Reserve's use of tapering to gradually reduce the amount of monetary stimulus in the economy.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. Yield-to-maturity (YTM) represents the expected return (expressed as an annualized rate) from the bond's future cash flows, including coupon payments over the life of the bond and the bond's principal value received at maturity. Yield-to-worst refers to the lesser of a bond's (a) yield-to-maturity or (b) the lowest yield-to-call calculated on each scheduled call date.

The **tax-equivalent yield** is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of the tax-exempt yield on a municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond to see which bond has a higher applicable yield.

The **Bloomberg Municipal Bond Index** is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. The index is a broad measure of the municipal bond market with maturities of at least one year. Bonds must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million.

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