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Goldman Sachs and abrdn Optimistic on Muni Bonds in 2024.

This year proved a difficult one for bonds as the Federal Reserve aggressively hiked rates for much of the year. With the rate narrative changing moving into 2024, investors moved back into bonds in a big way beginning in October, including municipal bonds. Alexa Gordon of Goldman Sachs and Jonathan Mondillo of abrdn discussed the performance of muni bonds this year as well as opportunities heading into 2024 at VettaFi's 2024 Market Outlook Symposium.

Attendees were asked if they believed municipal bonds are attractive compared to U.S. Treasuries. Of the advisors participating in the survey, 78% reported they believe municipal bonds are attractive in comparison.

It's an insight that reflected the majority of this year's muni performance according to Alexa Gordon, PM and head of muni ESG at Goldman Sachs. In an environment of rising interest rates, munis offered outperformance compared to U.S. Treasuries. There are still tailwinds for munis heading into the new year, particularly given low supply and high nominal rates.

"I think there's a real potential for munis to continue to get more attractive as we head into 2024," Gordon explained.

Both Gordon and Jonathan Mondillo, head of U.S. fixed income at abrdn, agree that municipal bond attractiveness depends greatly on the time frame. Currently, Mondillo sees less opportunity in high-grade municipal bonds compared to U.S. Treasuries.

"When we dip down into… single A-rated municipals, BBB-rated municipals, and you look at it on a spread basis after tax, we think things look extremely attractive," said Mondillo.

Muni Bonds Prove Resilient in a Difficult Rate Environment

This year proved challenging for bonds in the face of continued and aggressive Fed rate hikes. In the last 30 years, municipal bonds have only generated a negative annual return four times. Munis looked on track to end negatively for the year until October when the inflation and rate narrative changed. Since then, munis have bounced back and look to continue the uptrend heading into 2024.

The outlook for rates appears more favorable looking ahead to 2024. In an environment of interest rate stability, bonds benefit as flows return. "Munis benefit from this even more, given the retail client base," Gordon explained.

Despite aggressive rate hikes and resultant impacts on performance for the majority of the year, the recovery and performance of muni bonds exemplify the value of the asset class. "The fact that we can still end the year with positive returns — it speaks to not only the to the resiliency of the asset class more broadly, seeing the increasing demand, but also the importance of carry," Gordon explained.

“The short to intermediate range is where we see most of those clients in the retail space playing

Retail investors are primarily concentrated in short to intermediate muni bonds for now. It makes sense, given that yields in municipal bonds between 1-10 years are currently around 3%. That’s 70 basis points above the 20-year average of the related index according to Gordon.

Municipal Bonds: “This is a Great Time to Put Money to Work”

What’s more, muni credit proved resilient this year. Given the strong credit fundamentals, Gordon believes “this is a great time to put money to work” to capture potential highs in muni bonds, even as they retreat from October peaks.

Challenges do exist next year, with many major cities forecasting budget deficits in 2024. However, municipal bonds are well fortified to ride out any economic slowing according to Mondillo. Munis currently carry high rainy day balances and “heavy reserve fund balances”.

In the face of economic slowdown, “municipalities will actually be able to weather that storm quite well,” Mondillo explained. “The asset class overall should insulate investors.”

Looking to the second half of 2024, the potential for rate cuts could prove a tailwind for munis. Investors sought refuge in money market funds and short-duration Treasuries while interest rates soared. Now with markets pricing in rate cuts beginning next year, yields continue to fall and bond prices rise. Increasingly more investors are moving money back into long-duration core bonds, including munis.

The rate path may deviate from current market expectations around Fed rates. That 2024 is also an election year will bring its own volatility to markets.

“There’s a lot of timing questions that are still to be seen,” Gordon explained. It makes predicting the medium-term difficult. For now, Goldman Sachs believes that munis will continue their trend of positive returns moving into 2024. The Goldman Sachs Community Municipal Bond ETF (GMUN) is passive and seeks to generate tax-efficient income. The strategy focuses on higher credit quality within investment grade munis with maturities between 1-15 years.

The abrdn National Municipal Income Fund (VFL) is a closed-end fund. It offers a longer duration strategy within munis and is offering distributions close to 4% tax-exempt.

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