PNC Fixed Income

Municipal Market Quarterly Review

Second Quarter 2024

Municipal Market Review

The S&P Main Municipal Index (Municipal Index) returned 0.26% in the second quarter, bringing its year-to-date return to 0.17% (Figure 1). Pricing pressure from the rise in municipal yields was more than offset by income, resulting in a positive return for the quarter.

Municipal yields increased for maturities of two years and beyond. Short and intermediate yields rose more than long-term yields, leading to a flatter municipal yield curve as measured by the spread between 2- and 30-year rates. Conversely, the U.S. Treasury (UST) curve steepened as long-term yields increased more than short-term yields (Figure 2, page 2). The shift in municipal term structure indicated a decreased risk premium for interest rates (Figure 3, page 2). Longer-dated bonds underperformed shorter-dated bonds despite yields rising at a slower pace due to higher interest rate sensitivity, or duration.

Figure 1. Fixed Income Returns and Statistics
As of 6/30/2024

S&P Municipal Bond Indices	**Q2 2024 Return**	**YTD Return**	**Yield to Worst**	**Duration**
Main	0.26%	0.17%	3.81%	5.7
Intermediate	-0.38%	-0.62%	3.56%	4.7
Short-Intermediate	0.02%	-0.12%	3.46%	3.0
Short	0.58%	0.63%	3.47%	1.7
General Obligation	-0.33%	-0.45%	3.59%	5.4
Revenue	0.44%	0.56%	4.00%	6.2
Taxable	0.16%	0.38%	5.19%	7.9
Bloomberg Indices				
U.S. Treasury	0.09%	0.86%	4.57%	5.9
U.S. Aggregate	0.07%	0.71%	5.00%	6.1
U.S. Corporate	-0.09%	0.49%	5.48%	6.8

Sources: S&P Dow Jones Indices LLC, Bloomberg L.P., PNC

KEY THEMES

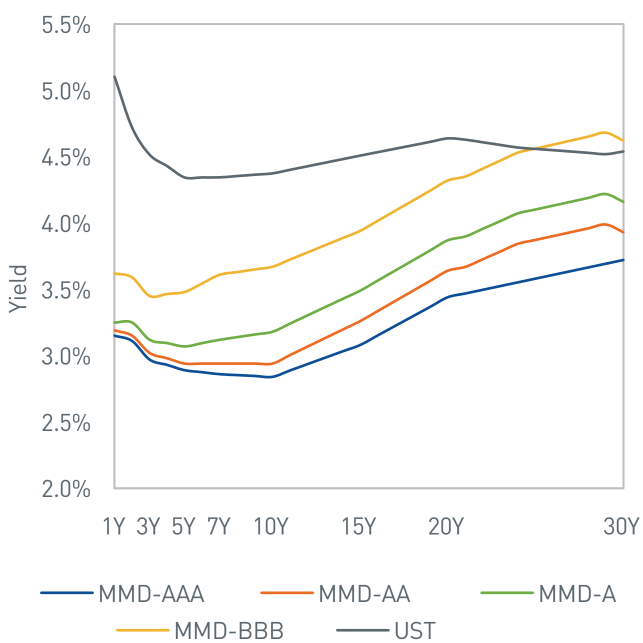
- The Municipal Index returned 0.26% in the second quarter.
- Municipal yields increased across most maturities, with short and intermediate yields rising faster than long-term yields, resulting in a flatter yield curve.
- Municipal valuations cheapened versus USTs on a maturity-matched basis, reflected in higher Municipal-to-Treasury (MT) ratios.
- From a fundamental perspective, municipalities remain well positioned given the increase in reserves over the past four years.
- Municipal yields offer a compelling option for tax-sensitive investors.

Figure 2. Quarter-over-Quarter Yield Curve Change (bps) (3/31/2024 – 6/30/2024)

Maturity	AAA	AA	A	BBB	UST
1 Year	-9	-6	-6	-8	9
2 Year	14	17	17	15	9
3 Year	20	23	23	21	10
5 Year	35	38	38	36	12
7 Year	37	40	40	38	13
10 Year	33	36	36	33	17
15 Year	10	13	13	9	17
20 Year	8	11	11	6	18
30 Year	4	7	7	2	19

Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

Figure 3. Municipal Market and UST Yield Curves As of 6/30/2024



Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

Relative to taxable fixed income sectors, the Municipal Index outperformed the Bloomberg U.S. Treasury Index by 17 basis points (bps) in the second quarter, due in part to lower index-level duration amid rising interest rates. Municipals also outperformed the Bloomberg U.S. Aggregate and Bloomberg U.S. Corporate indices by 20 bps and 35 bps, respectively, also driven by differences in index-level duration. Among quality cohorts, A-rated and BBB-rated bonds outperformed as higher yields helped offset the impact of rising rates.

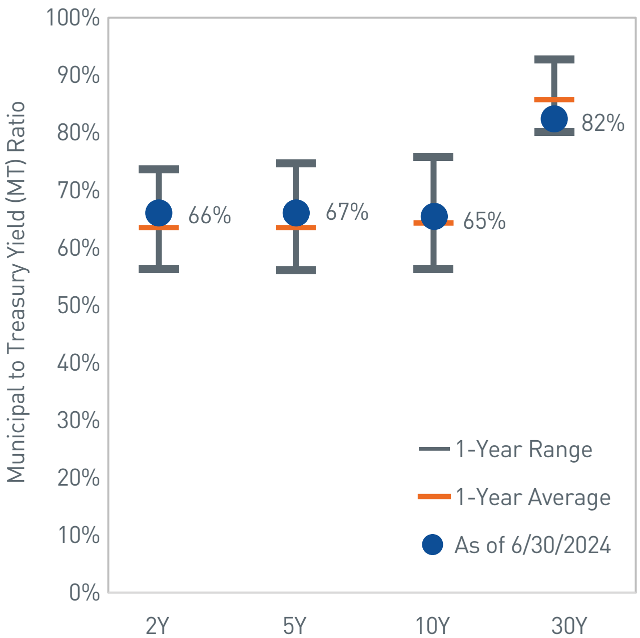
From a technical perspective, investor demand for municipals remained positive in the second quarter, with municipal mutual fund net inflows of $0.3 billion. This follows strong inflows of $10.3 billion in the first quarter of 2024. On the supply side, lower interest rates spurred a 30% increase in year-to-date municipal bond issuance compared to the same period in 2023. Only 7% of all municipal bonds issued in 2024 have been taxable compared to 12% during the same period in 2023.

Tax-Exempt Municipal Valuations

Rising municipal yields resulted in more attractive MT ratios for prospective tax-exempt investors. The shift in relative value was sharpest in the middle of the yield curve as 5- and 10-year MT ratios increased to 67% and 65%, respectively, while 2- and 30-year MT ratios remained relatively unchanged. The 2-, 5- and 10-year MT ratios are now above their respective 1-year averages, but the 30-year MT ratio remains below its 1-year average (Figure 4, page 3). The shift in yields makes tax-exempt municipal bonds more attractive on a tax-equivalent basis versus taxable alternatives. Assuming an estimated federal tax rate of 40.8% (37% maximum federal income tax level and 3.8% Medicare tax that may apply to some taxpayers), the tax-equivalent yield of a 10-year AAA-rated municipal bond now offers 110% of the 4.37% yield offered by the 10-year UST, up from 101% at the end of last quarter. For investors with an effective tax rate of 40.8%, tax-equivalent MT ratios are now above 100% across the yield curve. Comparatively, tax-equivalent MT ratios for investors with a tax rate of 30% are below 100% prior to 17 years to maturity (Figure 5, page 3).

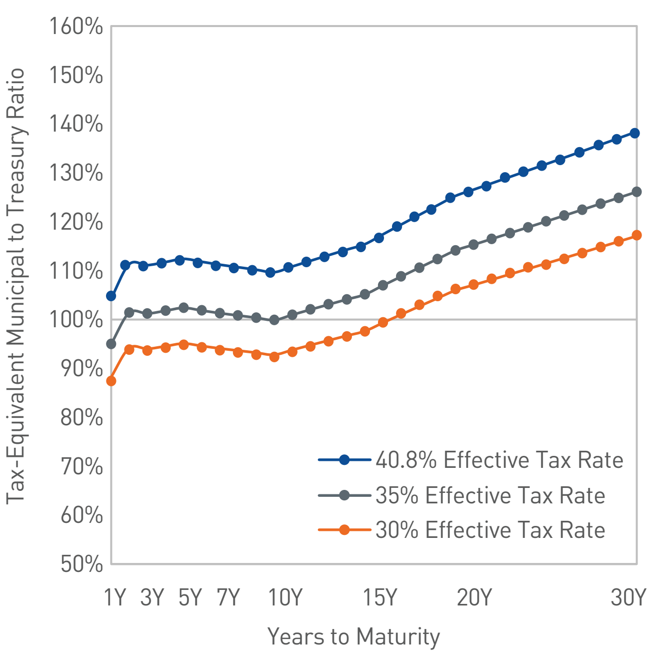
Indices are unmanaged, not available for direct investment, and not subject to management fees, transaction costs or other types of expenses that an account may incur.

Figure 4. Municipal-to-Treasury Yield Ratios
As of 6/30/2024



Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

Figure 5. Tax Equivalent MT Yield Ratios
As of 6/30/2024



Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

Taxable Municipals Underperform Tax-Exempt

he S&P Taxable Municipal Bond Index (Taxable Municipals) returned 0.16% in the second quarter, underperforming tax-exempt municipals by 10 bps. Taxable municipals outperformed the Bloomberg U.S. Corporate index by 25 bps, due to a higher degree of relative credit spread tightening. As a result, yields for A-rated taxable municipal bonds yields are now largely in line with A-rated corporates across the yield curve. We believe supply-side technicals remain supportive of valuations given the 23% decrease in taxable municipal issuance year over year.

Municipal Credit Review

In the second quarter of 2024, the municipal market attempted to keep pace with the credit spread tightening in the corporate market. BBB-rated credit performed the best, while A-rated bonds gave up some ground, reversing the prior quarter's trend. By the end of the first quarter, the rally in A-rated bonds offered space for BBB price improvement (Figure 6, page 4). Within the higher rungs of credit, the environment remained steady. In a relatively quiet quarter, notable credit events included significant underperformance among tobacco bonds, developments in the Puerto Rico Electric Power Authority (PREPA) court case and state budget proceedings.

Tobacco: Tobacco bonds underperformed in the second quarter as payments declined across most states due to a combination of lower shipments and softer inflation adjustments. States with some of the largest tobacco bonds, including New Jersey, California and Ohio saw payments decline by more than 11% compared to 2023.

PREPA: On Wednesday, June 12, the United States Court of Appeals for the First Circuit found that bonds issued by PREPA benefited from a secured claim on the entity's future revenues. This decision reversed a lower court ruling issued last year, which held that bondholders only had a secured claim on certain funds held by the utility and not on the utility's future revenues. The lower court's ruling challenged longstanding municipal market views regarding these types of revenues, but the appellate court ruling is significant in that it supports previously held market conventions. It is not yet known if the Financial Oversight and Management Board overseeing Puerto Rico's bankruptcy proceedings will appeal the most recent ruling.

State Budget Proceedings: Of the 46 states whose fiscal years ended on June 30, three ended the quarter without a budget for fiscal year 2025: South Carolina, Pennsylvania and Massachusetts. In fiscal year 2024, many states experienced revenue gains that slightly exceeded projections, which aided rainy day fund balances. During the quarter, Alaska received a rating upgrade, while Arkansas and Wyoming received an upgrade in their outlooks to Positive from Stable due to stronger reserves.

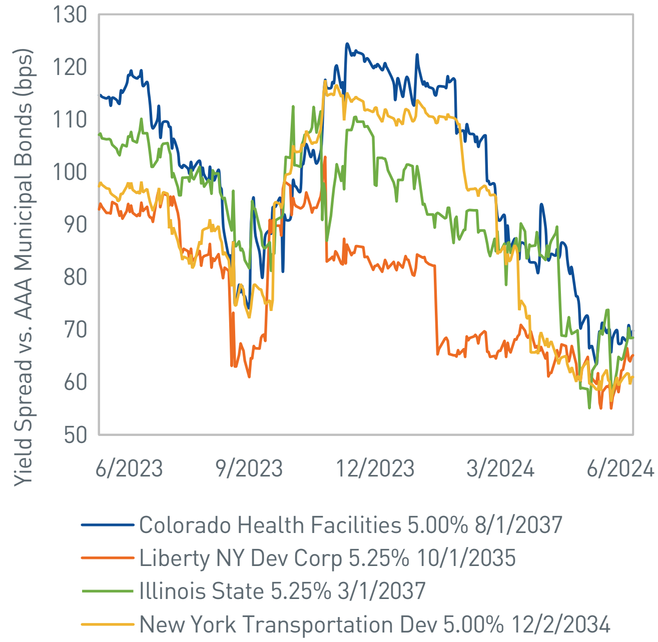
Looking Ahead

Stronger-than-expected economic data continues to lower expectations for Federal Reserve interest rate cuts in 2024. The PNC Economics team currently forecasts two rate cuts by the end of 2024, which would commence a new stage of the monetary policy cycle. We believe better-than-anticipated economic activity and looser financial conditions have increased the chances for the economy to achieve a soft landing following a historically aggressive rate-hike cycle.

Corporate credit spread widening throughout the month of June could place upward pressure on municipal spreads in the next quarter given relative valuation dynamics. From a fundamental perspective, municipalities remain well positioned given the increase in reserves over the past four years. July and August are expected to bring enhanced clarity around state budgets in a transitional year that will also see the expiration of most pandemic-related funding sources.

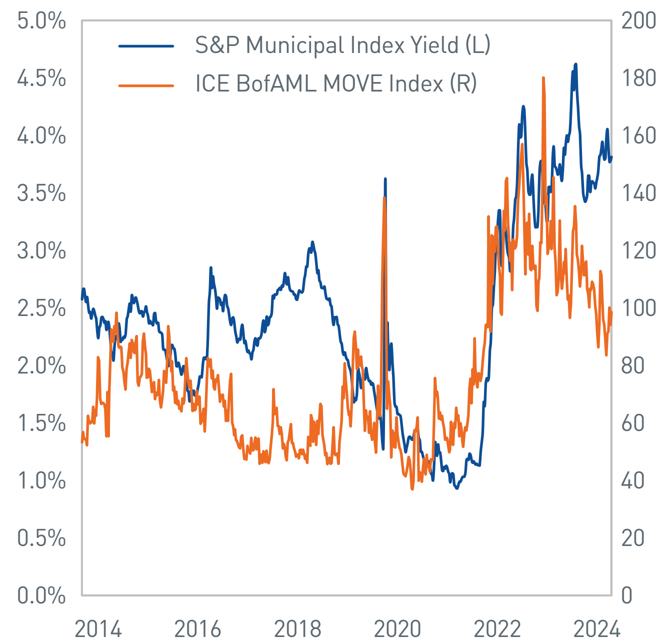
The increase in MT ratios has improved the value proposition of tax-exempt municipals versus USTs. While valuations relative to corporate bonds remain historically expensive, investors in the highest tax brackets can still find value in tax-equivalent municipal bond yields. The S&P Municipal Bond index yield remains in the 93rd percentile of weekly observations over the last 10 years (Figure 7). Given the rise in yields since 2021, long-term return expectations for the asset class remain much improved, in our view.

Figure 6. Select Tax-Exempt BBB-Rated Municipal Credit Spreads
As of 6/30/2024



Sources: Bloomberg L.P., PNC

Figure 7. S&P Municipal Bond Index Yield & Rate Volatility
As of 6/30/2024



Sources: Bloomberg L.P., PNC

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