

Weekly Market Commentary

Finding Value Among the Muni Market Malaise

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Client Summary

Positive Factors

- **Attractive Yields:** Current yields for municipal bonds are above their longer-term averages and are competitive compared to taxable alternatives, making them an attractive investment.
- **Low Default Rates:** The 10-year cumulative default rate for investment-grade municipal bonds is very low, barely above zero, which is significantly better than the over 2% default rate for similarly rated corporate bonds.
- **Historical Trends:** After periods of underperformance as seen recently, municipal bonds have historically rebounded, with an average excess return of 150 basis points over the following three months.
- **Strong Fundamentals:** Municipal bonds continue to benefit from strong revenue growth and stable property tax collections, supporting their attractive risk-adjusted value proposition.
- **Increased Crossover Interest:** The potential for increased interest from non-traditional buyers, such as banks and insurance companies, could help support prices and enhance demand.

Concerning Factors

- **Market Volatility:** The municipal bond market experienced significant volatility in April, driven by rising inflation expectations, the Federal Reserve's cautious policy stance, and other Treasury market factors.
- **Sharp Yield Fluctuations:** High-grade municipal yields fluctuated sharply in April, with AAA benchmark yields moving through an 85-basis point range in long-end tenors, leading to increased uncertainty.
- **Tax Policy Uncertainty:** Potential tax policy changes, including the possibility of altering the tax-exempt status of municipal bonds, could impact the market.
- **Supply Outpacing Demand:** Year-to-date issuance has exceeded 2024's record pace by 18%, which could continue to pressure muni prices in the near term if demand continues to lag supply.
- **Softening Demand:** Municipal mutual funds have recorded net outflows recently, indicating a softening in demand that could further affect market dynamics.

LPL Research's Perspective

- **Significant Volatility:** The Research team acknowledges the significant volatility in the municipal bond market in April, primarily driven by spillovers from the turbulent Treasury market.
- **Value in the Market:** Despite the volatility, the team believes that value has returned to the municipal bond market, with yields above longer-term averages and attractive relative to many taxable alternatives.
- **Focus on Quality:** The team recommends focusing on quality, prioritizing AA and A-rated issuers with stable revenue streams and strong reserves.
- **Dollar-Cost Averaging:** Implementing dollar-cost averaging over the next 2-3 months is advised to take advantage of potential near-term volatility.
- **Professional Management:** Leveraging professional management via high-quality mutual funds or separately managed accounts is valuable in navigating the complex municipal bond market environment.

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Disclosure

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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

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