Parametric

Municipal Bond Market Insight | February 2025

Hitting the Slopes

Key takeaways

- Elevated muni yields continued in January after closing 2024 on a high note.
- A record month followed a record year in municipal new-issue supply.
- The muni yield curve offers more than twice the slope of the US Treasury curve.
- Threats to the muni tax exemption continue.

General market update

With the new year now a month underway, we see a continuation of some of the themes from late last year still at work in the bond market. Among them are elevated bond yields driven by robust US economic data and slow progress on the inflation front. Although the Fed and chair Powell may enjoy this combination, the bond markets remain on edge. After repeated bouts of over-optimism when it comes to prospective rate cuts, market participants have more recently adopted a more measured pace of expectations.

Before delving further into our review and outlook, we sadly note that the Los Angeles wildfires captured the attention and hearts of the country in recent weeks, and our thoughts remain with those directly and indirectly impacted. While some concerns have surfaced in the muni bond market regarding issuers in or near affected areas, the market has been orderly, and few specific issuers have experienced pricing pressures or spread widening. Despite estimates that place this event as the largest natural disaster loss in US history, the muni market has a long history of resilience, and defaults from such tragedies have been rare. While ratings may be impacted in the near term, we believe insurance proceeds, combined with state and federal aid, will prevent and limit defaults for general obligation bonds and higher-rated essential revenue bonds. We remain comfortable with our portfolios' current exposures.

Getting back to our update, the new presidential administration is still situating itself, while market pundits assess the potential fiscal impacts of tariffs, deregulation, immigration and a host of other possible changes. The longstanding reality of US debt and deficits, coupled with renewed concerns over fiscal discipline, also casts a shadow. Uncertainty in the bond market generally tends to result in higher yields and cheaper bond prices. In fact, on January 31, the 10-year Treasury yield was just two basis points (bps) lower than the closing yield of 2024. Further, the high-low range during January was less than 30 bps.

Figure 1: Fixed income returns as of January 31, 2025

	MTD return	YTD return
Bloomberg Muni Index	0.5%	0.5%
Bloomberg US Treasury Index	0.52%	0.52%
Bloomberg US Aggregate Index	0.53%	0.53%
Bloomberg US Corporate Index	0.55%	0.55%

Source: Bloomberg, 1/31/2025. For illustrative purposes only. It is not possible to invest directly in an index.

Past performance is no guarantee of future results.

Figure 2: AAA municipal yields as of January 31, 2025

Year	Current	MTD change	YTD change
2-year	2.82%	-15 bps	-15 bps
5-year	2.87%	-10 bps	-10 bps
10-year	3.06%	-9 bps	-9 bps
30-year	3.90%	+7 bps	+7 bps

Source: Thomson Reuters Municipal Market Data, 1/31/2025. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Figure 3: US Treasury yields as of January 31, 2025

Year	Current	MTD change	YTD change
2-year	4.25%	-1 bp	-1 bp
5-year	4.36%	-4 bps	-4 bps
10-year	4.57%	-2 bps	-2 bps
30-year	4.81%	+1 bp	+1 bp

Source: Bloomberg, 1/31/2025. For illustrative purposes only. Not a recommendation to buy or sell any security.

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The 10-year Treasury note finished January at a yield of 4.57%. The major bond indexes posted positive but tepid January returns, with the Bloomberg US Aggregate Index rising just 0.53%, the Bloomberg US Corporate Index coming in at 0.55%, the Bloomberg Muni Index registering 0.5% and the Bloomberg US Treasury Index attaining 0.52%. As was the case at the end of 2024, the Bloomberg Municipal Bond High-Yield Index outperformed at 0.76%, and equity markets continued to overshadowed bonds, with the S&P 500® returning 2.8% for the month.

Supply

The new-issue muni bond market was quick to shake off its year-end dormancy, with primary market activity totaling a monthly record-setting $37 billion in January. This was a 17% increase from December and higher than the prior January. With 2024 being a record year for muni bond issuance, it seems that 2025 is already off to a good start.

Among the largest deals of the month were $2 billion in University of California revenue bonds, $1.4 billion in Oklahoma Turnpike revenue bonds, $1.3 billion in New York Triborough Bridge and Tunnel revenue bonds, $1 billion in Columbus, Ohio, Regional Airport revenue bonds and $996 million in San Francisco Airport revenue bonds.

Market opportunity

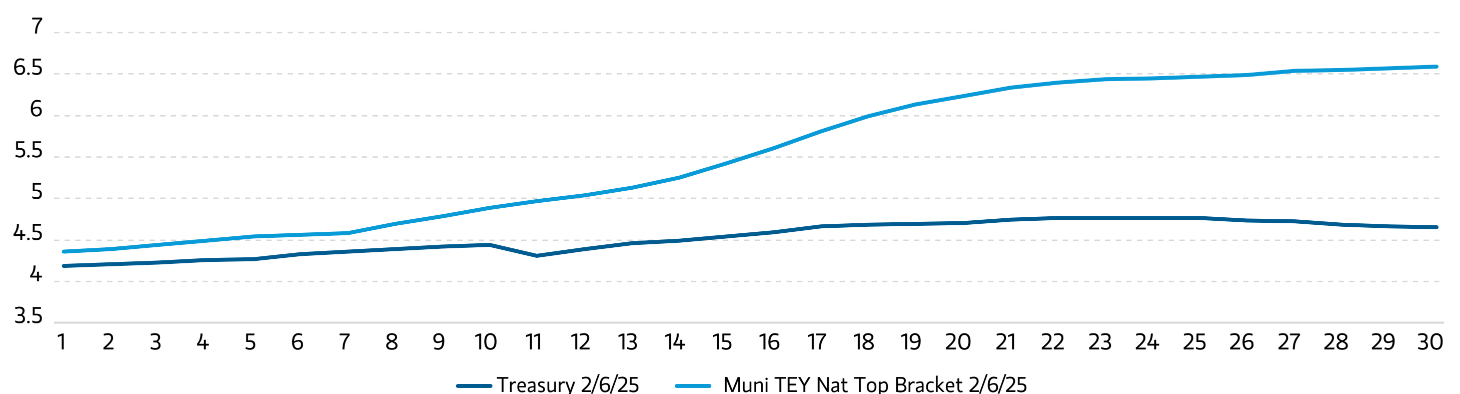
One of the defining attributes of the bond markets over the last few years was an inverted yield curve, with shorter maturities yielding more than longer ones. That dynamic largely ended with the close of 2024, but the stark contrast between certain parts of the muni bond yield curve and Treasury yield curve has endured. In our 2025 fixed income outlook published in December, we advocated approaching "munis as munis," because too many individual investors take their cues from the Treasury market to make decisions about tax-exempts. These two markets warrant individual attention; whether it be supply, credit quality or yield curves, they're simply different. Today we delve a little deeper into the shapes—or slopes—of these two yield curves. Similarities and differences found along these two trajectories can help to inform and guide investors toward strategies that may unlock value.

Starting with the overall magnitude of each yield curve, we note that the full one-to-30-year spectrum of maturities in the Treasury market offers a yield pick-up of approximately 57 bps. The benchmark AAA-rated muni yield curve in that same maturity range offers investors 132 bps of yield. That sharp contrast alone suggests that investors are being rewarding for extending maturities and duration in tax-exempts much more than in Treasurys. The question that quickly arises is what to do with this information.

The following figures show the two yield curves. The darker lines represent Treasurys, and the lighter lines represent benchmark AAA-rated muni taxable-equivalent yields (TEYs). This helps illustrate what a top-tax-bracket investor would need in a Treasury security to get the same after-tax yield as the federal-tax-exempt muni.

The data from this chart shows that the slopes of the one-to-five-year maturities are similar. In fact, the Treasury curve offers 16 bps compared with just 12 bps on the muni curve. Moving to the five-to-10-year section, we see identical slopes. This tells us that the potential reward for extending duration in the first 10 years of these two markets is roughly equal. For an investor interested in this part of the maturity spectrum, it might be worth considering a tax-optimized ladder, which uses the investor's individual tax bracket information to get the best after-tax yield for each sequential maturity along a one-to-10-year ladder by choosing among tax-exempt munis, corporates and Treasurys.

Figure 4: Slopes of municipal and treasury yield curves, as of January 6, 2025



Sources: Refinitiv MMD, Bloomberg and Parametric, 2/6/2025. For illustrative purposes only. It is not possible to invest directly in an index. **Past performance is no guarantee of future results.**

Heading toward the mid-sections—or bellies—of these yield curves, we note a striking contrast between these two slopes. Looking at the 10-to-20-year sections, the muni slope offers 76 bps, compared with just 29 bps for Treasurys. The potential benefit of extending duration in this area clearly suggests tax-exempts. Finally, we review the 20-to-30-year range, which we find quite interesting. Not only does the 21-bps slope of the muni curve sharply eclipse that of Treasurys, that slope is negative five bps. For an investor interested in these last two parts of the maturity spectrum, tax-exempt strategies worth considering are intermediate and long-duration munis. (Note: Please consult your financial advisor for further information regarding any of these investment strategies.)

Economic outlook

Uncertainty invites both volatility and elevated yields. Interestingly, much of the bond market angst in coming months may center less on the Fed and future monetary policy and more on policy moves from the new presidential administration. With potential change on many fronts happening simultaneously—including immigration, tariffs and the groundwork for tax reform—forecasting the impacts to economic growth may be more challenging than usual.

With the Fed's current dot plot indicating just two rate cuts this calendar year and the Fed funds futures market pricing in one or two cuts this year, it seems that the bond market and the Fed are finally on the same page, at least for now. As of this writing, the Fed funds futures market is fully pricing in one cut, with a 70% chance of a second cut by year-end. The Fed's dot plot suggests an implied Fed funds target of between 3.75% and 4% for the year. During the January Federal Open Markets Committee (FOMC) meeting, the FOMC voted to keep the benchmark rate in a target range of 4.25% to 4.5%. Chair Powell indicated during the related press conference that officials are not in a rush to lower interest rates, citing a strong economy and the need to see further progress on inflation. It appears that the Fed may be on hold until further notice.

Circling back to potential federal policy changes, specifically to the groundwork for tax reform, threats to munis' federal tax exemption continue. We've been here before (a number of times), and the broad tax exemption has endured throughout, but it's worth noting that the size of the tax-exempt muni market has been curtailed over the years, and we wouldn't be shocked to see further mitigation efforts.

Key economic data

Change in nonfarm payrolls (Jan.)	143K
Unemployment rate (Jan.)	4%
Core CPI–YoY change (Dec.)	3.2%
Core PCE–YoY change (Dec.)	2.8%
Average hourly earnings–YoY change (Jan.)	4.1%
Real GDP annualized (Q4 2024)	2.3%

Source: Bloomberg, 2/7/2025.

While our base case is still that the broad exemption will emerge unscathed, the tax-exempt muni market has a history of losing ground during major tax reform. Indeed, new issuance in the muni market was permanently mitigated in 1986, when advance re-fundings using tax -exempt bonds were limited to just once from the previously unlimited status. In the 2017 Tax Cuts and Jobs Act (TCJA), that one time was then eliminated, leaving muni bond issuers only the ability of advance re-funding with more expensive federally taxable muni bonds. Given that the muni exemption has made its way onto the list of potential revenue sources as legislators seek "pay-fors" in coming months, the related uncertainty can be unsettling.

Our optimism regarding the survival of the broad exemption for the majority of issuance rests beyond the simple fact that general obligation and essential service revenue bonds are primary needs for states, municipalities and local governments. Nor are we relying on our conviction that they should be financed in the most cost-efficient way for the residents whose taxes pay the debt service. It also doesn't rest on the fact that tax-exempt muni bonds finance approximately 75% of the infrastructure throughout our country—including schools, roads, bridges and tunnels. It doesn't even rest on the glaring need throughout the country for infrastructure replacement, upgrades and maintenance. It's clear that any loss or limitation of tax-exempt financing for issuers could be devastating and even dangerous. Our optimism rests on the fact that the math simply doesn't work for US taxpayers.

According to the House Ways and Means Committee, the cost of the federal tax exemption for muni bonds is $360 billion over 10 years, yet the projected cost to muni bond issuers if the exemption is removed is more than $800 billion over 10 years. Transferring and, in the process, raising the cost of bond issuance doesn't save taxpayers money. In fact, those very costs are borne by residents of those states, counties, towns and users of the financed facilities. We've been here before. During the Obama Administration, for example, the proposed capping of the muni exemption at what a 28% income tax bracket would enjoy (meaning a 9% tax for those in the 37% bracket) spiked borrowing costs to well over 100% of Treasury yields for many months. Though that proposal was included in a draft federal budget, markets are thankful it did't come to fruition.

Despite our base case being that the broad exemption will continue, history has shown that mitigation of the size and growth of the tax-exempt market can and has happened. That said, it appears that private activity bonds (PABs) may be in scope during this chapter of tax reform. With approximately $830 billion outstanding, PABs include healthcare, airports, stadiums and higher education and represent approximately 24% of the tax-exempt market. Finally, if the unthinkable does transpire, our contingency base case is that outstanding bonds will retain their tax-exempt status, commonly referred to as being "grandfathered".

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