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Municipal bond market recap and outlook

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Overview

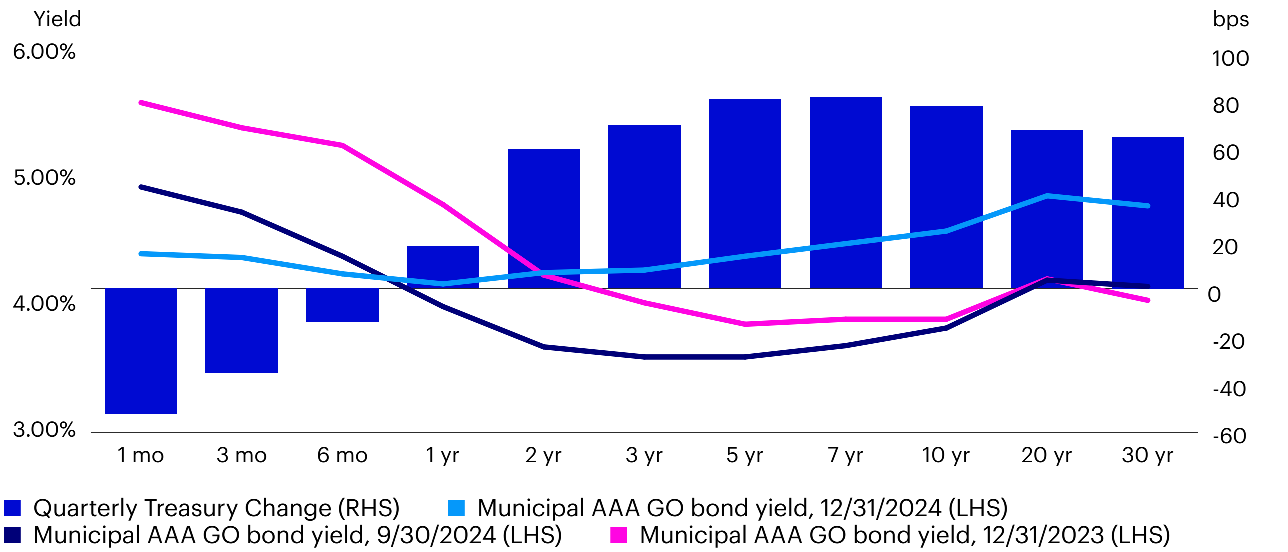
- Municipal bonds generated positive returns in 2024, despite sharply rising yields in the fourth quarter. High yield munis had particularly strong returns for the year.
- New issuance, which came at a record-setting pace, was well absorbed by the market.
- Investment flows were positive for the year due to municipal bond demand.
- Uncertainty increased after the November election, with municipal investors focused primarily on the incoming Trump administration's plans for tax policy.

The municipal bond market produced positive returns in the 2024 calendar year, overcoming some weakness in the fourth quarter. Bond yields rose during the quarter, as the Federal Reserve (Fed) signaled a slower pace of monetary policy easing and investors focused on the uncertainty following the US election and its policy implications. Investment grade, high yield and taxable municipal bonds returned -1.22%, -1.08% and -3.57%, respectively, in the fourth quarter, but they generated positive returns of 1.05%, 6.32% and 1.57%, respectively, for the 2024 calendar year.[1] Investors generally favored lower credit quality bonds, which helped high yield municipal bonds outperform investment grade municipals and taxable municipals in both the fourth quarter and calendar year.

The Fed, which had started its easing cycle in September, cut short-term interest rates twice during the fourth quarter, by 25 basis points (bps) in both November and December,[2] citing solid US economic activity. Policymakers also expressed their continued commitment to a 2% inflation rate and said future decisions would be based on incoming data, their evolving macro outlook and the balance of risks.[2] In December, as inflation pressures reemerged and uncertainty increased after the US election, the Fed indicated that there would be fewer and smaller rate cuts in 2025.[2]

In response to the Fed's more hawkish stance, US Treasury yields rose and the Treasury yield curve steepened. The yields of two-, five-, ten-, and thirty-year Treasury bonds increased 59 bps, 80 bps, 77 bps, and 64 bps, respectively, during the fourth quarter (see Exhibit 1). For 2024 overall, the yields of two-, five-, ten-, and thirty-year Treasury bonds rose 2 bps, 54 bps, 70 bps, and 75 bps, respectively.

Exhibit 1: The Treasury yield curve steepened amid changing expectations about the scope of Fed rate cuts



Source: US Department of the Treasury, Daily Treasury Yield Curve Rates. Data as of December 31, 2024. A yield curve is a curve showing several yields to maturity or interest rates across different contract lengths for a similar debt contract. The Municipal AAA GO bond yield is represented by the Municipal Market Data proprietary yield curve of AAA-rated state general obligation bonds, based on the institutional block size of $2million-plus market activity in both the primary and secondary bond market. Past performance does not predict future returns.

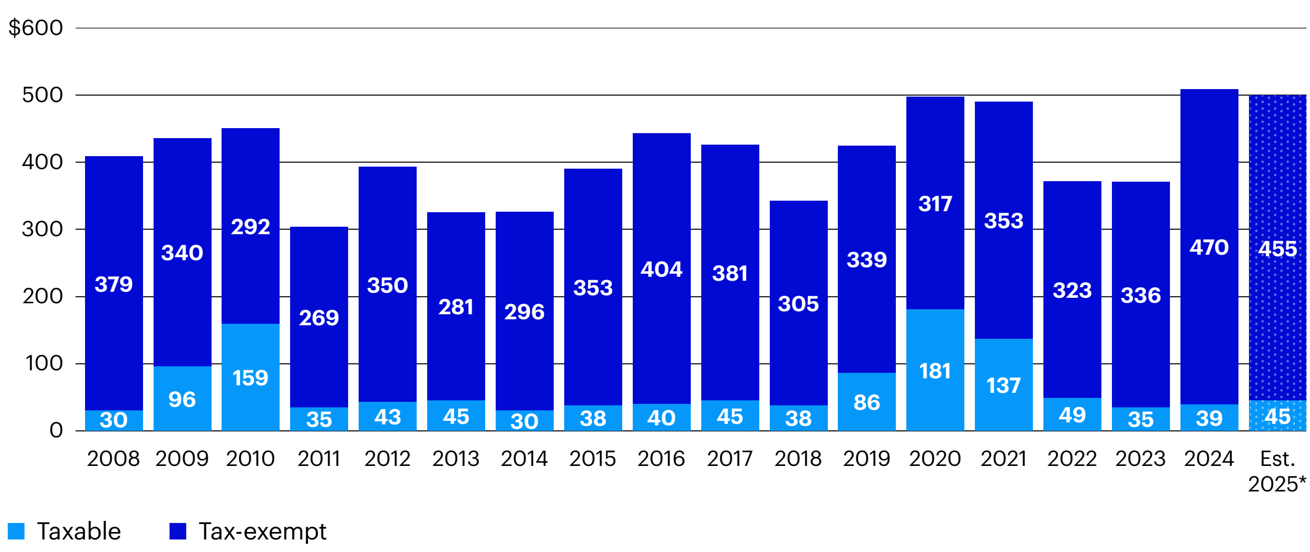
For most of 2024, municipal yields remained relatively range bound; however, volatility in the treasury market pushed yields higher in the fourth quarter. The yields of two-, five-, ten-, and thirty-year AAA general obligation bonds rose 52 bps, 56 bps, 46 bps, and 38 bps, respectively. Looking at 2024 as a whole, the yield of a two-year AAA general obligation bond fell 22 bps, while the yield of five-, ten-, and thirty-year AAA general obligation bonds increased 3 bps, 32 bps and 10 bps, respectively.

A record level of new issuance, with most of the supply well absorbed

Total municipal issuance in 2024 was about $509 billion,[3] higher than many had predicted at the start of the year[3] and topping the previous annual record of $463 billion set in 2020[3] (see Exhibit 2). Exceptionally large new issuance ahead of the US election contributed to record supply. Fourth quarter supply of $123 billion was 23% higher than the roughly $99 billion of new issuance in fourth quarter of 2023.[3]

Exhibit 2: Municipal market supply broke historical records in 2024

Annual Issuance ($B)



Source: Bloomberg Financial L.P., as of December 31, 2024.
* Source: Invesco Municipal Bond Team. Note: Fixed and zero coupon only. Notes excluded.

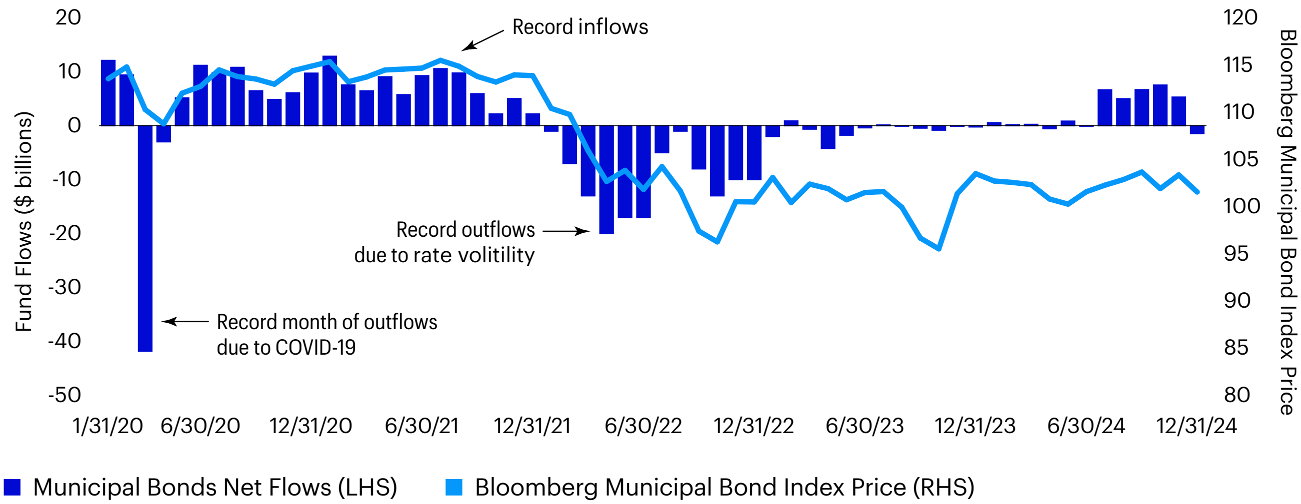
Tax exempt supply accounted for $470 billion of total new issuance in 2024, which was significantly more than the $369 billion issued in 2023.[3] It also broke the previous annual record of $433 billion achieved in 2007[3] and surpassed the last decade's average annual tax-exempt issuance of $330 billion.[3] In hindsight, inflation over the last few years increased prices across the board, so it isn't surprising that supply increased to keep up with costs.

As for taxable new issuance, it was approximately $39 billion during the 2024 calendar year,[3] slightly higher than the $35 billion issued in 2023.[3] Issuers continued to exercise the embedded extraordinary redemption provisions in their Build America Bonds, with many market analysts expecting the trend to continue in 2025. Taxable supply remained low compared to previous years, possibly because interest rates remained high by historical standards.

Demand for municipal bonds was strong during 2024. Overall, municipal bond mutual funds saw investment inflows totaling $42 billion in 2024, the first positive year of flows since 2021[4] (see Exhibit 3). Of the $42 billion in fund flows, roughly $18 billion went to high yield funds, which contributed to high yield's outperformance. However, outflows returned in December, as long-term bond yields rose sharply. Taxable municipal bonds continued to benefit from their high credit quality, especially as similarly rated investment grade corporate bonds tend to be scarce.

Exhibit 3: Investment flows turned positive in 2024 after two years of outflows

Monthly Municipal Bond Fund Net Flows and Muni Index Price History



Source: JP Morgan, Lipper, as of January 2, 2025. The Bloomberg Municipal Bond Market Index is an unmanaged index considered representative of the tax-exempt bond market. An investment cannot be made directly in an index.

Municipal credit fundamentals remained robust

Credit fundamentals were solid during 2024, supported by modest economic growth and somewhat lower inflation. States continued to maintain adequate financial reserves, and their rainy-day funds were at or near record highs.[5] As tax revenues shift back toward more normal levels, many governments have been working to moderate their spending growth.[5] Their efforts have been reflected in continued credit ratings upgrades, with an upgrade to downgrade ratio of 2:1 in 2024 and a nearly 4:1 upgrade to downgrade ratio in 2023.[6] Additionally, all US states are rated investment grade, with 48 of the 50 having credit ratings of AA- and higher.[6]

A look at the implications of the November election results

When it comes to elections, municipal investors typically place a high importance on the potential tax policies of the candidates. Donald Trump's victory and Republican control of Congress suggested the Tax Cuts and Jobs Act of 2017 (TCJA) would be extended. The TCJA capped itemized deductions of state and local property taxes (SALT) at $10,000, which effectively increased individuals' state tax rates. This, in turn, fueled demand for tax-free municipal bonds, particularly in high tax states like California, New York, and New Jersey. We expect the SALT cap to remain in place, likely with an increase in the deduction limit.

In addition, some market participants raised concern that the municipal tax exemption may come under increased scrutiny; however, we believe the muni tax exemption, which was established more than 100 years ago, is safe. We would also note that the nomination of Scott Bessent as US Treasury secretary is viewed in a positive light. In our opinion, Bessent understands fixed income markets and is likely to be a strong supporter of the municipal tax exemption. But in the unlikely event that something happens to the exemption, we expect existing municipal bonds to be spared from any tax law changes, which would make their existing exemption more valuable.

High interest rates have created a value opportunity in 4% coupons

Some attractive valuations have emerged among 4% coupon bonds, as municipal yields remain near their 15-year historical highs. Before 2022, when interest rates were lower, 4% coupons tended to trade at a premium. However, in the last few years, elevated interest rates have resulted in less issuance of 4% coupons and more issuance of 5% coupons. (Typically, 4% and 5% coupons are the most commonly issued tax-exempt bonds.) The prolonged higher-rate environment has caused 4% coupon bonds to trade at discounts to par, creating a potential upside opportunity for investors.[7]

Outlook

We expect one to two fed funds rate cuts in 2025, as the Fed continues managing monetary policy consistent with its dual mandate of pursuing maximum sustainable employment and low, stable inflation.[2] US economic growth will be durable, in our view, tempered on one hand by expected Trump administration policies, such as higher tariffs and tighter immigration, and enhanced on the other hand by various fiscal policies, including the possible extension of TCJA tax cuts.[7] We think municipal issuers are generally well positioned to manage policy shifts by the Trump administration.

Regarding municipal supply, we expect strong new issuance in 2025, comprised of $455 billion in tax-exempt munis and $45 billion in taxable munis (see Exhibit 2).[7] Although interest rates may not fall much from current levels, issuers must still address their funding needs and many cannot afford to wait for lower rates. Potential tax policy changes may also drive new issuance, especially early in the year, as some deals are brought to market ahead of any potential action by the Trump administration and Republican-controlled Congress. However, we do not anticipate heavy new issuance of high yield municipal bonds again this year.

As for demand, we may see occasional reversals in investment flows during 2025 on concerns regarding the new administration's policies, but we expect them to remain broadly positive throughout the year. As in 2024, we think much of the buying will be driven by individual investors, particularly those in the top income tax brackets, given the tax-exempt income that municipals can provide is likely to remain appealing.

In addition, if historical patterns hold, a unified Republican government in Washington, DC may bolster municipal performance in 2025. Four of the last five periods of unified government have created positive returns in the municipal market, with lower credit quality usually outperforming (see Exhibit 4).

Exhibit 4: A unified federal government has mostly been good for municipals

Presidential Term	George W. Bush 2003 – 2005	George W. Bush 2005 – 2007	Barack Obama 2009 – 2011	Donald Trump 2017 – 2019	Joe Biden 2021 – 2023
Investment grade muni	11.10%	7.89%	9.15%	6.58%	-4.60%
AAA	11.10	7.75	6.64	5.42	-4.97
AA	9.91	7.75	7.46	5.96	-4.57
A	11.61	9.37	10.66	7.40	-4.37
BBB	19.63	16.63	20.35	10.67	-4.81
High yield muni	20.97	19.83	32.16	13.70	-3.32

Source: Bloomberg, as of December 12, 2024. Dates used reflect January 20 of each year. Investment Grade Muni is represented by the Bloomberg Municipal Bond Index, an unmanaged index considered representative of the tax-exempt bond market. AAA is represented by the Bloomberg Municipal Bond AAA Index and is an unmanaged index of the AAA-rated municipal bond market. AA is represented by the Bloomberg Municipal Bond AA Index is an unmanaged index of the AA-rated municipal bond market. A is represented by the Bloomberg Municipal Bond A Index is an unmanaged index of the A-rated municipal bond market. BBB is represented by the Bloomberg Municipal Bond BBB Index is an unmanaged index of the BBB-rated municipal bond market. High Yield Muni is represented by the Bloomberg Municipal High Yield Bond Index which is generally representative of bonds that are non-investment grade, unrated or rated below Ba1. The Bloomberg Municipal High Yield Bond Index data as of inception of May 30, 2003. Monthly data is reflected from 2003-2005 and 2005-2007.

An investment cannot be made into an index. Past performance is not a guarantee of future results.

With continued Fed easing and steady new issuance, we see opportunities in the municipal bond market due to high absolute yields, strong fundamentals, and investor migration out of cash.

As always, we will continue to rely on our experienced portfolio managers and credit research staff to navigate the marketplace as they look for opportunities that can provide long-term value for investors.

1. Source: Bloomberg, as of December 31, 2024. Investment grade municipal bonds are represented by Bloomberg Municipal Bond Index. High yield municipal bonds are represented by Bloomberg Municipal High Yield Bond Index. Taxable municipal bonds are represented by the Bloomberg Taxable Municipal Index. An investment cannot be made into an index.
2. Source: Federal Reserve, as of December 18, 2024.
3. Source: Bloomberg, as of December 31, 2024.
4. Source: JP Morgan, Lipper, as of January 2, 2025.
5. Source: Barclays Municipal Research, as of December 5, 2024.
6. Source: Standard & Poor's. S&P rating changes: 747 credit ratings upgraded versus 345 downgraded over twelve months ending August 31, 2024. S&P rating changes: 1,400 credit ratings upgraded versus 350 downgraded over the twelve months ending December 31, 2023.
7. Source: Invesco, as of December 31, 2024.

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Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

Junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality.

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

All fixed income securities are subject to two types of risk: credit risk and interest rate risk. Credit risk refers to the possibility that the issuer of a security will be unable to make interest payments and/ or repay the principal on its debt. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Municipal bonds are issued by state and local government agencies to finance public projects and services. They pay interest that is typically tax-free in their state of issuance. Because of their tax benefits, municipal bonds usually offer lower pre-tax yields than similar taxable bonds.

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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The **Bloomberg Municipal Bond Index** is an unmanaged index considered representative of the tax-exempt bond market.

The **Bloomberg Municipal High Yield Bond Index** is generally representative of bonds that are non-investment grade, unrated or rated below Ba1.

The **Bloomberg Taxable Municipal Index** measures the US municipal taxable investment grade bond market.

US Treasury is represented by the public obligations of the US Treasury. Treasuries are backed by the full faith and credit of the US government as to the timely payment of principal and interest, while legislative or economic conditions could affect a municipal securities issuer's ability to make payments of principal or interest.

A basis point is a unit that is equal to one one-hundredth of a percent.