Municipal Bonds

August 2024

Ignore the election and focus on rate trajectory

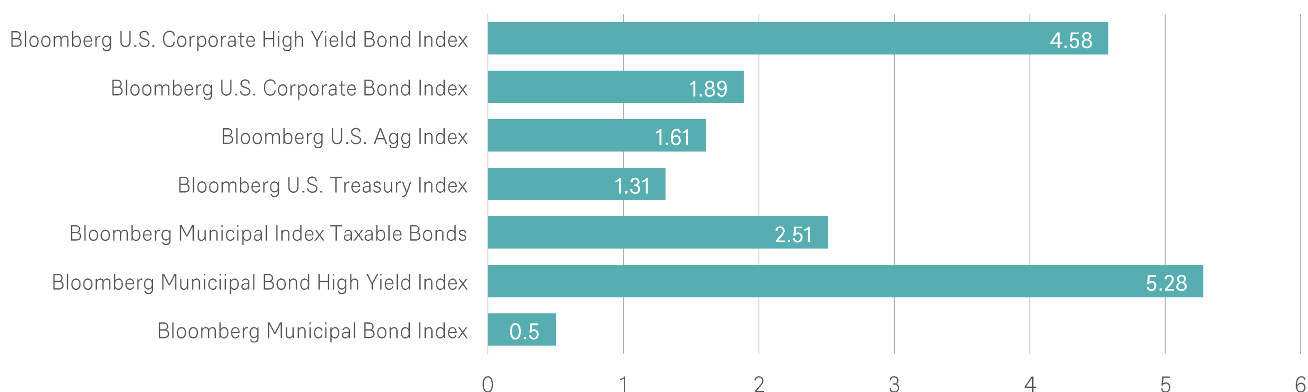
As we head down the homestretch of 2024, this is a good opportunity to recap performance so far, assess current market conditions and position for what may be around the corner.

- High yield municipal performance has been stellar and outperformed the barely break-even performance of the investment-grade part of the market.
- Credit spreads are tight, but if you pay taxes, absolute yields in tax-exempt bonds can be hard to ignore.
- The U.S. Federal Reserve (the Fed) appears on the verge of cutting, so longer duration and curve positioning is likely to become important.
- We think the municipal bond market is unlikely to be harmed in even the most extreme election outcomes.

Strong returns for High Yield

While the Bloomberg Municipal Bond Index through the end of July has only been slightly better than break-even, the Bloomberg Municipal Bond High Yield Index, on the other hand, has been one of the best performing sectors in the entire fixed income market, up more than 5.25% YTD through July 31. The high yield portion of the market benefited from stable credit fundamentals, a return of mutual fund flows and limited new issue supply. After two years of mutual fund outflows, mutual funds have now seen $14 billion of inflows, 60% of which has gone into high yield funds. Total municipal issuance is up over 2023 and 5-year averages, but high yield municipal supply has been limited. This supply/demand imbalance helps explain the significant spread tightening seen across all rating categories.

Year-to-Date Performance Total Returns thru July 31, 2024 Total Return (%)



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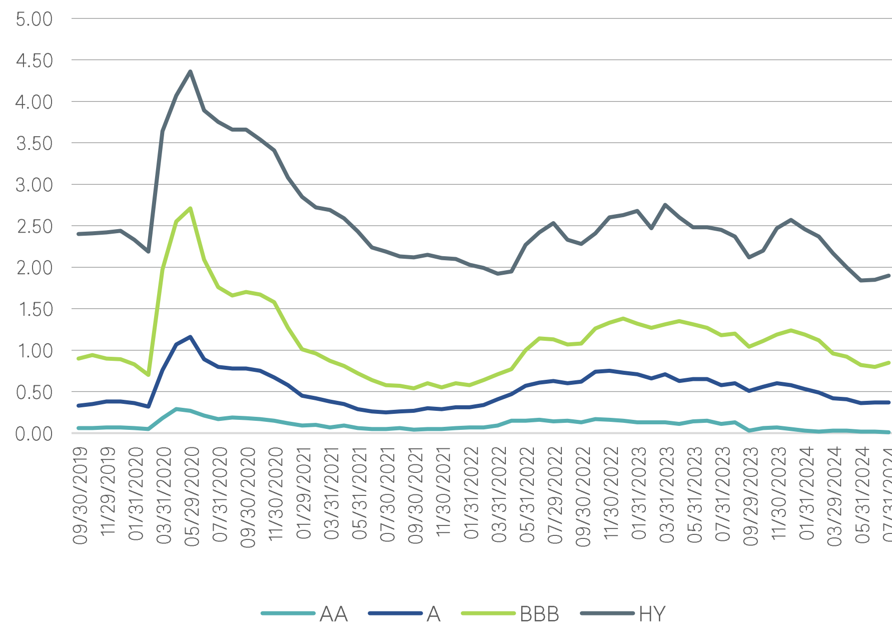
Tight credit spreads

Credit spreads for the high yield municipal market (as measured by the Bloomberg Municipal High Yield Index yield-to-worst versus the AAA component of the Bloomberg Municipal Bond Index) reached a five-year low in May 2024 and remain near those levels currently. DWS analysis points to credit conditions being stable and if fund flows continue to be positive--even increase in magnitude if we get rate cuts from the Federal Reserve--spreads may remain tighter than normal for an extended period. While spreads remain tight, absolute yields remain attractive. As of July 31, 2024, the yield-to-worst of the Bloomberg Municipal Bond Index was 3.58% and 5.34% for the Bloomberg High Yield Municipal Bond Index. For an investor in the highest tax bracket, the taxable yields necessary to match those tax-exempt levels would have to be 6.05% and 8.99%, respectively.

Muni spreads



	Current Spread	5-year Average	Yield-to-Worst
AAA	-	-	3.44
AA	1	10	3.45
A	37	53	3.81
BBB	85	112	4.28
HY	190	256	5.34

Source: Bloomberg Municipal Bond Index and Bloomberg High Yield Municipal Bond Index, July 2024

Positioning to consider: Lengthen duration as Fed shifts to cutting rates

The market is pricing in multiple cuts to the Federal Funds rate, so the shift toward longer duration fixed income could start gaining more favor. As we have observed over the summer, market sentiment can change quickly and result in almost immediate yield declines. Above average yields in July and early August may no longer be available once the Federal Reserve starts lowering the Federal Funds rate. The last few years have also taught us that even though lower rates are more likely than higher rates with inflation and the economy slowing, the road to lower rates will probably be bumpy. Given this outlook, some investors may have the risk tolerance to extend all the way out the yield curve. Another approach could be to focus on an intermediate strategy that locks in higher yields for longer than cash. An intermediate strategy that has weightings to bonds inside of 5 years may also see price gains as short rates fall faster than longer maturity rates. The lower interest rate risk of an intermediate strategy has the potential to lock in above average yields, realize upside as the Federal Reserve starts to lower the Federal Funds Rate, and possibly produce lower volatility as markets gyrate in coming months.

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Decision 2024

Elections have the potential to disrupt the municipal market given the government spending connection to credit quality and sensitivity to tax policy changes. This year is especially key as various tax measures implemented in 2017 expire in 2025. If no action is taken, which is quite possible under a divided government scenario, things like sunsetting of tax cuts and the higher income exemption for the Alternative Minimum Tax (AMT) would increase taxes and therefore make the tax-exempt nature of municipal bonds appear much more attractive. Even in scenarios where either party takes control of the White House and Congress and can implement all their policy views, which may be unlikely since majorities will be slim and divisions look to exist within both parties, the municipal market impact on balance should be neutral to slightly positive. The below table highlights what our Municipal Bond Management Research team believes could be policy changes assuming one party controls the executive and legislative branches and the potential market reaction:

Under a Republican sweep...

Further corporate tax cuts could make tax exempt bonds less attractive, but many of those corporate buyers appear to have already pulled back from the market with the tax cuts implemented in 2017, so further cuts should not change the current dynamic. Personal income tax cut extensions would similarly likely not change the status quo, while the extension of the AMT income exemption could be positive for that segment of the market. Various proposals around trade, healthcare, energy, and education have the potential to negatively affect certain sectors of the market, but nothing is so dramatic to cause any systemic weakening of credit quality.

Under a Democrat sweep...

If Democrats were to take control of executive and legislative branches, the balance of outcomes would lean more positive for the municipal market. Corporate and personal tax rates could increase, creating more demand for municipal bonds. With fewer threats to healthcare and education spending, credit quality may see limited to no impact, at least from potential federal policy actions.

Limited market impact no matter who wins

Policy area	**Republican sweep**	**Market reaction**	**Democratic sweep**	**Market reaction**
Corporate tax rates	Lower	Neutral	Higher	Positive
Indivdual tax rates	Tax cuts from 2017 extended	Neutral	Higher	Positive
Capital gains	No change	Neutral	Increase	Positive
Alternative minimum tax	Extension of AMT income exemption	Positive	More taxpayers subject to AMT	Positive
SALT	Maintain cap	Neutral	Restore full deduction	Negative
Education	Cut traditional spending/Boost school choice	Neutral	No material change	Neutral
Healthcare	Challenges to ACA	Negative	No material change	Neutral
Energy	Shift away from renewable transition	Neutral	No material change	Neutral
Trade	Tariff could increase costs that feed in to many market issuers	Neutral	No material change	Neutral

Source: Assessment of DWS Municipal Bond Research Team, July 2024

Bottom Line

Municipal market performance among lower quality bonds has been especially strong so far in 2024 and leads all fixed income sectors. This was mostly due to strong demand and less new debt issuance and has resulted in tighter than average credit spreads. However, credit quality remains stable so spreads may remain tight and absolute yields remain attractive. Slowing inflation and weakening economic conditions will likely lead to lower rates in coming months. Therefore, moving out of cash and into longer bonds to lock in yields and capture future price gains seems logical at this point. Furthermore, intermediate strategies could provide price upside as short rates decline and lock in above average yields for longer with less volatility. While it will be exciting to follow, the upcoming election is unlikely to have material negative implications for the municipal bond market.

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Contributors

Matthew Caggiano
Co-head of Municipal Bond Management

James Dearborn
Head of Municipal Bond Research

Chad Farrington
Co-head of Municipal Bond Management

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