

DON'T FORGET ABOUT MUNICIPALS:  
WHY NOW MAY BE AN OPPORTUNE TIME TO INVEST

Uncertainty is the norm in the capital markets, yet municipal bond investors have recently been forced to grapple with unusually high levels. Record YTD net issuance, rate volatility, monetary policy questions, and Fed leadership speculation have all led to increasingly unsettled markets. But with this uncertainty comes opportunity, and for those seeking tax-advantaged income, high-quality municipal bonds currently offer attractive yields at compelling valuations along with sound credit fundamentals.

Yield Levels Have Increased Considerably

Starting yield has historically proven to be a primary driver of forward bond returns, and today's levels are noteworthy.

The 10-year AAA yield-to-worst of 3.32% is well above the 5-year and 10-year averages of 2.20% and 2.05%, respectively (as of 7/31/25).<sup>1</sup>

Furthermore, on a tax-equivalent basis, 10-year AAA bonds are yielding 5.61%, arguably inviting net income given the credit quality of the underlying assets.<sup>2</sup>

10-Year AAA Yields Have Steadily Increased Off Of Covid-Era Lows



Curve Normalization Offers Substantial Incremental Income

An unprecedented inversion of the municipal curve is now a historical anomaly, and we welcomed further steepening during Q2. As a result, tax-exempt investors can now pick up additional income when extending maturity exposure, as confirmed by the spread between 2 and 10-year AAA maturities increasing from 60 bps on 3/31/25 to 93 bps on 7/31/25.

Incremental curve steepness positions intermediate strategies more favorably relative to shorter maturities, and it offers investors an incentive to move out of cash and equivalent instruments. Furthermore, adding duration in a slowing economy and with Fed Funds rate cuts likely to soon be initiated is worth considering, depending on one's objectives and risk tolerance.

Relative Valuation Looks Appealing

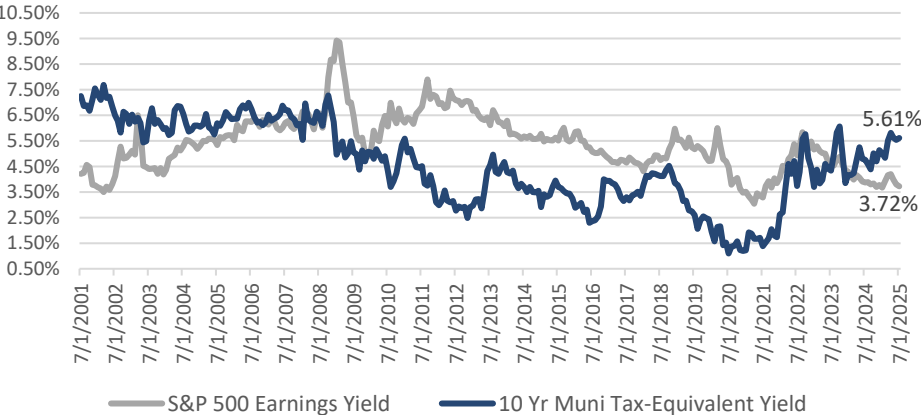
High-quality municipal bonds are also trading at attractive levels when compared to US Treasuries and equities. Municipal/UST yield ratios, a common valuation metric, have risen substantially from what had been persistently low levels. The bellwether 10-year AAA ratio of 75.97% is up considerably from atypically low sub-60% readings during Q1 2024.

For those seeking alternatives to equities, municipal valuations are by some measures more favorable than has been the case in many years. To this point, tax-equivalent AAA municipal yields are nearly 2% above the S&P 500's earnings yield.

	AAA Muni/ Treasury	AA Muni/ Treasury
2 Year	60.66%	61.42%
5 Year	63.89%	64.90%
10 Year	75.97%	78.49%
30 Year	95.50%	100.00%

Source: MMD, Treasury.gov

S&P 500 Earnings Yield vs. 10 Yr Muni Tax-Equivalent Yield



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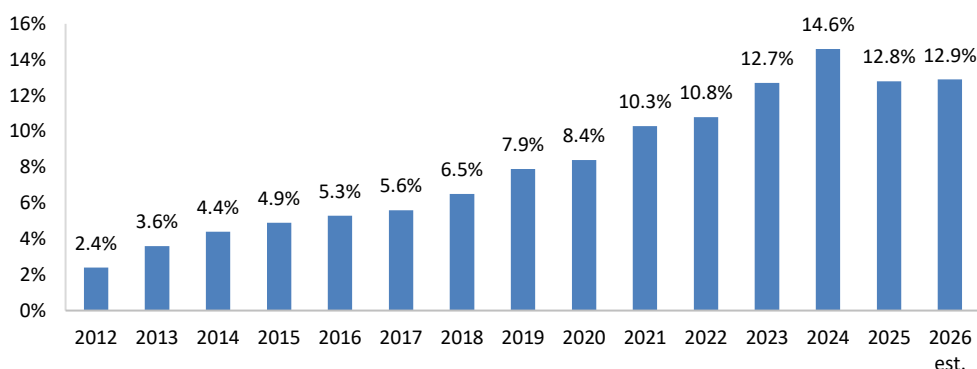
### A Benign Credit Environment

Municipal credit fundamentals also largely remain in a strong position. Acute federal policy pressure on bond issuers has been narrowly focused and primarily confined to Higher Education. Within this headline grabbing sector, as well as elsewhere across the issuer landscape, we favor large, well-run entities with revenue diversity, financial flexibility, experienced management teams, and consistent access to external liquidity.

Many bond issuers have fortified their balance sheets through conservative budgeting and revenue outperformance, and most came out of the Covid era in a better financial position than was initially expected, due in part to federal, state, and local aid.

State reserve fund data offers a compelling indication of fiscal strength as median rainy-day funds relative to expenditures ended FY '25 modestly below 2024's peak levels, but far above recent historical averages.

States Maintain Reserves at Historically High Levels  
(Median State Rainy Day Fund as % of Expenditures)



Source: National Association of State Budget Officers, Spring 2025 Survey

### A Technical Tailwind is Anticipated

Supply and demand levels have a great deal of influence on market pricing, and we anticipate a largely favorable technical environment over the next few quarters. The surge in net municipal issuance experienced so far in 2025 is unlikely to be sustained, particularly in sectors such as Higher Education. While we do not expect a sizeable decline in new offerings, even modestly reduced growth in issuance should dampen aggregate net new supply.

As to what may sustain demand, along with the desire of investors to access tax-advantaged income, look no further than the "dry powder" that lies in money market funds. The Investment Company Institute reports that money market fund assets exceed \$7 trillion, up almost \$1 trillion over the past year.<sup>3</sup> Fed watching is currently focused on the timing of rate cuts rather than the direction of policy, and when an easing cycle begins, it may nudge investor assets further out on the curve.

### A Favorable Entry Point for Bond Investors?

Absolute and tax-equivalent yields are near multi-year highs, municipal valuations compared to other asset classes are attractive, and credit fundamentals remain sound. While asset allocation and other elements of investment strategy should always be personalized, and what's seen as optimal for one client may not be for another, we feel financial advisors and tax sensitive investors would benefit from taking a closer look at municipal bonds.

1. YTW assumes that the investor holds the bond to its call date or maturity. YTW and YTM are two of many factors that determine the rate of return of a bond or portfolio. Other factors include reinvestment rate, whether the bond is held to maturity, and whether the entity makes the coupon payments.
2. Tax-Equivalent YTW is based on the YTW and an aggregate 40.8% marginal federal income tax rate (37% plus 3.8% tax on net investment income). This calculation is intended for illustrative purposes only to demonstrate the effect of tax-free treatment of municipal bonds on yields.
3. Investment Company Institute, 7/17/25

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