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Markets & Economies

Five Key Themes for Today's Municipal Bond Market

A closer look at the factors that could influence the municipal bond market in the months ahead.

Nicholas Bragdon,
Product Specialist

The past few years have been eventful ones for the municipal bond market. Following the low-rate environment coming out of the pandemic, munis suffered one of their worst periods in history in 2022, from both a performance and demand perspective. The market rebounded somewhat in 2023, with respectable performance and strengthening demand, particularly in Separately Managed Accounts.

In 2024, we've seen a continuation of that recovery, but there has been an important change in the market environment: After a series of rate hikes that began in March 2022, the U.S. Federal Reserve (Fed) cut interest rates in September—and the trend is largely expected to continue over the near term.

As we enter the final quarter of 2024, we will explore the opportunities in today's municipal market and highlight key themes we believe are important for municipal bond investors.

1. Year-to-Date Supply Is Near Record Highs

The municipal market has experienced a significant uptick in issuance this year, with tax-exempt supply reaching the highest levels in several years. In the first three quarters of 2024, total issuance was approximately $380 billion (based on data from SIFMA), growing over 40% from the same period in 2023 and 20% higher than the five-year average.

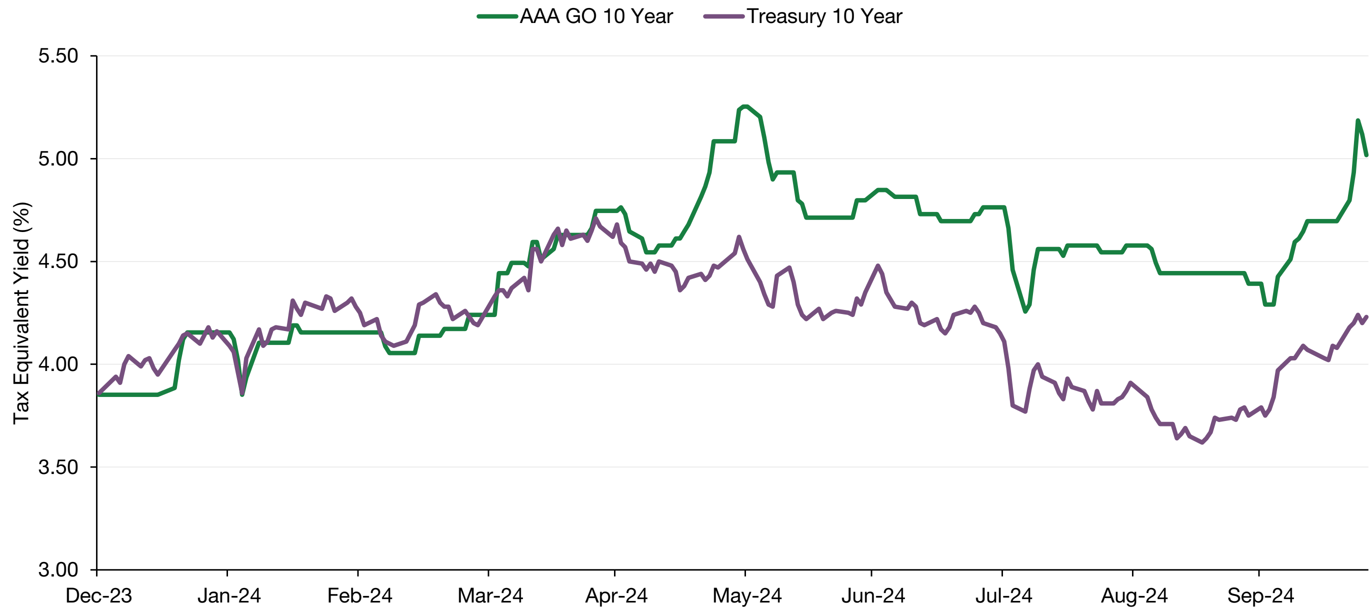
An increase was largely expected after two consecutive years of constrained issuance, continued infrastructure and capital spending needs, and an end to the historic federal stimulus related to the onset of COVID-19. Adding to this, uncertainty around the 2024 presidential election has led issuers to pull forward new issues, so we believe the pace of this year's record-setting supply may moderate after the election. Additionally, November and December have historically brought technical tailwinds for the market, given the sizable reinvestment capital that returns to the market at the end of the year. Therefore, we think the fourth quarter may present an attractive entry point for investors as the technical landscape potentially becomes more supportive.

2. Municipals Offer Attractive Value

With a moderation in the U.S. labor market and a cooling of price pressures, Treasury yields have adjusted lower over the past few months. But given the supply / demand dynamics in municipals, muni rates have not rallied to the same extent. Since Treasury yields peaked in late April, the yield on the 10-year U.S. Treasury note has declined by almost 50 basis points (bps), while the yield on AAA-rated municipal bonds is only about 15 bps lower than its 2024 peak.

Figure 1. Municipal Bonds Remain Attractively Valued versus Treasuries

Yield (Treasuries) and tax-equivalent yield (municipals), Dec. 29, 2023–October 25, 2024

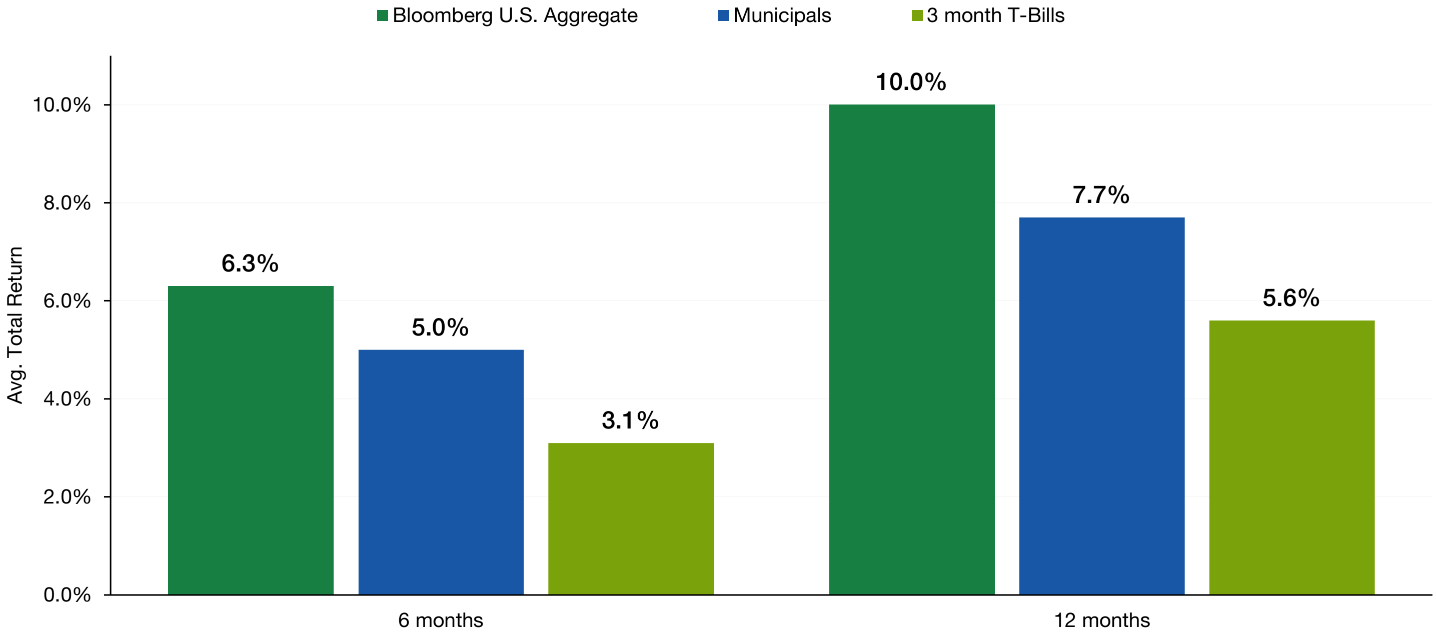


Source: MMD. AAA GO = AAA-rated general obligation municipal bonds. Tax-equivalent yield assumes the top marginal tax bracket of 40.8%, which includes the 37.0% income tax rate and the 3.8% in Medicare tax. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative 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.

While municipal yields are just off their recent highs, they remain elevated relative to much of the last decade, and attractive versus taxable fixed-income sectors. Furthermore, history has shown that as you move further into a period when the Fed is reducing interest rates, municipal bonds have generated strong absolute performance. With municipal yields across all maturities higher than at the start of the year and the curve continuing to show significant steepness, we believe investors may find this an opportune time to participate in the muni market as we enter the early stages of the Fed cutting cycle.

Figure 2. Municipal Bonds Have Performed Well After Fed Rate Cuts

Average total return following the first rate cut in the last seven U.S. Federal Reserve rate-cut cycles since 1984



Source: Bloomberg and Lord Abbett. Bloomberg U.S. Aggregate = Bloomberg U.S. Aggregate Bond Index. Municipals = Bloomberg Municipal Bond Index. 3-Month T-Bills = U.S. Treasury bills. Data represent the average performance of the indicated indexes and securities over the 6-month, and 1-year periods following the first federal funds rate cut in the previous seven cycles by the U.S. Federal Reserve. Start dates of the seven periods are 10/2/84, 10/19/87, 6/5/89, 7/6/95, 1/3/01, 9/18/07, and 7/31/19.

The historical data shown in the chart above are for illustrative purposes only and do 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.
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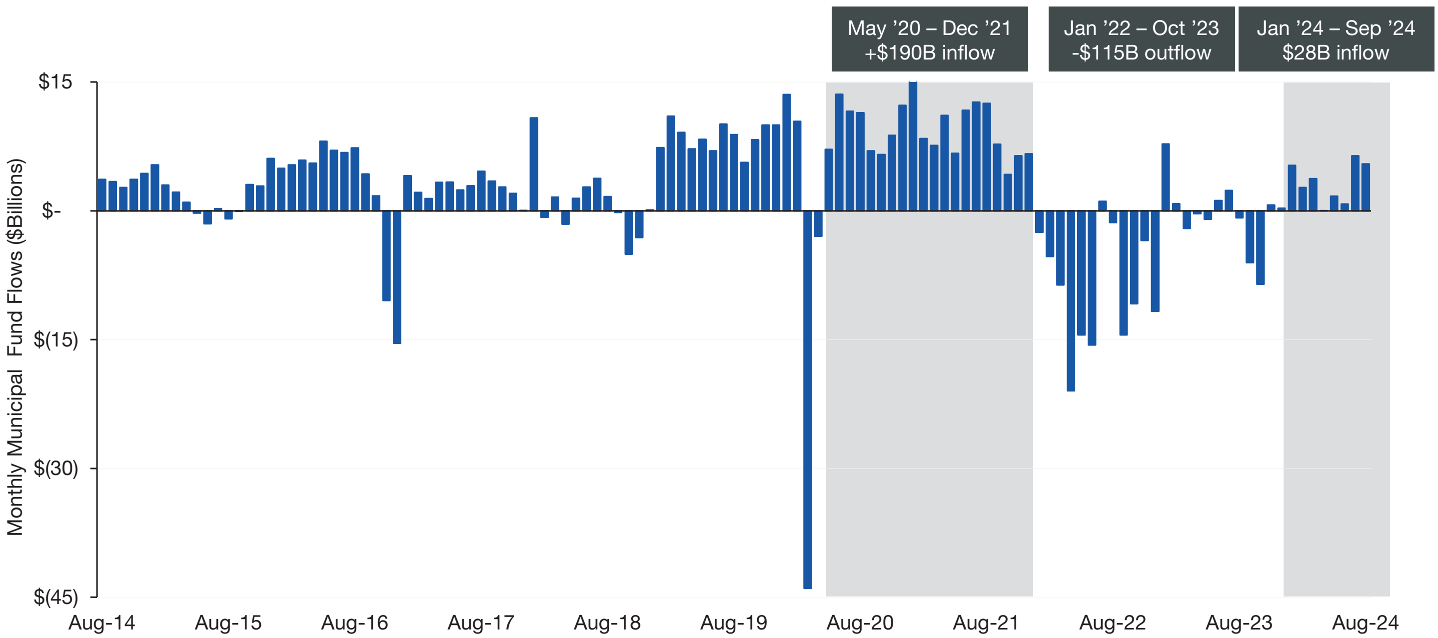
3. Inflows Are Strengthening

During the difficult market environment in 2022, municipal bond funds experienced record outflows with approximately $115 billion leaving the category between January 2022 and October 2023. (All fund-flow data cited here are from LSEG Lipper.) Inflows were slow to return despite municipals offering the highest yields in over a decade. Now, as investors anticipate additional rate cuts by the Fed, flows are starting to turn.

Since the start of the year, the market has experienced roughly $32 billion in inflows. This number alone leaves something to be desired, especially compared to the inflow cycle of 2021. But when looking closer, over half of 2024's total inflow has been realized since the end of June. In fact, the market has experienced 17 consecutive weeks of inflows so far in the second half of the year, with the weekly flow averaging close to $1 billion per week, much higher than weekly positive flows earlier in the year.

Figure 3. Muni-Bond Fund Flows: Reversal in Sentiment May Present a Tailwind for the Market

Monthly inflows/outflows for municipal bond mutual funds, August 2014–August 2024



Source: Morningstar and Bloomberg. Monthly mutual fund flows represented by Morningstar Municipal Bond Categories. The historical data shown in the chart above are for illustrative purposes only and do 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. **Past performance is no guarantee of future results.**

These data point strongly toward the long-awaited rebound in mutual fund flows. This is consistent with other periods in which the Fed has cut interest rates, as research from J.P. Morgan shows that the last six such periods led to significant stretches of inflows.

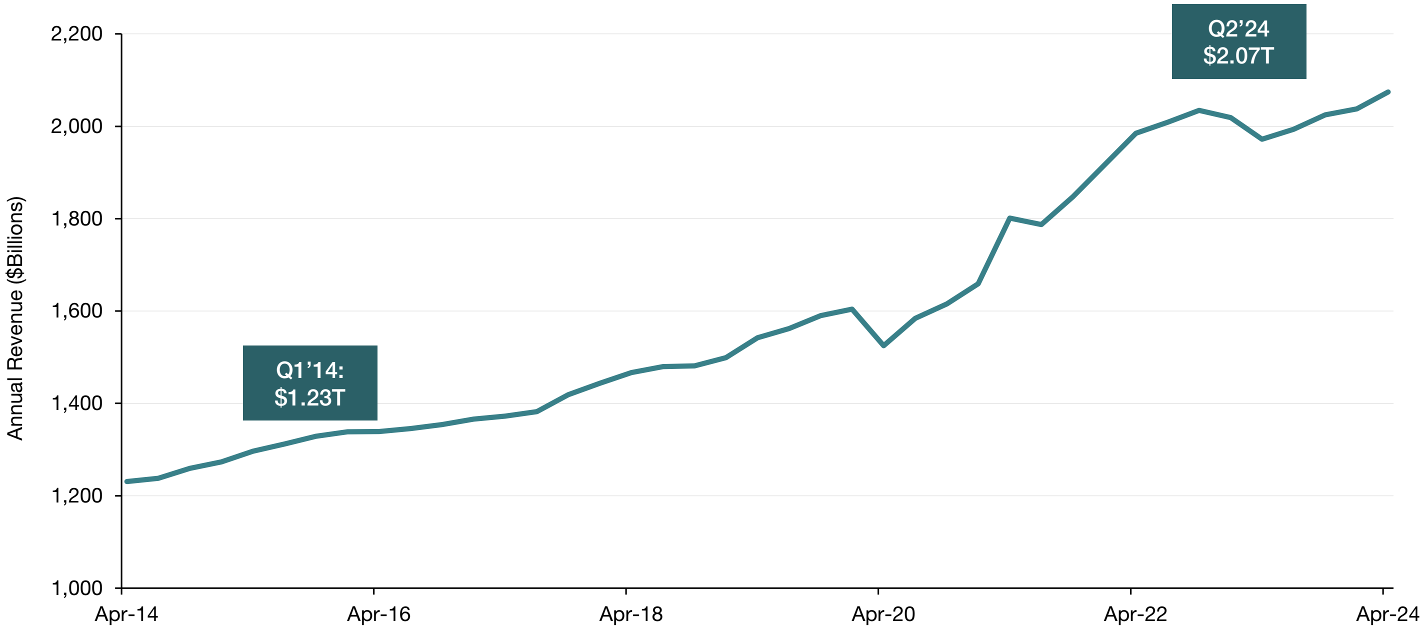
A continued resurgence in mutual fund flows may have significant implications for the market, namely in lending support to lower-rated, investment-grade municipals, high yield munis, corporate-backed bonds, and longer-duration bonds. Long-duration muni bonds have historically experienced significant demand as the market transitions into easing cycles. An increase in flows to funds focused on the longer end of the curve could serve as the catalyst for the much-anticipated rally in longer muni rates.

4. Market Fundamentals Remain Sound

While it's important to understand the technical environment, looking at fundamentals, municipal credit remains on sound footing. As of the end of the second quarter, state and local tax revenues grew over 7% compared to the previous year; compared to the five-year average, tax receipts were almost 18% higher.

Figure 4. State and Local Government Revenue Growth Remains Steady

Annual tax revenue from state and local governments, Q1 2014–Q2 2024



Source: U.S. Census Bureau. For illustrative purposes only.

In terms of ratings actions, August marked the 38th consecutive month that upgrades outpaced downgrades, according to S&P Global. Over the last 12 months, the upgrade/downgrade ratio was greater than 3-to-1.

High yield municipal credit fundamentals also remain sound. Municipal defaults have historically been rare and isolated to certain market segments, and so far in 2024, they remain below historical averages, suggesting a stable credit backdrop. More importantly, we are not seeing any significant uptick in indications of credit deterioration, such as dwindling reserves or issuers requesting covenant leniency—factors that historically have hinted at upcoming distress.

5. Opportunities in Muni Tax-Loss Harvesting

Given the current elevated level of yields, along with supportive credit fundamentals and technical factors, we believe this is a good time for investors to consider municipal bonds. As we head into the final quarter of the year, we also think it is important for investors to review their existing portfolios to see if there are opportunities for tax-loss harvesting. While municipals have had positive returns over the past year, there may be positions still trading at a loss due to the bond market volatility of 2022. Tax-loss trading can turn those losses into an asset, offsetting gains in other parts of the portfolio to reduce overall tax bills, while repositioning portfolios to take advantage of today's market. Rather than waiting for year-end, when liquidity may be limited as we approach the holiday season, we suggest looking for opportunities for tax harvesting throughout the year.

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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.

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 Bloomberg Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term, tax-exempt bond market. Bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two ratings agencies. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date.

The Bloomberg U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Total return comprises price appreciation/depreciation and income as a percentage of the original investment.

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.

Important Information

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

References to fund yields are for informational purposes only and are not meant to represent any specific Lord Abbett bond fund or portfolio.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

No investing strategy can overcome all market volatility or guarantee future results.

The value of investments and any income from them is not guaranteed and may fall as well as rise, and an investor may not get back the amount originally invested. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance.

Market forecasts and projections are based on current market conditions and are subject to change without notice.

Projections should not be considered a guarantee.

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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.

This material may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

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Lord, Abbett & Co. LLC | 30 Hudson Street | Jersey City, NJ 07302-4804 | T 1.888.522.2388 | lordabbett.com

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