Municipal Basis Points

1Q 2025

MUNICIPAL FIXED INCOME TEAM

Looking to Fundamentals

- The Federal Reserve and markets have dialed back expectations for rate cuts this year.
- Fiscal policy and the economy will likely have a bigger impact on interest rates going forward.
- Robust municipal supply and tight credit spreads should put a premium on active management and security selection.
- We believe investors should consider putting excess cash to work to capitalize on appealing municipal yields.

Active management and security selection will likely drive results in 2025.

The municipal bond market ended 2024 on a weaker note with AAA yields rising in December. The market sell-off was driven by an array of factors, including stronger economic data, expected pro-growth policies from the incoming Trump administration, and investor demand for more yield to own longer-dated Treasury securities.

Given the economic strength to end the year and an improved outlook for growth in 2025, the Federal Reserve and the market dialed back expectations for interest rate reductions in 2025. Municipal supply continued to be elevated in the fourth quarter, which further weighed on the market. For the year, AAA muni yields were higher on average by roughly 56 basis points with the "belly" of the curve (five to 10 years) being the weakest segment.

Given heavy supply, valuations relative to Treasuries improved from the frothy levels that existed at the start of 2024. Despite the backup in rates, investment grade munis delivered mostly positive returns across the curve with shorter-dated bonds performing the best. With the higher yields that prevail in today's market, there was ample income to cushion portfolio returns despite the rise in yields. That was clearly not the case for investors just a few years ago when yields were below 1%. Lower-rated credits (BBB and high yield) substantially outperformed higher quality as demand outstripped supply and the economic backdrop for credit investing remained favorable.

In our view, an important transition is taking place in the market. For years, interest rate moves were mostly driven by the actions of the Fed. With this easing cycle expected to come to an end sooner than market participants originally expected, the central bank is about to "get out of the way." As a result, we believe that fiscal policy and the performance of the economy will have a much bigger impact on rates going forward.

We are constructive on the municipal market in 2025 for a few reasons. First, higher yields should protect portfolios from swings in interest rates: Intermediate investment grade munis entered this year yielding almost 3.40%. Second, supply is generally expected to approach record levels in 2025, which should lead to bigger concessions (i.e., higher yields) in order for new issues to clear the market. Third, with our expectation for solid, above-consensus economic growth, the backdrop for muni credit quality should be favorable.

As noted, lower-rated bonds rallied in 2024 and, as a result, their spreads are tighter. Given the abundance of bonds to choose from in 2025 due to our expectation for elevated supply and tighter spreads on lower-rated bonds, we believe active management and security selection will likely drive results in the new year.

Strategy and Outlook

High issuance and solid economics put a premium on security selection.

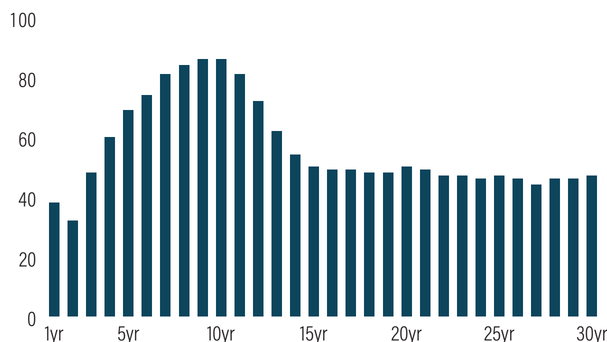
BACKGROUND

Fed policy: In December, the Federal Reserve lowered interest rates by 25 basis points, marking a total reduction of 100 basis points since September. The central bank signaled a desire to prioritize maximum employment in future meetings, with a gradual approach to further rate cuts.

Yields: Despite policy easing, municipal yields rose in the fourth quarter due to a combination of increased new issue supply and rising rates. They moved in tandem with U.S. Treasuries, driven by ongoing strength in economic data and persistent if declining inflation.

MUNI YIELDS ARE UP

Increase in AAA Municipal Yield by Maturity During 2024 (Basis Points)



Source: Bloomberg, as of December 31, 2024.

CURRENT VIEWS

Issuance: Last year set a record with issuance of roughly $500 billion, but this year's total could be even higher, creating new opportunities for active managers. Key factors behind the recent and future supply include deals expedited ahead of the presidential election, passage of ballot propositions requiring spending, and municipalities replenishing federal COVID stimulus funds.

Duration: We currently favor neutral duration (exposure to changes in interest rates) compared to indices given potential volatility as the new administration begins implementing policy.

Selection: In our view, security selection may largely drive municipal performance in 2025, especially in the A and BBB sectors. In our view, AAA and AA municipal bonds are fairly valued versus U.S. Treasuries, even as investor demand remains strong.

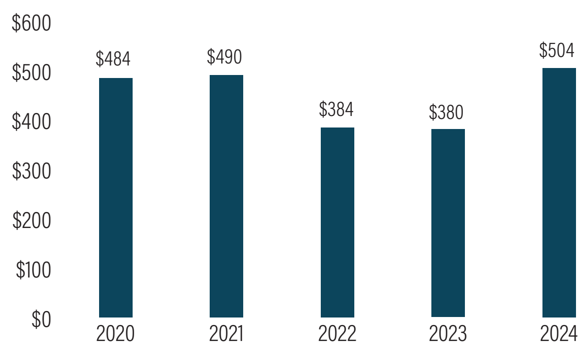
Fundamentals: We believe municipal credit fundamentals should remain solid due to higher-than-expected tax collections, helping municipalities in the event economic growth softens this year.

PUT CASH TO WORK

With the Fed gradually lowering rates, we believe investors should consider putting available cash to work in municipals to capitalize on favorable yields. Intermediate and longer-duration bonds currently offer a predictable stream of tax-free income, which could become more valuable as inflation moderates.

MUNICIPAL SUPPLY HAS BEEN ROBUST

$ Billions



Source: Lipper.

Deeper Dive

Pro-growth policies could favor municipal fundamentals, with some caveats.

The reelection of Donald J. Trump represents a notable shift in the U.S. political landscape. Trump's return to the presidency has been met with both optimism and scrutiny; however, from the perspective of municipal credit markets, we expect his administration to positively affect the fiscal health of state and local governments in 2025. Although there may be discrepancies between campaign promises and enacted legislation, the overarching economic priorities of the Trump administration should stimulate economic growth, thereby improving the fiscal health of many municipal governments.

The administration's pro-business policies, which focus on lowering taxes and reducing regulations, should foster a conducive environment for business expansion, job creation and increased consumer spending. These factors could enhance government tax revenues, with solid forecasts for 2025. Despite potential challenges unique to certain state and local governments, we feel that prospects for overall revenue growth appear favorable.

STATE AND LOCAL TAX REVENUE SHOULD CONTINUE TO GROW

2025 Revenue Forecast (Year-Over-Year)

Source: U.S. Census, Morgan Stanley Research.

That said, some policy changes may have uncertain impacts, with tariffs, immigration reform, reduced federal spending and tax cuts potentially affecting municipalities.

Beyond state and local governments, we hold a positive outlook on sectors poised to benefit from economic growth and increased consumer spending—namely, the airport and toll sectors. We expect plane travel to increase, especially if discretionary income rises in a robust economy. Similarly, we think the toll sector should continue to capitalize on increased ridership in 2025. These two sectors have been areas of optimism for us over several years, and we believe that positive trends should persist under the new administration.

We are more cautious on the higher education sector due to notable headline events of the 2023–24 academic year, alongside preexisting financial difficulties for specific institutions. We anticipate heightened momentum for endowment taxation, which could pressure certain schools. Consequently, we foresee policy or funding revisions to occur against a backdrop of bifurcation within the sector between well-endowed institutions and those facing financial constraints.

In closing, we recognize that Trump's policies will not uniformly affect all sectors. Our research team remains committed to evaluating each credit on an individual basis, carefully analyzing the potential implications of various economic and policy environments. Nevertheless, we are confident that 2025 will offer numerous opportunities in credit supported by a robust economic landscape.

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