FIXED INCOME | March 31, 2025

Taxable Municipals

Market Review and Outlook

Market Summary

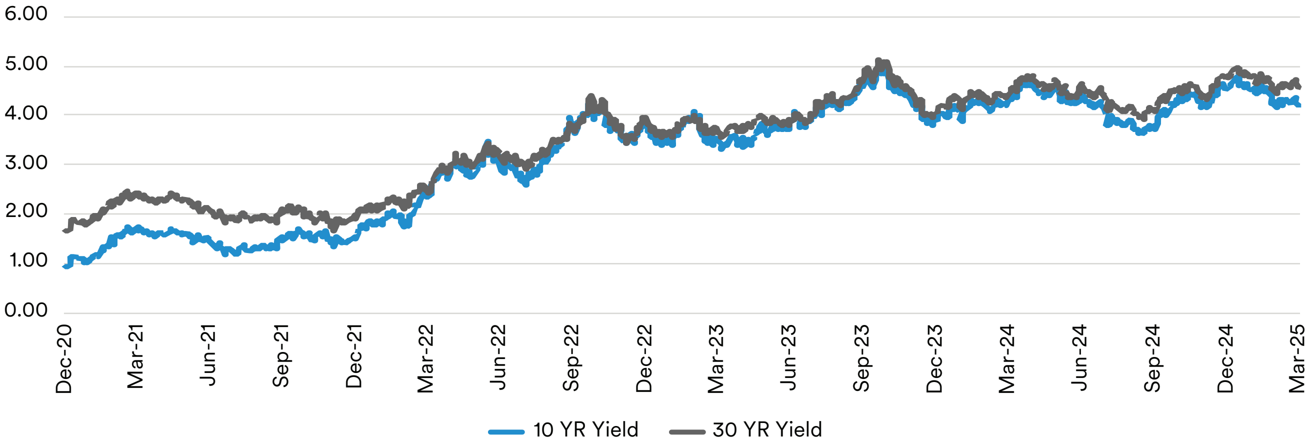
	3/31/2025	12/31/2024	1Q 2025 Change
10-Year U.S. Treasury Yields	4.21%	4.57%	-0.36%
30-Year U.S. Treasury Yields	4.57%	4.78%	-0.21%
Bloomberg Taxable Muni Index OAS (bps)	109	104	+5
Bloomberg Taxable Muni Index YTW	5.01%	5.25%	-0.24%
Bloomberg U.S. Corporate Index OAS (bps)	94	80	+14
Quarterly Taxable Municipal Issuance ($Bn)	$6.7	$8.7	-23%

Source: Bloomberg LP as of March 31, 2025

MetLife Investment Management

Taxable municipals recorded solid returns in the first quarter but for the wrong reasons. Uncertainty related to tariffs, growth, and inflation increased across markets. This led to a flight to safety that pushed rates down and spreads wider. The 5-basis point move wider on the OAS for the Bloomberg Taxable Municipal index was more than offset by the sharp move lower in Treasury yields. As a result, the Taxable Municipal index returned 2.99% in the first quarter. This compares favorably to the returns of 2.31% for the U.S. Corporate Investment Grade index, and -0.23% for the broad tax-exempt Municipal Bond index.[1]

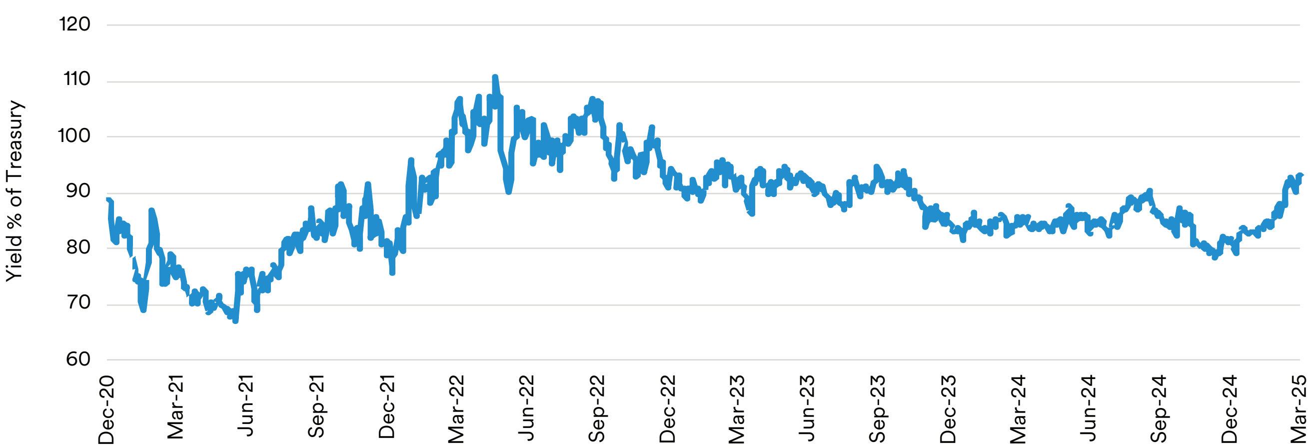
Figure 1 | 10-Year and 30-Year U.S. Treasury Yields



Source: Bloomberg LP as of March 31, 2025

Tax-exempts lagged across the curve, with the long end underperforming the most. The 5-year index returned 0.87%, while the 20-year index returned -1.31%. From a starting point of fairly rich valuations at the beginning of the year, tax-exempts were pressured by heavy supply, weaker seasonal technicals, and fund outflows later in the quarter. This caused ratios to adjust higher. The increase in tax-exempt yields relative to Treasuries explains the weaker returns for tax-exempts despite lower rates across the curve. Ratios at the long end—a part of the curve less favored by retail investors—fared the worst. The ratio of the AAA tax-exempt BVAL curve to the Treasury yield in 5 years moved six percentage points higher in the quarter, while the same ratio at the 30-year point on the curve moved 11 percentage points higher to 93%—the highest level since November 2023. For reference, the average for the 30-year ratio over the last three years is 91%.[2] This implies that valuations at the end of the quarter were not "cheap"—just slightly cheaper than average.

Figure 2 | BVAL AAA Muni Yield % of Treasury 30-Year

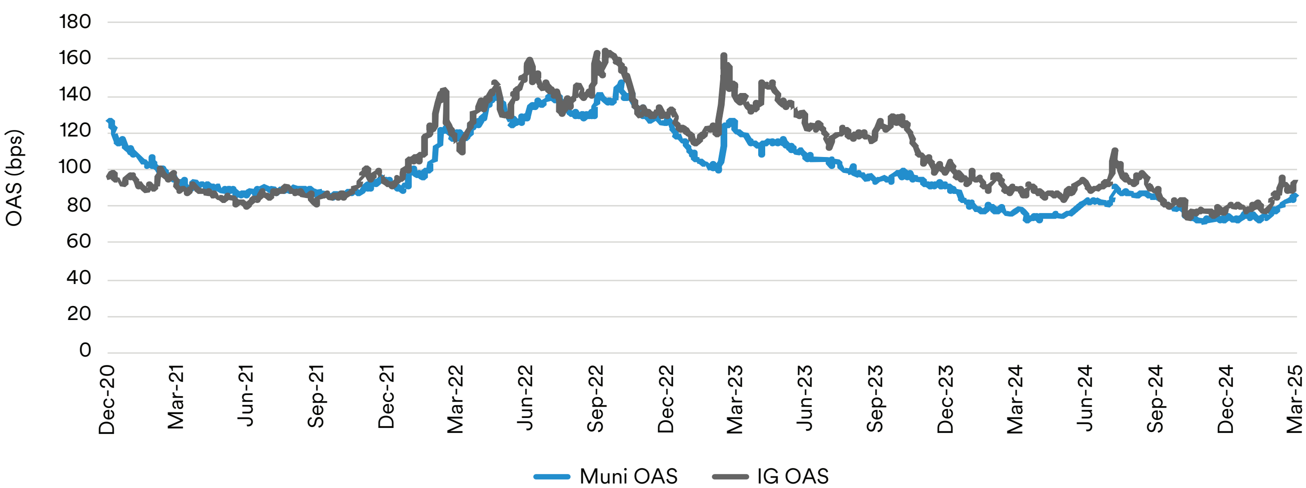


Source: Bloomberg LP as of March 31, 2025

In our view, it makes complete sense that tax-exempt valuations appear more attractive than average considering the potential threat to the very existence of the tax exemption. The House Ways and Means Committee recently published a document outlining a laundry list of budget expenditures that could be reduced or eliminated as "pay fors" to offset tax cuts and/or other policy priorities of the Trump administration. This document includes a provision to "Eliminat[e] Exclusion of Interest on State and Local Bonds", with reported savings of $250 billion over 10 years. We continue to believe that a full repeal of the tax exemption is unlikely. It would require an act of Congress, and such act would be unlikely to pass in our view, given the thin Republican majority and public comments in support of the tax-exemption from several Republican representatives. Still, the risk is not zero, and we think certain limitations on the tax-exemption, such as a 28% cap or eliminating the availability of the tax-exemption for Private Activity Bonds (PABs), is much more plausible—call it 50/50. We wait for guidance from the administration as budget reconciliation maneuvering get under way. For now, we are in the dark.

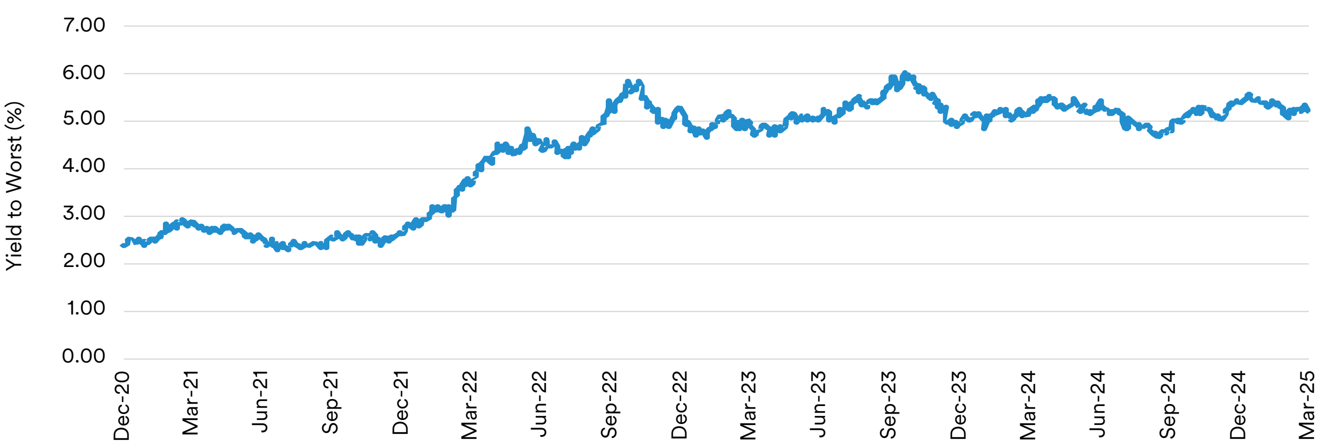
In taxables, the OAS on the Bloomberg Aggregate Eligible Taxable Municipal index broke through the upper band of the narrow trading range that had persisted since October. The lower band of this trading range was also the all-time tight OAS for the index, at 71 basis points. As was the case in tax-exempts, the starting point was one of historically rich valuations that left very little margin of error for any kind of bad news. And bad news is what the market got. Or at least, the post-election exuberance over DOGE and deregulation shifted to uncertainty over tariffs and inflation as the extent of Trump's policy agenda came into sharper focus.

Figure 3 | Taxable Municipal Spreads vs. IG Corporates



Source: Bloomberg LP as of March 31, 2025

Figure 4 | Yield on Bloomberg Aggregate – Eligible Taxable Municipal Index

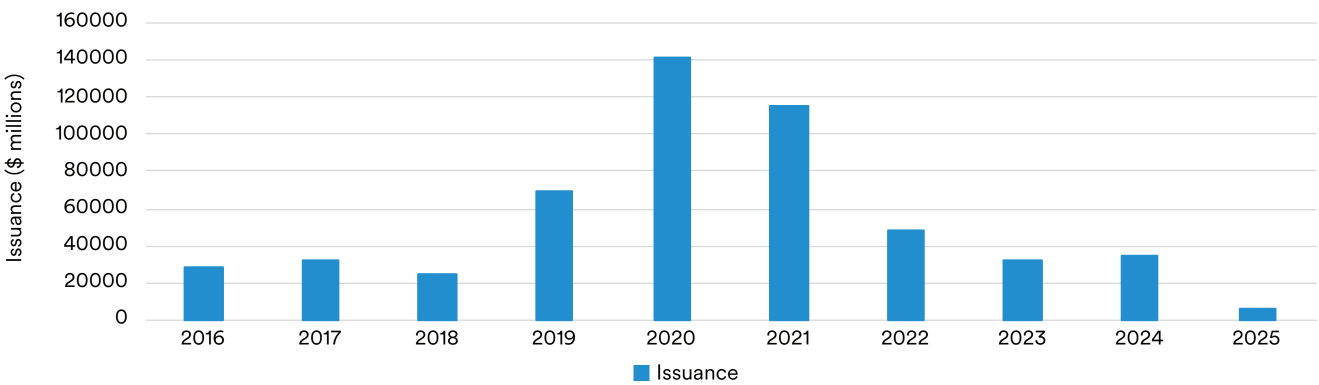


Source: Bloomberg LP as of March 31, 2025

Unlike tax-exempts, however, the Bloomberg Taxable Municipal indices posted positive returns across the curve, with longer maturities performing the best. Quarterly returns for the 1-5 year, Intermediate, and Long indices were 1.92%, 2.47%, and 3.35%, respectively.[3] As expected, Build America Bonds (BABs) outperformed non-BAB taxable municipals in a spread widening environment because BAB spreads were already considerably wider than spreads for non-BAB taxable municipals. This is due to the fact that BAB spreads have been largely tethered to +100 ERP[4] spread over the relevant Treasury yield. As such, non-BAB spreads "caught up" to BABs, which caused the spread differential between the two to compress. The Bloomberg Taxable Municipal Build America Bonds index returned 3.11%, while the Taxable Municipal *ex* Build America Bonds index returned 2.95%. The difference in duration between the two indexes is less than 0.5 years,[5] so we attribute the difference in performance primarily to structural characteristics (namely, the ERP) rather than to duration.

The excess return for the broad Bloomberg Taxable Municipal index was 0.91% related to duration-matched Treasuries in the first quarter. Excess returns were positive for every sector with a benchmark weight of at least 1%. Housing was the best performing sector by far, with excess returns of 2.29%. The other top performing sectors—again with a benchmark weight of at least 1%—were Pre-Refunded (1.10%), and Local GOs (1.01%). The weakest performing sectors were Healthcare (0.53%), Corporate Municipals (0.58%), and Transportation (0.73%).[6] The underperformance in healthcare aligns with concerns that the Trump administration may target Medicaid reimbursements to states in budget negotiations, which if passed would pressure hospital margins, all else equal.

Figure 5 | Taxable Municipal Issuance



Source: Bloomberg LP as of March 31, 2025

Outlook

MIM Chief Market Strategist Drew Matus sees a 60% probability of a recession in 2025. In that context, the OAS of 86 basis points on the Bloomberg Aggregate Eligible Taxable Municipal index as of March 31st strikes us as rather tight. It is only 15 basis points wider than the all-time tights of 71 basis points set in November 2024. It is 14 basis points *through* the average index OAS over the last three years, and it is miles away from the peak OAS of 262 basis points at the height of the COVID pandemic. What do we make of this in a macro landscape plagued with uncertainty (with respect to policy, tariffs, trade, growth, inflation, etc.)? We think it's time to play offense in the municipal market.

Our thesis is as follows: **Yields** are relatively high (5.20% for the Bloomberg Aggregate Eligible Taxable Municipal index as of March 31st), taxable **supply** is likely to remain relatively muted, **demand** for high quality assets with spread and duration continues to be robust, and we expect municipal **fundamentals** to remain resilient. As such, we like the idea of playing offense—*disciplined* offense—if municipal valuations cheapen further, whether it be from an outflow-driven dislocation in tax-exempts, an adverse policy development related to the tax-exemption, a surge in taxable supply, or from a general risk off stance in the market. Opportunities to buy taxable municipals at attractive spreads have been few and far between in the last 12 months. We think future opportunities are likely to be short-lived because they will eventually (if not quickly) be met with demand. Municipals are regional entities, by definition. As such their exposure to international trade issues is a second or third order credit impact. The biggest driver of municipal credit quality is likely to be macroeconomic in nature, away from idiosyncratic issues. If the economy enters a recession, tax revenues will decline and state budgets will be more constrained. But whether tariffs on global trading partners are 10% or 145%, traffic on Texas toll roads isn't likely to change sufficiently to alter the credit profile. Similarly, hospitals will continue to treat patients that require care, and households will still pay their utility bills to have access to electricity and clean drinking water.

We caution yield-based investors against waiting for ever wider spreads because this may come at the expense of lower yields, especially if the impetus for wider spreads is weaker prospects for the economy. In either case, we think municipal credit will muddle through with relative stability. We like somewhat wider spreads at still elevated yields *now* versus much wider spreads at much lower yields *later*. But these two are also not mutually exclusive. If there's cash to invest now, we would not shy away from the market, save for a few areas where we would tread more carefully, like weaker hospital operators, seaports (on account of uncertainty related to global trade flows), and universities that do not have crystal clear business profiles to compete either on quality (the top tier universities) or cost (flagship public universities). If spreads do move materially wider, we advocate for opportunistically buying more and locking in spreads that reflect broad macro weakness rather than credit deterioration specific to municipals. At the same time, in volatile markets we think it makes sense to reduce portfolio beta in periods of strength in order to free up capital to buy high quality bonds in periods of weakness.

We also think it's worth keeping an eye on the tax-exempt market for adverse policy developments related to the tax exemption that could trigger a herd mentality among retail investors. Tax-exempt bonds at nominal yields (not tax-adjusted) that compare favorably to yields on similar taxable securities have historically been very attractive buying opportunities. Until then, we are mindful of policy risks on the horizon that could make a "cheap" bond look like a bad idea the very next day.

Endotes

1 Information in this paragraph sourced from Bloomberg LP

2 Information in this paragraph sourced from Bloomberg LP

3 Barclays Live

4 Refers to the Extraordinary Redemption Price in all Build America Bond indentures, whereby the issuer has the option to redeem the bonds at a price equivalent to the Treasury yield plus 100 basis points upon the occurrence of an Extraordinary Event, which includes a reduction in the BAB subsidy from the federal government to the issuer.

5 Barclays Live

6 Barclays Live

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