# Municipal Bonds

January 2025

## Higher Rates for Longer Doesn't Mean Forget Munis

— After-tax municipal bond yields are attractive, especially for those in higher income tax brackets

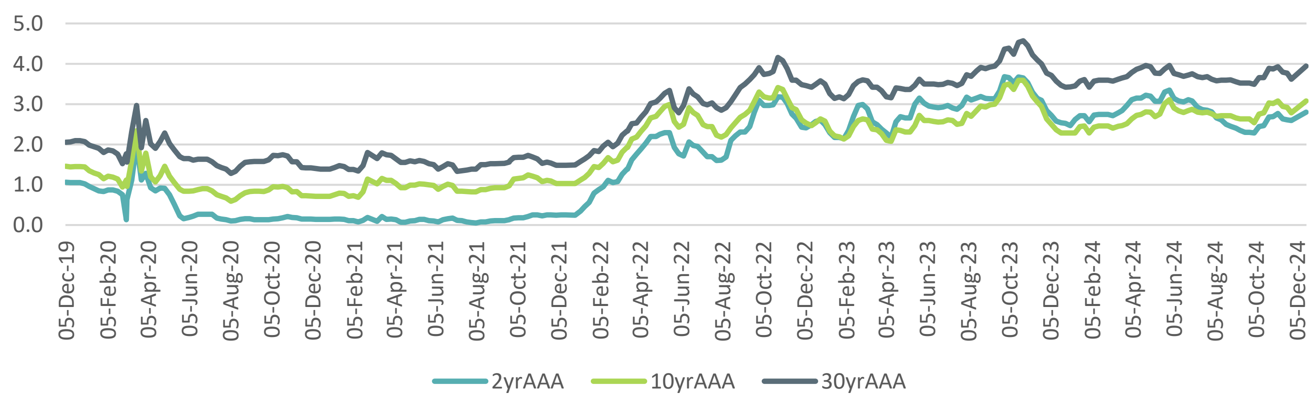
— Another strong year of supply should offer good entry points, especially when considering typical seasonal trends

— Yields already priced for higher inflation are in better position to offset negative economic shocks and weaker equity market returns

Now that the Federal Reserve has dialed back the pace of rate cuts, investors may feel less urgency to consider fixed income. Yields are higher than where they were before the Fed started hiking in 2022, but if they aren't likely to decline significantly, then an investor is left with a low, single digit return from the income and little chance for additional price return. This type of expectation pales in comparison to the 20%+ annual returns investors have experienced with the S&P 500 in each of the past two years and even significantly higher returns from other alternatives like Bitcoin. However, we think investors should remember that fixed income isn't meant to produce equity-like returns. As part of a diversified portfolio, the steady income component of bonds can provide a good source of stability to offset the volatility of other riskier market segments like equities. While we may be past the peak in yields for this cycle, yields are still attractive, especially on an after-tax basis for those subject to high income tax rates and the expectation for another year of heavy supply in the municipal market may present an opportune time to invest in tax-exempt bonds.

Municipal yields most likely peaked in late 2023, barring any inflationary spike that requires the Fed to begin hiking rates again. While benchmark AAA municipal yields are 14% below the highs achieved in October 2023, they remain close to 50% higher than the previous five-year average. The pace of cuts may have slowed, but the trajectory is still for lower rates unless economic growth strengthens and inflation spikes. A 3.94% AAA tax-exempt yield equates to more than 6.3% for an individual in the highest income tax bracket. Yields get even more attractive as an investor moves down the quality spectrum. Therefore, yields around current levels remain attractive for investors with high income tax liabilities.

**AAA Muni Yields**

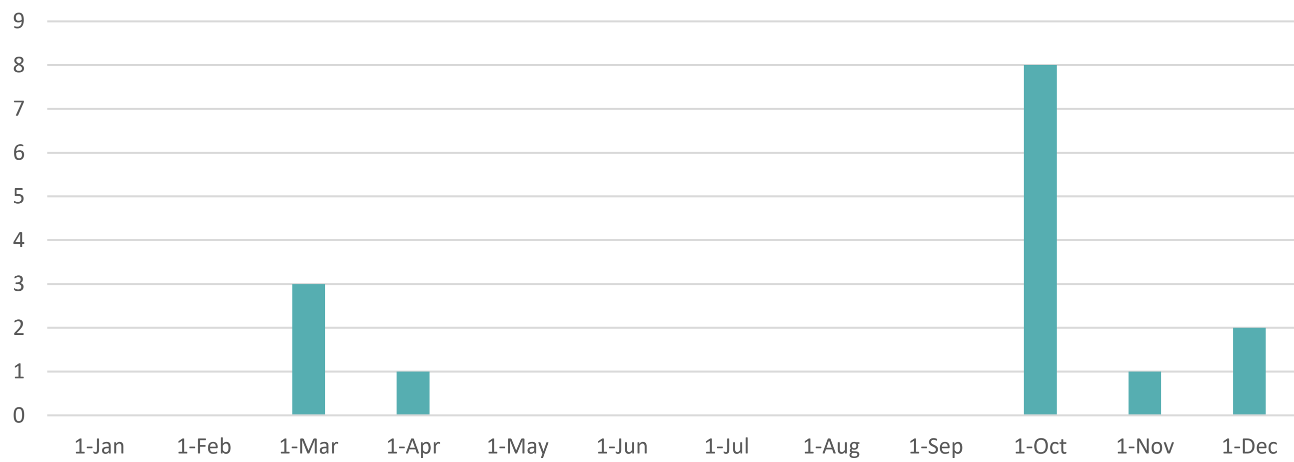



Source: Bloomberg, December 2024

Market consensus is for another strong year of bond issuance after a record year of supply in 2024. Given the added uncertainty of impending tax code changes that are most likely to occur later in the year due to other priorities like immigration and tariffs, many issuers could try and come to market in the first half of the year to avoid any potential noise around tax policy. However, issuance could also exceed normal averages toward the end of the year if any tax code changes directly impact particular sectors or the entire market, similar to what was experienced in 2017. This may be a real possibility for certain sectors of the municipal market that have been targeted in the past, like higher education and other areas of private activity, that may rush to market as the window closes on their ability to issue tax exempt debt. The municipal market easily absorbed record supply of more than $500 billion in 2024 due to a return of mutual fund inflows, positive ETF flows, and the consistent demand of individual buyers. Yet, there are no guarantees that these trends will continue and further Treasury rate volatility or distractions from more favorable alternatives could at the very least moderate money invested into the municipal bond market. These dynamics could create periods of opportunity to buy tax-exempt bonds at attractive yields in 2025.

There have historically been months in each year that see more supply. That doesn't mean that those are always the best months to invest. However, if those periods of supply spikes coincide with modest demand and rate volatility, they can be very favorable times to get invested. In the past 20 years, there have been certain months when more supply was issued in that month than any other month that year. In 2017, the last year when tax policy changes had a direct effect on the municipal market, the largest month of supply was in December as issuers rushed to advance refund outstanding bonds before it would no longer be allowed. In our opinion, it is unknown when the best value will occur in 2025 and current yields levels already offer value, but an understanding of historical seasonal trends is another variable that can add value on the margin.

**Number of years where each month had the largest issuance**




Source: Bloomberg, December 2024

Interest rates may be staying higher for longer, but that doesn't mean investors should avoid municipal bonds. The Fed has signaled a slowing pace of Fed Funds Rate increases, and as a result rates may remain elevated and move sideways in coming months. In our view, any significant move higher would require a reversal in recent inflationary and/or employment trends. Higher municipal bond supply projections and market volatility could present opportunities to add attractive yields in 2025. Now that higher inflation is priced into bond yields, municipal bonds likely have negative correlation to equity returns and may outperform corporate bonds if the economic outlook weakens. Negative stock market performance would put fixed income, especially higher quality municipal bonds back in favor and the lower but at least positive returns may be a welcome outcome for many investors.

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