Municipal Market Insights

Federated Hermes CW Henderson
A division of Federated Investment Counseling

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Municipal yields hit their highest levels of the year in early November, due in part to market uncertainty from massive supply and post-election posturing. In the end, technicals prevailed over volatility and yields fell, until rates sharply bounced mid-December after the hawkish FOMC meeting and heavy muni ETF selling. The 10-year AAA Municipal Market Data (MMD) yield began the quarter at 2.60% and finished at 3.06%, after peaking at 3.13% on November 7. Issuers front-loaded borrowing before the election, which resulted in net positive supply in October and ratios that approached the highest levels of 2024. Ten-year Treasuries started the third quarter at 3.79% and finished at 4.58%, with the benchmark steadily rising in December.

Ten-year prime Municipal/Treasury ratios opened at 69% and finished at 67% , as the supply picture became more balanced as the quarter progressed. Two-year ratios began at 63% and finished at 66%.

The slope of both the Treasury and municipal yield curves changed only slightly during the quarter. Two-year municipal yields rose 52 basis points, and the 10-year yields rose by 46 basis points, while 2-year Treasuries rose 60 basis points, and 10-year yields rose 79 basis points.

The all-muni funds category saw inflows for 23 consecutive weeks, before outflows in December, mostly driven by ETF selling. LSEG Lipper reported total inflow of $15.3 billion for the quarter, consisting of open-end funds +$9.0 billion and ETF's +$6.3 billion.

Primary market issuance in the fourth quarter was $121 billion (8% taxable), bringing the year-to-date total to a record $508 billion, eclipsing the previous high of $485 billion in 2020. The front-loading of issuance prior to the November 5 presidential election brought a massive $65 billion of securities to market in October, the largest monthly amount since records began to be kept in 1986. Like the prior two quarters, large issuers maintained their presence with 13 deals greater than $1 billion. Secondary market selling rose to $1.18 billion daily, 26% higher than the previous quarter.

Federated Hermes CW Henderson had an active fourth quarter. The record issuance leading up to the election created a market imbalance that resulted in net positive supply and created the best buying opportunity of the year. Also, rising interest rates allowed for opportunities to generate alpha in client accounts through tax loss harvesting transactions. With the uptick in secondary market selling, consisting of many seasoned structures, we were able to access an above-average amount of short callable paper and augmented our barbell strategy with favorable yield pick-up over non-callable, bullet securities. Duration targets remained unchanged from the third quarter in the 4.00 to 4.20 range.

At the adjournment of its December 18 meeting, the Federal Reserve lowered interest rates by 25 basis points to the 4.25-4.50% range, marking 100 basis points in easing since the September meeting. The forecast for next year is more hawkish than expected, with the median estimate of Fed officials now projecting two cuts instead of four in 2025. Projections for 2025 now show a 3.90% median for the fed funds rate (up from 3.40% in the previous estimate in November), 3.40% for 2026 (up from 2.90%) and 3.10% for 2027 (up from 2.90%). The unemployment rate for 2025 is now estimated at 4.30% (down from 4.40%), 4.30% in 2026 (unchanged) and 4.30% in 2027 (up from 4.20%). Policymakers now expect the median core PCE Index to be 2.50% in 2025 (up from 2.20%), 2.20% in 2026 (up from 2.00%) and 2.00% in 2027 (unchanged). Median projections for gross domestic product are now 2.10% in 2025 (up from 2.00%), 2.00% in 2026 (unchanged) and 1.90% in 2027 (down from 2.00%). The central bank will continue to let its monthly holdings of Treasury securities fall by up to $25 billion and mortgage-backed securities decline by $35 billion, the same amounts as its prior month's statement.

Looking ahead, volatility may return after the reinvestment cycle starts to wane late in the first quarter of 2025. The overall supply picture is likely to remain elevated, with many analysts calling for a second consecutive year of new issuance exceeding $500 billion. According to projections collected by Bloomberg, most analysts expect issuance to range

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between $460 billion and $540 billion, with an outlier calling for $745 billion in 2025. Higher nominal yields, elevated supply and potential market volatility should create attractive entry points for new dollars throughout the year. But a disciplined approach is warranted, with close monitoring of the Fed, the new issue calendar and the new cycle of government policy. Demand for municipals should remain robust in 2025, given the strong credit profiles of upper echelon issuers and attractive risk-adjusted returns amid palatable debt levels.

Market Yields

	12/31/2024	9/30/2024	6/30/2024	3/31/2024
1 yr. AAA Muni	2.86	2.55	3.15	3.24
5 yr. AAA Muni	2.87	2.31	2.89	2.54
10 yr. AAA Muni	3.06	2.60	2.84	2.51
30 yr. AAA Muni	3.90	3.52	3.72	3.68
10 yr. U.S. Treasury	4.58	3.79	4.34	4.19
10 yr. Muni/UST Ratio	67%	69%	65%	60%

Sources: Bloomberg and The Bond Buyer

Key Market Points & Commentary

- Supply was $121 billion in the fourth quarter.
- The all-muni funds category net inflows totaled $15.3 billion.
- The municipal yield curve "bear flattened," with 2-year yields rising 52 basis points and 10-year yields rising 46 basis points.
- As always, Federated Hermes CW Henderson's focus remains on high-quality, liquid and thoroughly researched credits with good management teams. Credits owned are monitored on a regular basis.
- Intermediate product portfolio durations are targeted at 4.00 - 4.20 years.
- Ultra Short product portfolio durations are targeted at about 0.65 years.

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Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

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