General Commentary

Markets were served their own March Madness this week as early optimism for a solution to the logjam of cargo ships unable to traverse the Hormuz ultimately fizzled out and fears of a prolonged and painful war grew. After the February PPI report printed higher than expected, the Fed dot plot showed fewer participants penciling in rate cuts this year. Chair Powell emphasized in his press conference that to resume lowering rates, officials would need to wait and see evidence of slowing inflation, especially in goods that have been boosted by tariffs. The next morning, both the BOE and ECB signaled they may need to hike rates 2 or 3 times beginning in April to combat the inflationary effects of the energy spike. While markets oscillated some, treasuries were hit hard again on Friday after news outlets began reporting that President Trump is considering a plan to occupy or blockage Kharg island. Yields jumped by double digits and finished the week with a massive bear flattening after the 2y rose by 18bps while the 30y softened just 4bps. Interestingly, markets completely priced out any chance of a Fed cut this year and now assign a 34% chance of a hike by the October FOMC meeting.

IG Munis

The broader macro volatility crept into the muni market as the tone was strong during the first half of the week but materially worsened alongside the rate selloff. The benchmark AAA MMD curve rose 8-13bps, outperforming by 2-6bps up front and underperforming by 3-4bps out long. Dealers cited strong demand from ETFs early on which added a layer of support to the market, while SMAs focused on the 15-20y part of the curve. Lipper's fund flow tally showed $2.196bn into ETFs while open-end funds lost $391mm. Unfortunately, the flip was switched after the Fed meeting and dealers rushed to cut offerings. By Friday, prints were all over the place. One dealer highlighted four different airport trades ranging from 6-26bps behind evals. While some of the marks may have been stale, the sticker shock will likely cause accounts to reevaluate their portfolios. Importantly, these trades began approaching or crossing over the psychologically important 5% yield threshold that has attracted strong IG buyer interest in the past.

Next week's primary calendar is set to be at least $14bn, with one dealer estimating $17bn+, which would be the largest of the year. Unfortunately, this couldn't be coming at a worse time, and we expect there to be significant concessions on offer which will likely flow through to the secondary. While we noted last week that accounts have some time to begin legging in, the ongoing volatility and heavy new issue calendar will likely present some good opportunities to put cash to work as soon as next week.

HY Munis

Despite the rising fears of a global slowdown and resultant 50+bps of widening in HY corporate CDS spreads since the start of the war, the HY muni market continued to hang in just fine. The early optimism helped pull in buyers off the sidelines, with most names trading 3-4bps tighter on Monday and Tuesday. Dealers reported it was beginning to feel like a short squeeze as accounts who had sold or were sitting in cash rushed to put money to work. Like the IG market, the tone performed a 180-degree turn into the back half of the week. Ultimately, benchmark names like Buckeye Tobacco ended off 11bps, while Cofina 2058s kept pace with MMD by trading 7-8bps weaker. Select "different name" credits outperformed. A recent NR private school that came via a new issue in mid-February saw a two-sided market on Friday at 6.10%/6.00% vs a customer purchase at 6.05% last week.

We are highly skeptical that HY muni outperformance can continue. After the Bloomberg HY muni index reached a nearly 2y wide in spreads relative to the IG muni index the week before the war began, yields have compressed 15bps over the past 3 weeks. This flies in the face of every other risk asset class - whether we look at HY corporates mentioned above or the S&P500 down >5% over the same period. The 2-month streak of inflows combined with a very light primary calendar left the market quite imbalanced as sellers were nonexistent and fund managers had to push prices higher to get invested. However, after last week's paltry $40mm inflow into HY funds, Lipper reported a sizable $651mm outflow this past week. With the war seemingly having no end in sight and each passing day increasing the probability of weaker growth but higher inflation, we suspect investors will want to continue rotating up in quality and move cash to safe havens. While funds have built a sizable cushion and have been able to handle this past week's outflows with ease, the longer this drags on, the more we are likely to see forced sellers emerge. In these environments, we typically see liquidity dry up quickly and very few bidders for bonds. If we are correct and HY munis begin following other asset classes wider, managers that have saved up some dry powder should have several opportunities to be liquidity providers when few else are willing or able to step up.

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Market Commentary

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