THE BOND BUYER

May volume drops 29% as rates rose, Fed policy weighed

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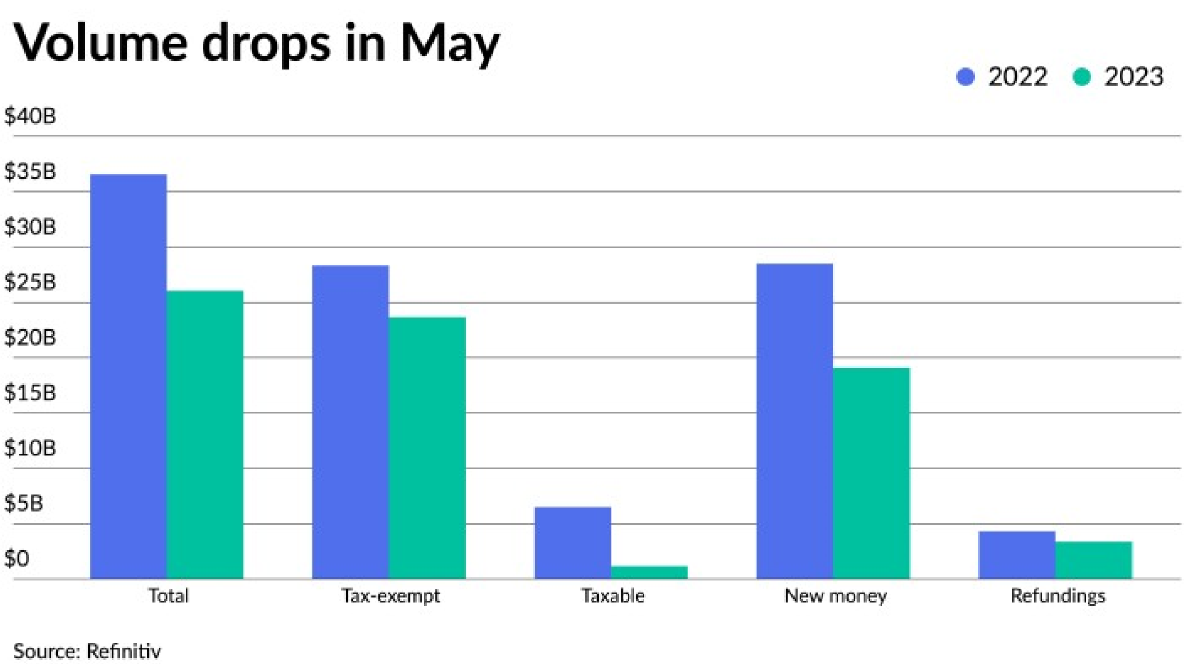
May municipal bond issuance dropped 29% year-over-year in May as issuers dealt with rising interest rates stemming from debt ceiling concerns, Federal Reserve policy uncertainty and overall market volatility.

Total volume for the month was $26.062 billion in 677 issues, down from $36.583 billion in 928 issues a year earlier, according to Refinitiv data.

Tax-exempt issuance fell 16.4% to $23.677 billion in 588 issues from $28.333 billion in 801 issues in 2022. Taxable issuance totaled $1.161 billion in 76 issues, down 82.2% from $6.508 billion in 114 issues a year ago. Alternative-minimum tax issuance dropped to $1.225 million, down 29.7% from $1.742 billion.



New-money issuance fell 33% to $19.093 billion in 617 transactions from $28.514 billion a year prior. Refunding volume decreased 22.1% to $3.350 billion from $4.301 billion in 2022.

May volume "continued the downward supply trend that has framed 2023 year-to-date, creating a sense of déjà vu," said Jeff Lipton, managing director of credit research at Oppenheimer Inc.

"Rising interest rates throughout the month, monetary policy uncertainty, availability of stimulus funds, generally favorable credit quality, ongoing banking stress concerns, the dynamics of a debt ceiling debate, and tempered demand are all contributing factors to the nearly 30% drop in May's year-over-year primary issuance, keeping many issuers on the sidelines," he said.

However, he said the No. 1 reason for the drop in volume in May "has to do with the overall rise in municipal bond yields throughout the month of May with the concerns over another 25 basis point rate hike at the June [Federal Open Market Committee] meeting," he said.

Of these factors, Matthew Gastall, head of Wealth Management Municipal Research at Morgan Stanley, concurred, saying rising interest rates were the main reason for the decrease in issuance.

Over the past several weeks, there has been an uptick in interest rates, which has done several things.

For one, the higher rates have caused "a number of refundings to fall out of the money," he said.

Gastall noted the Tax Cuts and Jobs Act of 2017 placed limitations on the abilities of issuers to advance refund debt, "which back the early stages of the pandemic, rates, for the most part, have come down so low that we saw a number of taxable deals that were being used to refinance outstanding taxes, and just because rates were so much lower."

The market has entered a period where rates have come up, and now "we don't have as much of a larger supply or healthy supply of refinancings, because of higher interest rates, coupled with the provisions that were passed in TCJA," he said.

Lipton said a lack of compelling market opportunities "has particularly held taxable issuance at bay and refunding candidates down to a limited number of transactions."

He believes "most of the refunding activity was tax-exempt as opposed to taxable."

Given where muni yields currently are, he noted there is little support for taxable advance refundings.

"While the debt ceiling impasse had factored into rising yields, resolution has arrived and once the June FOMC concludes, market technicals may become the driving force," Lipton said.

Net supply is negative $23.5 billion over the next 30 days, per Bloomberg data, and "even deeper supply deficits [are] anticipated for the following two months," he noted.

With this expected technical shift, he said muni mutual fund flows "may be able to move into positive territory and the well-tested attributes of strong credit quality, diversification and tax efficiency should guide investor preferences."

With a more receptive investor community, Lipton said "issuers may find themselves inclined to come in from the sidelines."

However, it all comes back to rates, according to Gastall.

There is still some debate over what the Fed will do for the second half of the year if the Fed continues its progress with controlling inflation — albeit modest for the most part. That, Gastall said, coupled with any type of slowing economic growth, could bring interest rates down in the belly and in the long end of the yield curve.

Then "you wonder if some issuers are waiting to see how that plays out through the summer," before returning to issuing debt in the fall, he said.

If the Fed continues to raise rates on the short end "or we get one more additional hike and if we start to see some type of economic slowing in the second half of this year, that could create a flight-to-quality that benefits bonds and specifically municipals," he said.

This could bring rates down and help supply to pick up in the back end of September and October.

Like previous months, supply continues to be down year-over-year. This is also due to "post-COVID stimulus and infrastructure funds on balance sheets, as well as higher rates," Robert Dailey, head of public finance at PNC, said.

"So much of our industry gets driven by the health of the balance sheet at the state level, and they're still somewhat flush [with cash]," he said.

Dailey believes this year "is the last fiscal year where most of the Federal dollars are explicitly in hand to be spent."

Moving forward, he expects state budgets to be thinner and leaner again, and those balances spent down.

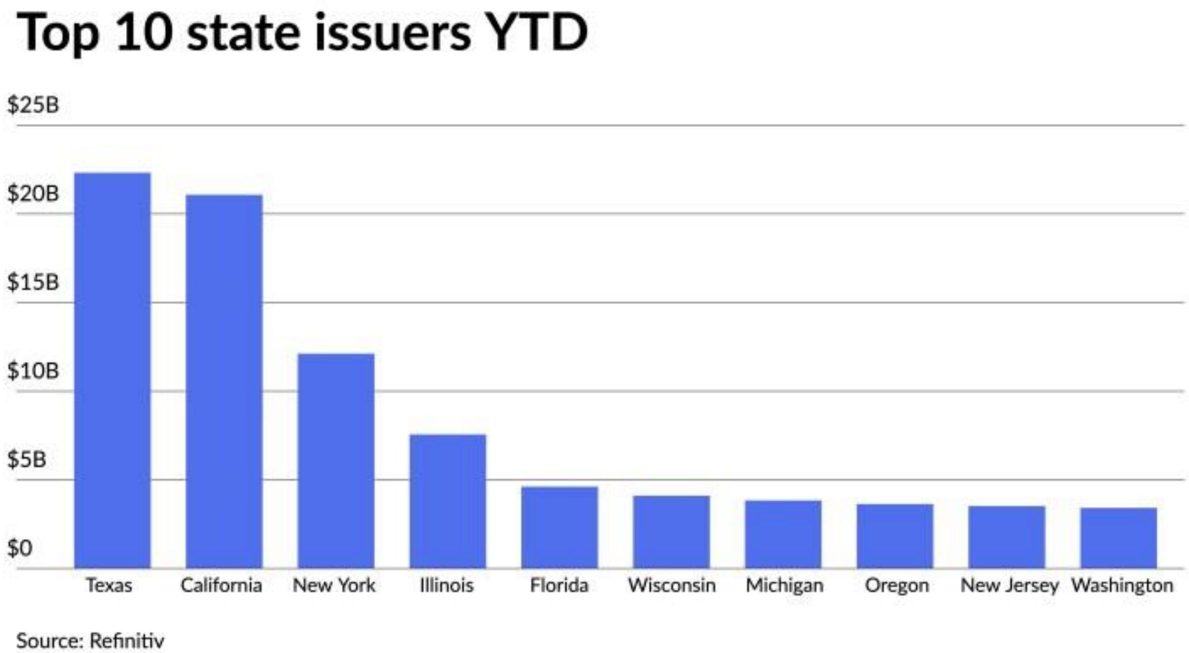
"That's going to carry us through the balance of this calendar year, and then we'll see a pickup in issuance volume next year," Dailey said.

Issuance details
Revenue bond issuance decreased 23.2% to $16.301 billion from $21.215 billion in May 2022, and general obligation bond sale totals dropped 36.5% to $9.762 billion from $15.368 billion in 2022.

Negotiated deal volume was down 27% to $20.674 billion from $28.324 billion a year prior. Competitive sales decreased 10.5% to $5.166 billion from $5.770 billion in 2022.

Deals wrapped by bond insurance rose to $4.397 billion in 109 deals from $3.739 billion in 152 deals in 2022, a 17.6% increase.

Bank-qualified issuance dropped 30.4% to $720.8 million in 209 deals from $1.035 billion in 273 deals a year prior.



In the states, Texas claimed the top spot year-to-date.

Issuers in the Lone Star State accounted for $22.323 billion, up 15.4% year-over-year. California was second with $21.077 billion, down 6.6%. New York was third with $12.116 billion, down 47.6%, followed by Illinois in fourth with $7.561 billion, up 18.9%, and Florida in fifth with $4.615 billion, a 42.7% decrease from 2022.

Rounding out the top 10: Wisconsin with $4.106 billion, up 5.7%; Michigan with $3.839 billion, down 39.7%; Oregon with $3.634 billion, up 43.3%; New Jersey at $3.519 billion, up 33.1%; and Washington with $3.418 billion, down 12.8%.