Invesco

Municipal bond market recap and outlook

FIRST QUARTER 2025

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Overview

- Municipal bonds generated mixed results, with the first quarter marked by interest rate volatility and heightened policy uncertainty.
- Investment flows were positive overall for the quarter, though they turned negative in March, which was partly due to tax season selling.
- Supply remained at record levels, with new issuance higher than normal at the beginning of the calendar year.
- Longer duration municipals offered attractive relative value, as they hit their cheapest levels versus US Treasurys in recent months.
- Hospital and higher education credits face headwinds from federal funding cuts and other Trump administration policies.

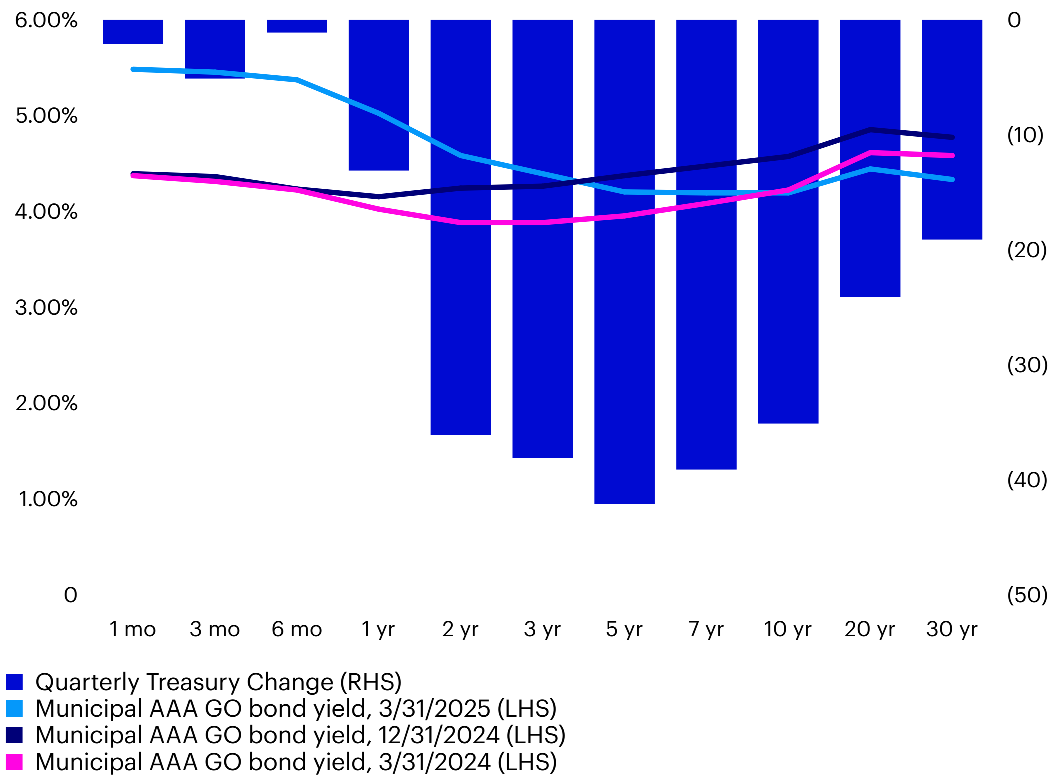
The municipal market got off to a volatile start in 2025. January and February posted gains, benefiting from a seasonal imbalance in supply and demand. The favorable market technicals reversed in March, and municipals generally declined. Worries about the potential impact of President Trump's tax-policy, as well as layoffs from the federal government workforce, may have further unsettled investors. For the first quarter overall, investment grade, high yield, and taxable municipal bonds returned -0.22%, 0.82%, and 2.99%, respectively.[1] Investors in the tax-exempt space continued to favor lower credit quality bonds, helping high yield municipal bonds outperform investment grade municipals.

The Federal Reserve (Fed) maintained its transitional stance and left the federal funds rate unchanged during the first quarter. Fed policymakers cited indicators showing that economic activity had continued to expand at a solid pace and unemployment had stabilized at a low level. The Fed stated that future decisions would be based on incoming data, the evolving outlook and the balance of risks, and their continued commitment to a 2% inflation target and maximum employment.[2]

Treasury yields were volatile over the quarter but ended lower, as investors sought to gauge the size and timing of future Fed rate cuts. The Treasury yield curve steepened as shorter- and intermediate-term yields fell more than longer-term yields. The yields of two-, five-, ten-, and thirty-year Treasury bonds dropped 36 bps, 42 bps, 35 bps, and 19 bps, respectively over the quarter (see Exhibit 1).

In the municipal market, elevated levels of supply and falling demand pushed longer-term yields higher and shorter-term yields lower. The yields of two- and five-year AAA general obligation bonds decreased -14 bps and -1 bps, respectively, while the yields of ten- and thirty-year AAA general obligations bonds increased 20 bps and 34 bps, respectively (see Exhibit 1).

Exhibit 1: Municipal yields fell on the short end of the curve, but rose on the longer end



Source: US Department of the Treasury, Daily Treasury Yield Curve Rates. Data as of March 31, 2025. 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 obligation bonds, based on the institutional block size of $2 million-plus market activity in both the primary and secondary bond market. Past performance does not predict future returns.

Municipal valuations grew more attractive, as muni bonds broadly lagged Treasurys. A key indicator of relative value is the municipal-to-Treasury (M/T) ratio, where the greater the ratio, the cheaper muni bonds appear compared to Treasurys. At quarter end, the thirty-year AAA-rated M/T ratio stood at its highest level since the November US presidential election, having risen 15 percentage points from its six-month low of 78% on December 11, 2024[3] (see Exhibit 2). The M/T ratios of five-, ten-, and thirty-year AAA-rated municipal bonds were 72%, 77%, and 92%, respectively, at the end of the first quarter versus 66%, 67%, and 80%, respectively, at the end of 2024.[3]

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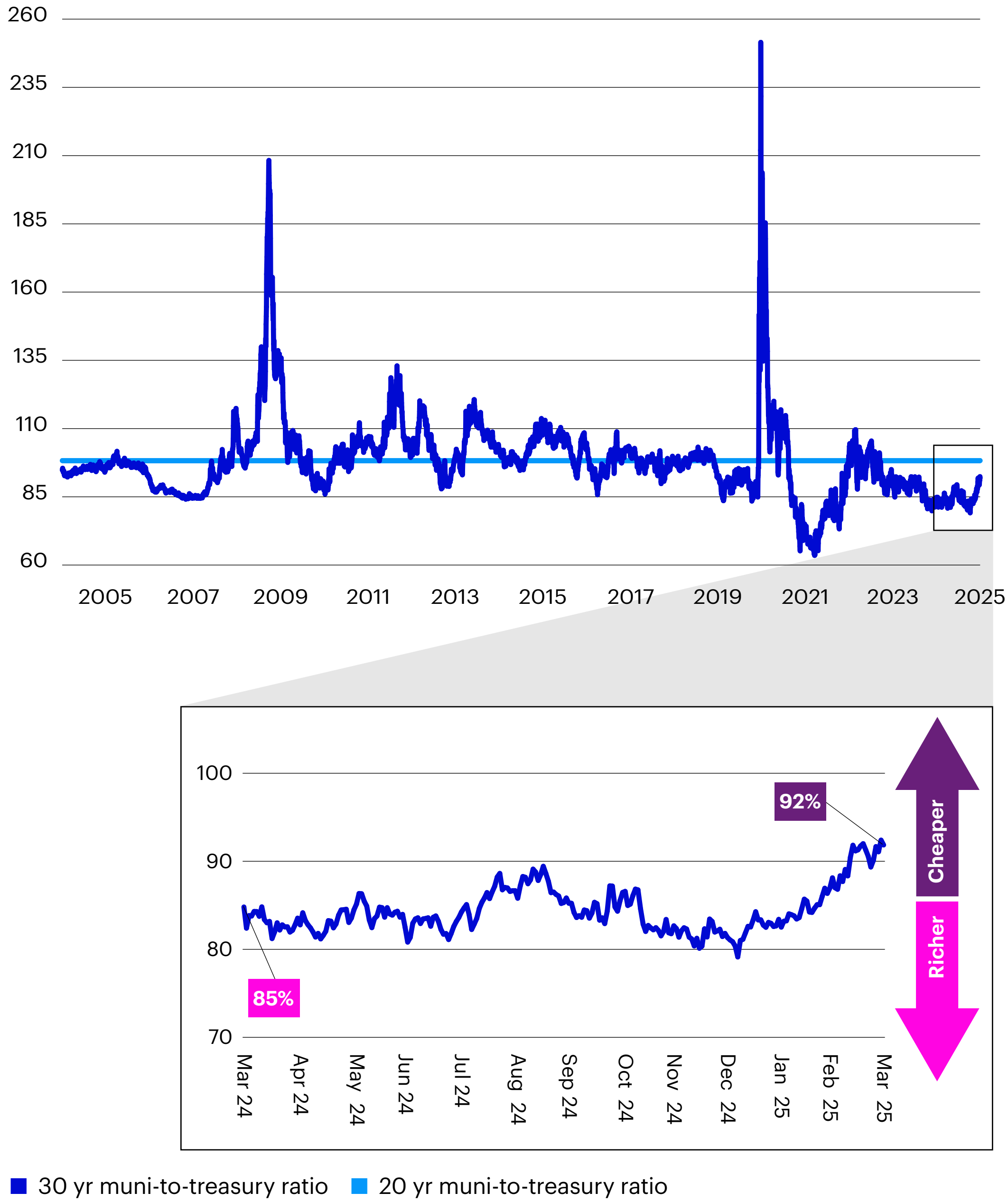
Exhibit 2: The 30-year AAA municipal-to-Treasury ratio has rebounded significantly from its six-month low



Source: Thomson Reuters TM3, as of March 31, 2025. Average shown is for 20 years, from March 31, 2005, to March 31, 2025.

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.

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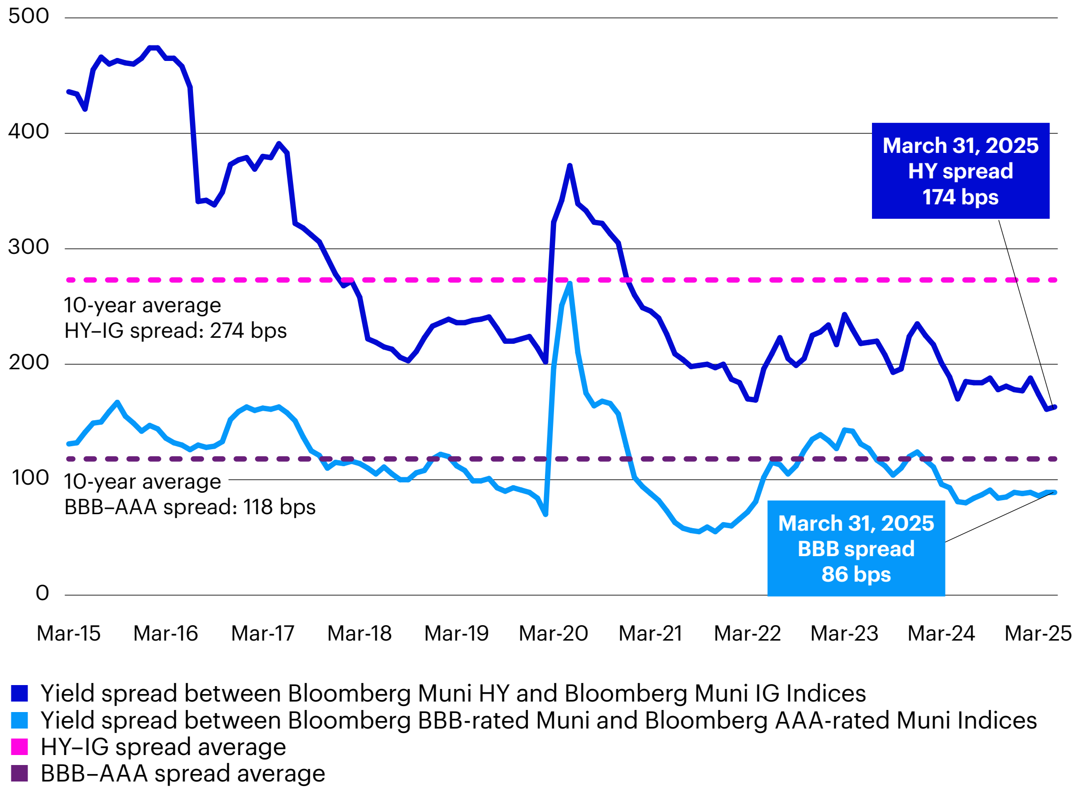
Municipal credit fundamentals appeared sound

Credit fundamentals remained solid despite increased economic uncertainty. Overall, upgrades continued to outpace downgrades, driven primarily by rating activity in the local government sector.[4]

State governments began 2025 in a sound fiscal position. Collections from sales taxes, income taxes, and property taxes were higher than pre-pandemic levels. Reserve balances were generally robust with state rainy-day funds at or near record highs.[5] As state governments start the budgeting process for their new fiscal year—beginning on July 1 for 47 of 50 states, they will have to deal with more uncertainty than usual amid confusion around federal funding freezes announced by the Trump administration. Many are likely to scale back their spending, as they have done in previous times of uncertainty.

Municipal credit spreads suggest a generally positive credit outlook by investors, given that BBB and high yield spreads have stayed rather consistent relative to AAA spreads (see Exhibit 3). Spread movements during the first quarter were driven mainly by interest rate volatility.

Exhibit 3: Municipal credit spreads reflect a positive view of fundamentals



Source: Bloomberg, as of March 31, 2025. Past performance cannot guarantee comparable future results. AAA-rated and BBB-rated municipal bonds are represented by the Bloomberg AAA Index and Bloomberg BBB Index respectively. Muni High Yield is represented by the Bloomberg Municipal High Yield Index. Investment Grade bonds (IG) are represented by the Bloomberg Municipal Investment Grade Index. An investment cannot be made in an index.

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Market technicals grew less favorable as the quarter progressed

First quarter supply was stronger than usual for the beginning of a calendar year. Municipal new issuance of $122 billion[6] was considerably higher than the approximately $100 billion of new issuance in the same period last year.[7]

Tax-exempt supply accounted for $114 billion of the total,[6] on par with the fourth quarter of 2024[8] and greater than the $95 billion in the first quarter of 2024.[7] Taxable new issuance was approximately $8 billion in the first quarter of 2025.[6] While slightly higher than the same period in 2024, taxable supply was low compared to previous years, possibly because interest rates remained high by historical standards.[6]

Demand was robust during January and February, on reinvested proceeds from coupon and principal payments, and investment inflows to municipal bond mutual funds continued. However, tax-policy uncertainty, stagflation fears, typical tax season pressures, and Treasury yield volatility dampened investor sentiment in March, leading to investment outflows. Overall, inflows were positive for the first quarter, totaling $9 billion,[9] which was slightly less than the $10 billion of inflows during the first quarter of 2024.[10]

Health care and higher education credits face new headwinds

Trump administration policies are likely to have an impact on a number of municipal sectors, notably health care and higher education. We continue to monitor legislative policies and have thoughts on possible scenarios.

Hospitals

Possible Medicaid reforms and cuts are being considered by the Trump administration and Congress. If significant cuts come to fruition, health care systems that maintain a low market share, are small in scale, or operate in rural regions are likely to be affected. We tend to avoid credits from providers like these. Safety net providers and children's hospitals could also be affected due to the high percentage of patient revenue coming from Medicaid. However, we prefer a select number of large-scale safety net providers that have shown resilience and are of critical importance in large communities or service areas. Additionally, we believe children's hospitals should be able to offset Medicaid cuts with other sources of revenue given their inherent ability to fundraise.

Higher Education

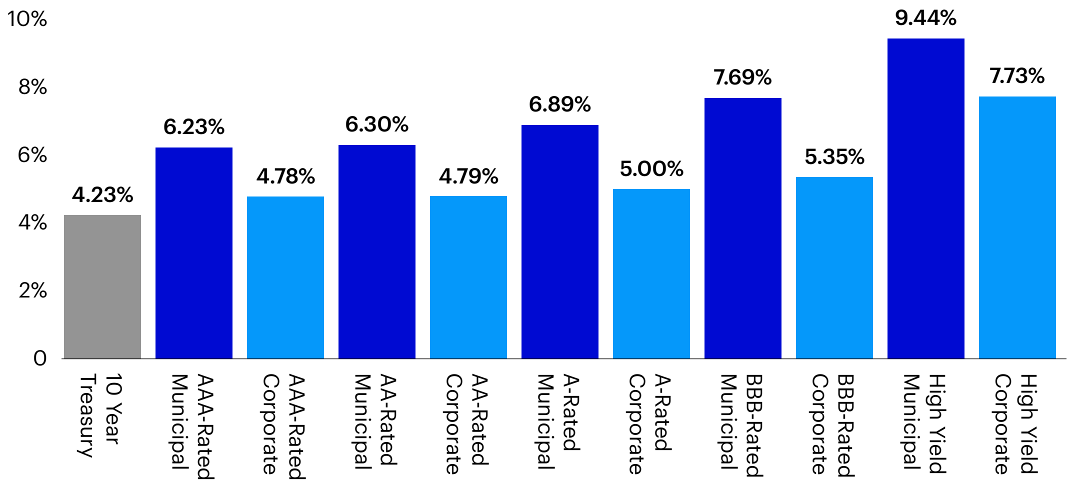
Higher education institutions are dealing with a difficult fundraising environment and falling enrollment numbers. These challenges have been compounded by planned federal funding cuts by the Trump administration. The possibility of private higher education losing its tax exemption is also a potential concern. Against this backdrop, S&P and Fitch made more downgrades than upgrades in 2024 for this sector.[11] We favor larger institutions with established endowments and strong alumni support, which are less dependent on tuition payments and federal funding.

Outlook

With multiple Fed rate cuts predicted for 2025 and steady new issuance, we see opportunities in the municipal bond market due to high absolute yields and strong fundamentals. We expect municipal performance to improve during the summer months as market technicals become more constructive. Muni issuance is often slower in the summer, with less supply to be absorbed. This coincides with an increase in reinvestments from coupon payments and maturing bond proceeds in July and August.

In the near term, we expect continued volatility in the financial markets. Municipals may benefit, as they have historically been a refuge for investors during turbulent periods, This potential benefit may add value to a portfolio by helping to mitigate risk, which can be especially important during periods of uncertainty. Additionally, municipal bonds offer an attractive amount of tax-exempt income on an absolute and relative basis (see Exhibit 4).

Exhibit 4: Yields on municipal bonds are compelling
Tax Equivalent Yields at 40.8%* for selected fixed income municipal bond indices



Source: Bloomberg L.P., data as of March 31, 2025. AAA-rated municipal is represented by the Bloomberg Municipal Bond AAA Index, AA-rated municipal by the Bloomberg Municipal Bond AA Index, and A-rated municipal by the Bloomberg Municipal Bond A Index. BBB-rated municipal is represented by the Bloomberg Municipal Bond BBB Index. High yield municipal is represented by the Bloomberg High Yield Municipal Bond Index. AAA-rated corporate is represented by the Bloomberg US Corporate Bond AAA Index, AA-rated corporate by the Bloomberg US Corporate Bond AA Index, and A-rated corporate by the Bloomberg US Corporate Bond A Index. BBB-rated corporate is represented by the Bloomberg US Corporate Bond BBB Index. High yield corporate is represented by the Bloomberg US Corporate High Yield. An investment cannot be made directly into an index. **Past performance is no guarantee of future results.**

*Assumes a top tax rate of 40.8%: 37% federal tax rate and 3.8% net investment income tax (NIIT), effective Jan. 1, 2025. Irs.gov, as of October 22, 2024. Top marginal tax rate for single taxpayers with more than $626,350 in taxable income or couples with $751,600 or more. NIIT is the net investment income tax investment income for single taxpayers with more than $200,000 in taxable income or couples with $250,000 or more.

Regarding fiscal policy, any tax policy changes that could impact municipals are not expected to take effect until 2026; however, we will continue to monitor developments related to the Tax Cuts and Jobs Act, which is set to expire at the end of this year. In the coming months, we may see some municipal market volatility stemming from discussions around tariffs, legislative proposals related to the municipal tax exemption, the state and local tax deduction, private activity bonds, and tax rates.

We remain committed to our time-tested process, taking a long-term view without reacting to short-term market events. Our seasoned credit research team will continue to help us to identify opportunities, as we seek to provide long-term value for investors.

1. Source: Bloomberg, as of March 31, 2025. 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. Past performance does not guarantee future results.
2. Source: Federal Reserve, as of January 29, 2025.
3. Source: Thomson Reuters, data as of March 31, 2025.
4. Source: Standard and Poor's, as of March 31, 2025.
5. Source: Barclays Municipal Research, as of December 5, 2024.
6. Source: Bloomberg, as of March 31, 2025.
7. Source: Bloomberg, as of March 31, 2024.
8. Source: Bloomberg, as of December 31, 2024.
9. Source: LSEG Lipper, as of March 31, 2025.
10. Source: LSEG Lipper, as of March 31, 2024.
11. Source: Barclays, as of March 13, 2025.

A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other debts. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. NR indicates the debtor was not rated and should not be interpreted as indicating low quality. For more information on rating methodologies, please visit the following NRSRO websites: www.standardandpoors.com and select 'Understanding Credit Ratings' under Rating Resources 'About Ratings' on the homepage.; https://ratings.moodys.io/ratings and select 'Understanding Ratings' on the homepage.; www.fitchratings.com and select 'Ratings Definitions Criteria' under 'Resources' on the homepage. Then select 'Rating Definitions' under 'Resources' on the 'Contents' menu.

Market technicals include supply and demand for a security and how it can affect changes in price, volume, and volatility.

Bloomberg Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market.
Bloomberg Municipal High Yield Bond Index is generally representative of bonds that are non-investment grade, unrated or rated below Ba1.
Bloomberg Taxable Municipal Index measures the US municipal taxable investment grade bond market.
Bloomberg Municipal Bond AAA Index is an unmanaged index of the AAA-rated municipal bond market.
Bloomberg Municipal Bond BBB Index is an unmanaged index of the BBB-rated municipal bond market.
Bloomberg Municipal Bond AA Index is an unmanaged index of the AA-rated municipal bond market.
Bloomberg Municipal Bond A Index is an unmanaged index of the A-rated municipal bond market.
Bloomberg Municipal Bond BBB Index is an unmanaged index of the BBB-rated municipal bond market.
Bloomberg US Corporate Index is an unmanaged index considered representative of the fixed-rate taxable corporate bond market
Bloomberg US Corporate Bond AAA Index is an unmanaged index considered representative of AAA-rated fixed-rate taxable corporate bond market.
Bloomberg US Corporate Bond AA Index is an unmanaged index considered representative of AA-rated fixed-rate taxable corporate bond market.
Bloomberg US Corporate Bond A Index is an unmanaged index considered representative of A-rated fixed-rate taxable corporate bond market.
Bloomberg US Corporate Bond BBB Index is an unmanaged index considered representative of BBB-rated fixed-rate taxable corporate bond market.
Bloomberg US Corporate High Yield Index is an unmanaged index considered representative of fixed-rate, noninvestment-grade taxable corporate bond market.
US Treasury is represented by the public obligations of the US Treasury. Treasurys 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.

About Risk

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.

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Past performance does not guarantee future results.

Diversification does not guarantee a profit or eliminate the risk of loss.

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There is no guarantee the outlooks mentioned will come to pass. These opinions may differ from those of other Invesco investment professionals.