

# Municipal Bonds: The Next Potential Asset Rotation



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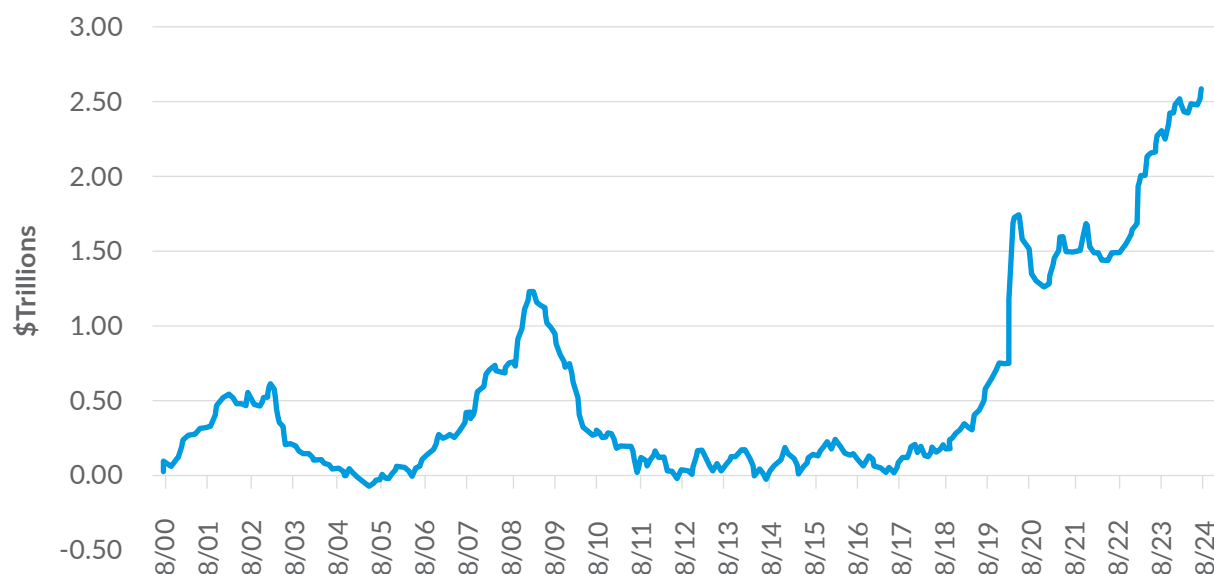
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## Summary

- Cash balances remain at historic levels as investors have been able to capture yield in this interest rate cycle.
- Markets anticipate that the U.S. Federal Reserve (Fed) will begin to cut interest rates, which is likely to be the first of a series of cuts, rather than an isolated event.
- The backdrop for the dual drivers of fixed income returns, duration and credit, support a move from cash-like assets to municipal bonds.

After a generation of negative real returns in risk-free assets, investors have moved capital into money market funds at a historic clip (as shown below). Over \$2 trillion of cumulative flows have made their way into money market funds, exceeding flows in both the tech bubble at the turn of the 21st century and financial crisis of 2008-09. This positioning has enabled investors to sidestep U.S. Federal Reserve (Fed) policy of rising interest rates and eliminate macro risks, while earning a positive real return over the past year.

## Cumulative Money Market Flows



Source: Morningstar Direct as of August 31, 2024

## Is Cash Risk Free?

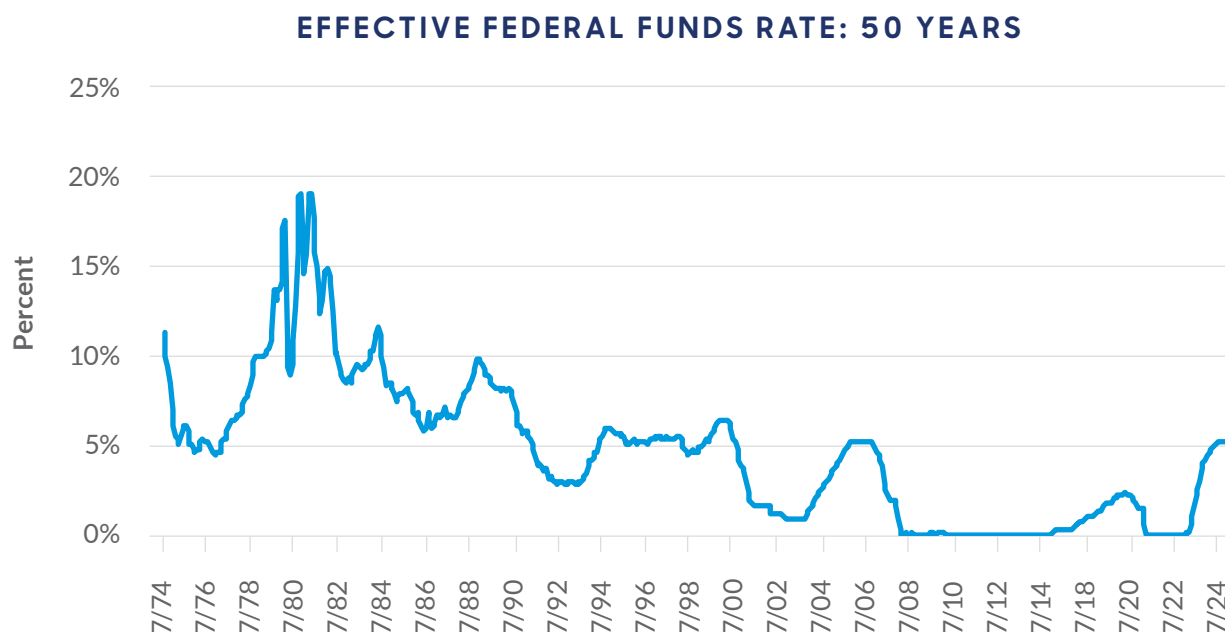
However, focusing on the short end of the yield curve — with yields of short-term securities that generally mature in one year or less — can present a challenge for a long-term investment strategy. While cash has little market or duration risk, there is one often overlooked risk embedded, and that is the risk of reinvestment. The reinvestment rate risk and opportunity cost associated with cash and cash equivalent investments can be extremely high under certain circumstances. The harsh reality that investors may face is the changing Fed interest rate policy regime. The attractive yields investors have experienced in cash and cash equivalent securities over the past few years (due to rising interest rates) is expected to reverse going forward, as the market expects a series of rate cuts through the end of 2025.

We believe utilizing the backdrop for the dual drivers of fixed income returns, duration and credit, support a risk-aware move from cash-like assets to assets like municipal bonds.

## Duration: Don't Fight The Fed

While short-term rates have risen to the highest levels in over a decade, investors have to consider the likely fleeting nature of these higher yields. We now know from the Fed's recent meeting and corresponding commentary that its September interest rate cut will likely be the first of a series of cuts, rather than an isolated event. The chart below shows the effective federal funds rate over the past 50 years. The federal funds rate is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight. It is important to note that despite current market pricing, the federal funds rate has troughed below prior lows in each interest rate cycle over this time period.

## Federal Funds Rate: 50 Years



Source: St. Louis Federal Reserve as of 8/31/24.

The first rate cut of an easing cycle has generally resulted in a “tightening” of financial conditions rather than an easing. The reason for this seemingly contradictory outcome rests in the notion that the first cut is a unique and extraordinary statement to corporations, home buyers, car buyers, commercial property investors. Once the cut is made, borrowers tend to delay their borrowing needs in the hopes of achieving lower borrowing costs in the future, as they may believe that future cuts will be forthcoming. Incentivizing borrowers, corporations, and individuals to wait until lending and financial conditions ease or improve further, causes loan demand to fall, results in a cascading effect, triggering a further contraction in economic activity. This forces the Fed to cut rates more deeply to incentivize borrowers off the sidelines. This is why the Fed has been forced to reduce interest rates more aggressively than initially planned during prior recessions and easing cycles.

When it comes to asset-focused duration, municipal bonds can offer a more efficient means of capturing duration relative to other fixed income segments. It's important to keep in mind that duration measures the sensitivity of a fixed-income investments' price to changes in interest rates. While the treasury yield curve remains inverted — long-term rates (10-year) are less than short-term rates (2-year) — the municipal yield curve and the unique characteristics of its investor base, results in a greater spread between 2 year and 10-year rates. Duration (interest rate risk) is a risk premium, and we believe that investors should be compensated for taking that risk. While investors are compensated nearly 50 basis points for moving out the yield curve (longer duration) in the municipal market, there is little corresponding premium as you extend term on the treasury yield curve.

## Credit: A Move Up in Quality

On average over the past 50 years, the economy tends to enter a recession four to six months after the Federal Reserve begins cutting rates.<sup>1</sup> The extremely weak July payroll report triggered the Sahm Recession Indicator after the three-month unemployment rate average increased. This is a key recession indicator for the Fed that was developed in 2019 and has been extremely accurate at predicting that the U.S. economy has entered recessions going back to 1970 (on a historical/backdated basis).<sup>2</sup> While past isn't always prologue, tight corporate credit spreads, deteriorating economic conditions, and seasonal volatility may warrant a move up in credit quality.



**Steady/Predictable  
Income**



**Tax Efficiency**



**Safe but with Risk**



**Local Investment**

Besides the potential opportunities shown above, municipal bonds provide the key credit characteristic of higher quality. While credit ratings are not apples-to-apples between corporate and municipal credit markets, municipal bonds have experienced significantly lower defaults than corporate credits at the same credit quality tier.

For example, A-rated municipal bonds defaulted only 0.10% of the time over a 10-year basis, while corporate bonds defaulted nearly 2%. The dispersion becomes even more pronounced as you move lower in rating, with defaults of only 3.3% in the Ba municipal space, compared to nearly 16% of the time in corporate bonds. This provides investors an opportunity to capture additional yield, while being thoughtful about where and how they allocate risk in their

<sup>1</sup> Source: St. Louis Federal Reserve as of 8/31/24.

<sup>2</sup> Source: St. Louis Federal Reserve, Real-time Sahm Rule Recession Indicator, as of 8/1/24.

portfolios. A structural opportunity exists not just between municipal bonds and corporates, but within municipal bond credit tiers as well. For only an additional 1% in default risk, investors can capitalize on the historical near 1% annualized return advantage for Baa-rated municipal bonds versus A-rated municipal bonds.

## Potential Benefits of an Active Approach

The interest rate and credit profile of municipal bonds offers investors an opportunity to be proactive in positioning portfolios. The high levels of reinvestment rate risk inherent in cash and cash-like instruments, whose yields are likely to fall precipitously going forward, may offer minimal compensation to investors who remain passive. Active investment management of municipal bonds can position investors to identify market inefficiencies through targeted trading and reinvestment.

**While municipal bond funds primarily invests in municipal securities that are exempt from federal taxes, investors may be subject to state and local income taxes as well as the federal Alternative Minimum Tax.**

**Credit Quality** does not include cash and equivalents and represents the grading of a debt security with respect to the issuer's ability to meet interest and principal requirements in a timely manner.

**Duration**, expressed in years, measures the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. The higher the duration number, the more sensitive a fixed-income investment will be to interest rate changes.

**Ratings** by S&P, Moody's, or any other Nationally Recognized Security Rating Organization (NRSRO) are measured on a scale that generally ranges from AAA (highest) to D (lowest). Issues rated AAA, AA, A and BBB are considered investment grade. Bonds, including government and government-related, not rated by a NRSRO are included in the Not Rated category. Higher-rated bonds generally provide lower returns and greater safety. Weighted average ratings methodology uses the highest of any NRSRO.

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