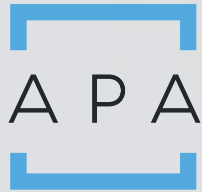


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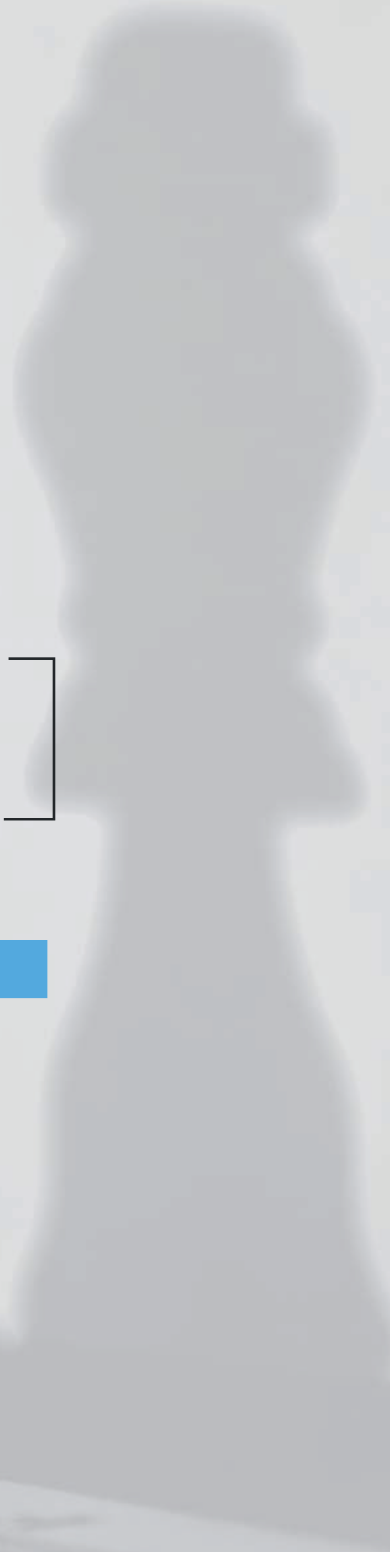
# MARKET COMMENTARY

Q4 2024



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## FOURTH QUARTER HIGHLIGHTS

- The fourth quarter opened with a stronger-than-expected jobs report (+254k) and accelerating inflation in both CPI and PCE, dampening expectations for aggressive Fed policy easing.
- Additionally, the fourth quarter saw market sentiment shift in response to the increased likelihood and, ultimately, confirmation of a "red sweep" in the US elections.
- As policy implications of the new administration were digested, yields moved higher as investors priced in the potential for higher inflation and increased Treasury issuance to fund the anticipated fiscal expansion.
- Despite the 25bps cut in rates at the December FOMC meeting, the tone was notably hawkish, with officials signaling fewer rate cuts in 2025 due to stalled progress on inflation.
- As of readings in December, CPI stood at 3.3% year-over-year, while PCE reached 2.8%, highlighting that more work remains to achieve the Fed's 2% inflation target.
- Over the fourth quarter, AAA-rated municipal yields rose by 52bps, 56bps, 46bps, and 38bps for 2, 5, 10, and 30-year maturities, respectively.
- Municipal bond issuance in 2024 reached a record $507.7 billion, a 32% increase from 2023, surpassing the previous annual high set in 2020.
- Following net outflows in 2023, tax-exempt mutual funds saw inflows of $31.5 billion in 2024, reflecting renewed investor demand for municipal bonds.

## QUARTERLY MARKET UPDATE

October opened with a stronger-than-expected jobs report, showing a month-over-month gain of 254k, the largest monthly gain since March of this year. Additionally, inflation measures in both CPI and PCE accelerated in September (released in October), undermining expectations of aggressive Fed policy easing.

Alongside the strong jobs report and inflation data accelerating, market focus turned toward the upcoming election, with sentiment shifting to the increased probability of a "red sweep." As policy implications were digested, yields moved higher throughout the month on the notion that stimulative tax cuts could support ongoing economic

recovery while potentially fueling inflation and leading to increased Treasury issuance. This, in turn, dampened previously anticipated expectations for aggressive Fed easing.

Municipals followed Treasury yields higher while facing added pressure from robust new issue supply. According to SIFMA, October's municipal issuance surged to $65.8 billion, a 66% increase compared to the same month last year. As a result, municipal yields rose across the curve, with 2, 5, 10, and 30-year maturities increasing by 39, 37, 41, and 35 basis points, respectively.

On the credit front, in October, Pennsylvania received a one-notch upgrade by Moody's to Aa2 from Aa3. In its action, Moody's cited the Commonwealth's sound fiscal management, balanced budgets, and steady economic growth, reflecting its improved credit profile.

In early November, yields continued their upward climb following cofirmation of the GOP sweep of the presidency and both houses of Congress in the November 5th elections and how this would impact the trajectory of growth and inflation. However, fixed-income markets experienced a strong rally in the latter half of the month as cabinet appointments began to be announced, and markets began to factor in the GOP's very slim majority in the House of Representatives and the potential limitations this could impose on advancing significant legislation.

The devastating effects of Hurricane Helene influenced economic data in November, though inflation concerns persisted. The October CPI report, released in November, showed inflation accelerating to 2.6% month-over-month, up from 2.4%. At its November FOMC meeting, the Federal Reserve lowered rates by 25 basis points, as anticipated, signaling a cautious and gradual approach to monetary policy to support growth while addressing inflation risks.

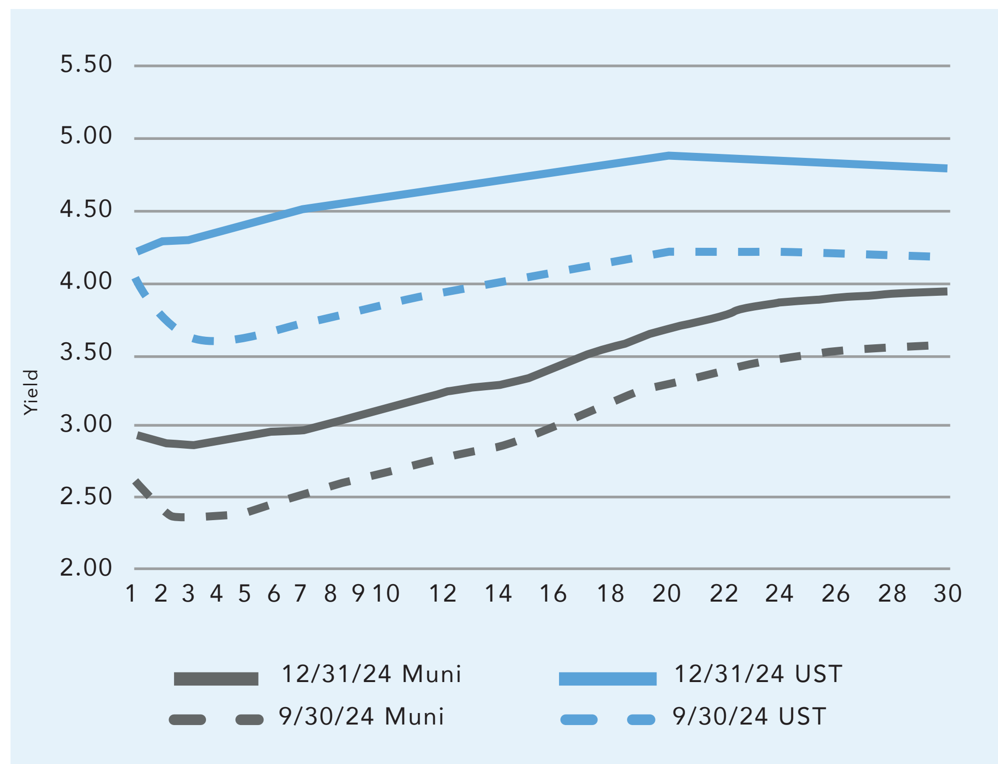
Municipal bond prices moved higher, with yields declining, supported by a stabilization in Treasury yields and a notable slowdown in primary market supply. November saw just $24.9 billion of new issue supply, the lowest monthly total of the year, as supply was pulled forward ahead of the election and November FOMC meeting. For the month, AAA muni yields in 2, 5, 10, and 30-years declined by 10, 7, 23, and 25 basis points, respectively.

Fixed income markets finished the final month of the year on a weaker note, with yields rising across the curve. Bond yields moved higher, reflecting the repricing of Fed expectations for rate cuts and continued digestion of policies of the incoming administration and the potential inflationary impacts. The peak in the selloff occurred after the FOMC meeting that concluded on December 18, where the Fed reduced the overnight rate by 25bps to a target range of 4.25-4.50%. Despite the

anticipated cut, the tone was notably hawkish, with officials signaling fewer rate cuts in 2025 due to stalled progress on inflation. As of readings in December, CPI stood at 3.3% year-over-year, while PCE reached 2.8%, highlighting that more work remains to achieve the Fed's 2% inflation target.

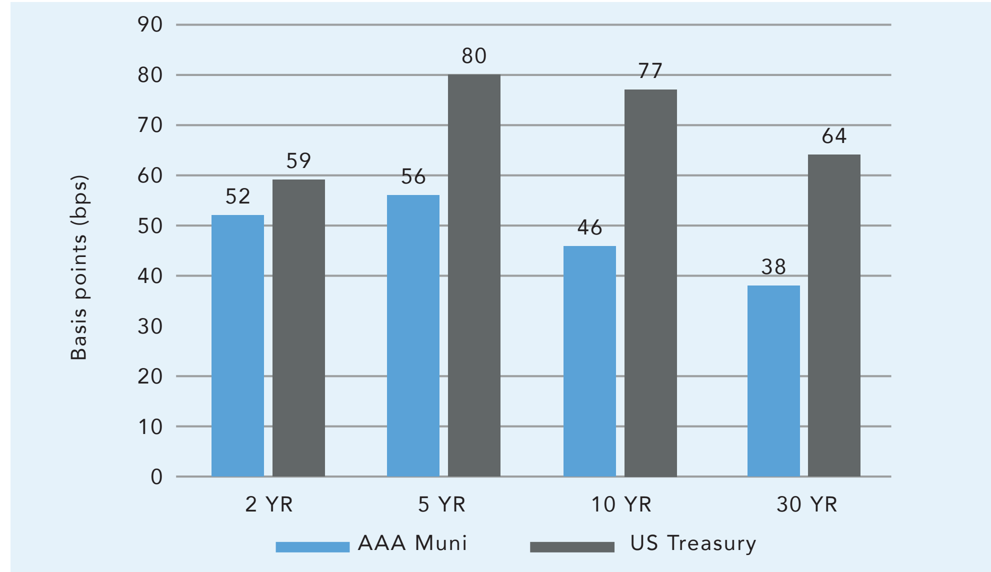
Municipal yields increased by an average of 27 basis points across the curve in December. Over the fourth quarter, AAA-rated municipal yields rose by 52bps, 56bps, 46bps, and 38bps for 2, 5, 10, and 30-year maturities, respectively.

MUNI & TREASURY YIELD CURVES




Source: Municipal Market Data, US Treasury

Q4 2024 YIELD MOVES (bps)

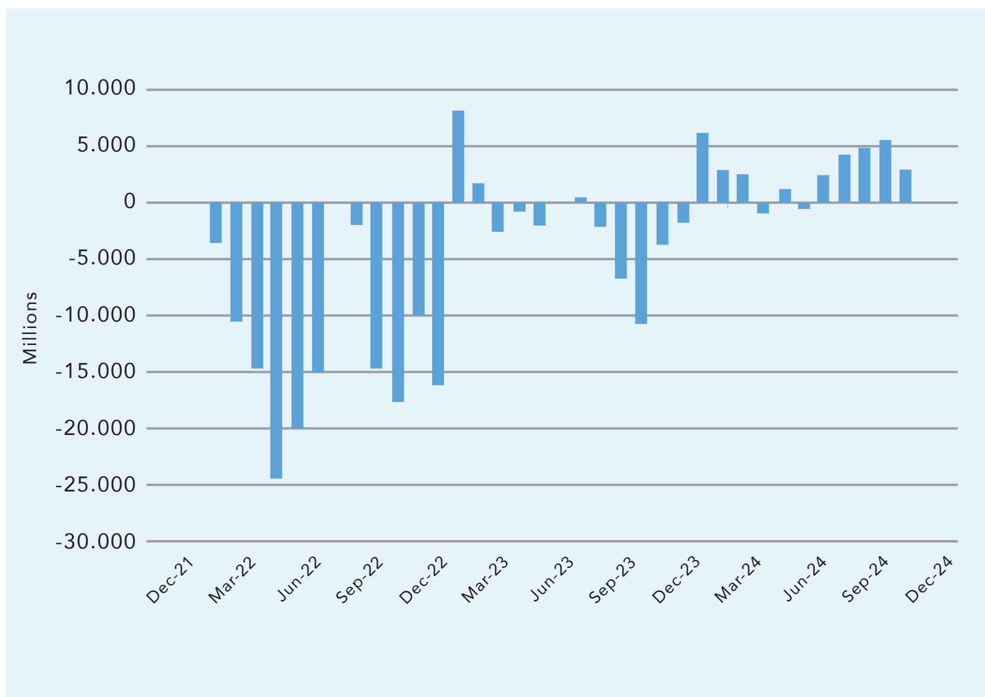



Source: Municipal Market Data, US Treasury

## FUND FLOWS

Per ICI data, municipal mutual funds experienced strong inflows for the quarter. Municipal mutual funds brought in $8.5 billion for the period, with each month of the quarter seeing net positive flows. After seeing average net positive inflows of $4.2 billion in October and November, December saw just $54 million of net inflows, with the last two weeks seeing net outflows. After seeing net outflows for the calendar year 2023, tax-exempt mutual fund inflows totaled $31.5 billion in the calendar year 2024.

MONTHLY FUND FLOWS

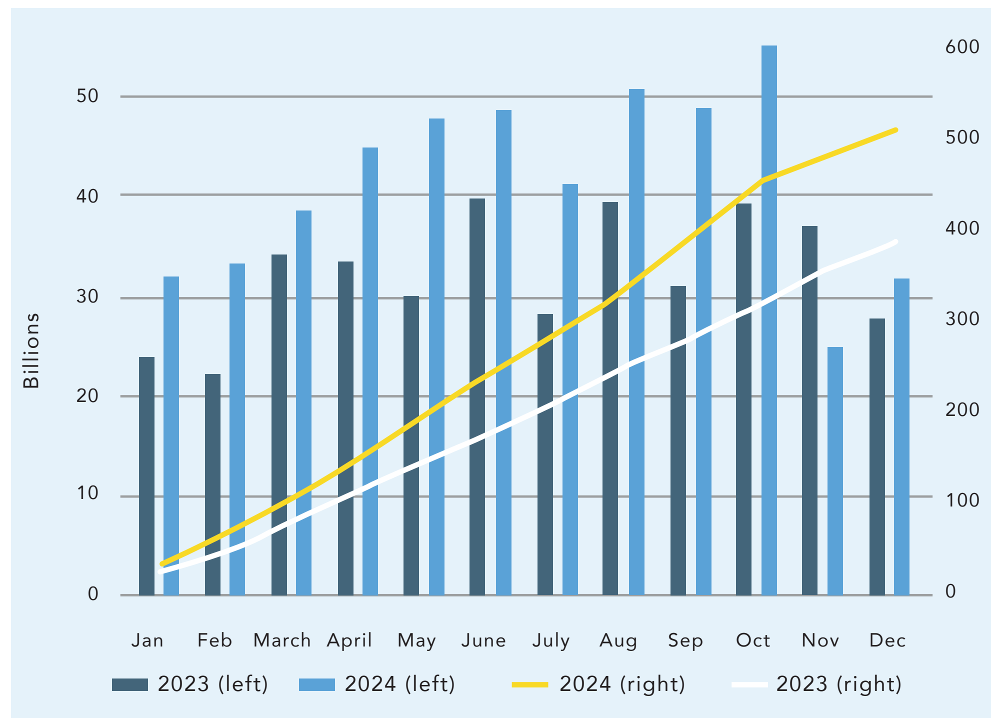



Source: Investment Company Institute (ICI)

## SUPPLY

Municipal new issue supply remained strong in the fourth quarter. As issuers raced to get ahead of potential election-induced volatility, October saw a new issue supply of $65.8 billion, the highest monthly total for the year. Supply slowed down in November following the election and FOMC meeting; however, new issue volume closed out the quarter at $122.4 billion, an 18% increase over the same period last year. This brought the 2024 calendar year supply to a record $507.7 billion, a 32% increase from 2023, surpassing the previous annual high set in 2020.

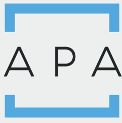
MUNICIPAL MARKET SUPPLY




Source: SIFMA

## OUTLOOK

As the Federal Open Market Committee (FOMC) initiated its easing cycle with a 50bps rate cut on September 18, reducing policy rates from their 5.25% peak, the intermediate and longer end of the curve has been on a march to higher yields. The fact that longer yields have moved higher since the FOMC began to cut rates is extremely rare – following the commencement of the Fed's easing cycle, the 10-year Treasury rate closed the year higher by nearly 90 basis points. Comparatively, the average move during the first 100 days following the first Fed cut is for the 10-year yield to be lower by roughly 20bps. The oft-quoted 3mo / 10yr UST slope steepened from an inverted -85bps on September 30 to close the year at a positive sloping +24bps.



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Although tax-exempts did not experience the typical strong performance that the market has become accustomed to in closing out the year with the broad market posting only its second negative fourth-quarter return of the last 15 years, APA's modified ladder structure was built to insulate portfolios from a steepening yield curve. As our clients know, we look to be active and take advantage of changing dynamics and yield curve movements throughout the year, not just waiting until year-end. However, during the volatile periods of the 4th quarter, APA looked to take advantage of opportunities to align portfolios with the new interest rate environment and the changing dynamics of the supply picture in our market.

The abrupt repricing, however, of FOMC expectations in December and new administration's potential policy implications led to a flurry of activity to end the year, with many individuals looking to take losses that were not available earlier in the year or to ramp up a duration extension along a steeper yield curve.

The market has come to grips with exempt valuations that are much tighter than historical norms, with intermediate AAA/UST Ratios averaging between 65-70% throughout the year, compared to the historical average of 85%. The difference today, however, lies in the higher nominal yields of tax exempts, leading to higher taxable equivalent yields, providing investors with the cover to continue to buy at current levels. This coincides with the explosion of growth of SMA and ETF products, with high-net-worth individuals less concerned with relative value and more concerned with earning tax-exempt income, which leads us to believe the tighter ratios may be here to stay. This does not even include the fact that the denominator (UST) may not be the risk-free benchmark it once was. Moody's rating outlook on the US Government's AAA rating is on negative watch, and we think there is a non-zero chance we will see that rating move lower in 2025.

New entrants into the fixed-income world in 2024 witnessed what "carry" can mean for total return. As we like to remind our clients, the income generated from individual positions is often the largest driver of performance over the long term. Despite overall yields moving higher through the year and short-term periods of negative price returns, the additional level of income that is now generated acted as a ballast, and the broad muni market maintained a positive total return for the year.

The year was headlined by high-yield performance, as the inflows to new and existing products alike created more cash than there were bonds to fill the inquiry, which bled into the lower IG market, compressing spreads on BBB, A, and AA-rated names. While we looked to take advantage of the rising tide that lifted all boats over the last few years of credit strength, we do feel that in the years ahead, it will become essential to lean back into bond picking, carefully analyzing valuations and credit metrics of what will be a new, post-pandemic aid, era of credit.

As the market tries to price what is to come with a second Trump presidency and the policies that will accompany it, we feel the move higher in rates and the changing shape of the yield curve provides an intriguing new entry point for fixed income.

As markets continue the shift from focusing on monetary policy towards fiscal policy, and, in turn, what that may mean for monetary policy, we feel that rates have the potential to stay higher for longer and keep the "income" in fixed income as a viable long-term investment, that now offers some of the highest real yields seen in years.

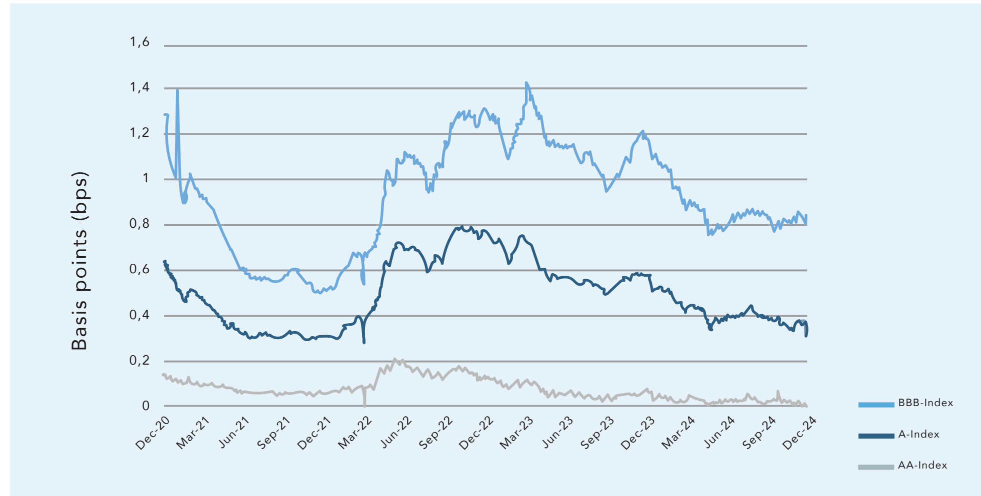
For the municipal market heading into 2025, eyes are on Federal tax policy and what form the extension of the 2017 Tax Cuts and Jobs Act (TCJA) will take. As is the case with most election cycles, discussion on municipal bond tax exemption is being tossed around as a way to raise revenue in the face of a growing deficit. The conversation this year feels a bit more urgent than in the past, and we expect the headlines to continue in the near term, but we ultimately expect muni tax exemption to be retained. The push by local officials, their tax-paying citizens, and the robust need for ongoing infrastructure improvements will likely keep the tax exemption as a means of cheap financing for state and local governments. We believe this relief, coupled with the feeling that rates may be at these levels for longer, will lead to continued heavy supply, with the potential for another year north of $500bln.

Other key aspects of the potential extension or expansion of the TCJA that could impact the municipal market include the permanency of the top marginal tax rate, a corporate tax rate remaining low enough to keep demand subdued, and the continuation of the higher AMT exemption, which limits its impact to a smaller pool of taxpayers. Additionally, whether the SALT cap remains at $10,000 or increases to $20,000, we anticipate continued strong demand from high-net-worth investors in high-tax states. While we expect the broad municipal tax exemption to remain intact, changes in taxation could target specific sectors, potentially affecting a wider range of private activity bonds, including those issued by private higher education institutions.

Ultimately, we feel municipals are at intriguing levels, and we remain cautiously optimistic for long-term allocations taking on a bit more aggressive approach. Though the rotation out of cash has been forecast for well over a year, we feel that the steep yield curve finally provides a reason and opportunity for individuals to extend out the curve. We talked a bit about the new credit landscape that issuers now find themselves in without the tailwind of Federal aid, but credit profiles are broadly stable with still-strong revenues and reserves. While the ratio of upgrades to downgrades "slowed" to 3:1 in 2024, we feel the issuers we focus on at APA are well suited to manage through changing cycle dynamics. While corporate credit markets have tightened toward all-time lows as equity markets have notched record high after record high, there is an argument to be made that municipal credit spreads are

still compelling, especially when getting back to a bond-by-bond selection process.

**CREDIT SPREADS VS. AAA-RATED INDEX**




Source: Bloomberg, ICE Data, Bank of America (YTW of AAA, AA, A, BBB-Rated ICE BofA Indices).

APA

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Since its founding, Asset Preservation Advisors is committed to delivering a high level of service, quality and wealth preservation. APA believes our growth in assets under management can be attributed to a consistent investment process and corresponding trading discipline.

We value highly the trust our clients have shown in APA and remain committed to adhering to a high level of ethical, moral and business standards first envisioned at our founding in 1989. Asset Preservation Advisors (APA) is a registered investment advisor founded and specializes in managing high quality, tax-exempt and taxable municipal bond portfolios for other registered investment advisors, family wealth offices and institutional clients.

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