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Putting One Foot In Front Of The Other

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As we begin our journey through 2025, municipal bond market participants have a lot to digest, perhaps more than usual.

Any assessment of the municipal bond market and where it might be headed should include an analysis of two broad areas: what are Treasury bond yields likely to do and what are the supply/demand fundamentals specific to the municipal bond market? To assess the Treasury bond market, the usual assortment of macro factors including economic growth, the labor market, inflation, geopolitical events, and Federal Reserve policy come into play. At the start of 2025, we also have potential policy changes from a new administration to consider. How will Treasury bond yields react to developments in all these areas? Their reaction since mid-September of last year has been to adjust upward to a significant degree, moving from 3.62% to 4.67% on the ten-year Treasury bond in early January. Ten-year high grade municipal bond yields have followed suit, rising from 2.58% in early October to 3.17% currently.

So where do we stand on those previously mentioned macro factors? While numbers specific to manufacturing have shown some weakness, overall economic growth has been moderately strong with little hint of a recession. The inflation rate has come down from its high level a year and a half ago but, frustratingly, that last mile's journey to 2% inflation has been sticky and slow-going, even showing modest reversals here and there. The labor market has weakened somewhat but remains reasonably healthy by historical standards. Geopolitical risks in the Middle East and Ukraine could present potential shocks to oil prices, inflation, and economic growth as well as flight-to-quality rallies in Treasuries. The Fed has stated that it continues to expect cuts in the Fed Funds rate in 2025, though now only two of them are projected compared to the three it expected previously. More importantly, the Fed has also communicated clearly that a pause in rate cutting is appropriate at the present time. In addition to all this, the Treasury bond market is trying to sort out the effects to inflation and economic growth from possible tariffs should they be implemented by the new administration.

Regarding the muni-specific factors of supply and demand (and all the developments that could impact those fundamentals), there is plenty to chew on as well. Federal Income Tax brackets for individuals and corporations will be debated this year and perhaps lowered. Federal budget, debt limit, and growing deficit talk are likely to fill the airwaves. The search for new Federal government revenue to offset possible declines resulting from the new administration's tax priorities could lead to a re-examination of the long-standing Federal tax exemption of municipal bond interest. Debates about the muni bond exemption have surfaced from time to time in the past four decades. Each time mayors and governors across party lines have strenuously and persuasively made the case that traditional tax-exempt municipal bonds are an important source of low-cost financing and are critical to state and local government's ability to complete essential infrastructure projects. Each time the exemption on municipal bond interest has remained essentially untouched.

As we catalogue all that is presently on the plate for municipal bond market participants to consider, we understand the impulse to shrug one's shoulders and find a safe hiding place. There are indeed many potential crosscurrents and scenarios to assess. It is helpful to be aware of them to gain perspective on potential movers of the bond market. But even with the uncertainty and volatility we expect in the next six months, we do not subscribe to the all-or-nothing idea of staying on the sidelines. The need to fulfill investment objectives does not take a rest in challenging times of uncertainty and volatility. Opportunities for capturing value exist and we suggest a steady program of uncovering attractive yield and spread at points on the yield curve that make sense…of simply putting one foot in front of the other to continue to make progress on investment goals that need to be met. We are finding value currently in the 1 to 5-year range as well as in 10 to 15-year maturities.

By early January, municipal bond yields in the intermediate maturity range have risen to levels seen just twice in the past ten years. Currently, single A-rated municipal bonds in the attractive 10 to 15-year range offer yields of 3.90% to 4.25% tax-free, or a 6.19% to 6.75% taxable equivalent yield for top tax bracket investors. We continue, as always, to use careful judgment on the pace at which we invest cash. We remain committed to our dogged and judicious search for value in the investment grade, intermediate maturity space of the municipal bond market.

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