THE BOND BUYER

Munis ignore UST selloff on risk-on trade after Powell testimony

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Municipals saw small cuts to triple-A yield curves, outperforming large losses in U.S. Treasuries, while equities rebounded from two days of large losses after Fed Chair Jerome Powell told Congress a 25-basis point hike is likely this month.

Triple-A yields rose one to three basis points across yield curves while UST saw yields rise 17 to 19 basis points across the curve.

Municipal to UST ratios fell as a result of the moves, putting the five-year at 74% (down from 84% Tuesday), 86% in 10 (down from 89%) and 88% in 30 (down from 91%), according to Refinitiv MMD's 3 p.m. read. ICE Data Services had the five at 73% (down from 80%), the 10 at 87% (down from 93%) and the 30 at 88% (down from 93%) at a 4 p.m. read.

A 25-basis-point rate hike should be appropriate later this month, the first in a “series” of increases, Powell told the House Financial Services Committee Wednesday, but the Fed is prepared to raise rates by a larger amount in coming meetings if inflation doesn’t moderate later this year.

“To the extent that inflation comes in higher or is more persistently high than that, then we would be prepared to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings,” Powell said at the hearing.

Thursday may be a better indicator of how munis will react, as the asset class was slow to show weaker trades until later in the day Wednesday and may play catch up. Refinitiv Lipper fund flows will also be telling as to how much the improvements of Monday and Tuesday have had on retail sentiment.

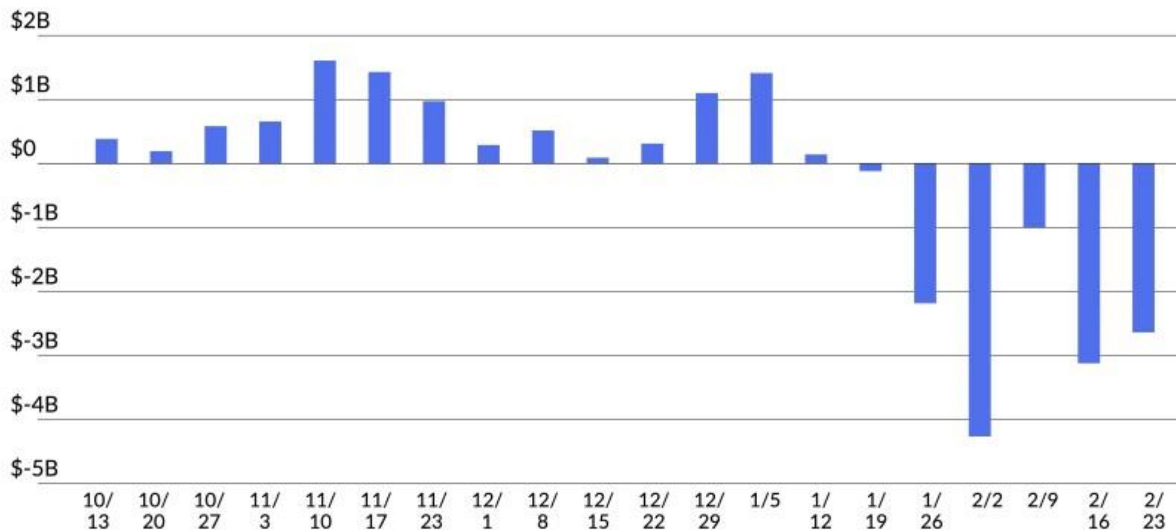
The Investment Company Institute on Wednesday reported $2.637 billion of outflows in the week ending Feb. 23, down from $3.120 billion of outflows in the previous week.

Exchange-traded funds saw inflows at $556 million versus $627 million of inflows the week prior.

"Municipal funds are sitting on lofty cash balances, while their AUMs have dramatically increased over the past decade — meaning that massive muni fund outflows would be needed to move the needle," Barclays said in a monthly strategy report.

Poor secondary liquidity due to much lower dealer appetite for risk and the abundance of low-coupon debt trading close to de minimis or even below it, thus causing profit and loss pain and extending portfolio duration, are also a concern, according to strategists Mikhail Foux, Clare Pickering and Mayur Patel.

Going into March's FOMC, there might be more rate volatility, they said, adding that credit spreads have not widened enough, and they prefer the "up-in-quality approach," although at cheaper levels they "would consider some low single-As, BBBs and possibly high-yield bonds."



Tax-exempts continue to underperform and the market "remains vulnerable, as fund outflows and rate volatility have not been conducive for risk-taking," they said. "If supply picks up, munis may underperform even more."

They also note that more and more low-coupon debt is coming under pressure and there might be some forced liquidations by investors, the main risk they see for munis near term.

"Taxable municipals are doing well by comparison, but have become quite rich versus corporates and their upside is clearly capped at the moment," the report said.

The primary market was active Wednesday, led by BofA Securities pricing for the Los Angeles Department of Airports $541.975 million of taxable consolidated rental car facility project customer facility charge revenue green bonds. Bonds priced at par: 3.158% in 5/2029, 3.408% in 2032, 4.058% in 2037 and 4.242% in 2048, callable 5/15/2032. Insured by Assured Guaranty Municipal Corp.

BofA Securities priced for Michigan State University (Aa2/AA//) $500 million of taxable general revenue century bonds. Bonds mature in 5/15/2122 at 4.165% par, callable 2/15/2122, make whole call.

In the competitive market, the Virginia Transportation Board (Aa1/AA+/AA+/) sold $263.985 million of transportation capital projects revenue and refunding bonds to Wells Fargo. Bonds in 5/2023 with a 5% coupon yield 0.90%, 5s of 2027 at 1.41%, 5s of 2032 at 1.70%, 4s of 2037 at 2.05%, 2.625s of 2042 at 2.72% and 2.75s of 2046 at 2.87%, callable in 5/15/2032.

Baltimore County, Maryland, sold $225 million of general obligation bonds consolidate public improvement bonds to TD Securities. Bonds in 3/2023 with a 5% coupon yield 0.81%, 5s of 2027 at 1.32%, 5s of 2032 at 1.57%, 5s of 2037 at 1.73% and 4s of 2042 at 2.07%, callable 3/1/2032.

Baltimore County also sold $100 million of certificates of participation to J.P. Morgan Securities LLC. COPs in 3/2023 with a 5% coupon yield 0.87%, 5s of 2027 at 1.39% and 5s of 2032 at 1.70%, noncall.

Cambridge, Massachusetts (Aaa/AAA/AAA/) sold $81.75 million of general obligation bonds to Morgan Stanley & Co. Bonds in 2/2023 with a 5% coupon yield 0.78%, 5s of 2027 at 1.27%, 5s of 2032 at 1.50%, 2.375s of 2037 at 2.42% and 2.5s of 2042 at 2.56%, callable in 2/15/2032.

Secondary trading:
Delaware 5s of 2023 at 0.82%. Gwinnett County, Georgia, 5s of 2025 at 1.23% versus 1.25% Friday. New York City 5s of 2026 at 1.47%. California 5s of 2027 at 1.51%-1.50%. Gwinnett County 5s of 2027 at 1.38% versus 1.42% original.

Florida PECO 5s of 2028 at 1.42%, same as Tuesday. Minnesota 5s of 2028 at 1.50%. Ohio common schools 5s of 2030 at 1.59%. North Carolina 5s of 2030 at 1.51%. Washington 5s of 2031 at 1.67%.

New York City water 5s of 2032 at 1.38% versus 1.38%-1.36% Tuesday. Delaware 5s of 2034 at 1.64%-1.63% versus 1.77% on 2/16. Connecticut 5s of 2034 at 1.88% versus 1.83% Tuesday. Arlington County, Virginia, 5s of 2034 at 1.69%.

Baltimore County, Maryland, 5s of 2035 at 1.74%. New York City TFA 4s of 2037 at 2.28%. California 5s of 2041 at 2.02% versus 1.91%-1.90% Friday.

New York MTA dedicated tax 5s of 2044 at 2.29% versus 2.32% original. Fairfax County, Virginia, 4s of 2050 at 2.29%.

AAA scales

Refinitiv MMD's scale: the one-year at 0.81% and 1.05% in two years. The five-year at 1.30%, the 10-year at 1.56% (+3) and the 30-year at 1.96% (+3).

The ICE municipal yield curve: 0.80% (unch) in 2023 and 1.09% (+2) in 2024. The five-year at 1.30% (+2), the 10-year was at 1.60% (+2) and the 30-year yield was at 1.98 (+1) in a 4 p.m. read.

The IHS Markit municipal curve: 0.79% in 2023 and 1.06% in 2024. The five-year at 1.33%, the 10-year at 1.58% (+2) and the 30-year at 1.95% (+2) at a 4 p.m. read.

Bloomberg BVAL: 0.81% (+1) in 2023 and 1.03% (+1) in 2024. The five-year at 1.33% (+2), the 10-year at 1.57% (+2) and the 30-year at 1.95% (+3) at a 4 p.m. read.

Treasuries sold off while equities ended the day in the black.

The two-year UST was yielding 1.53% (+19 from Tuesday), the five-year was yielding 1.781% (+18), the 10-year yielding 1.907% (+18), and the 30-year Treasury was yielding 2.28% (+17) at the close. The Dow Jones Industrial Average gained 596 points or 1.79%, the S&P was up 1.69% while the Nasdaq gained 1.62% at the close.

Russia impact TBD

It is too soon to evaluate the impact the Russian invasion of Ukraine will have on the U.S. economy, Powell said at the House hearing, noting the "near-term effects on the U.S. economy of the invasion of Ukraine, the ongoing war, the sanctions, and of events to come, remain highly uncertain."

"Making appropriate monetary policy in this environment requires a recognition that the economy evolves in unexpected ways," he said. "We will need to be nimble in responding to incoming data and the evolving outlook.”

When asked if the Fed made a policy mistake by not raising rates earlier, Powell said the Fed pivoted quickly once it was clear inflationary pressures were not as transitory as expected.

“The Fed has room to move on inflation and the market shouldn’t see it as taking away the punch bowl,” said Eric Merlis, managing director of corporate risk solutions at Citizens Bank.

The Russian invasion of Ukraine "has deflated expectations for the Fed to be super aggressive in its rate hikes,” said Scheherazade Rehman, professor of international finance at George Washington University. “At least for now it is proceeding carefully.”

But the situation will not stop the Fed from removing accommodation at its upcoming meeting, said Chris Low, chief economist at FHN Financial. “The conflict in Ukraine is another reason to be nimble in tightening, but not a reason to avoid it,” he said.

“Frankly, given the inflation shock from the loss of Russian commodities in the world market, the war is further reason to tighten, though Powell does not say that,” Low continued.

The crisis in Ukraine is worse than markets expected, said R.J. Gallo, senior portfolio manager and head of municipal bond investment group at Federated Hermes. This could “complicate” the Fed’s plans. A 50-basis-point liftoff has been ruled out, Gallo said, and the terminal rate “is potentially lower too.”

Rates shouldn’t go much higher short-term, he said, “but longer term, the moderation of global activity related to the effects of the invasion will only take some of the steam out of the inflation kitchen for the Fed.”

The hostilities in Ukraine will ramp up inflation, said Brian Coulton, Fitch ratings chief economist.

“While it could be argued that this is only a shock to headline inflation and not the core CPI, the backdrop is that U.S. core CPI inflation is running at three times the Fed’s target,” he said. “Headline inflation shocks matter if they keep on coming.”

If inflation remains elevated this year and medium-term inflation expectations grow, Fitch said, the Fed may have to raise rates as high as 3% before yearend.

“A more abrupt adjustment path could take a big toll on GDP including through tighter credit conditions and a sharp rise in long-term U.S. bond yields,” Fitch said. Economic growth may be below 0.5% next year in that case, although Fitch’s base case is 1.9% growth.

Look for the Fed to note “rising risks on both sides of the outlook,” said Rhea Thomas, senior economist at Wilmington Trust. “The bias is to continue hiking in 2022 in light of the inflation outlook but they will be sensitive for any signs of consumer weakness.”

Separately, private payrolls rose by 475,000 in February after an upwardly revised 509,000 gain in January, first reported as a 301,000 decline. Economists polled by IFR Markets expected 350,000 jobs added.

The report “shows broad based job growth for February which is a positive indicator,” said Steve Skancke, chief economic advisor at Keel Point. “It is a big turnaround from a huge miss in January so it's hard to know how much is correcting for January and how much is showing strong employment growth in February.”

Perhaps, the only negative, Thomas said, “was a decline in hiring at small businesses (-96,000), the first drop since April 2020.”

Despite Powell’s statement regarding a 25-basis-point rate hike at the March 15-16 meeting, Friday’s employment report will be watched by the markets.

Skancke expects about 600,000 jobs added. “Part of this is the post Omicron-COVID rebound and part is the employer survey catching up to the household survey, which has been more positive over the past several months.”

“The key is labor market participation and whether it continues to expand,” said Wilmington’s Thomas. “We expect it will have picked up in February after being held down by Omicron in January.”

Wilmington expects 500,000 jobs added.

“High frequency data on job openings suggest employers may be cooling their appetite to hire as they deal with rising labor costs and are figuring out how to manage with current levels of employees,” Thomas said.