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Quarterly Bond Market Overview

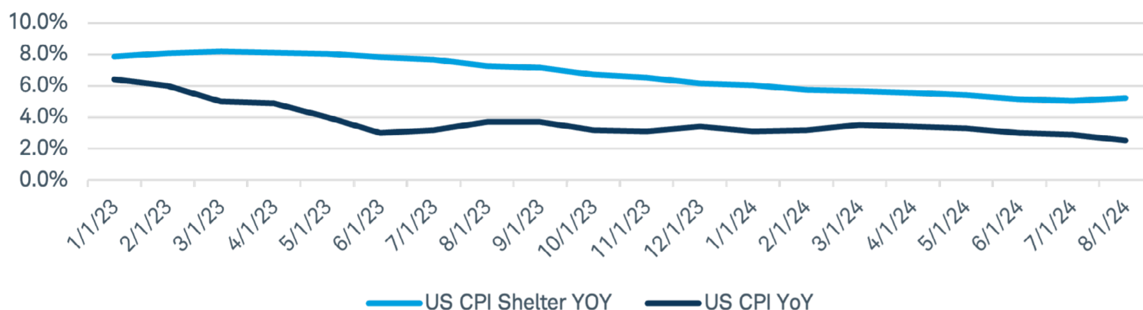
September 30, 2024

Finally

Tom Richmond, Co-Head of Taxable SMA Strategies, Senior Portfolio Manager

As we guessed (hoped) in our update last quarter, the third quarter finally delivered some action on several fronts worthy of discussion and analysis. The U.S. economy continued to perform reasonably well, as third quarter Gross Domestic Product growth is currently estimated to come in, yet again, solidly above 2% in real (inflation adjusted) terms. Inflation continued to generally behave, and would essentially be back to the Federal Reserve Open Market Committee's (FOMC's) stated target of around 2% were it not for stubbornly elevated housing costs (see chart below). The macroeconomic piece that was a bit concerning was the employment picture in the U.S.; monthly job creation numbers stagnated, and the prior year's data was revised sharply downward, even though the rate of unemployment remained historically low and first-time claims for jobless benefits were rangebound. Data early in the quarter was such that the FOMC declined to cut rates in late July before seeing more inflation and employment data. See it they did.

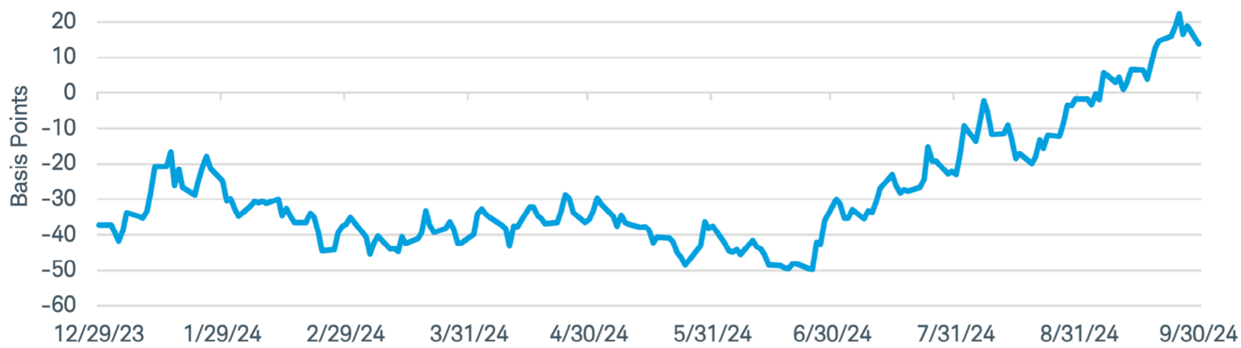
Elevated Housing Costs



Source: Bloomberg 9/30/2024

Only two days after that decision was made the August employment report reflected a slowdown; the unemployment rate rose to a two-year high of 4.3% and the change in payrolls missed estimates badly. At that point the bond markets decided that the Fed should have eased, and yields dropped markedly, especially in the short end of the U.S. Treasury curve where the FOMC exerts the most control through their policy rate. This move down, as you will read in the coming sections, continued throughout August and into September, fueled by FOMC Chair Jay Powell's pronouncement at the Jackson Hole Symposium that 'the time has come' for rate cuts. Another weak employment report in early September also contributed, along with data showing that inflation continued to slowly ease – both just before and just after the employment report. In this case, the market guessed correctly: at their meeting concluding on September 18, the Federal Reserve (Fed) did reduce their target for the Federal Funds rate, not by the 25 basis points that the markets had priced in for most of the quarter, but by a more aggressive 50 bps. In his press conference following the meeting, the Chair made it clear that this bigger move was not in response to a more deeply struggling economy but rather because they had missed the chance to cut at their prior meeting by those two days.

2-10 Year Bond Yield Spread



Source: Bloomberg 9/30/2024

It seems that the fourth quarter should be interesting here in our world as well. At that same FOMC meeting, the Summary of Economic Predictions (SEP) showed that the median estimate of its members was for two further 25 basis point reductions at their next two meetings – although the market still thinks they may end up cutting a bit more aggressively. Longer rates did rise late in the quarter as the economy continued to perform well and on the view that a less aggressive FOMC could lead to renewed inflation. This view has only gained more traction early in October, as both the increasing tensions in the Middle East and the recently initiated Dockworkers' strike on the East and Gulf coasts are thought to be inflationary impulses. That said, as you will read below, interest rates are significantly lower than they were last quarter, and risk assets remain well supported despite the cross currents. Given this backdrop and the looming elections in early November, our best guess is that volatility may be the star of the show in the coming months, and that active managers like us should look for interesting opportunities along the way.

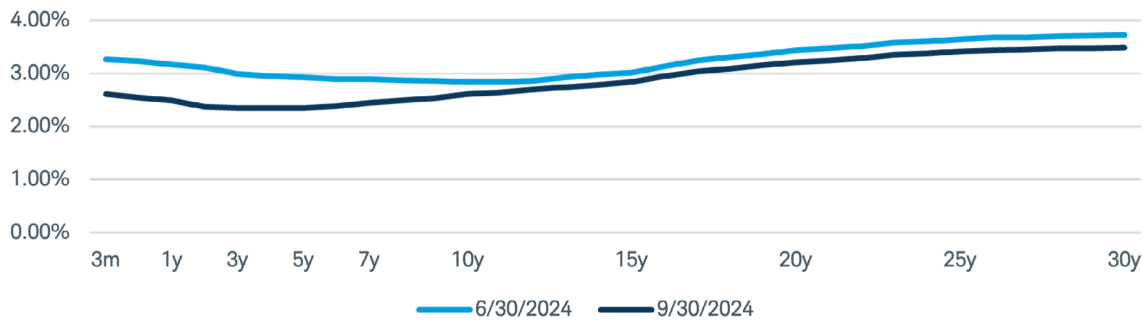
Tax-Exempt Market

Jason Diefenthaler, Managing Director and Head of Tax-Exempt Strategies

The municipal bond market exhibited solid performance throughout the 3rd quarter of 2024 as lower Treasury yields and strong investor demand propelled the Bloomberg Municipal Bond Index to a 2.71% total return. The rally in Treasuries was fueled by long simmering expectations for Federal Reserve rate cuts, which finally materialized with a 50 basis point (bps) cut in September. This drove 1- to-3-year Treasury yields lower by as much as 110 bps, with yields on 10- and 30-year Treasuries lower by 40-60 bps. Tax exempt yields saw similar but less dramatic moves, falling by as much as 75 bps on short maturity bonds, with longer bonds seeing yield declines of 20-25 bps. Due to these dynamics, the municipal bond market underperformed relative to taxable bonds. The Bloomberg 10-Year Municipal Bond Index recorded a return of 2.64% for the quarter compared with a total return of 5.80% for the Bloomberg 10-Year U.S. Treasury Index.

There were notable developments in the slope of the tax-exempt yield curve during the quarter. The curve had been inverted, with 2-year bonds yielding more than 10-year bonds (2s10s) since February 2023, and entered the quarter at a spread of -28 bps. Thanks to the bull steepening move in the municipal bond market during the quarter, with short-term yields falling more than longer-term yields, that inversion was wiped out with 2s10s ending September at +24 bps. This helped return the shape of the yield curve to a more historically normal pattern and provides investors with an opportunity to look at total return options through analysis of yield curve roll down, while lessening the attractiveness of barbell structures. For longer duration strategies, the spread between 10-year and 30-year maturities decreased slightly during the quarter to +92 bps. We still see longer maturities presenting attractive opportunities for investors willing to accept higher volatility for additional yield, particularly when compared to the much flatter +35 bps slope in the Treasury curve from 10-years to 30-years.

Bloomberg AAA Tax Exempt Yield Curve

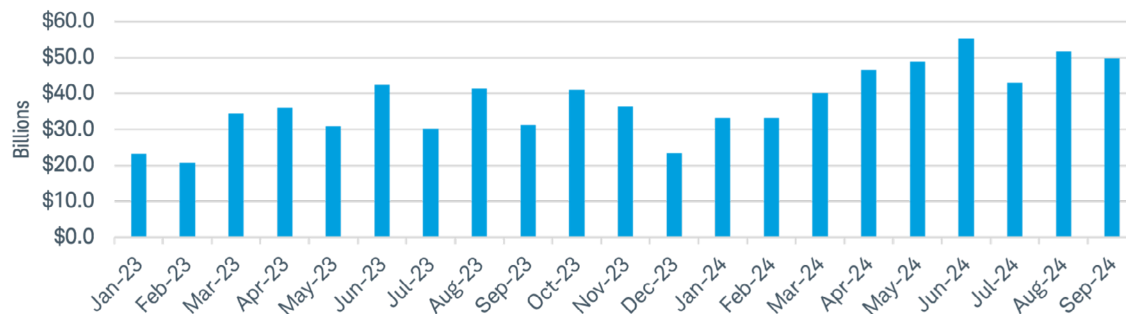


Source: Bloomberg 9/30/2024

Single-A and BBB rated investment grade municipal bonds generally performed in-line with AAA rated municipals during the quarter. This can primarily be attributed to the significant rally in lower rated bonds (via tighter credit spreads) over the course of the prior 12 months. While there remain pockets of credit value in the market, we favor a more neutral approach at this stage of the economic cycle with our primary active positioning being maintained in single-A general obligation and essential service revenue issuers – as opposed to BBB or below investment grade bonds. That said, fundamentally, the municipal bond market remains on a strong footing, with credit metrics across state and local governments and most revenue sectors exhibiting continued stability.

The most impactful theme for municipal bond investors during the quarter remained the heavy volume of new deals that were brought to market. Approximately $145 billion in new deals were priced during the third quarter compared with $103 billion during the same period last year. September was a record seventh consecutive month where supply totaled more than +$40 billion, leaving 2024 ($402 billion YTD) within reach of the annual issuance record of $485 billion set in 2020. Normally, absorbing this elevated supply would correlate with some degree of market softness, yet that hasn't been the case during this issuance uptick. This is largely due to a combination of low interest rate volatility and elevated investor demand, with LSEG Lipper data showing 13 consecutive weeks of net inflows (+$10 billion) to municipal bond funds to end September.

New Municipal Deals



Source: Bloomberg 9/30/2024

We believe the municipal bond market will likely be wrestling with multiple thematic inputs over the coming months. Issuance in October is expected to remain elevated as borrowers look to get in front of any post-election volatility that might arise; for context, the market's single month issuance record of $82 billion was set in the month before the last election (October 2020). Longer-term federal budget and tax policy positioning should remain a focal point for the market; topics including marginal tax rates, caps on state and local tax deductions (SALT) and even the broader market tax exemption will be in focus. Expectations for the path and pace of future Federal Reserve rate cuts seem to gyrate from one week to the next depending on data and media commentary from various Fed officials. And while credit quality remains

stable across most sectors of the market, the trend of tightening risk premiums has seemingly stalled out in recent months, implying more performance parity for investors irrespective of their portfolio's quality posture. This suggests that active positioning should remain somewhat dialed back, with duration and curve targets running more neutral, while also maintaining a more defensive coupon structure with a continued overweight to single A rated essential service revenue and general obligation credits.

Taxable Market

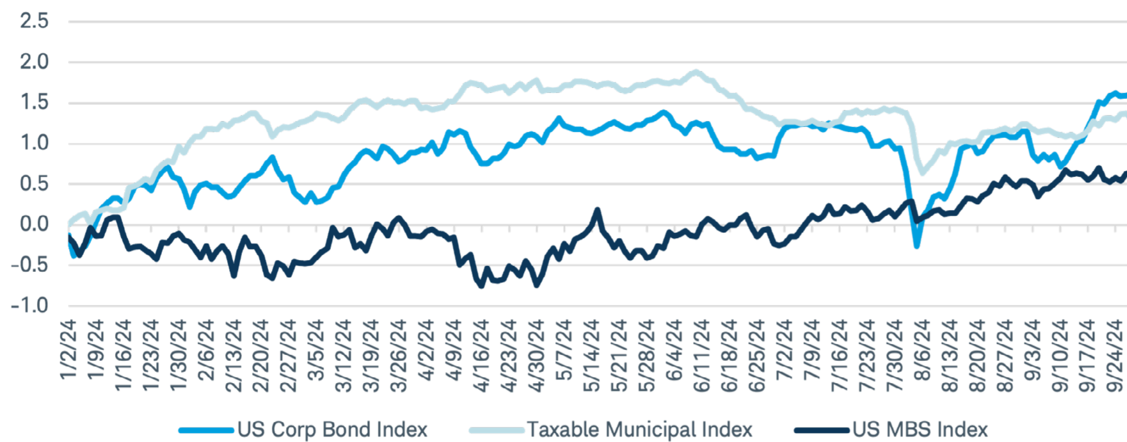
Brian Ferry, Senior Portfolio Manager

The investment grade corporate bond market regained its momentum in the third quarter. Issuance for the third quarter came in at $460 billion, which brought the first three quarters of the year to $1,380 billion. Investment grade corporate issuance in the third quarter increased 52% from the previous period in 2023. This was the biggest September issuance on record with $190 billion across 141 issuers. The Bloomberg US Corporate Bond Index outperformed like duration Treasury bonds by 77 bps in the third quarter. The option-adjusted spread (OAS) of the index was able to withstand the intra-quarter widening to finish the quarter 5 bps tighter at 88 bps, or just 4 bps above the tightest levels of 2024. The corporate bond market ended the quarter on very firm footing after bouts of volatility throughout the quarter.

Unlike their corporate peers, the taxable municipal market did not bounce back after a disappointing second quarter. However, the municipal market did stop the bleeding and finished in a more stable environment. The Bloomberg Taxable Municipal Index underperformed like duration Treasury bonds by just 4 bps last quarter. The OAS of the index increased 3 bps to finish at 85 bps, and still below the 92 bps where it started the year. Issuance continued to be above expectations with $9.3 billion worth of deals coming to market in the quarter across 146 issuers. This was an increase of 26% above last year's pace. In total for the year, issuers have priced just under $31 billion worth of new deals.

The Agency MBS market was the best performing sector in the third quarter. The Bloomberg US MBS Index outperformed like duration Treasury securities by 78 bps in the third quarter– its first quarter of outperformance in 2024. The powerful performance in the quarter was able to push the index into positive excess return territory of 52 basis points for the year. A more stable rate environment and gradual decline in interest rate volatility was the primary driver of outperformance for the Agency MBS market.

YTD Excess Return Over Treasuries



Source: Bloomberg 9/30/2024

In short, the third quarter can be summarized as an improved, more stable environment for spread sectors from the previous quarter. After a tough, and disappointing end to the second quarter most spread sectors were able to recover throughout the summer months. Further clarity on the path of the federal funds rate from the Fed late in the quarter along with a stable employment backdrop and upside surprise in growth made a constructive backdrop for spread sectors (corporate, taxable municipal, and Agency MBS).

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