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2024 Mid-Year Update: Are Municipal Bonds on the Road to Recovery?

Muni bonds underperformed in the first half of 2024 due to robust economic conditions and increased supply, but strong credit fundamentals and potential rate cuts could improve performance later.

Through the first half of this year, municipal bonds fell short of projected performance expectations. The essential elements of a reliable source of income due to strong credit quality and benefits of interest income exempt from taxes remain foundational. Yet, the anticipated strong performance of the asset class so far has not materialized. So, we ask if our outlook has changed for the remainder of the year to provide some context for our outlook for the second half of 2024.

Expectations for the Second Half of 2024

The risks we discussed in our Muni Trends to Watch in 2024 focused on the U.S. economic environment, individual state laws and the municipal sector's challenges. Appropriately, we felt that our domestic economy would fairly quickly feel the bite of higher rates and efforts of the Federal Reserve ("Fed") to tighten monetary policy to temper inflation. History tells us not to ignore the risks of recession. The market's consensus in the direction of Fed rate cuts in early 2024 would have put municipals on a path to strong positive performance results because muni rates would have dropped. As we now see, that call was premature. Robust economic performance and lingering inflation have pushed out the likelihood of rate cuts to the third or fourth quarters as is the timing for better muni market performance.

Supply of new-issue bonds is the other primary area of change. The increase in newly issued bonds originates from a significant increase in the re-financing of older, outstanding debt.* Since this component is now expected to add $30-50 billion to year-end totals, the immediate effect has been to keep rates high and within zones of comparative attractiveness. It would not be surprising to see additional supply later this year, primarily in re-financing, should the Fed cut rates and spur a potential muni rally. Increased supply would provide a greater variety of available bonds in the market and a moderate move to lower rates—a classic example of cause and effect.

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