

# Reconsidering municipal allocations: Is it time to get excited again?



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## From asset class fatigue to excitement?

Municipal bonds have long been a haven for investors for their diversification benefits, relatively low risk and lower default rates relative to corporates, historical income stability, potential tax benefits, and support for public projects. While none of these potential benefits have changed, investors have become fatigued by lackluster performance over the last few years relative to their history and compared to other asset classes. Despite some headwinds, we believe that the overall health of the municipal market remains strong. Given attractive valuations, historically high yields along with slowing supply, and an interest rate cut acting as a catalyst for demand, we believe that now is the time to reconsider current municipal bond allocations in investors' portfolios. We will explore what is driving investor fatigue, and whether concerns of the overall credit health of the municipal market is warranted. Most importantly, we outline what an entry point back into municipal bonds could look like and where we are finding compelling opportunities.



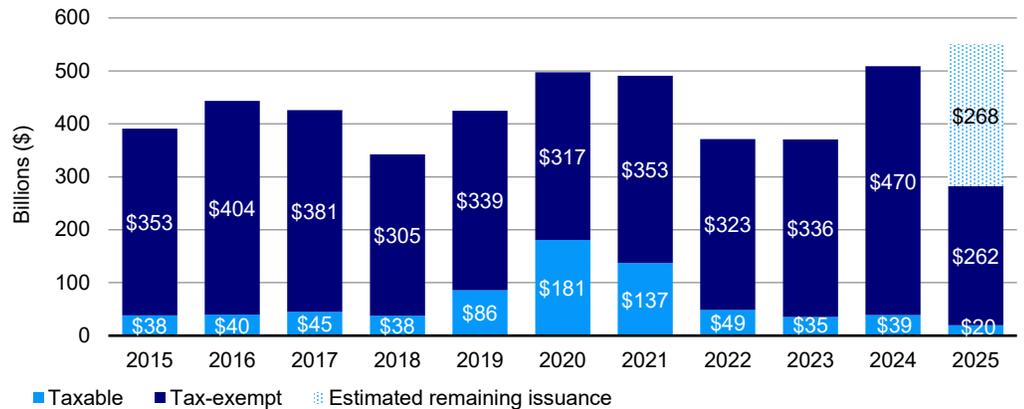
Increased supply, higher interest rates, investor uncertainty, and attractive ultra-short duration yields have resulted in a drag on municipal performance in 2025.

### Overcoming investor fatigue

For eight consecutive years municipal bond investors enjoyed positive returns alongside the tax-exempt income their investments generated. In 2022, we saw a reversal and municipal bonds had their first negative return since 2013. Since then, fixed income markets have experienced a more challenging period due to rising interest rates to combat inflation; and more recently, policy uncertainty resulting in mixed performance. This year has been no different and the S&P Municipal Bond Index returned 0.40% through the end of August.<sup>1</sup> Investors have historically looked to this asset class for tax-exempt income, resilience during market downturns, and relative stability compared to equity markets. However, investors are increasingly fatigued by the market results relative to other asset classes and are starting to question if there are more systemic issues that are driving the performance. We do not believe that is the case as municipal bonds have experienced mostly technical anomalies in 2025:

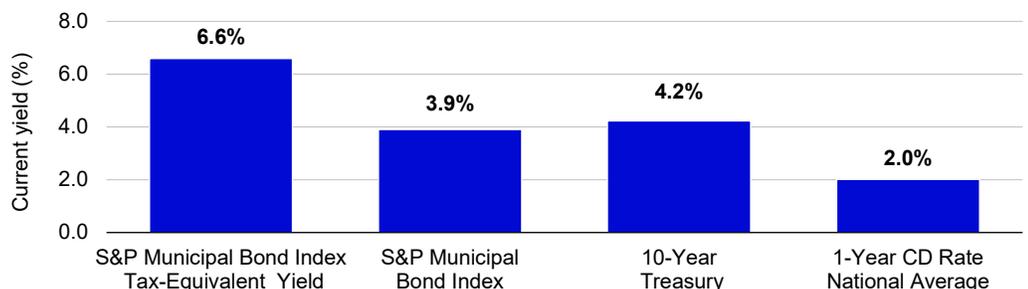
- **Increased supply:** With COVID-19 stimulus winding down and higher construction costs due to inflation, states and local governments have been issuing more debt. Issuers also front-loaded supply at the beginning of the year due to policy uncertainty around the tax-exempt status of municipal bonds. Current estimates for 2025 have been revised upward throughout the year and annual issuance is currently estimated to be \$550 billion (see Exhibit 1). We believe an increase in supply is the “new normal” with the market being able to absorb the higher level of new issuance.
- **Higher interest rates:** Bond prices were boosted by rate cuts in 2024, but rates remain relatively high as the Federal Reserve (Fed) is taking a conservative approach to managing inflation.
- **Investor uncertainty:** The potential elimination of the tax-exempt status for municipals, resulted in a more cautious approach from investors. While this has abated, it did act as a headwind earlier this year.
- **Attractive yields in US Treasuries and CDs:** Currently the 10-Year US Treasury is 4.2% and the national average for the 1-year CD rate is 2.0% (see Exhibit 2).

**Exhibit 1: Municipal market supply 2015-2025**



Source: Bloomberg. Data as of June 30, 2025. Fixed and zero coupons only. Notes excluded. There is no guarantee estimates or forecasts will come to pass. Most recent data available.

**Exhibit 2: Current yields (%)**



Source: Standard & Poor's, Bloomberg, Bankrate.com, as of August 31, 2025. Past performance is not a guarantee future results. For illustrative purposes only. It is not possible to invest directly in an index. Tax-equivalent yield is the pretax yield a taxable bond needs to equal that of a tax-free municipal bond. The maximum tax rate of 40.8% (maximum tax bracket and 3.8% health care tax) was used to calculate the tax-equivalent yield in the chart above. The yield for the 10-Year Treasury Note and the 1-Year CD Rate National Average. Please refer to the index definitions on page 8.

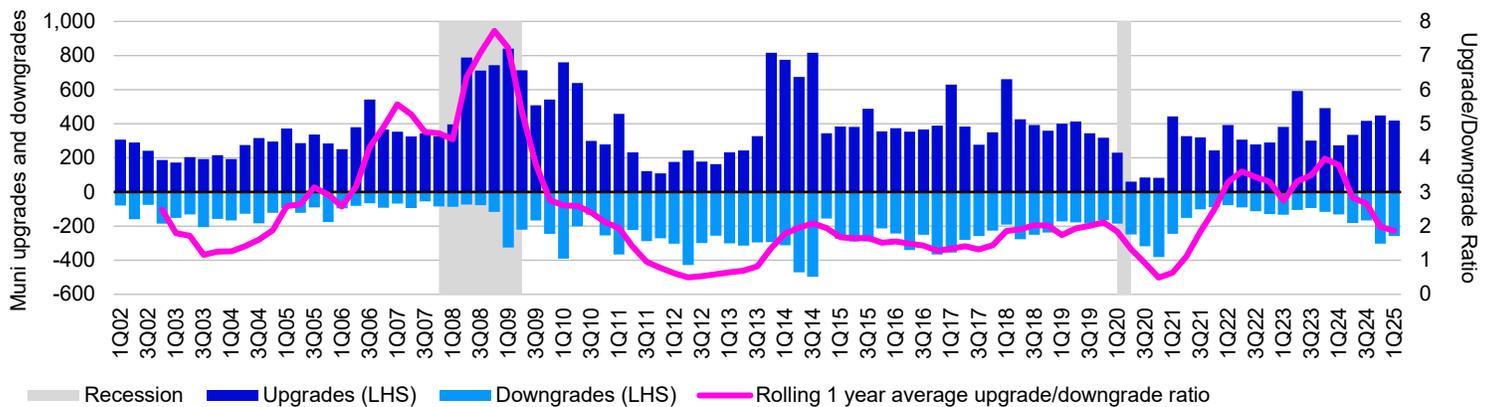


## Is the credit market in good health?

Fundamentals have remained strong as we have seen 17 consecutive quarters of upgrades outpacing downgrades (see Exhibit 3). However, economic growth is moderating, and ratings along with it. For the first time since the fourth of quarter 2020, Moody's had downgrades slightly outpacing upgrades, while S&P has continued to have upgrades outpacing downgrades. This combination has resulted in a net positive for the most recent quarter. Another sign of improving credit health is the recent upgrade by Moody's for the state of New Jersey to Aa3 from A1. They also revised their outlook from positive to stable, noting its growing tax revenue, and the administration's commitment to fully fund the pension system.<sup>2</sup> While we would expect some moderating to continue, almost 92% of the municipal market is rated above investment grade. Furthermore, roughly 97% of AAA credits and 94% of AA credits maintained their S&P ratings from 1986 – 2024.<sup>3</sup> We believe these stats underscore the historical stability of the municipal market and we do not believe there will be a meaningful weakening of average ratings. Municipals have also had historically low default rates as well, with BBB municipals defaulting at a lower rate than AAA corporates (see Exhibit 5).<sup>4</sup>

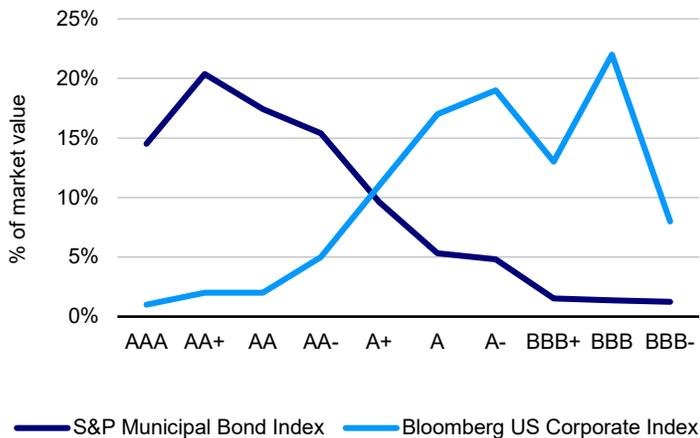
### Exhibit 3: Credit upgrades outpace downgrades

Upgrades exceeded downgrades for the 17th consecutive quarter in 1Q 2025



Sources: S&P Global Ratings Research and Moody's Investors Service, J.P. Morgan, as of March 31, 2025, latest data available. Chart reflects net total of both S&P and Moody's upgrades and downgrades. Moody's Investors Service, gray shaded area indicates recessionary period (data not available prior to 1Q 2002). 1Q 2017 saw a revision of local govt GO methodology, leading to one-time spike in upgrades.

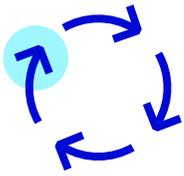
### Exhibit 4: Credit breakdown by market value



### Exhibit 5: Standard & Poor's (S&P) cumulative historical default rates (rated issues only)

Rating categories (Moody's/S&P)	S&P	
	(1986-2024)	(1981-2024)
AAA	0.00	0.81
AA	0.03	0.96
A	0.08	1.57
BBB	0.73	3.80
BB	4.14	12.90
B	10.32	24.20
CCC-C	36.31	55.70
Investment Grade	0.15	2.33
Non-Investment Grade	7.41	22.18
All	0.24	10.96

Exhibit 4 sources: Morgan Stanley Research, Bloomberg Composite Ratings, as of June 30, 2025. Exhibit 5 source: Standard and Poor's ("S&P") data through December 31, 2024, released April 29, 2025. Past default rates are no assurance of future default rates. 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. For more information on rating methodologies, please visit the following NRSRO websites: [www.standardandpoors.com](http://www.standardandpoors.com) and select 'Understanding Credit Ratings' under Rating Resources 'About Ratings' on the homepage; <https://ratings.moody's.io/ratings> and select 'Understanding Ratings' on the homepage; [www.fitchratings.com](http://www.fitchratings.com) and select 'Ratings Definitions Criteria' under 'Resources' on the homepage. Then select 'Rating Definitions' under 'Resources' on the 'Contents' menu. Please refer to the index definitions on page 8.

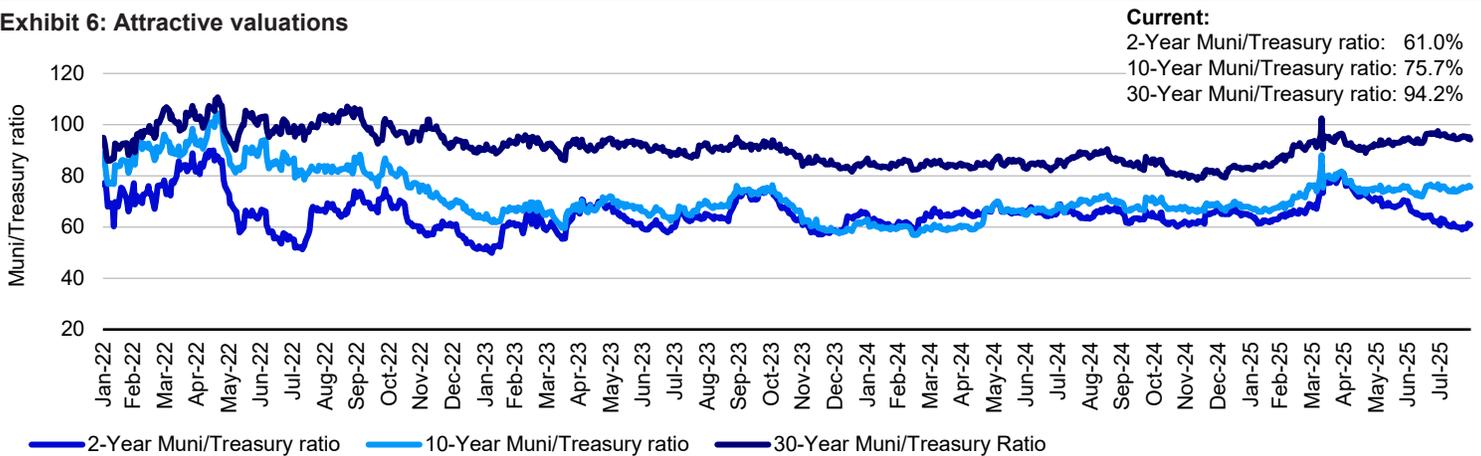


## What does an attractive entry point look like?

There are several factors that can point to an entry point for municipal bonds and many already exist currently in the marketplace.

- **Attractive valuations:** Muni/Treasury ratios above 80% indicate a better relative value for municipal bonds relative to Treasuries – and even more so – when considering their tax-exempt status. Over the last 10 years, valuations for municipals at the longer end of the curve are currently most attractively valued for investors in our view (see Exhibit 6).
- **Steepening yield curve:** Since the beginning of the year, we have started to see a steepening at the longer end of the yield curve driven by shifting investor demand, record supply, and uncertainty around federal policy. This steepening has resulted in higher yields compared to shorter-term bonds. While we believe that yields are attractive across the entire credit spectrum, they are the highest in the BBB to high yield range (see Exhibit 7).

Exhibit 6: Attractive valuations



Source: Bloomberg, as of August 31, 2025. Past performance is no guarantee of future results. The Municipal/Treasury Ratio is calculated by comparing the yield of a municipal bond vs the yield of equivalent US Treasuries. The ratio is used to measure relative value, and a lower ratio indicates municipal bonds are more expensive and less attractive on a pre-tax basis while a higher ratio suggests that municipals may be undervalued and potentially offer more compelling after-tax income for investors. Past performance is no guarantee future results.

Exhibit 7: AAA municipals – historical curve steepness

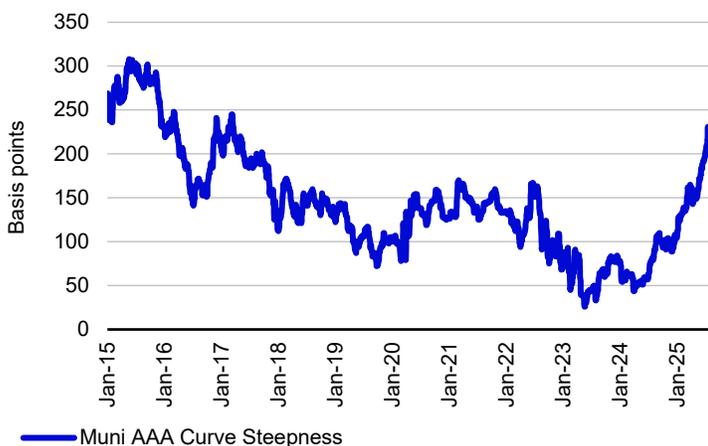


Exhibit 8: Municipal bond yields across the credit spectrum

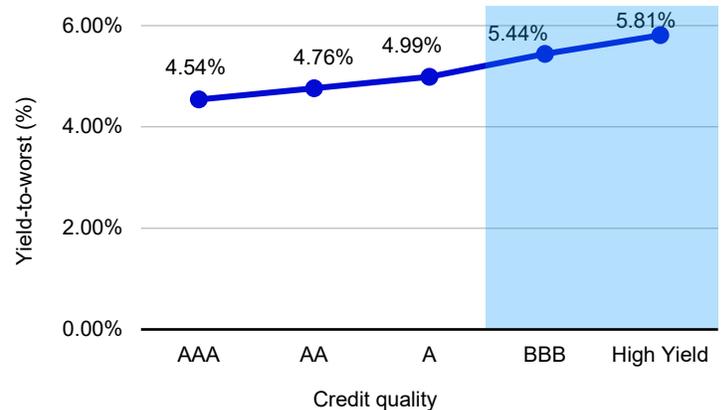
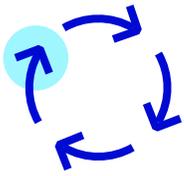


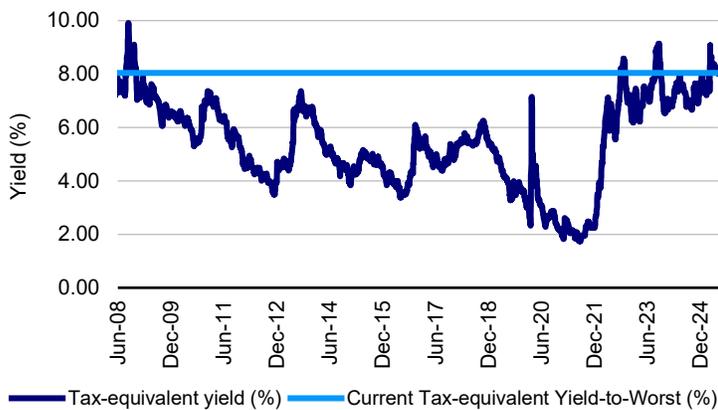
Exhibit 7 source: MMD, as of August 31, 2025. Exhibit 8 source: Source: Barclays, Invesco, as of June 30, 2025. Based on thirty-year maturities. Shaded area represents securities rated BBB (investment grade) to BB and below (high yield). Lower-rated municipal bonds involve a greater risk of default or price changes due to changes in the credit quality of the issuer. The values of such bonds fluctuate more than those of high-quality bonds in response to company, political, regulatory or economic developments. Values of these bonds can decline significantly over short periods of time. Yields for AAA, AA, A, and BBB rated funds are based on the Bloomberg Municipal AAA, AA, A and BBB Indices. The yield for high yield is based on the Bloomberg High Yield Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Please refer to the index definitions on page 8.



## What does an attractive entry point look like? (continued)

- High tax-equivalent yields relative to history:** Munis not only offer attractive after-tax yields compared to riskier corporate bonds and equities, but their current tax-equivalent yields are also near 15-year highs for top bracket investors (see Exhibit 9). Additionally, municipal bonds offer important diversification and quality characteristics (see Exhibit 10). Munis are currently offering tax-equivalent yields around 8%, which is an equity-like return level, and with a fraction of the volatility compared to equities (see Exhibit 10).<sup>5</sup> When municipals are presenting at historically attractive yield levels, they can offer investors an entry point to potentially maximize income and capital appreciation.
- Interest rates may act as a catalyst for flows and returns:** When interest rates have fallen, investors have historically moved quickly into municipal bonds as illustrated during both the financial crisis (see Exhibit 11) and the interest rate cycles (see Exhibit 12). Municipals are already trading at attractive valuations; have historically high yields with appealing volatility characteristics and an interest rate cut could further boost bond prices.

**Exhibit 9: Municipal bonds offer attractive tax-equivalent yields**



**Exhibit 10: Municipal bonds offer attractive volatility characteristics**

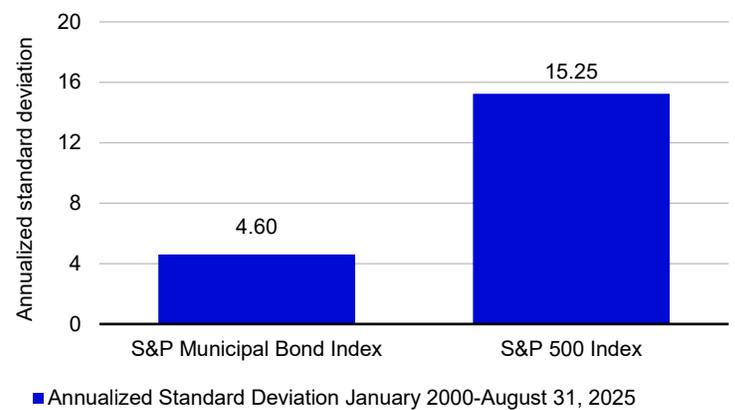
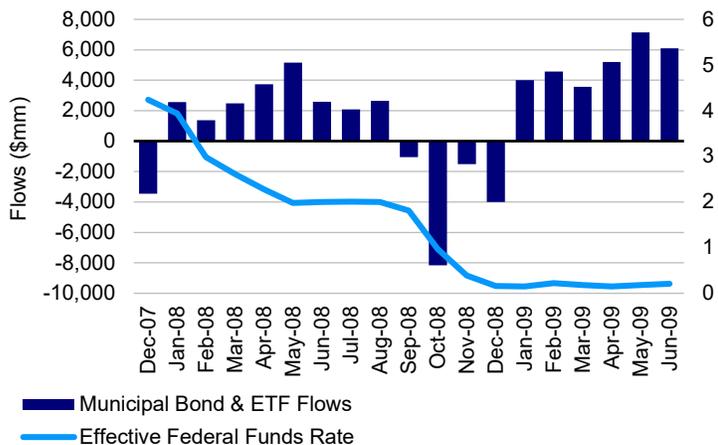
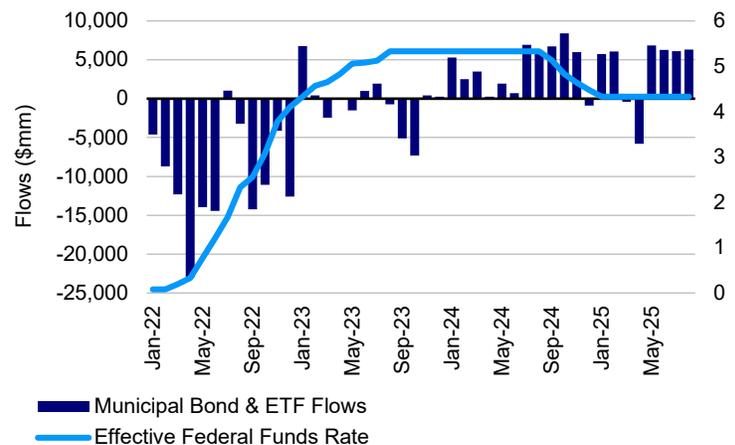


Exhibit 9 source: Bloomberg. Data as of June 30, 2025. Assumes a federal tax rate of 35% from 2004 to 2012, 39.6% from 2013 to 2017, and 37% from 2018 to 2025. Also assumes an additional 10% state income tax and 3.8% Net Investment Income (NIIT) tax as of 2013. Exhibit 10 source: Morningstar, as of August 31, 2025. Standard deviation is Standard deviation is used to measure the dispersion within a dataset relative to the mean and is often used as a measure of the relative riskiness of an asset. Past performance is no guarantee of future results. For illustrative purposes only. Please refer to the index definitions on page 8.

**Exhibit 11: Interest rate cuts during the financial crisis**



**Exhibit 12: Interest rate increases and cuts: 2022-2025**



Exhibits 11 and 12 sources: Morningstar and Bloomberg. Data as of August 31, 2025. Morningstar fund flows are that of all open-end mutual funds and ETFs across all municipal bond categories. Federal Funds rate is Federal Funds effective rate and is a spliced series of the mean-based calculated values of the effective rate prior to March 1, 2016, and the median-based calculated values of the effective rate from March 1, 2016. Past performance is no guarantee future results.

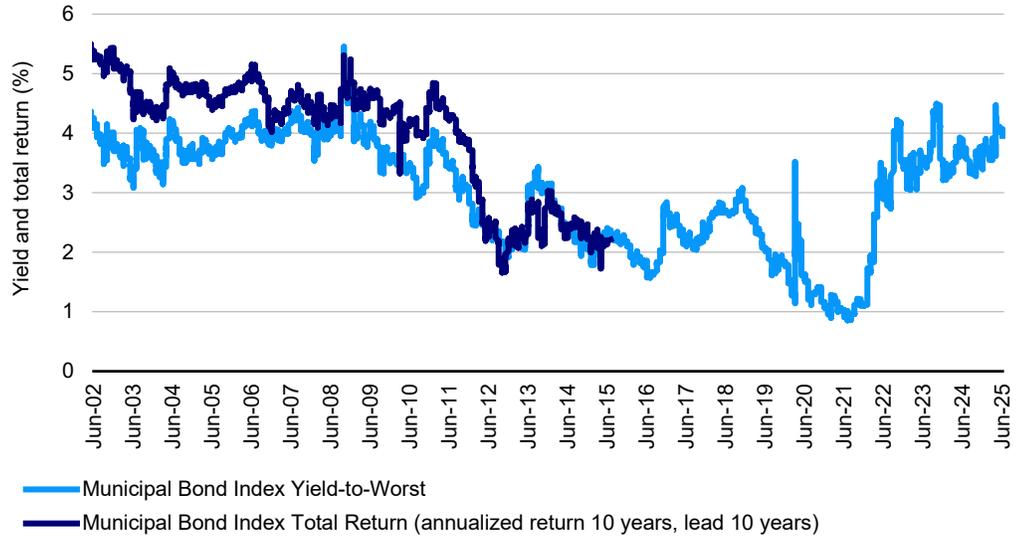


Over time, yield drives total return. As investors wait for quantitative easing to resume, municipals are paying out attractive levels of income. In essence, they are being paid to wait for an increase in municipal valuations.

### The importance of yield

Yield matters for several reasons. It is a measurement of comparative strength to other fixed income securities, a potential indicator for an entry point when at historical levels, and an indicator of potential for capital appreciation. There is up to a 90% correlation between starting yields and future 10-year returns (see Exhibit 13).

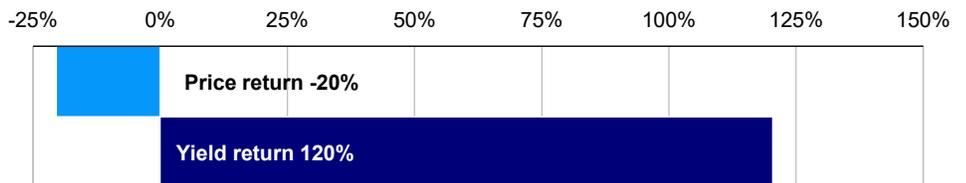
**Exhibit 13: Historical correlation up to 90% between starting yield and future 10-year returns**



Sources: Macrobond, Bloomberg. L.P. Data as of June 30, 2025. Past performance is no guarantee future results. Correlation data is a 10-year lag. Please refer to the index definitions on page 8.

While yield levels are an indicator for future potential income and returns for investors, they also play an important role in current and historical returns. Yields have been the primary driver of total return performance over the last 10 years (see Exhibit 14). While a combination of price return and yield return is optimal to maximize performance, investors are currently being paid to wait for the capital appreciation of the bonds they own.

**Exhibit 14: Contribution to cumulative 10-year total return**



Bloomberg High Yield Municipal Index return (%)			
	Price return	Yield return	Total return
Cumulative	-22.76	134.19	111.43
Annualized	-0.72	5.84	5.12

Source: Morningstar, as of June 30, 2025. The Bloomberg High Yield Index is represented above. An investment cannot be made directly in an index. Past performance is no guarantee future results.



We believe active management gives investors the greatest potential to capture opportunities across the credit quality and duration spectrum to capture income and potential capital appreciation.

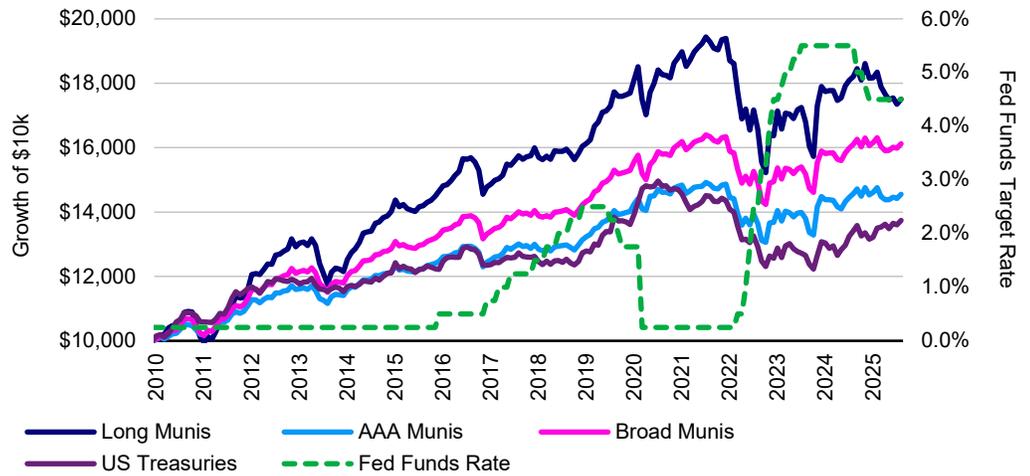
### Navigating the market & discovering opportunities

With recent interest monetary easing, and more anticipated on the horizon, now might be an opportune time for investors to reevaluate their allocation and investment strategies with municipals. The market is already pricing in an interest rate cut and the yield curve is already flattening at the shorter end of the curve. As of mid-September, the 10-year treasury yield is just over 4.0%.<sup>6</sup>

Overall, we believe yields are attractive across the credit spectrum and especially at the longer end of the curve. Actively managed strategies give investors options to remain flexible to capture the best opportunities whether it is across the credit spectrum or through extending duration.

Currently, we believe lengthening a portfolio’s duration could help to take advantage of the potential price appreciation while providing income for longer, in a falling interest rate environment. Investors have been focused on the shorter end of the curve; however, longer-term municipals have remained attractive from a yield and price appreciation perspective (see Exhibit 15). We also believe that their market position will strengthen and are poised for a bounce as the Fed continues to cut rates.

**Exhibit 15: Contribution to cumulative 10-year total return**



Source: Bloomberg, L.P. Data as of August 31, 2025. Chart above shows the growth of a \$10,000 investment since from January 1, 2010 – August 31, 2025. Long Munis are represented by the Bloomberg Municipal Long Bond Index. AAA Munis are represented by the Bloomberg Municipal Bond AAA Index. Broad Munis are represented by the Bloomberg Municipal Bond Index. US Treasuries are represented by the Bloomberg US Treasury Index. The Fed Funds Rate refers to the upper limit of the federal funds target range established by the Federal Open Market Committee. Past performance is no guarantee future results. It is not possible to invest directly in an index.

### Summary

While municipal bonds have faced some headwinds in 2025, we believe that overall credit health remains strong, valuations are attractive, and yields are at almost historical highs. We believe further monetary easing may be the final piece to a potential rally, making this a good time to revisit allocations to municipal bonds.

Furthermore, we believe that active management gives investors the potential to capture opportunities across the credit quality and duration spectrum that translate into capital appreciation and income.

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](http://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](http://www.fitchratings.com) and select 'Ratings Definitions Criteria' under 'Resources' on the homepage. Then select 'Rating Definitions' under 'Resources' on the 'Contents' menu. A basis point is a unit that is equal to one one-hundredth of a percent. Market technicals include supply and demand for a security and how it can affect changes in price, volume, and volatility. Fundamentals refer to financial and operational data of state and local government issuers, used by investors to analyze the creditworthiness of municipal bonds. This data includes the issuer's overall fiscal health, debt burden, revenue growth, reserve positions, liquidity, and pension obligations.

## Sources

1. Morningstar. Data as of August 31, 2025. Past performance is no guarantee of future results.

Calendar Year Total Return	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
S&P Municipal Bond Index	-2.55	9.26	3.32	0.77	4.95	1.36	7.26	4.95	1.77	-8.05	6.03	1.90

2. Source: Moody's Ratings. Data as of September 18, 2025.

3. Source: J.P. Morgan Intelligence, as of August 31, 2025.

4. Source: J.P. Morgan Intelligence, as of May 31, 2025.

5. Source: Morningstar as of August 31, 2025. The year-to-date return for the S&P 500 Index was 10.79%.

6. Source: Bloomberg L.P. The 10-year U.S. Treasury yield between June 1, 2025 – September 15, 2025.

## Index definitions

The S&P Municipal Bond Index is a broad, market value-weighted index that seeks to measure the performance of the US municipal bond market.

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

The Bloomberg Municipal Bond High Yield Index is an unmanaged index considered representative of noninvestment grade and non-rated municipal bonds.

The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It is not possible to invest directly in an index.

The MMD AAA curve is a market leading yield curve used by buy side and sell side institutional market participants for over 30 years to measure market risk, interest rate risk and determine yield action on an intraday basis. The middle point where institutional sell side and buy side accounts expect to transact. The MMD AAA curve is derived using tax-exempt state GO bonds with AAA rating, 5% coupon, 10-year par call, non-AMT and \$2m+ in size. In addition, inputs into the creation of the curve are both objective and subjective. Examples of objective analysis are observable and measurable and include primary market levels, secondary market trades, two sided markets, bids and offerings and many other factual data points. Examples of subjective analysis include information from an MMD analysts' point of view, including validating perceptions and concerns of market activity using insight and opinion.

The S&P 500 Index is an unmanaged index considered representative of the U.S. stock market.

The Bloomberg Municipal Bond AAA Index is an unmanaged index considered representative of the AAA municipal bond market.

The Bloomberg US Treasury Index measures U.S. dollar-denominated, fixed rate, normal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint. STRIPS are also excluded from the index because of their inclusion would result in double-counting.

## 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 typically pay interest that is tax-free in their state of issuance. Because of their tax benefits, municipal bonds usually offer lower pre-tax yields than similar taxable bonds.

All data as of September 25, 2025, unless otherwise stated. All data provided by Invesco unless otherwise noted. The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals. Invesco does not provide tax advice. The tax information contained herein is general and is not exhaustive by nature. It is not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding tax penalties that may be imposed on the taxpayer under US federal tax laws. Federal and state tax laws are complex and constantly changing. Investors should always consult their own legal or tax professional for information concerning their individual situation.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions. Past performance does not guarantee future results. An investment cannot be made into an index. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations. There is no guarantee the outlooks mentioned will come to pass. Diversification does not guarantee a profit or eliminate the risk of loss.