Parametric

Municipal Bond Market Insight | January 2025

Yields End on a High Note and May Linger

Key takeaways

» 10-year muni yields finished 2024 only seven basis points (bps) below the 3.14% year-to-date (YTD) high and only 55 bps away from the decade high.

» The 10-year Treasury yield rose more during the first three months of this rate-cutting cycle than in any easing cycle since 1989.

» We expect municipal bonds to play a larger role in diversified portfolios this year.

» We believe tax-free municipal bond yields of 3% to 3.5% represent uncommon value, with taxable-equivalent yields of 6% to 7%, assuming the top federal tax rate.

General market update

At the start of 2024, municipal bondholder expectations for positive total returns were robust but went largely unfulfilled. Bond market turbulence persisted amid consistently strong economic data and a Fed that seemed poised to cut rates but did so only late in the year. While the muni bond market was able to achieve a positive total return by year-end, it was modest at best. We're now managing expectations for 2025 based on recent Fed guidance.

Although market sentiment that the Fed was done raising rates was indeed accurate, few envisioned a nine-month wait for the first rate cut of the cycle, September's 50-bps reduction. Coming off a 23-year high, the half-point cut in the fed funds rate was the first policy easing in four years. The rhetoric from Fed chair Jerome Powell during his press conference stressed that the half-point reduction was a catch-up move designed to keep the Federal Open Markets Committee (FOMC) from falling behind. Economic data received after the July meeting suggested they should have cut rates in the summer. Meanwhile, the FOMC's dot plot suggested two more 25-bps cuts by year-end, which arrived at the November and December meetings.

Benchmark 10-year muni yields followed undulating Treasury yields throughout the year. However, they often lagged in bond market rallies because of a constant flow of heavy new-issue supply that endured through the typically sparse summer months. On the final trading day of the year, 10-year muni yields finished just seven bps shy of the 3.14% year-to-date (YTD) high and only 55 bps away from the decade high set in late 2023.

Interestingly, the 10-year Treasury yield rose more during the first three months of this rate-cutting cycle than in any easing cycle since 1989. This was a sharp reversal from where 2024 began, with the 10-year muni yield now a whopping 78 bps higher. The market narrative on Fed monetary policy in 2023 was "higher for longer," but despite 100 bps of rate cuts, it was 2024's yields that stayed higher for longer. We view this recent bout of elevated yields as an opportunity for investors who have yet to extend out on the yield curve or have ready cash to put to work.

Figure 1: Fixed income returns as of December 31, 2024

	MTD return	YTD return
Bloomberg Muni Index	-1.46%	1.05%
Bloomberg US Treasury Index	-1.54%	0.58%
Bloomberg US Aggregate Index	-1.64%	1.25%
Bloomberg US Corporate Index	-1.94%	2.13%

Source: Bloomberg, 12/31/2024. 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 December 31, 2024

Year	Current	MTD change	YTD change
2-year	2.82%	+23 bps	+30 bps
5-year	2.87%	+26 bps	+59 bps
10-year	3.06%	+28 bps	+78 bps
30-year	3.90%	+28 bps	+48 bps

Source: Thomson Reuters Municipal Market Data, 12/31/2024. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Figure 3: US Treasury yields as of December 31, 2024

Year	Current	MTD change	YTD change
2-year	4.24%	+9 bps	-1 bp
5-year	4.38%	+33 bps	+53 bps
10-year	4.57%	+40 bps	+ 69 bps
30-year	4.78%	+42 bps	+75 bps

Source: Bloomberg, 12/31/2024. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Figure 4. 11 years of benchmark AAA tax-exempt yields, 2014–2025

Source: Refinitiv, 1/7/2025. For illustrative purposes only. Not a recommendation to buy or sell any security. It is not possible to invest directly in an index. Indexes are unmanaged and do not reflect the deduction of fees or expenses. Past performance is no guarantee of future results.

Supply

The top story of the muni year was supply, with a new-issue market driven by lower rates than the prior two years, pent-up issuer demand and dwindling federal stimulus dollars. With weekly calendars that were frequently double recent years' averages, primary market supply ended 2024 at approximately $500 billion, well above street consensus expectations and more than 30 % higher year over year (YoY). Despite the relentless supply onslaught, buyer demand was up to the task, driven primarily by individual investors in mutual funds and separately managed accounts (SMAs). Muni mutual funds experienced 23 consecutive weeks of inflows before reversing course in mid-December. This strong demand was enough to support a slightly above-fair-value ratio of 10-year benchmark muni yields compared with corresponding-maturity Treasurys. The full-year relative value average was approximately 64%, but there were periods of both richness and cheapness. Munis began the year relatively expensive in the mid-50% range, only to drift higher and offer more value, reaching a high of approximately 73% before settling in for the holidays around 67%, which we view as slightly above fair value.

The runner-up story was the return of a (mostly) positively sloped muni yield curve. While the one-to-30-year muni yield curve never fully inverted—unlike Treasurys—it opened 2024 inverted to almost halfway out the maturity spectrum, with the one-year yield eclipsing that of the 13-year maturity. At the close of 2024, that inversion was whittled down to just four years. By contrast, the Treasury yield curve, which inverted earlier and more severely, sported a positively-sloped year-end curve (from one to 30 years) of 63 bps. The same range of muni yield curve held 104 bps of slope, a significantly greater reward for muni investors willing to venture out on the curve.

Index performance rounds out our 2024 recap. Both the Bloomberg Municipal Bond Index and the Bloomberg US Treasury Index offered thrills and chills throughout the year, which consequently offered numerous opportunities for tax-loss harvesting. Final total-return readings weren't exciting, with Treasurys at 0.58% and munis at 1.05%. This does set the stage nicely for better performance in 2025.

Market opportunity

According to Bloomberg, street-consensus average forecasts for the 10-year Treasury stand at 4.12% by the end of 2025 and 4% by the end of 2026. These would be modest moves relative to the intense volatility experienced over the past two years. These expectations reflect the shallower path for further rate cuts, as the Fed's latest dot plot indicates. With the Fed now signaling just two 25-bps cuts during calendar 2025 and attractive yields near decade highs for munis and Treasurys, we expect bonds to play a larger role in diversified portfolios this year. Specifically, we believe tax-free municipal bond yields ranging between 3% and 3.5% represent uncommon value. Assuming a 40.3% tax rate, those are taxable-equivalent yields of 6% to 7%.

Key economic data

Change in nonfarm payrolls (Nov.)	227,000
Unemployment rate (Nov.)	4.2%
Core CPI–YoY change (Nov.)	2.6%
Core PCE–YoY change (Nov.)	2.8%
Average hourly earnings–YoY change (Nov.)	4%
Real GDP annualized (Q3 2024)	2.8%

Source: Bloomberg, 1/13/2025.

The recent outperformance of the equity markets and, more specifically, the equity risk premium add to this favorable backdrop for bonds. Equity risk premium is a good measure of the relative value between stocks and bonds. When expressed as the difference between the S&P 500® earnings yield—reflecting the expected return of stocks—and the 10-year Treasury yield, that spread currently stands at six bps, compared with a long-term average of 300 bps. By that measure, bonds enter the new year at their most undervalued relative to stocks in the last 20 years. Indeed, the time may be right to revisit asset allocation models with an eye toward rebalancing. We believe an environment of moderate growth, declining inflation and continued Fed easing will support fixed income performance in 2025.

Economic outlook

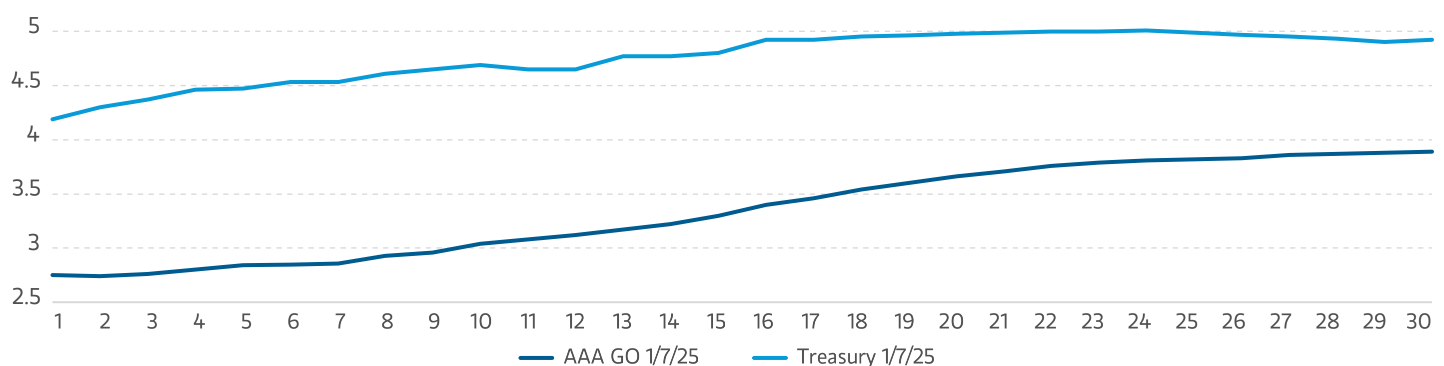
There are many potential sources of volatility heading into 2025. Among them are opposing monetary and fiscal factors, which include the Fed's commitment to cutting their way toward a yet-to-be-determined neutral rate that neither hinders nor bolsters the US economy; an incoming administration that may enact policies to boost economic growth (and possibly inflation); the ongoing growth of US debt and deficits; and the need for tax reform ahead of the Tax Cuts and Jobs Act (TCJA) expiry at the close of 2025. All this may unearth multiple opportunities for fixed income investors.

Just as we expect the Fed to continue its easing cycle, certain trends in the muni market should also continue. As previously noted, the primary market was the top story in munis last year. While the YoY increases are unlikely to be repeated, we do anticipate a healthy level of issuance as issuers continue to fund a backlog of projects and perhaps new infrastructure in response to strong economic growth. In fact, a resumption of the last year's pace could bring yet another year of record issuance. A robust pace of issuance is favorable for prospective buyers, since it tends to keep outperformance at bay by facilitating attractive pricing.

Inflows into mutual funds are likely to resume after a break in tax-loss-harvesting over the holidays. Mutual fund flows tend to be pro-cyclical, with inflows during periods of rising prices/declining yields and outflows during periods of declining prices/rising yields. Supporting this notion is a string of mutual fund inflows during each of the last six easing cycles. Over all of 2024, inflows totaled approximately $42 billion, including $26 billion into open-end funds and $16 billion into ETFs. Muni ETFs saw impressive growth last year, with many new ETFs launched. This is a trend we expect to continue.

Another key development we expect to continue this year is the return to a full positively-sloped muni yield curve, with shorter maturities yielding less than longer ones. Yield-curve inversion had a heavy impact on investor sentiment, with many individual investors opting for the perceived safety of elevated short-term yields rather than extending out the curve to lock-in somewhat similar or even lower yields. That "inversion diversion" is now gone. While short-term rates haven't fallen immensely, they've drifted lower following 100 bps of rate cuts from the Fed and more to come. In the opening days of 2025, the full slope (one- through 30-year maturities) of the Treasury yield curve stood at 63 bps, while the full muni yield curve offered 104 bps of yield pickup for investors willing to extend. This suggests investors are being rewarded for extending maturities and duration on the muni yield curve materially more than on the Treasury yield curve. For those reluctant to go the distance to 30 years, the 20-year maturity captures 93% of the yield of a 30-year bond. As an aside, yield-curve inversions in recent decades have typically signaled an oncoming recession. As was the case during the pandemic and its aftermath, this time was different. Street consensus expectations now call for a soft landing, and we agree.

Figure 6. Municipal bond yields vs. US Treasury yields, January 2025



Source: Refinitiv, 1/7/2025. For illustrative purposes only. Not a recommendation to buy or sell any security. It is not possible to invest directly in an index. Indexes are unmanaged and do not reflect the deduction of fees or expenses. **Past performance is no guarantee of future results.**

As for muni total-return performance for 2025, we anticipate low- to mid-single-digit positive total returns by year-end. Returns will depend on curve positioning, with intermediate and long durations outperforming the short end of the yield curve. While last year didn't feature a historic year-end rally like 2023, it did offer some of the highest muni yields seen in the last decade.

From a credit quality standpoint for 2025, the municipal bond market remains solid, with stable sector outlooks from Moody's for governments, mass transit, housing and water and sewer utilities. In fact, Moody's credit rating upgrades outnumbered downgrades during Q3 2024 by almost four to one. Accordingly, we expect investment-grade muni credit spreads to be generally unchanged to slightly tighter in the coming months.

Next up, in the "wild card" category, we have potential volatility stemming from pending tax reform. As has frequently been the case when tax reform surfaces, the tax-exempt muni market tends to experience anxiety. With an extension of the TCJA expected on the new administration's to-do list, lawmakers may look for various ways to pay for it. This could include a revision to the federal tax exemption that municipal bonds enjoy. Weighing in on the optimistic side of the conversation, the federal government has never interrupted or mitigated the tax exemption, which includes during the passage of the TCJA itself. On the pessimistic side, we remember the volatility experienced during the Obama administration, when the government considered a limit to the exemption but never imposed it. While tax reform could impact certain sectors and bond types, our base case is that the vast majority of municipal bond issuers will emerge with their full tax exemption intact. That said, we'd view any related weakness or underperformance tied to these concerns as a buying opportunity.

We believe it's a good time to consider buying the dips and to approach munis as munis. Too often individual investors look at Treasurys, then decide what to do in the municipal market. Although yields in both markets do tend to move in the same general direction, they have very different supply-and-demand dynamics. The yield curves for these two markets also differ greatly. Investors are being rewarded for extending maturities and duration along the muni yield curve materially more than they are on the Treasury yield curve. Opportunistic yield-curve positioning is just one way professional management may help improve investment returns. This added value, along with robust credit research, year-round tax-loss harvesting and relative-value trading may promote a smoother ride for investors navigating an increasingly complex municipal bond market.

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