Municipal Market Update

1st Quarter 2025

By: Loomis Sayles Municipal Bond Team

ECONOMY AND RATES

- Treasury yields fell during the first quarter of 2025. Through the first two months of the quarter the Treasury yield curve fell fairly uniformly as the market consensus centered around a softening economy and a dovish Federal Reserve (Fed).
- In March however, rate markets reacted to the Fed being on "pause" for the time being, in tandem with a fraying economic consensus and growing concerns about the potential inflationary effects of a long-term tariff war, or at least the threat thereof. As a result, long-term Treasury yields rose more than the front-end during March, so the net effect for the full quarter was a lower but steeper yield curve.
- Since embarking on its easing campaign with three cuts totaling 100 basis points (bps) beginning last September (50 bps in September, 25 bps in both November and December), the Fed has held the overnight borrowing rate steady at its two most recent meetings. The Fed's forecasts are now factoring in a slower pace of economic growth coupled with sticky or perhaps even re-emergent inflation sparked by escalating tariff policies. Although not specifically described by the Fed, the dreaded "stagflation" word has started to be used by some market commentators.
- The 10-year Treasury yield closed out the quarter at 4.21%, having entered 2025 at 4.57% and having begun calendar year 2024 at 3.88%. For reference, the benchmark rate still sits roughly ¾ of a percent below the cyclical peak of roughly 5% which was notched in October 2023.
- As of 4/8/2025, Loomis Sayles' Macro Strategies team currently assigns a 60% probability to a "Downturn" macro scenario as their base case, where consumer confidence is poor and the wealth effect is seemingly fading as equity markets drop; we're looking for a pullback in spending. "Late-Cycle/Stallflation" (growth likely to slow as the economy adjusts to a historically high tariff rate) and "Late-Cycle/Off-Ramp" (potential for a stronger risk-backdrop if we see a plausible off-ramp from the Trade War) are the other potential scenarios.

MUNICIPAL MARKET PERFORMANCE

- Municipal (muni) yields beyond the 5-year part of the muni curve rose during the first quarter and the yield curve steepened, driven by many of the same forces which influenced the Treasury market along with considerations which were specific to the muni market. These considerations included the evolving fiscal relationship between the federal government and the states, as well as a high level of new issuance and other technical factors.
- The upward trend in yields beyond 5 years, somewhat offset by an elevated level of carry (i.e., the absolute level of yields) longer on the curve, produced a modestly negative total return of -0.22% for the Bloomberg Municipal Bond Index in Q1.
- Revenue bonds slightly outperformed General Obligation bonds for the quarter, and lower quality bonds performed more strongly than higher quality.

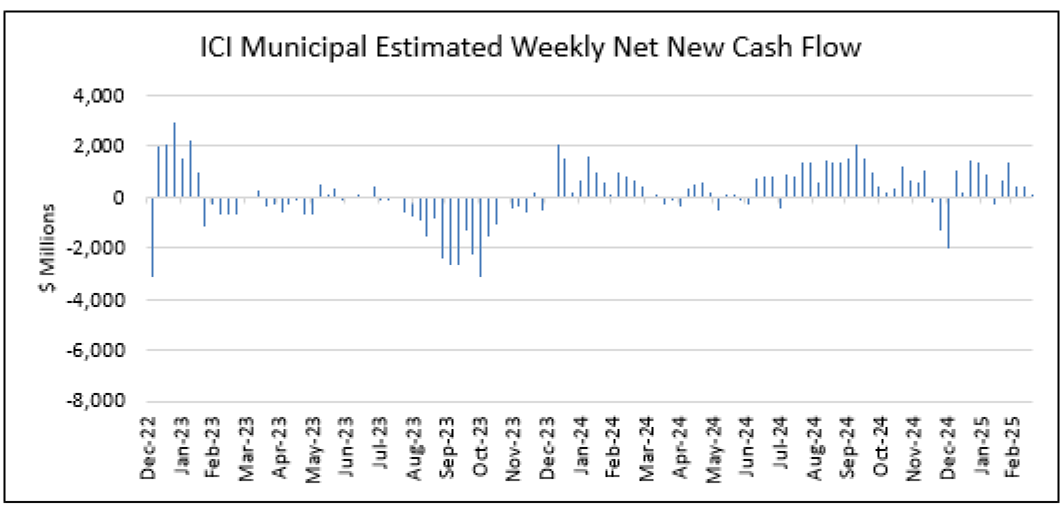
- In spite of the elevated levels of uncertainty caused by evolving US policy and future funding decisions, some of which have the potential to affect the muni market directly, coupled with the usual murkiness of forecasting economic outcomes, in our view the muni market has remained resilient amid consistently strong demand especially from high tax bracket private investors.

				TRAILING RETURNS AS OF MARCH 31, 2025 (%)					
Index Data	Duration (Years)	Quality	YTW	Quarter	YTD	1-year	3-year	5-year	10-year
Bloomberg Municipal Bond Index	6.45	AA-	3.84%	-0.22	-0.22	1.22	1.53	1.07	2.13

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 Q1, 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 $7 billion in the quarter, a modest downshift from the $9 billion in Q4, according to Bloomberg. There were a few notably negative weekly mutual fund flows early in the quarter, as the spike in yields which dated back to December spooked investors before topping out in January. After that point, yields generally trended down until March and weekly fund flows were consistently positive. Given the upward creep in yields during March we wouldn't be surprised to see some negative weekly fund flows prints as the calendar flips over into Q2.

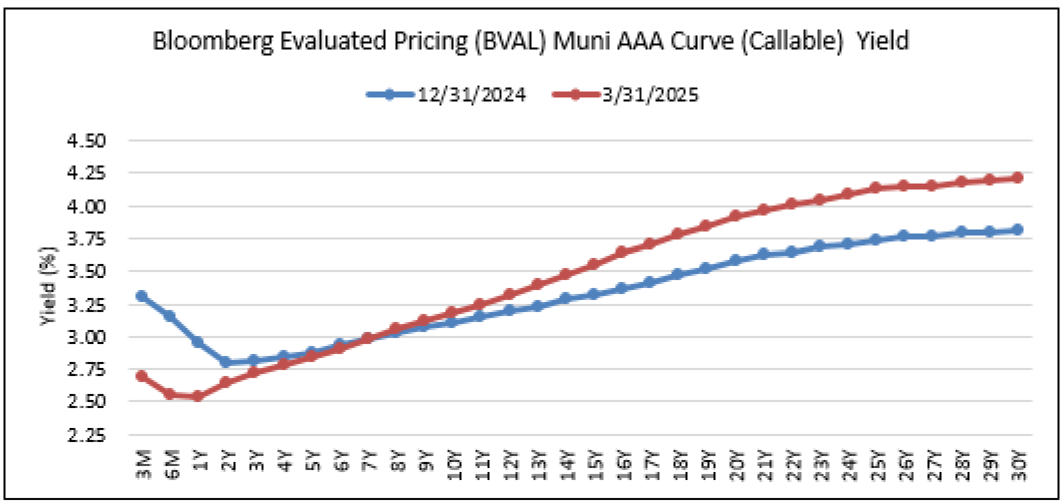


Source: Bloomberg as of 3/31/2025
Past market experience is no guarantee of future results.

- New bond issuance in Q1 tracked approximately 16% ahead of Q1 2024's pace. Muni market strategists expect the robust pace to continue, with concerns about potential changes to the tax code serving as a catalyst for issuers to lock down financing.
- As the quarter ended, the muni market moved into its seasonally weak period for reinvestment flows from bond coupons and maturities, which should persist through the month of May. While this cycle is a known annual event, and just one factor in what moves the muni market, weaker seasonals can help to create a buying opportunity in an environment of otherwise-strong demand for munis.

YIELD CURVE

- The Muni yield curve steepened during the first quarter, with yields in the front end of the curve declining, while rising and steepening toward the longer end of the curve.
- The curve maintained a generally normal, upward-sloping shape, aside from a bit of a "hook" on the front end where yields are elevated in correlation with the Fed funds rate. This curve shape stands in sharp contrast to the unusual inverted shape of the curve which was in place a year ago at this time, and is reflective of the Fed's cutting actions since then while the longer term market consensus is still focused on inflationary factors.



Source: Bloomberg as of 3/31/25
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- Relative valuations of munis, as measured by the muni-to-treasury ratio, cheapened during the first quarter. This reflects the fact that Treasurys received a strong flight-to-quality bid driven by heightened economic uncertainty, which munis did not receive in equal abundance especially given new bond supply tracking at-or-above record levels as we move into a seasonally weaker period of demand.

Muni/Treasury Ratio			
	12/31/2023	12/31/2024	3/31/2025
5 Year	58%	66%	72%
10 Year	58%	68%	76%
30 Year	83%	80%	92%

Source: Bloomberg as of 3/31/2025
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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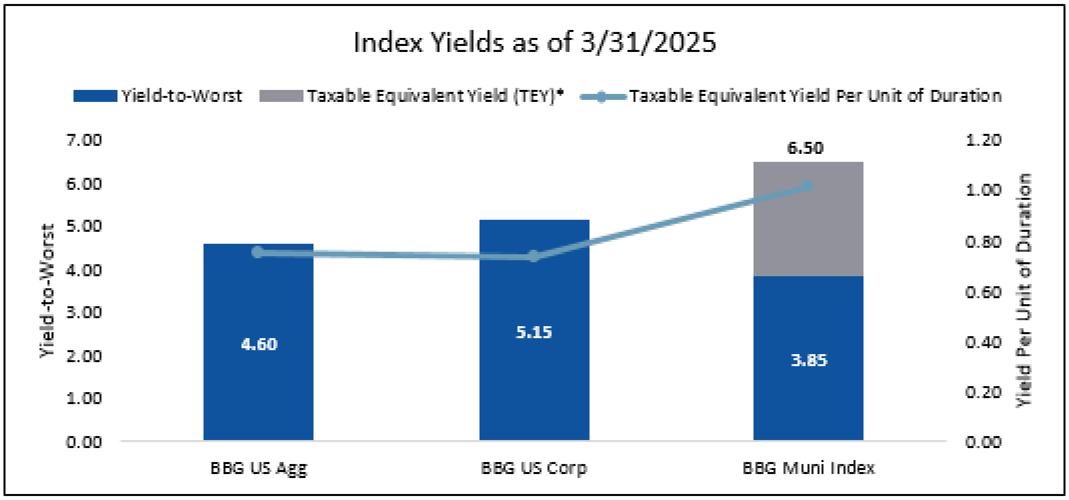
OUTLOOK

- The following conditions underpin our constructive view on the outlook for the municipal market at this time:
  - We expect demand from retail investors in mutual funds, ETFs and separately managed accounts to continue absorb the heavy pace of new issuance in 2025 as long as yields do not climb significantly higher (which is not our base case).
  - Relative valuations have eased recently amid the flight-to-quality Treasury rally and credit spreads have recently widened slightly.
  - 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. We are carefully monitoring what we consider to be moderately deteriorating credit conditions in a select group of muni sectors, and we are ensuring that our exposure within these sectors is primarily focused on issuers with the most stable financial footing.
  - 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, the risk of a substantive withdrawal of Federal fiscal support for state and local government programs, and the possible usage of the muni Federal tax exemption as a budgetary bargaining chip.

OUTLOOK (CONTINUED)

- The Bloomberg Municipal Bond Index sported a 3.85% yield at quarter-end, which equates to a 6.50% 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 3/31/2025
***The chart presented above is shown for illustrative purposes only**. Some or all of the information on this chart may be dated, and, therefore, should not be the basis to purchase or sell any securities. The information is not intended to represent any actual portfolio currently managed by Loomis Sayles.*
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