Fed Looks Ready to Pause

As expected, the Federal Reserve (the Fed) increased its overnight rate by 0.25% on May 3, bringing the federal funds rate range to 5.00%-5.25%, and there were notable changes to the Federal Open Market Committee (FOMC) statement. Removed was language indicating the FOMC anticipates some additional tightening would be appropriate and added was language regarding the need to closely monitor incoming information and assess the implications for monetary policy. The Fed has telegraphed the previous 10 consecutive rate increases and barring some unexpected economic data between now and the second week in June, the Fed looks ready to pause.

Banking Sector

The failure of three banks in March focused attention on the impact of the Fed's rate increases on the value of bank assets. As interest rates increase, the value of high-quality loans and long-dated U.S. government bonds decrease, often substantially. When the value of a bank's assets decreases and depositors withdraw funds out of fear or perhaps just looking for higher yielding options, the forced sale of formerly held-to-maturity assets can doom a bank.

First Republic Bank had been limping along since the March banking failures and was placed into the receivership of the Federal Deposit Insurance Corporation (FDIC) before markets opened on Monday, May 1. Contemporaneously with the receivership news, the FDIC announced that JPMorgan Chase Bank would assume all of the deposits and substantially all of the assets of First Republic Bank as the result of a bidding process conducted over the weekend. Based on assets, First Republic was the second largest bank failure in U.S. history. The JPMorgan purchase was a positive for the muni market as First Republic had a very large portfolio of municipal securities and there was concern about how a potential sale of these securities could impact yields in the municipal bond market.

While JPMorgan Chief Executive Jamie Dimon said "This part of the crisis is over," on May 1, and the Fed stated that "The U.S. banking system is sound and resilient." on May 3, the Fed would presumably very much welcome softer economic data so that it can see the lagging effects on the economy of raising the overnight rate by 5.00% during the past 14 months. It remains to be seen if the desired softer economic data comes at the cost of a deepening banking crisis. One struggling bank to keep an eye on is PacWest Bancorp. Its stock was near $27 a share in March and was trading in the $5-6 range earlier this week.

Labor Market

The April jobs report from the Department of Labor was released on Friday, May 5 and it estimated that nonfarm payrolls increased by 253,000, which was an upside surprise. That stated, the report included downward revisions to the March and February estimated job gains. The unemployment rate and the labor force participation rate were little changed at 3.4% and 62.6%, respectively. Hourly wages for April grew by 4.4% over the past 12 months. The jobs market remains resilient.

Inflation Measures

On Wednesday, May 10, the April consumer-price index (CPI) was released and the data was generally consistent with market estimates. Headline CPI showed a seasonally adjusted monthly increase of 0.4%, and an increase of 4.9% over the past 12 months. This was the smallest annual increase since the period that ended April 2021.

The so-called core CPI, which excludes energy and food prices, rose 0.4% on a month-over-month basis and on an annual basis gained 5.5%. This was the second month in a row that the 12-month core CPI was higher than the 12-month all items CPI. Prior to March 2023, core CPI had not exceeded the all items CPI since January 2021.

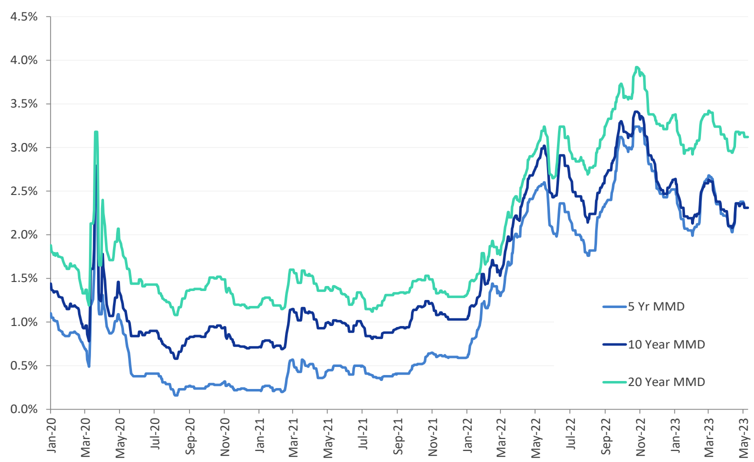
The Fed

The next FOMC meeting will conclude on June 14, and interest rate traders have a probability of no rate change at the June meeting at over 90%, which is consistent with recent Fed statements. What does not appear to be consistent with Fed statements is that traders have an over 40% probability of a rate cut at the July 26 FOMC meeting. It is hard to imagine inflation data coming down that fast in two months, which leads one to believe there are traders who see something breaking by then.

Municipal Market Update

Municipal bond rates have given back some of the recent declines in yields, but are still lower than the beginning of March. The following chart provides Municipal Market Data (MMD) AAA yields since the start of 2020 for 5-year, 10-year, and 20-year maturities. As illustrated, interest rates on municipal bonds are lower than their 2022 peak that occurred during the last week in October. Since March 1, yields on the below maturities have decreased by 0.33%, 0.28%, and 0.26%, respectively.

5-, 10-, 20-yr AAA MMD Yields | January 2020 - Current



REFINITIV MMD yields for 5-, 10-, 20-yr maturities, AAA-rated, General Obligation (5.00% coupon).

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.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