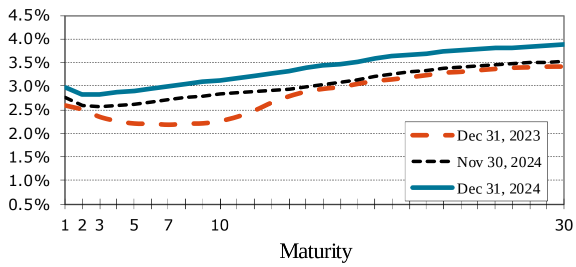
Baird Advisors
Municipal Fixed Income Market Commentary
2024 Review and 2025 Outlook

2024 Municipal Market Review

2024 was a year in which tax-exempt rates rose, the yield curve returned to an upwardly sloped posture and credit spreads narrowed, enhancing the performance of lower-quality issues relative to higher-quality. Intermediate yields rose the most, as illustrated by the 10yr AAA yield ending December at 3.13%, near the high mark of the year, and up 86 bps YoY. Shorter and longer maturities rose less; 2's were up 38 bps and 30's were up 47 bps. Somewhat unusually, municipal yields rose more than Treasuries in 2024 except for the 30yr maturity. This underperformance improved the relative value of the asset class vs. taxables. The primary cause of the heightened municipal volatility was a record level of tax-exempt supply. Investors had to absorb $500B of total municipal issuance, $460B tax-exempt and $40B taxable. Thankfully, the combination of appealing tax-free yields, the normalizing yield curve and enhanced valuations all helped sustain positive net flows into municipal funds/ETFs. Total net fund/ETF inflows of $42B for the year was a dramatic turnaround from the outflows experienced in the two previous years. Of course, the Fed moving to an easier monetary policy provided a favorable backdrop for the bond market as the Fed lowered its target for the Fed funds rate by 100 bps between September and December. Providing cover for the Fed rate cuts was a gradual decline in the inflation rate, albeit slower than the Fed expected. Complicating the Fed's mission, however, was the political cycle. The Republican sweep of the White House as well as the Senate and the House in November pushed market rates higher on expectations of stronger growth and inflation. Overall, 2024 was a year that produced positive returns for municipal investors, but one in which yield curve positioning and credit posture played particularly important roles in determining both nominal and relative performance.

AAA Municipal Yields



Maturity	12/31/23	9/30/24	11/30/24	12/31/24	1Mo Chg	Q4 Δ	2024 Δ
1	2.59%	2.52%	2.76%	2.97%	0.21%	0.45%	0.38%
2	2.50%	2.39%	2.58%	2.82%	0.24%	0.43%	0.32%
3	2.35%	2.37%	2.56%	2.83%	0.27%	0.46%	0.48%
5	2.22%	2.37%	2.61%	2.90%	0.29%	0.53%	0.68%
7	2.19%	2.47%	2.70%	3.00%	0.30%	0.53%	0.81%
10	2.27%	2.63%	2.83%	3.13%	0.30%	0.50%	0.86%
30	3.40%	3.55%	3.53%	3.87%	0.34%	0.32%	0.47%

Cash Flows and Yield Curve Slope

As noted above, after an unprecedented eighteen months of inversion, the 2s10s segment of the municipal curve moved to a positive slope in August. The yield spread between these two maturities ended the year at +31 bps, 63 bps steeper than the -32 bps of inversion at the start of the year. The importance of this is that it once again offers investors the opportunity to enhance returns by rolling down a positively sloped curve. Historically, there has also been a positive correlation between the slope of the curve and municipal fund flows. When investors are incentivized to extend along the yield curve (i.e. to pick up yield), they tend to do so – whether that be through the direct purchase of individual bonds or intermediate and/or long-term municipal funds. However, not all of the curve is positively sloped – yet. Tax-exempt cash rates remain elevated relative to intermediate yields, but they would be expected to gradually fall along with the fed funds rate. As this unfolds, the incentive to extend will increase and should have a positive impact on fund flows as well.

Strong, but Changing Credit Backdrop

The backdrop for municipal credit was fundamentally strong throughout the year. Solid economic growth since the Covid-related lockdowns have helped boost both income and sales tax revenues in recent quarters, as rising home values also lifted local property tax revenues. Based on enacted FY25 budgets, total state reserve balances stand at 24% of expenditures (according to NASBO), which is more than double long-term averages. This fundamental strength encouraged a risk-on mentality in 2024, increasing demand for BBB and High Yield credits. This, combined with relatively light high yield issuance, helped narrow municipal credit spreads. BBBs narrowed to AAAs by 36 bps (from +125 bps to +89 bps), and high yield spreads tightened by 67 bps (+259 bps to +192 bps). Rating agency upgrades also once again exceeded downgrades this year, although the pace slowed. As of mid-December, S&P's upgrade to downgrade ratio for the year was 1.6 to 1, down from 3.5 to 1 at the same time in 2023. Inflationary pressures are now increasingly impacting municipal expenses just as revenue growth is slowing. Although the credit backdrop remains strong overall, the municipal market has moved beyond peak credit conditions and is returning to a more normal environment, which means that state and local governments are once again having to make tougher choices on general fund spending to keep budgets aligned.

Sector Performance

Revenue bonds marginally outperformed GOs for the year, and three Revenue sub-sectors were helpful in this effort. The first was corporate-backed municipal (IDR/PCR) issues. These are bonds backed by large, money-center banks or other strong financial institutions which provide the counterparty guarantee for the delivery of natural gas or electricity issues on prepay gas deals. Credit spreads narrowed in this sector along with corporate bond spreads in the taxable market, enhancing their performance. Another strong performer was the Housing sector, which benefited from additional yield and narrowing spreads as prepayment speeds stabilized. Similarly, federal-backed, multi-family Housing issues also performed well. A third outperforming sector was Hospitals. Net operating margins continued to improve, strengthening their credit metrics, allowing spreads to narrow. Among the sector laggards this year were Higher Education issues, which remained challenged by demographic headwinds. A recent study from the Western Interstate Commission of Higher Education indicates US high school graduates will peak in 2025 and fall from there as birth rates have seen a steady decline, leading to fewer high school students. Mergers, acquisitions and closures continued as small, private schools try to find a way to adapt to the new education environment. Many colleges also continue to face elevated fixed costs for tenured faculty as well as imbalances between the majors offered and majors sought by employers. Students and families are also increasingly weighing the costs of a traditional, four-year college education against other education and career options. This remains a sector that is expected to see further downgrades and consolidation as the supply of schools aligns with the demands of fewer college students.

Tax Policy Risk

President-elect Trump ran on a platform of extending the tax cuts from the 2017 Tax Cuts and Jobs Act. Now, with a Republican Congress, he is expected to pursue this goal along with other potentially meaningful policy measures. Passing any tax legislation is inherently difficult, particularly when needing to offset the nearly $5 trillion estimated cost over ten years of maintaining current tax rates. In 2017, some segments of the municipal market came under review for elimination to help pay for that bill, and tax-exempt refundings ultimately went away. Private activity bonds were also at risk of losing access to the tax-exempt market at that time but survived. It is too soon to know what revenue offsets Congress may consider now, but we believe that major changes to the tax-exempt municipal market are unlikely. The cost offsets that could be captured in the municipal market are small in relation to the total goal and the lobbying efforts of state and local governments is much better prepared to push back than it was eight years ago. Importantly, the federal government has been seeking more infrastructure spending/borrowing, rather than less, and the municipal market plays a critical role in this effort.

Negative Q4 Pulls Down 2024 Results – But Positive Full-year Returns Remain

The rise in rates in Q4 was not enough to erase the full year gains for the municipal market. Short-term maturities bested longer maturities for the quarter and year, with the intermediate area of the curve performing the worst. The Revenue sector underperformed GOs for the quarter but held a slight edge for the year. And the shorter duration Prerefunded sector outperformed both Revenue and GOs over all periods. Finally, as noted earlier, lower-quality outperformed higher-quality in 2024. BBBs outperformed AAAs by 254 bps for the year while High Yield municipals outperformed by nearly 600 bps, as both the additional yield and narrowing credit spreads boosted returns.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	December	Q4	2024	2023	*Duration*	Bloomberg Quality	December	Q4	2024	2023	*Duration*
Municipal Bond Index	-1.46%	-1.22%	1.05%	6.40%	*6.21*	AAA	-1.57%	-1.32%	0.33%	-7.93%	*6.40*
General Obligation bonds	-1.36%	-1.18%	0.55%	5.62%	*5.88*	AA	-1.36%	-1.18%	0.79%	-7.97%	*6.06*
Revenue bonds	-1.51%	-1.25%	1.22%	6.89%	*6.42*	A	-1.47%	-1.19%	1.78%	-9.06%	*6.19*
Prerefunded bonds	-0.40%	-0.48%	2.08%	2.99%	*2.47*	BBB	-1.94%	-1.32%	2.87%	-11.63%	*7.17*
Long maturities (22+ yrs.)	-2.49%	-1.65%	1.40%	9.35%	*9.69*	High Yield	-1.66%	-1.08%	6.32%	-13.10%	*6.67*
Intermediate maturities (1 - 17 yrs.)	-1.01%	-1.06%	0.88%	5.26%	*4.80*	HY, ex-Puerto Rico	-1.64%	-1.07%	6.78%	-12.64%	*6.61*
Short maturities (1 - 5 yrs.)	-0.34%	-0.40%	2.07%	3.58%	*2.37*						

2025 Outlook

The outlook for the municipal market in 2025 is favorable. Income, which is the dominant contributor to total return in any bond investment over an extended period, is higher from levels a year ago thanks to the recent rise in yields. When municipal yields are properly tax adjusted, yields are even more appealing. The investment backdrop is enhanced by a Fed seeking to lower short-term rates further, as economic conditions allow. Lower short-term rates should help to further steepen the curve and not only enhance the rolldown benefit that an upwardly sloped curve provides, but also industry flows into mutual funds and ETFs as well. We are also optimistic that investor demand will remain supportive, as an aging society increasingly seeks the safety and income that higher-quality tax-free bonds offer. We expect supply to remain abundant, perhaps even once again approaching the record levels of 2024. Federal efforts to stimulate infrastructure spending will continue to encourage state and local issuance. The credit backdrop is also favorable and remains strong even as the importance of monitoring credits remains paramount. Although pandemic federal stimulus funds are now exhausted, state reserve levels are high, helping to support state and local budget balancing efforts. A modest credit overweight remains appropriate, even with narrower credit spreads, but we will increasingly seek additional yield through structural nuances that the municipal market offers, particularly in the highly rated, single-family and multi-family Housing sector. Tax policy discussions will be closely monitored, but we believe serious challenges to the tax-exempt status of municipal bonds are a low probability.

Disclosures

Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risks such as interest rate risk, credit risk, inflation risk, and liquidity risk. In a rising interest rate environment, the value of fixed-income securities generally decline and conversely, in a falling interest rate environment, the value of fixed-income securities generally increase. High yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield.

The Bloomberg Municipal Bond Index is a broad-based, total-return index. The bonds are all investment-grade, tax-exempt, and fixed-rate securities with long-term maturities (greater than 2 years). They are selected from issues larger than $50 million. The components listed below the Municipal Bond Index (long maturities, intermediate maturities, short maturities, prefunded bonds, general obligation bonds and revenue bonds) are subsectors of the Bloomberg Municipal Bond Index and do not represent separate indices.

The Bloomberg High Yield Municipal Index includes bonds with a par value of at least $3 million and must be issued as part of a transaction of at least $20 million. The maximum rating for inclusion is Ba1/BB+/BB+ using the middle rating.

For more information about the Bloomberg Municipal Bond Index or Bloomberg High Yield Municipal Index, please visit https://index.barcap.com/Home/Guides_and_Factsheets.

Municipal securities investments are not appropriate for all investors, especially those taxed at lower rates. The alternative minimum tax (AMT) may be applicable, even for securities identified as tax exempt. Past performance is not a guarantee of future results.

Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest). Investment grade investments are those rated from highest down to BBB- or Baa3.

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