General Commentary

With a continued lack of economic data, investors were optimistic heading into the week that US/China trade tensions would de-escalate and the Fed would signal a continuation of the rate cut path that markets had been pricing in. The former came to fruition as Presidents Trump and Xi agreed on a truce whereby the US cut tariffs on China by 10% in exchange for a pause in export controls on rare earth elements. However, the latter turned out to be a major disappointment. The FOMC cut rates 25bps and announced an end to QT as expected, but Chair Powell offered some unusually strong pushback against another cut in December saying it "is not a foregone conclusion, far from it" and that there were "strongly different views" from Fed officials. Rates sold off 9-10bps across the board after the comments and closed the week 6-9bps higher. While three Fed officials spoke out against further cuts, only one is a voting member of the committee this year, leaving Fed futures to still price in a 68% chance of a cut in December.

IG Munis

The muni market outperformed treasuries across the board, only falling modestly after the large rate moves took hold. The benchmark AAA MMD curve saw yields rise just 2-3bps out to 10y and 5bps in 30y, while dealers cited a very constructive tone in the market. In a continuation of the themes we have seen all month, there was little selling pressure as mutual funds saw solid inflows with Lipper reporting another +$718mm in IG funds this week and the new issue calendar remains elevated but manageable. Further, we just got past what was supposed to be a seasonally weak stretch of performance for the muni market where supply outpaces redemption cash, but instead we finished the month with the best October return in 30 years. Participants are especially optimistic heading into the end of the year which are typically strong months defined by heavy reinvestment cash to support demand while deal flow slows down over multiple holiday and vacation periods. Further, primary market concessions have fallen over the past few weeks and in some cases we have seen new issues price on top of or even through secondary market spreads, which is driving more participants and better inquiry into the secondary market. While a meaningful rise in interest rates would surely knock the wind out of the muni market's optimism, several dealers expect any backup would be well bid and would soften the blow.

HY Munis

The HY market continued to limp along, closing September with another month of underperformance (3 out of the last 4) as both trade volumes and conviction remained low. An important data point we highlighted a few weeks back is mutual fund flows and Lipper reported just $2mm of inflows this week, the second time in three weeks where flows were

nearly flat. While some complexes may be seeing outflows and others stagnant, it still has not translated into any material sell pressure as JPM reported HY BWICs down 5% this week relative to recent averages. On the other hand, customer purchases are dwindling, falling 34% this week as investors sit on cash, see limited secondary sellers, and have very few new deals to choose from. Benchmark names like Buckeye and Cofina generally kept pace with the broader market moves, off ~3-5bps. That said, dealers had been reporting that stronger bid sides were beginning to develop pre-Fed as IG yields continued to grind lower and HY spreads became increasingly attractive. Despite recent headlines, the $1.09bn BB+ rated Chicago Board of Education deal was as much as 6x oversubscribed in the longer maturities and bumped 7bps. Bonds traded up 4bps on the break on Wednesday (pre-Fed) but by Friday the bid side was 4bps worse than new issue.

We attended a HY municipal bond conference this past week and listened to several panels filled with a variety of buyside investors, bankers, and issuers which helped provide some interesting perspectives on the broader outlook for certain HY sectors. There was a lot of caution around education sectors such as college/university credits and charter schools. In general, educators have not adjusted to a new normal without access to one-time Covid stimulus funds and declining Federal grant money. Instead, many of these institutions have taken on expenses they cannot afford on an on-going basis without these revenue streams and have been unable or unwilling to make the necessary expense cuts. It is expected that we will see several multi-notch downgrades in higher education credits and rising defaults in charter schools as liquidity dries up and the cash flow cannot meet debt loads.

On the other hand, investors were more optimistic in senior living and development deals. For senior living, investors cited the lack of new projects over the past few years amidst the continued aging of the baby boomer generation which has helped shore up demand and is leading to a supply/demand imbalance expected by 2030. In a similar vein, the bullish assessment on development deals was driven by an undersupplied residential housing market and interest rate relief that should help support home values over time. Finally, investors were cautiously optimistic on healthcare and hospitals as they viewed the OBBBA to have been way less punitive than feared, while labor costs and inflation is cooling, and some organizations have been successful in lobbying states for additional funding sources.

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Market Commentary

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