Invesco

Investment Insights

Five reasons why municipal bonds are compelling post-election

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Key takeaways:

Monetary easing - A macroeconomic environment of potentially lower rates is supportive of municipal bonds.

Attractive yields - Muni yields are still near their 10-year historical highs following two years of Federal Reserve (Fed) rate hikes.

Supportive fundamentals - Fiscal stimulus and strong revenue collections have helped maintain robust muni credit fundamentals**.**

With the presidential and congressional elections in the rearview mirror, we're now focused on the road ahead. Here are five key reasons to consider an allocation to tax-exempt munis now.

1. A unified government has mostly been good for munis

Many financial pundits have said a divided government is good for the markets, but unity has also been good for municipals. Four of the last five periods of unified government have created positive returns in the municipal market, with lower credit quality usually outperforming. (See chart below.) Remove the period with the end of a global pandemic and aggressive rate increases, and the remaining four united periods have averaged 8.70% for the investment grade index and 21.67% for the high yield index. Of course, past performance is not a guarantee of future results.

Presidential term	George W. Bush 2003 - 2005	George W. Bush 2005 - 2007	Barack Obama 2009 - 2011	Donald Trump 2017 - 2019	Joe Biden 2021 - 2023
Investment grade muni	11.10%	7.98%	9.15%	6.58%	-4.60%
AAA	11.10	7.75	6.64	5.42	-4.97
AA	9.91	7.75	7.46	5.96	-4.57
A	11.61	9.37	10.66	7.40	-4.37
BBB	19.63	16.62	20.35	10.67	-4.81
High yield muni	20.97	19.83	32.16	13.70	-3.32

Source: Bloomberg, as of December 12, 2024. Dates used reflect January 20 of each year. Investment Grade Muni is represented by the Bloomberg Municipal Bond Index, an unmanaged index considered representative of the tax-exempt bond market. AAA is represented by the Bloomberg Municipal Bond AAA Index and is an unmanaged index of the AAA-rated municipal bond market. AA is represented by the Bloomberg Municipal Bond AA Index is an unmanaged index of the AA-rated municipal bond market. A is represented by the Bloomberg Municipal Bond A Index is an unmanaged index of the A-rated municipal bond market. BBB is represented by the Bloomberg Municipal Bond BBB Index is an unmanaged index of the BBB-rated municipal bond market. High Yield Muni is represented by the Bloomberg Municipal High Yield Bond Index which is generally representative of bonds that are non-investment grade, unrated or rated below Ba1. The Bloomberg Municipal High Yield Bond Index data as of inception of May 30, 2003. Monthly data is reflected from 2003-2005 and 2005-2007. An investment cannot be made into an index. **Past performance is not a guarantee of future results.**

2. Yields are attractive

Bonds are back to acting like bonds, and this includes munis. Today's yields are attractive, providing higher income levels and lowering the correlation between bonds and equities. Muni bond yields are higher than they've been in the past several years following two years of unprecedented interest rate hikes by the Fed. The good news is that the Fed has finally begun to cut interest rates. The great news is we're only in the very early innings of the easing cycle. The muni market has experienced 23 consecutive weeks of net inflows, as of December 4, 2024.[1] Yet, there remains over $7 trillion on the sidelines in money market funds.[2] When these dollars truly start to go to longer duration options, the muni market should benefit, resulting in lower yields and higher prices.

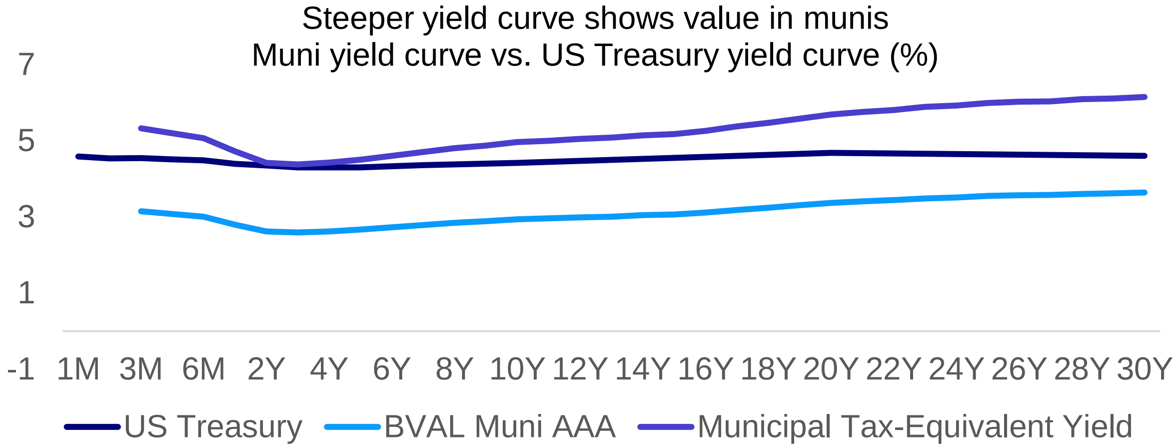
3. Tax exemption is key

As always, taxes are what will matter the most for munis. Trump's victory and red sweep will likely result in an extension of the Tax Cuts and Jobs Act of 2017. This act capped itemized deductions of state and local property taxes (SALT) at $10,000, which effectively increased individuals' state tax rates. This, in turn, was viewed as a driver of demand for tax-free municipals, particularly in high tax states like California, New York, and New Jersey. An additional 3.8% tax on wealth – levied by the Affordable Care Act and exempt from muni income – drives the total tax rate up to 40.8%, which is higher than the George W. Bush years of 37% and only 2% lower than the Obama years. We believe there will likely be no change in top individual tax rates, and the SALT cap will remain in place, possibly with an increase in the deduction cap, which should keep munis in high demand. If an investor in the highest federal tax bracket earns 4% in a tax-exempt municipal bond fund, they would need to earn 6.75% in a taxable fixed income investment to take home the same amount of money after taxes. If they earned 5% in a municipal fund, they need almost 8.5% tax-equivalent yield, and that doesn't account for potential state taxes.[3]

Additionally, there have been some reports that the municipal tax-exemption could come under increased scrutiny. While this makes for a snappy headline, we believe the muni tax exemption, which was established over 100 years ago, is safe. If something were to happen to the exemption, we strongly believe existing muni bonds would be exempt from any tax law changes, which would make the existing exemption more valuable.

4. Steeper yield curve indicates value

Municipal investors should benefit from higher yields on the long end compared to the relatively flat US Treasury curve, as the chart below shows.



Source: Bloomberg, L.P. as of December 9, 2024. A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. Past performance does not predict future returns. The BVAL AAA Callable Curve is a standard market scale with non-call yields up to year 10 and callable yields thereafter. US Treasury is represented by the public obligations of the US Treasury. 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. An investment cannot be made directly into an index.

5. Municipal credit fundamentals remain robust

Municipal bonds have a long history of low defaults compared to corporate bonds, because they fund essential US services. Credits are currently very strong, and in 2024, we're seeing two credit rating upgrades for each credit rating downgrade.[4] This is on the heels of a nearly 4-1 upgrade to downgrade ratio in 2023. Additionally, all states are investment grade, with 48 of the 50 having credit ratings of AA and higher.[5] This is due to strong balance sheets, robust rainy day fund balances expected to end higher than the previous fiscal year, and, state and local taxing bodies collecting higher revenues than in pre-COVID-19 years.

What's notable is that the state and local authorities have been fiscally responsible with the influx of cash, beefing up reserve funds instead of spending the money frivolously or on new programs that would be difficult to maintain without a continuous flow of federal dollars. This means the vast majority of municipal bonds have the ability to continue paying principal and interest to bondholders.

Potential Bonus Reason

Many municipal market participants, our team included, view the nomination of Scott Bessent as Treasury secretary in a positive light. Bessent understands fixed income markets and is likely to be a strong supporter of the municipal tax exemption.

Quick Sector Views

Charter Schools	Tobacco: Master Settlement Agreement (MSA)	Transportation
The Republican-led House Appropriations Committee supported increasing charter school funding. The potential for increased federal funding would be a credit positive for the sector.	This sector lagged in 2024 and is among the least expensive parts of the high yield municipal market. The next chief of staff, Susie Wiles, is a former tobacco lobbyist; regulators might begin to snuff out illegal cigarettes which decreases MSA participant's market share, and a proposed ban on menthol cigarettes could be paused or abandoned.	Increased tariffs could have a negative impact on certain subsectors within transportation. A reduction in imports and cargo shipments could decrease margins at ports, and, to a lesser degree, some airports.

Conclusion

Muni bonds are compelling in the current environment, especially when investors begin to seek duration as the Fed continues its monetary easing cycle. We believe a favorable macroeconomic environment – attractive yields, positive market technicals and credit fundamentals, election results, and an eventual return to longer-term investments as investors move out of cash – suggest potential positive muni performance ahead.

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

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.

Sources:

1. Lipper, as of December 4, 2024.
2. Bloomberg, as of November 14, 2024.
3. Assuming 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.
4. S&P rating changes: 747 credit ratings upgraded versus 345 downgraded over twelve months ending August 31, 2024.
5. Bond Buyer, as of September 18,2024.

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 December 4, 2024, unless otherwise stated.

All data provided by Invesco unless otherwise noted.

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