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Municipal bond green shoots: Early signs of spring

March 06, 2024

Waiting for rates to fall could mean missing out on compelling total return opportunities.

With the Federal Reserve appearing to be done with its tightening cycle, and with rates stabilizing at still attractively high levels, municipal bonds are positioned to deliver compelling returns. We saw an early example of what that could look like in the last two months of 2023 when interest rates dropped in anticipation of an end to the Fed's hiking cycle, and bonds rallied. Will this momentum continue?

While some valuation metrics within the muni space (e.g., the ratio of municipal to U.S. Treasury yields) may not appear attractive relative to history, we believe this is due to technical factors — specifically high investor demand. On a tax-equivalent basis, we think the current environment represents an opportunity to lock in historically attractive yield levels before the Fed starts to cut rates. For investors comfortable with going out on the risk and duration spectrum, intermediate bonds can offer attractive value while maintaining a cushion for potential interest rate volatility. Going a little further out, longer duration bonds have greater total return potential, given the additional income.

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The tax-equivalent yield for investment-grade munis remains above its 10-year average

(Yield to worst, %)

Source: Bloomberg L.P., Columbia Threadneedle Investments. Data as of Feb. 14, 2024. Investment-grade municipal bonds are represented by the Bloomberg Municipal Bond Index. Taxable equivalent yields are based on the top federal bracket (37%) and net investment income tax (3.8%). Other taxes are possible. The average is based on daily observations over the trailing 10-year period. **Past performance does not guarantee future results.** It is not possible to invest directly in an index.

A resilient economy is supportive of revenue sectors

The stronger-than-expected economy, buoyed by the resilient U.S. consumer, is supportive specifically of sectors that initially struggled post-COVID, such as airports, tolls, hospitals and continuing care retirement centers (CCRCs), but that are now showing signs of improvement:

- **Airports.** Even though the post-pandemic surge in passenger growth rates has somewhat moderated, record-setting airport volumes echo the strength of U.S. consumer balance sheets and the U.S. economy as a whole.

- **Tolls.** Traditional toll roads have rebounded to pre-COVID levels, exhibiting strength and stability with healthy balance sheets that we expect will be maintained throughout the economic cycle.

- **Hospitals.** The outlook for the sector has been upgraded to stable after almost four negative years, reflecting a return to profitable operations, albeit at much lower levels relative to pre-COVID.

- **CCRCs**. Demand for CCRCs has been fairly robust, especially for independent living. The metrics for the sector including total units occupied and occupancy rates have already surpassed, or are expected to surpass, pre-pandemic levels. Our positive outlook is driven by aging demographics and baby boomers' interest in lifestyle-oriented senior living.

We believe that in these sectors, intermediate and longer maturity municipal bonds offer an attractive level of income relative to associated risks. Market conditions are also supportive of high-yield munis — inventory is limited, the probability of a recession is fading and the rate environment has stabilized.

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The bottom line

We are constructive about the municipal bond market this year. A stable rate environment, strong investor demand and a resilient economy set the stage for green shoots continuing to grow.

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CTBP61U (02/24) CTNA6413305.1