Municipal Market Update

2nd Quarter 2025

By: Loomis Sayles Municipal Bond Team

ECONOMY AND RATES

- Geopolitical risks dominated the economic headlines in the second quarter – especially President Trump's "Liberation Day" tariff proclamations in early April and the combined US/Israeli attacks on Iran's nuclear facilities in late June. Macroeconomists were challenged to handicap the effect of these events on the path forward for growth, inflation, Fed policy, and the broader economy. However, markets are entering the third quarter on a sanguine note, with US equity markets near all-time highs, steeply sloped yield curves, relatively tight credit spreads, and an expectation that the Fed's rate pause will end with easing rather than tightening later this year.
- 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 taken a wait-and-see stance as it awaits clearer trends in employment and inflation to guide its actions. As of this writing, the futures markets are indicating two, if not three, rate cuts before the end of the year.
- The Treasury yield curve steepened during the second quarter of 2025. Yields inside of 8 years fell, with the largest decline at the 3-year mark (which fell approximately 14 bps), reflecting the safe-haven status of Treasurys in a time of geopolitical strife and uncertainty. Conversely, yields longer on the Treasury curve rose (with yields in the 20-30-year range rising approximately 15-20 bps), lifted by longer-term inflationary expectations.
- The 10-year Treasury yield closed out the quarter at 4.23%, 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 6/26/2025, Loomis Sayles' Macro Strategies team currently assigns a 60% probability to a "Stallflation" macro scenario as their base case, which forecasts that growth is likely to slow in reaction to unpredictable tariff policy and lingering elevated inflation which undermines demand. "Downturn" (essentially a mild recession scenario marked by poor consumer confidence, negative S&P 500 earnings growth, and an increasingly accommodative Fed) is assigned a 20% likelihood, and "Late Cycle Off-Ramp" (marked by a notable tariff war de-escalation, a more resilient economic growth trend, an upward bias to yields, and an ongoing Fed pause) is also assigned a 20% likelihood.

MUNICIPAL MARKET PERFORMANCE

- When looking at the entirety of the second quarter, Municipal (muni) yields reset in a similar fashion to Treasurys. The muni curve steepened, with yields declining inside of 10 years and yields rising beyond 10 years. Yield decreases were most pronounced in the 4-8 year "belly" of the curve while the 20-30 year long end of the curve saw the highest yield increases in the 20-25 bps range.
- That being said, muni yields did not move in lockstep with Treasurys *throughout* the quarter. The post "Liberation Day" spike in yields was more pronounced in munis, primarily because it occurred during a seasonally weak part of the calendar year where reinvestment flows from maturities and coupons are below average. This pronounced selloff caused munis to appear inexpensive (by historical measures) relative to Treasurys for 4-6 weeks. However, as June approached we moved into the seasonally stronger part of the year for munis, which when coupled with an overall improvement in market

sentiment, caused muni yields to snap lower, especially inside of 10 years. So, from a full-quarter perspective, the muni curve seems to have reshaped similarly to the Treasury curve, but the muni curve took a more circuitous path *during* the quarter.

- Although yields in the long end of the muni curve rose, this was accompanied by a relatively high level of absolute yields (or "carry"). This, combined with the decline in yields in the belly of the muni curve, caused the performance of the Bloomberg Municipal Bond Index to be relatively flat (-0.12%) in Q2. This result, when combined with a similarly benign index performance in Q1, left the index -0.35% at the mid-year mark.

				TRAILING RETURNS AS OF JUNE 30, 2025 (%)					
Index Data	Duration (Years)	Quality	YTW	Quarter	YTD	1-year	3-year	5-year	10-year
Bloomberg Municipal Bond Index	6.70	AA-	3.94%	-0.12	-0.35	1.11	2.50	0.51	2.20

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.

- General Obligation muni bonds slightly outperformed Revenue bonds for the quarter, and the performance differential among muni quality (ratings) levels was relatively inconsequential as well. We view this as reflecting a cautious market environment which didn't put a premium on spread exposure during the quarter.
- At quarter end, the muni curve maintained a generally normal, upward-sloping shape, aside from a bit of a "hook" inside of six months where yields were 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 in our view is reflective of the Fed's cutting actions since then, while the longer-term yields are more closely tied to inflationary factors.
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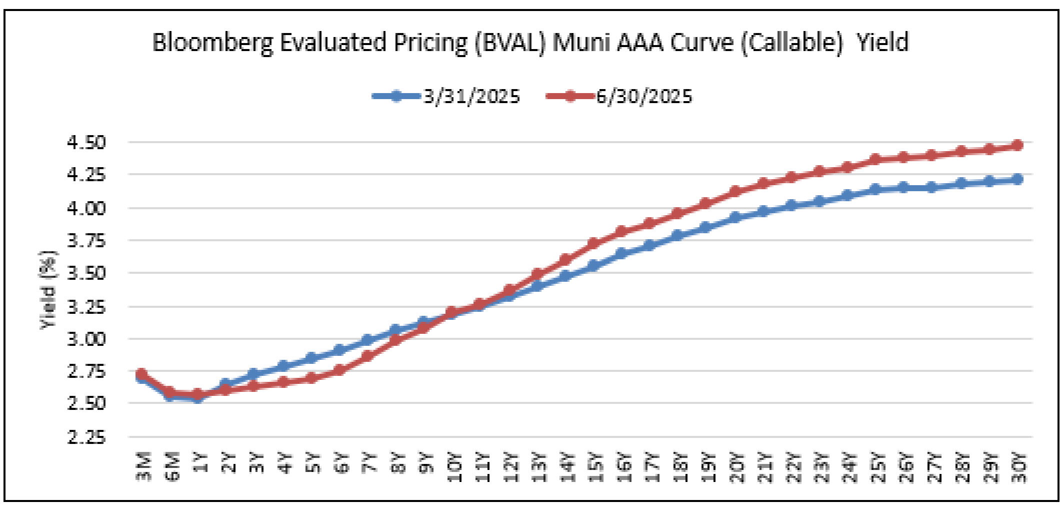

Source: Bloomberg as of 6/30/25
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- Relative valuations of munis, as measured by the muni-to-treasury ratio, cheapened significantly during April's muni selloff. Ratios tightened in May as concerns about the implications of fiscal policy changes began to wane, and remained mostly range-bound in June as the seasonally stronger technical environment for munis arrived. When all was said and done, ratios ended the quarter roughly where they started and still look somewhat attractive relative to their 1-year and 3-year averages.

Muni/Treasury Ratio			
	12/31/2023	12/31/2024	6/30/2025
5 Year	58%	66%	71%
10 Year	58%	68%	75%
30 Year	83%	80%	94%

Source: Bloomberg as of 6/30/2025
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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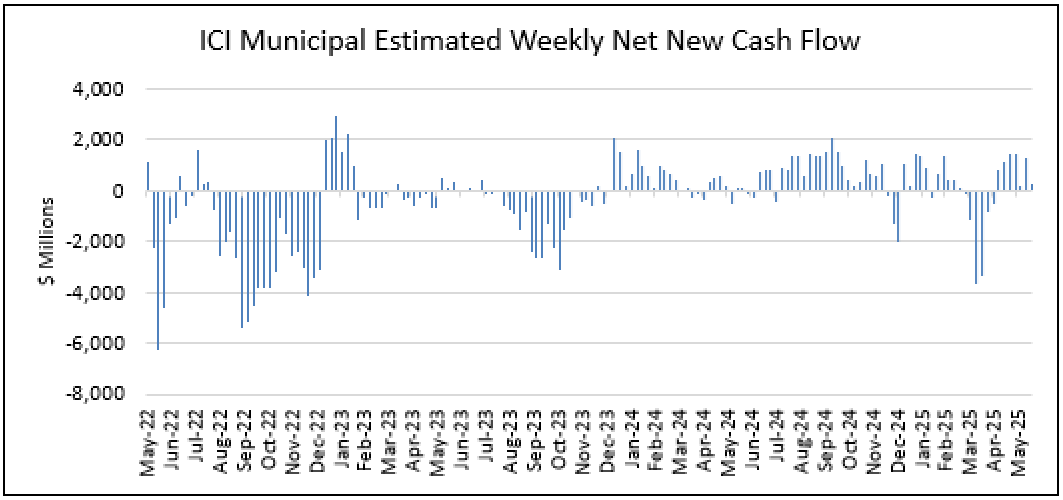
- In spite of the elevated levels of uncertainty caused by evolving US policy and future funding decisions, some of which have the potential to affect the muni market directly, coupled with the usual murkiness of forecasting economic outcomes, in our view the muni market has remained resilient amid consistently strong demand especially from high tax bracket private investors.

MUNI SUPPLY AND DEMAND

- The flow of investor money into municipals demonstrated a typical sensitivity to the direction of interest rates in Q2, with weekly muni mutual fund flows already turning slightly negative in response to rising interest rates as the quarter began. The flows turned starkly negative during the first half of April as muni yields peaked, but the negative flows abated as bond yields receded during the next couple of weeks. Flows flipped back into positive territory as May began, where they remained for the remainder of the quarter.
- When all was said and done, the late quarter inflows did not completely recoup the net outflows from earlier in the quarter. This led to net muni mutual fund flows of approximately -$2 billion in Q2, in comparison to $6 billion in Q1, according to Bloomberg.



Source: Bloomberg as of 6/30/2025
Past market experience is no guarantee of future results.

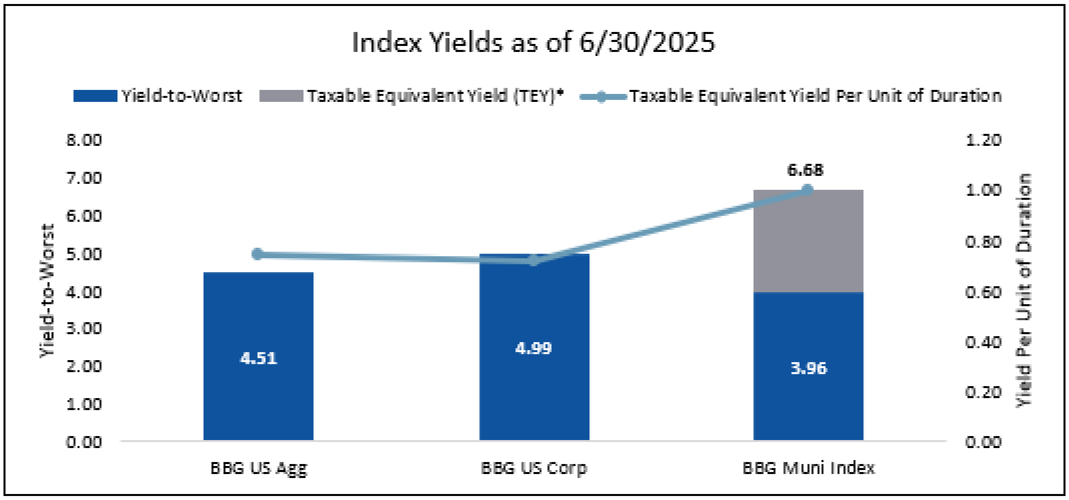
- Year-to-date new muni bond issuance is tracking approximately 21% ahead of last year's pace. We are seeing deals being pulled forward given the elevated level of economic and federal policy uncertainty.
- As the quarter ended, the muni market moved into the heart of its seasonally strong period for reinvestment flows from bond coupons and maturities, which should persist through the month of August. While this cycle is a known annual event, and just one factor in what moves the muni market, stronger seasonals can help to create an additional demand tailwind in an environment of otherwise strong demand for munis.

OUTLOOK

- The following conditions underpin our constructive view on the current outlook for the municipal market:
  - Elevated absolute yields and a steepened muni yield curve offer an opportunity for attractive carry and rolldown.
  - On a "tax equivalent" basis, munis provide a compelling alternative to other investment grade credit asset classes, particularly for high tax bracket investors.
  - We expect demand from retail investors in mutual funds, ETFs and separately managed accounts to continue absorbing the heavy pace of new issuance in 2025 as long as yields do not climb significantly higher (which is not our base case).
  - Credit spreads have widened in comparison to the last year, but are still somewhat tight by longer term historical averages.
  - Credit conditions are difficult to gauge given the ongoing Federal policy shifts, but we believe opportunities still exist for investors to find value.
  - Relative valuations are fairly aligned with historical averages and somewhat attractive by more recent 1-year and 3-year averages.
  - Munis enter the third quarter following strong performance in June and with a technical tailwind from expected reinvestment flows in July.
  - The risks which challenge our constructive view include Federal policy uncertainties which could impact the credit fundamentals of weaker quality muni issuers, the Fed's extent and

timing of future rate cuts, and the potential for an unexpectedly strong economy which pressures long-term rates higher.

- The Bloomberg Municipal Bond Index sported a 3.96% yield at quarter-end, which equates to a 6.68% 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 6/30/2025
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Market conditions are extremely fluid and change frequently.
Diversification does not ensure a profit or guarantee against a loss.
Any investment that has the possibility for profits also as the possibility of losses, including the loss of principal.

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