



# Key Factors for Investment-Grade Municipal Bonds in 2024

**Favorable fundamentals and attractive yields offer a supportive environment for investment-grade municipal bonds as the New Year begins.**

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## Key Points

- Favorable fundamentals should provide a tailwind for the investment-grade segment of the municipal bond market in the New Year.
- Supporting factors include solid levels of tax receipts and strong rainy-day fund levels.
- As 2024 begins, the muni yield curve presents attractive opportunities in investment-grade issues, especially for those considering barbell strategies.

The fundamental backdrop of the municipal market remains strong as we begin 2024. Over the last year, the record-setting growth in tax revenues and rainy-day balances has moderated, and municipal credit is returning to a more normalized environment. Municipal tax receipts are still significantly above levels experienced prior to the COVID-19 pandemic, and we expect that these revenue streams will continue to come in at healthy levels over the next year. We also anticipate spending growth to decelerate, as many states move beyond the one-off expenditures of last year, following the unprecedented fiscal stimulus during the pandemic.

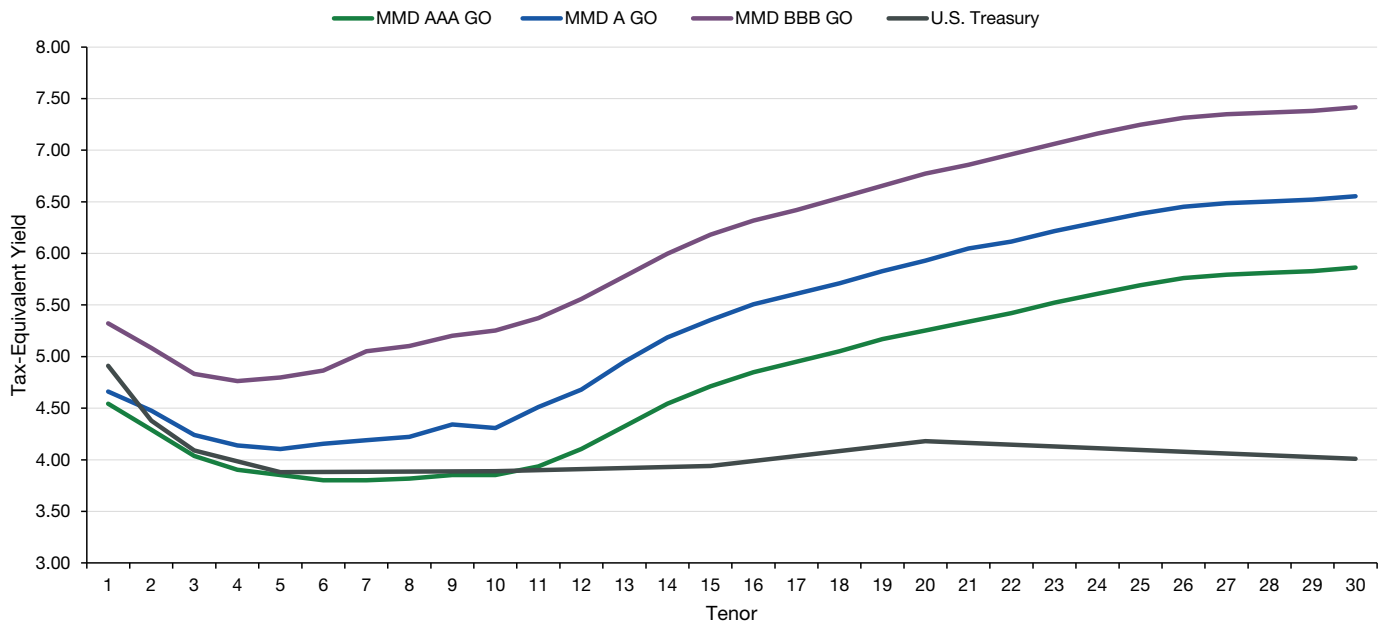
Though we anticipate a slowdown in the U.S. economy, the near-record level of rainy-day fund balances and moderate spending levels leave many municipal issuers well prepared for a moderation in growth. Going forward, we favor toll roads and various airports within the transportation sector, established higher education institutions, larger hospitals, and various corporate-backed bonds in the industrial development sector.

We also believe the municipal yield curve is providing investors with tremendous opportunities. First, the historic inversion of portions of the front end has allowed muni buyers to capture higher yields than the belly (middle) of the curve, with less rate risk, through barbell strategies. Beyond the front end, the curve is showing significant steepness from 12 to 17 years, leading to barbell opportunities for attractive total return potential.

The municipal yield curve slope from two to 30 years is roughly 100 basis points (bps), compared to -42 bps over the same range in U.S. Treasuries, presenting a compelling opportunity for investors seeking to buy high-quality duration. As seen in Figure 1, long dated A-rated bonds, with historically very low default risk, are yielding over 6% on a tax-adjusted basis.

## Figure 1. Investment-Grade Municipal Yield Curve Signals Attractive Opportunity in Longer Maturities

Tax-equivalent yield (%) by ratings category as of December 20, 2023



Source: MMD Refinitive. Data as of 12/20/2023. Tenor refers to the time to maturity of a debt issue. Tax-equivalent yield assumes the top marginal tax bracket of 40.8%, which includes the 37.0% income tax rate and the 3.8% in Medicare tax. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

With starting yields being a strong predictor of future performance, high-quality municipals are nearing performance potential similar to equities. But no matter where investors target on the curve, they will generally be locking in yields not seen for much of the last decade.

Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies.

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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.

In fixed income, a **barbell strategy** is constructed in such a way that half the portfolio contains long-term bonds and the other half holds short-term bonds.

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.

**Spread** is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage

points or basis points (which equal one-one hundredth of a percentage point). The **option-adjusted spread (OAS)** is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

**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 Municipal Market Data (MMD) AAA Curve is a proprietary yield curve that provides the offer-side of "AAA" rated state general obligation bonds, as determined by the MMD analyst team. The "AAA" scale (MMD Scale), is published by Municipal Market Data every day at 3:00 p.m. Eastern standard time, with earlier indications of market movement provided throughout the trading day. The MMD AAA curve represents the MMD analyst team's opinion of AAA valuation, based on institutional block size (\$2 million+) market activity in both the primary and secondary municipal bond market. In the interest of transparency, MMD publishes extensive yield-curve assumptions relating to various structural criteria, which are used in filtering market information for the purpose of benchmark yield-curve creation.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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