

The Tapering Begins

On November 2-3, 2021 the Federal Reserve's (the Fed) Federal Open Market Committee (FOMC) held one of its eight regularly scheduled meetings for the year. At the post-meeting press conference Chairman Jerome Powell indicated that short-term rates would be kept near zero (0.00 – 0.25%), but that the Federal Reserve would reduce the monthly pace of its net asset purchases by \$10 billion for Treasury securities and \$5 billion for agency mortgage-backed securities later this month. This reduction in net asset purchases was widely expected and is one of the first steps in the Federal Reserve's withdrawal of emergency support for the economy after the onset of COVID-19 in this country in March of last year.

The FOMC indicated that a similar monthly reduction of net asset purchases will likely be appropriate each month but will be reevaluated and adjusted as necessary. Based on the current net monthly purchase of \$80 billion in Treasury securities and \$40 billion in agency mortgage-backed securities and the proposed monthly rate of reduction, the FOMC could be finished with net asset purchases by June of 2022.

Chairman Powell also indicated that the Fed can be patient with respect to raising short-term rates, but will not hesitate to act sooner if needed. Investors are increasingly betting that the Fed will raise the overnight rate by 0.25% by its June 2022 meeting, and an additional 0.25% sometime later in the year. That stated, some market observers think the Fed will move slower than what the futures markets predict, and the November midterm elections could be another factor to delay the rate of increases.

The slope of the yield curve is typically described by the difference between the 2-year and 10-year U.S. Treasury rates. After Chairman Powell's press conference, markets closed with the 2-year U.S. Treasury at 0.47% and the 10-year at 1.60%. This spread or slope of 1.13% is only 0.09% less than it was a month ago (0.27% / 1.49%), and essentially the same (0.01% more) as it was two months ago (0.21% / 1.33%). So while the 2-year and 10-year Treasury securities have risen during the past two months, and there has been volatility along the way, the increases have more or less been the same (0.26% and 0.27%, respectively) during this period.

If increases in the Fed Funds rate come to fruition in 2022, then we know that that short end of the yield curve (i.e., years 0-5) will increase accordingly. What's less known is what will happen to longer term (i.e., 10-year and greater) rates. Will the Fed tighten interest rates in a manner sufficient to limit inflationary pressures, or will it continue its accommodative stance and allow those inflationary pressures to persist? How markets view the answer to that question could have a material impact on the long end of the yield curve.

The United States is not the only country in the process of reducing monetary stimulus in the face of high rates of inflation and softening economic growth. Last week the Bank of Canada

ended its government bond purchases. Earlier this week the Reserve Bank of Australia took the first step in abandoning its yield curve control program, which had been suppressing rates.

Central banks that have been slow to adopt any meaningful monetary tightening include the European Central Bank and the Bank of England, the latter of which surprised markets on Thursday by keeping short-term rates at 0.10% when markets expected an increase to 0.25%.

Municipal Market Update

Municipal bonds have experienced some recent rate increases in sympathy with U.S. Treasuries, but all things considered continue to do well. Per the Bloomberg AAA Municipal Curve (BVAL), interest rates have increased by as much as 0.08% or 8 basis points (bps) since October 1st, depending on the term. On the demand side, the week ended October 27th saw \$584 million of inflows into municipal bond mutual funds, the 34th consecutive week, while exchange-traded funds (ETFs) experienced inflows of \$219 million. On the supply side, there is a slight uptick in the 30-day visible supply at \$12.1 billion. The ratio of the 10-year Aaa tax-exempt municipal and the 10-year U.S. Treasury was 76% on November 3, essentially unchanged since a month ago (77%), indicating continued strong value for tax-exemption, but off of the high range (55%-60%) for the year.

Unfortunately, the news does not look good for the inclusion of several municipal bond market priorities in the reconciliation bill contemplated by Congress. At this time, we are doubtful that the restoration of tax-exempt advance refundings, an increase in the bank-qualified limit from \$10 million to \$30 million and a new direct-pay bond program will be included in the final version of the legislation that continues to be negotiated in Washington. Should that change in the days ahead we will follow up with a separate update.

Despite all of this news, municipal bond rates are still very low from a historical perspective. As the Fed contemplates raising short-term interest rates in the future and other important market dynamics continue to evolve, we may see upward pressure on municipal rates in the next several months. If you have any questions about the municipal bond market in general or your specific bond issue, please feel free to contact a PMA advisor below.



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