# Municipal Market Update

4th Quarter 2024

By: Loomis Sayles Municipal Bond Team

## ECONOMY AND RATES

- 5-year and longer Treasury yields (including 10-year, 20-year and 30-year) rose during the fourth quarter and for the full year 2024. During the third quarter a downward trend in both short and long term interest rates was in effect, owing to a cooling sentiment about the U.S. economy and an expectation for an aggressive easing campaign by the Federal Reserve (Fed). However, during the fourth quarter the narrative shifted incrementally toward a resilient economy and in our view the Fed being more mindful of persistent inflation in making policy decisions.
- Short term (3-month) Treasury rates did fall during the quarter, pushed downward by the Fed's 25 basis point reduction to the Fed Funds rate in both November and December. However, the Fed's December policy statement contained new language introducing doubt about the "extent and timing" of future rate cuts, which lowered expectations for the magnitude of easing in 2025. This led to a steepening the yield curve and a bond market rout in December.
- Broadly speaking and using the 10-year Treasury yield as the market barometer, yields rose into the November election as the implications of a potential Republican sweep came into focus. After a couple weeks of remaining rangebound post-election, rate markets rallied into November month-end partially buoyed by Scott Bessent being nominated as the next Treasury secretary and the general belief that he would be an inflation hawk from a fiscal perspective, helping to ease inflation concerns associated with the anticipated tariffs under the new administration. Rate market sentiment turned bearish once again in December as economic data indicated a resilient economy, persistent inflation, and portended a less accommodative Fed narrative, which appeared to be confirmed by the Fed's comments post the December Federal Open Market Committee (FOMC) meeting.
- The 10-year Treasury yield closed out the quarter at 4.57%, having entered the fourth quarter at 4.17% and having begun the calendar year 2024 at 3.88%. For reference, the benchmark rate still sits more than a quarter point below the cyclical peak of roughly 5% which was notched in October 2023.
- Loomis Sayles' Macro Strategies team currently assigns a 55% probability to a "Softer Landing" scenario, which we frame through the lens of an economy where GDP remains near the current 1.5%-2.0% growth trend. "Higher Landing" (indicative of an economy where growth ticks up slightly above the current trend and the Fed becomes increasingly hawkish) has ascended to become their second most likely scenario at 35%. Meanwhile, "Growth Scare"—a notable softening of economic growth where the GDP growth rate decelerates to near 0%—has been demoted to their least likely scenario at 10%.

## MUNICIPAL MARKET PERFORMANCE

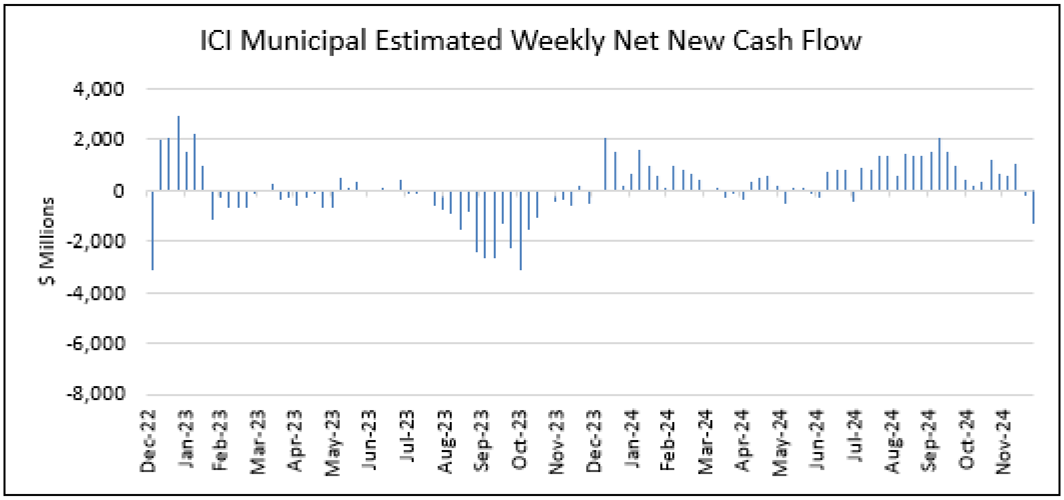
- Municipal (muni) yields rose in the fourth quarter, reversing the trend from the third quarter, while generally outperforming Treasurys.
- The upward trend in yields produced a negative total return for the Bloomberg Municipal Bond Index, which posted a -1.22% return in Q4, while posting a modestly positive total return of 1.05% for the full year.
- While the intermediate and long portions of the muni curve saw negative performance in Q4, the front-end inside of 2 years eked out slightly positive returns due to its elevated level of carry and lower price sensitivity to interest rate increases.
- On balance, the overall muni market has remained stable, marked by generally resilient fundamentals, relative valuations which we characterize as fair to somewhat rich on the long-end of the curve, a supportive technical environment, and a return profile which we expect to be primarily driven by carry rather than price movement in the coming year.
- There was not a wide dispersion of returns between higher quality and lower quality issuers in the fourth quarter, although for the full year lower quality issuers outperformed due to the buoyant economy and stable fundamentals which kept credit spreads in a relatively tight range.

| | | | | TRAILING RETURNS AS DECEMBER 31, 2024 (%) | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Index Data | Duration | Quality | YTW | Quarter | YTD | 1-year | 3-year | 5-year | 10-year |
| Bloomberg Municipal Bond Index | 6.2 | AA- | 3.74% | -1.21 | 1.05 | 1.05 | -0.55 | 0.99 | 2.25 |

*Source: Bloomberg*
*Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.*
***Past market performance is no guarantee of future results.***

## MUNI SUPPLY AND DEMAND

- The flow of investor money into municipals demonstrated a positive trend in Q4, with weekly muni mutual fund flows remaining primarily positive and with separately managed account (SMA) demand remaining robust as well. Mutual fund net inflows summed approximately $9 billion in the quarter, a slight downtick from the $10 billion in Q3, according to Bloomberg. The flows were more consistently positive earlier in the fourth quarter and actually posted negative weekly flows toward the end of the quarter as rates continued to rise.




*Source: Bloomberg as of 12/31/2024*
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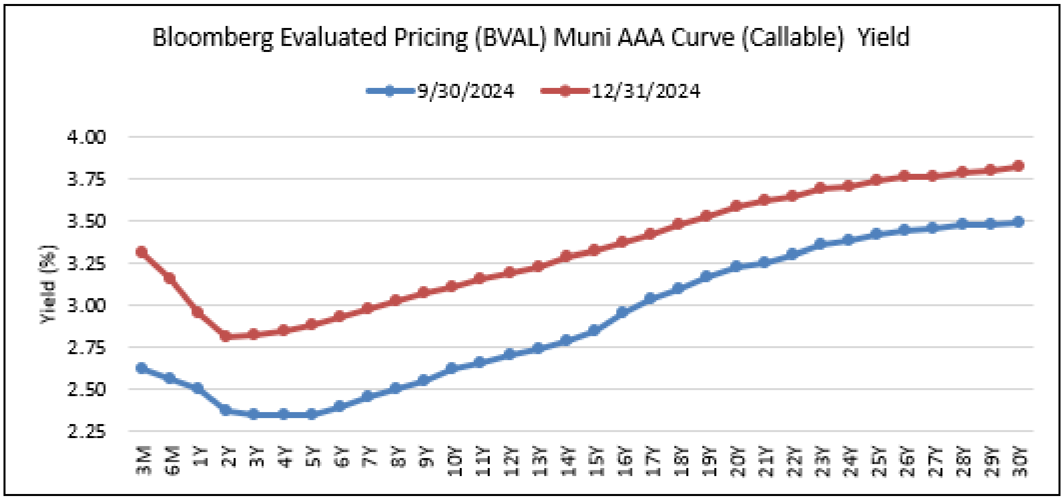
- Our view remains that some of the "dry powder" created by 2022-2023's considerable muni mutual fund outflows continues to remain on the sidelines and may be drawn back into the asset class once market sentiment turns back in favor of a falling rate trend.
- New bond issuance tracked approximately 40% ahead of 2023's pace. Muni market strategists are currently calling for 2025 supply to be on a similar order of magnitude, with concerns about potential changes to the tax code serving as a catalyst for issuers to lock down financing.
- As December began, the muni market moved into its seasonally strong period for reinvestment flows from bond coupons and maturities. We believe this provided an important backstop to the muni market that should persist through January. While this cycle is a known annual event, and just one factor in what moves the muni market, stronger seasonals can help offset a potential lessening of demand caused by the upward drift in interest rates.

## YIELD CURVE

- Muni market yields reset higher during the fourth quarter, with the 5- to 10-year part of the curve rising the most.
- For the full year, the dis-inversion of the muni yield curve led to stronger relative performance on the short-end of the curve. The 10-year part of the curve saw the most uptick in rates, which essentially canceled out the positive effect of elevated absolute yields and delivered a slightly negative return. Conversely, the long-end of the curve saw rates rise somewhat less than the 10-year, thus the carry effect was able to shine through and deliver a full year total return in the 1-2% range.
- As the year ended, the muni yield curve maintained a normalized upward shape beyond the 2-year mark, with short term yields remaining higher in sympathy with the still-elevated Fed Funds rate.




*Source: Bloomberg as of 12/31/24*
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- Relative valuations of munis, as measured by the muni-to-treasury ratio, remained stable during the fourth quarter in the 5- and 10-year tenors while richening modestly in the 30-year tenor. Ratios do remain somewhat rich by historical standards but are generally aligned with recent trading ranges.

| Muni/Treasury Ratio | | | |
|---|---|---|---|
| | 12/31/2023 | 9/30/2024 | 12/31/2024 |
| 5 Year | 58% | 66% | 66% |
| 10 Year | 58% | 69% | 68% |
| 30 Year | 83% | 85% | 80% |

*Source: Bloomberg as of 12/31/2024*
*Note: We provide an update on the metric above as it is a "shorthand" way of assessing relative valuation that muni market participants frequently reference. That said, our analysis has found that it has minimal predictive value in forecasting future market performance.*
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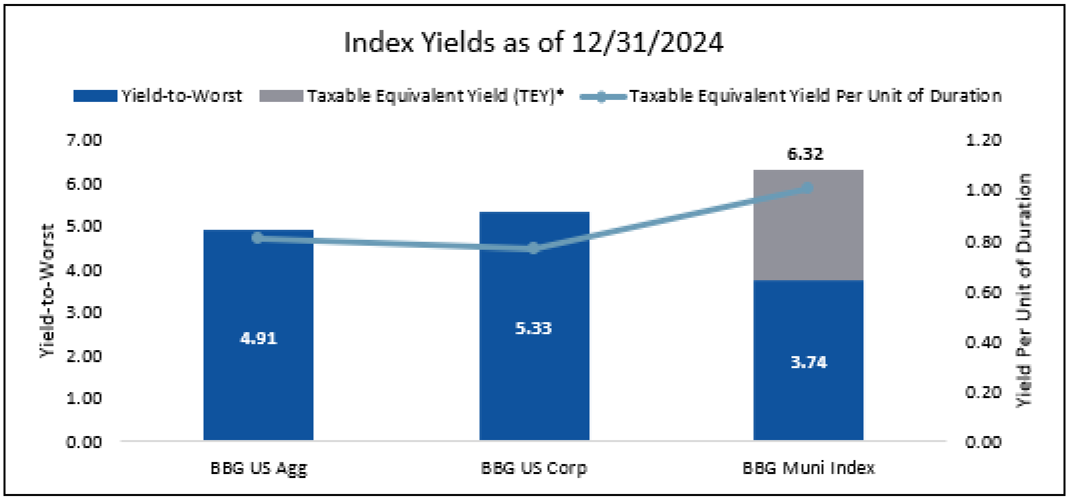
## OUTLOOK

- The following conditions underpin our constructive view on the outlook for the municipal market at this time:
  - Muni market demand in 2024 absorbed a consistently heavy pace of new issuance. We expect demand from retail investors in mutual funds, ETFs and separately managed accounts to continue to support new issuance in 2025 as long as rates do not climb significantly higher (which is not our base case).
  - The potential for new capital to be pulled out of money market funds and into muni bonds once the market arrives at a consensus that yields have peaked, further stimulating demand for munis.
  - Relative valuations, while rich by historical standards, are currently in line with recent trading ranges and do not currently present a headwind to performance, in our view.
  - Municipal bond yields currently remain higher than the average yields we've seen during the last decade, and could be considered attractive to high tax bracket investors on a tax-adjusted basis relative to taxable alternatives.
  - Credit conditions, which in our view have continued to remain relatively stable for the vast majority of quality issuers, remain supported by the resilient economy.
  - The risks which challenge our constructive view include uncertainties around the Fed's "extent and timing" of future rate cuts, the potential for an unexpectedly strong economy which pressures long term rates higher, and the possible usage of the muni Federal tax exemption as a budgetary bargaining chip.
  - We forecast positive market performance over the next twelve months for the investment grade muni asset class under our base case ("Softer for Longer") and economic downside ("Growth Scare") scenarios where we expect Fed easing to continue and longer-term yields to stabilize. Under an economic upside ("Higher For Longer") scenario where longer term Treasury yields are pressured higher we do forecast potential modestly negative returns for longer duration munis during the next year. However, this adverse outcome is not our base case.

## OUTLOOK (CONTINUED)

- The Bloomberg Municipal Bond Index sported a 3.74% yield at quarter-end, which equates to a 6.32% Taxable Equivalent Yield (using an effective tax rate of 40.8%). We believe this represents value - and a possible entry point - relative to the Bloomberg US Corporate Bond Index and the Bloomberg US Aggregate Index.




**The taxable equivalent yield is calculated using an effective tax rate of 40.8% which includes the 37.0% top federal marginal income tax rate and the 3.8% Net Investment Income Tax to fund Medicare.*
*Source: Loomis Sayles and Bloomberg as of 12/31/2024*
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